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Scotland's Currency Options

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The objective of this paper is to consider which currency option would be best for an independent Scotland. We examine three currency options: being part of a sterling currency union, adopting the euro, or having an independent currency. No currency option is the best when considered against all criteria. Therefore, making the decision requires deciding which criteria are most important.

Recent events around the world, particularly in Europe, have shown that fiscal sustainability and currency arrangements cannot be considered in isolation. Hence, the share of the existing UK public debt that an independent Scotland would inherit is central to understanding its currency choices. We consider how the debt may be divided, and the ability of an independent Scotland to pay its share. For an independent Scotland to prosper it requires a 'hard' currency, one in which investors are willing to hold long-dated Scottish government debt at a reasonable price. A necessary condition for a 'hard' currency is that government solvency is always beyond doubt.

We address two key quantitative issues related to government debt and solvency. First, how much higher would an independent Scotland's borrowing costs be if it keeps using sterling than for the rest of the UK? We estimate that an independent Scotland would face additional interest rate costs of between 0.72% to 1.65% above the UK borrowing costs for 10 year debt (or technically a spread of 72 to 165 basis points over the average 10 year UK bond yield of 4.10% between 2000 and 2012).

Once we have an estimate of borrowing costs, we can ask our second question: What sorts of fiscal policy would be consistent with debt stabilization? Specifically, we estimate the primary or underlying surplus (excluding interest payments) that Scotland would need to run in order to achieve a Maastricht-defined debt to GDP ratio of 60% after 10 years of independence. Using the lower bound borrowing cost, Scotland would need to run primary surpluses of 3.1% annually order to achieve this target. Given Scotland's estimated average primary fiscal deficit of 2.3% (including taxes from oil and gas) over the period 2000-2012, running a surplus of 3.1% would represent a substantial fiscal tightening of 5.4%. These estimates assume that Scotland would receive a geographic share of hydrocarbon reserves, a per capita share of existing public sector debt (on a Maastricht basis) and real GDP would grow at 2% annually. If the fiscal tightening were to lead to a slow-down in real GDP growth, then even larger primary surpluses would be necessary to achieve the 60% debt to GDP target within 10 years.

Such a fiscal tightening would leave an independent Scotland with very little room for fiscal manoeuvre in the case of a negative shock, such as a drop in the oil price or a recession. That makes it important to have other policies available, such as interest rate or exchange rate adjustment.

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Among the currency options open to an independent Scotland, having its own currency would give it more flexibility to respond to shocks. While there are significant transitional challenges, over the medium and longer term this would be more consistent with independence.

Clearly much depends on the inheritance of existing UK debt which will inevitably be negotiated. We also propose a novel way of reducing the initial debt burden which would leave an independent Scotland looking more like the successful independent Scandinavian countries which also have their own currencies. An oil for debt swap – where the oil revenues would pass over to the UK in exchange for an appropriate write down of the debt that Scotland would otherwise assume - would greatly reduce the economic risks of independence, although there may be significant political limitations to this possibility. We conclude that debt is of central importance for Scotland's choice of currency. The greater the amount of public debt an independent Scotland assumes, the greater the importance of retaining some policy flexibility and the stronger the case for an independent currency.