Currency Options for an Independent Scotland

A hail bawbee mine and aw tae mysel
Wi joy I'm like chowking if truth I maun tell
How best I micht spend it I cannae richt say
I'm fair in a muddle tae ken what tae dae

My First Bawbee, by Archibald McKay

What currency would be used in an independent Scotland? Probably no other issue caused more confusion in the 2014 referendum campaign or cast more doubt on the coherence of the plans of supporters of independence.

When the dying Sir Walter Scott left Abbotsford for Naples in 1831, we may imagine that he carried with him a bag of sovereigns bearing the head of the late King George and a letter of credit from his bank in Scotland - although from what we know of Sir Walter's finances it is unlikely that he would have been pre-approved for the American Express card. These could have been exchanged for Neopolitan gold piastras bearing the head of King Ferdinand of the Two Sicilies to meet his hotel bills, and for smaller Neopolitan coins to tip the street urchins who carried his bags. This was the world of chartalism, an international gold standard in which the local currency was identified with the sovereign.

In his famous 1919 essay on 'The Economic Consequences of the Peace' Keynes described how '(a member of the upper or middle classes) could secure forthwith, if he wished it, cheap and comfortable means of transit to any country or climate without passport or other formality, could despatch his servant to the neighbouring office of a bank for such supply of the precious metals as might seem convenient, and could then proceed abroad to foreign quarters, without knowledge of their religion, language, or customs, bearing coined wealth upon his person, and would consider himself greatly aggrieved and much surprised at the least interference.'

Keynes' point, of course, was that this world had ended in 1914. Still, concepts from that chartalist era continue to influence popular discussion. Through the next fifty years, attempts were made to restore that Victorian stability - the most notable was the 1944 Bretton Woods agreement largely crafted by Keynes himself. But that system broke down by the early 1970s, symbolised by Nixon's formal abandonment of the gold standard in 1971.

And so today's financial world is very different from the one that Innes Smith described in the lectures on Money and Banking which I attended at Edinburgh University in 1968, in what I do not apologise still to call the David Hume Tower. That world was overtaken by financial deregulation in the 1970s and 1980s which abolished restrictions on credit, replaced reserve requirements on banks with rules on capital adequacy and allowed these banks to engage in a wide range of activities that the bank managers of an earlier era had not even imagined. New technologies made many of these activities possible.

And made obsolete the exchange controls which many countries worldwide, including the UK, maintained until the 1980s. Individuals and companies had needed government or Central Bank approval to hold foreign currency. With the growth of foreign travel, global trade and financial innovation, it is impracticable for financially-advanced democracies to implement such controls.

Today you can make payments almost anywhere in the world in virtually any currency you choose. And both households and businesses do. You can order a coffee in Aarhus, Los Angeles or Zagreb and the payment will be debited in your preferred currency in the country where you choose to locate your account. Fintech is reducing the price of once ludicrously high cross-border retail transactions to nominal proportions. East Europeans sceptical of their own country's government and judiciary make contracts in dollars or euros, enforceable under English law.

Still, some of the principles which Innes Smith enunciated remain valid today. Perhaps the most fundamental is that *money is transferable debt*. And to that he added the three functions of money - as *medium of exchange, unit of account*, and *store of value*.

Money is today as always a means of transferring credit. Consider the three principal ways in which individuals or businesses transact in a modern economy. You walk into a Hawick woollen mill and buy a sweater with cash. The Bank of England's former obligation to you becomes its obligation to someone else.

The most common method of payment, however, is to transfer money between bank accounts. When you pay a £50 electricity bill, the £50 that the Bank of Scotland owes to you becomes £50 that the Royal Bank of Scotland owes Scottish Power. And when you buy the sweater online with a credit card, you incur a debt of £50 to Barclaycard which is converted into a debt of £50 from Worldpay - the online shop's merchant acquirer - to the retailer.

The process of converting an obligation from A to B into an obligation from X to Y is an electronic one that frequently has many stages. C substitutes for A, and then D is substituted for B, and so on until the desired final outcome is reached. Several agents may be involved in the chain - some with acronyms like CHAPS and BACS, agents of the major Banks, some private companies such as Visa and Mastercard but not necessarily the Bank of England, which inter alia serves as the bankers' bank.

Measures of money

Money is simply transferable debt. Such debt may be issued by governments or private actors and specified in any unit of account. The most familiar and narrowest concept of money is the banknote. The value of notes currently circulating in Scotland is probably around £7-8bn, roughly equally divided between Bank of England notes and those of the Scottish banks (Bank of England, 2021c). This £7bn figure should be compared with Scottish national income of around £163bn (National Statistics 2021).

It may be reasonable to assume that Scotland would begin independent life carrying, explicitly or implicitly, a pro-rata share of UK debt, which might be in the region of £180bn. Scotland would also need to borrow to cover its budget deficit after independence, a figure which might initially be between £10bn and £20bn annually. This scale of borrowing should not be difficult to service if the new government showed ordinary fiscal prudence. However, it is likely that international lenders would choose to provide - and receive payment in - pounds, dollars or euros rather than bawbees.

Issuance of notes and coins is therefore very small relative to the scale of government borrowing, yet very large relative to the practical need of the public for a medium of exchange. Cash was only used in about 20% of UK transactions in 2019 (down from ~80% in 1990). Since few high-value transactions are made in cash, the proportion of the value of transactions represented by cash is much smaller.

'The death of cash' is an end state already approached in some countries such as Sweden. Debate as to which famous Scots would be portrayed on bawbee notes, although entertaining, is of little relevance.

The unit of account

Just as no single agent 'owns' the medium or mechanism of exchange, no one 'owns' the unit of account. Among large British companies, AstraZeneca and BP choose to present their reports in dollars and Vodafone in euros, while keeping accounts and maintaining bank accounts in many currencies. Most physical commodities are traded in dollars and foreign currency mortgages are common in Europe. Neither households, businesses or - potentially - governments need the permission of the Bank of England to use sterling as the unit of account or the Bank's notes as a medium of exchange.

Thus the choice of currency is nowadays not just a matter for governments but also a matter of the choices made by households and businesses. The machinery of monetary transmission is largely independent of government; for much of history it operated without any official engagement or sanction and could readily do so again today. Firms and households will choose the units of account most relevant to their own circumstances. All of these mechanisms are now digital. It is difficult to overemphasize the significance of these developments for the Scottish currency debate.

Government and currency

But governments have three roles in relation to currency. The ability to define legal tender. The power to legislate on the use of currency. And the obligation to choose the unit of account in which they maintain their own accounts, pay bills, and collect taxes.

Governments determine what is legal tender in their jurisdiction. In the modern world, legal tender has no practical significance. There could be no better illustration than the curiosity that, by historical accident, the only legal tender in Scotland today is coin from the Royal Mint. I doubt if anyone in this audience has offered a cab driver a £10 Bank of England note and been told ‘that’s not legal tender, guv’.

Governments can influence currency choices by passing legislation. Such laws might require businesses and households to maintain accounts in a particular currency and prohibit the holding of accounts in another currency. Some despotic states have provisions of this kind - typically more honoured in the breach than in the observance - and some of the former Soviet republics did prohibit continued use of the ruble at the break-up of the USSR. It is, I hope, unimaginable that a Scottish government would try to do this.

A more serious option is to legislate to rewrite existing contracts in a new currency. For example, the European Commission issued regulations in 1997 and 1998, binding in all member states, which decreed that all contracts in French Francs were converted at a rate of 6.56 FF to the Euro. A Scottish government could legislate that any reference to the pound should be construed as a reference to ten bawbees. But the French transition applied to all agreements involving the French Franc, virtually all agreements in French Francs were made under European laws, and the external value of the French franc had been fixed relative to other potential eurozone currencies for several years. As a result, no one perceived any gain or loss as a result of the change or saw any need to rearrange their business or financial affairs in anticipation.

None of these conditions would apply to the introduction of the bawbee by a Scottish government. Self-evidently, most sterling contracts do not involve

Scots residents or Scots law. So what would be the scope of the Scottish legislation? Whose pounds, exactly, would be translated into bawbees? As the Greek government has learnt, the logistics of joining a currency union are much easier than the logistics of leaving one.

If the move has an effect, positive or negative, on the value of existing loans, mortgages and bank deposits, the consequential gains and losses raise problems of equity, politics and law. While a reduction in the burden of existing mortgages would undoubtedly be welcomed, a corresponding reduction in the value of existing bank deposits and pensions would not. If the bawbee represented an appreciation, mortgagees would be upset, but depositors and pensioners delighted. The measure would invite claims of expropriation and challenge under the European Convention on Human Rights, to which Scotland would presumptively be a signatory.

Perhaps more seriously still, anticipation of such changes and associated uncertainty would lead to preemptive action of a disruptive kind. As the introduction of the bawbee approached, loans secured against Scottish property would be hard to obtain; the savings of Scots residents would be moved outside the potential jurisdiction of Scots law. The financially sophisticated would gain at the expense of the rest of the population.

Any discussion of currency options after independence should make clear that a potential Scottish Government would have no intention of changing the terms of its own existing contracts or of legislating to change the terms of private contracts. This assurance should include, but not be confined to, agreements governing savings and loans, employment and pensions. **This paragraph is the most important in this essay**.

The introduction of the bawbee

The key to any currency transition is the decision to change the government's own unit of account. Every government must decide in which currency it will keep its own records, pay its employees and beneficiaries and require payment of taxes. This is the third, and most important way, in which government influences currency in the modern world.

It is a choice that does not necessarily have any implication for private actors. To illustrate with a ludicrous thought experiment, if the Scottish government chose to adopt bitcoin or the Vietnamese dong for its own receipts and payments, then an exchange booth might immediately spring up in St Andrew Square to enable bitcoin or dongs to be readily converted to and from some more practically useful medium of exchange. Neither Satoshi Nakamoto nor the Central Bank of Vietnam need be consulted. And the coffee shop in the Square would no doubt continue to accept sterling and prefer plastic cards.

In practice, it is unlikely that the Scottish Government would make any payments at all in cash. The days when pensioners queued at post offices each week clutching a book of vouchers have gone and the UK government is currently finally phasing out the small residual cash payments of benefits made in this way. Virtually all Scottish Government expenditure would be made by direct transfer to the commercial bank accounts of recipients. If the payments were in bitcoin or dongs, the recipient bank would likely effect the conversion automatically, and the exchange booth would enjoy little custom. The expectation of such immediate conversion means that the Scottish Government would need to adjust its payments in bitcoin or dongs to maintain the value of its payroll to the recipients, and to secure supplies of goods and services in the face of fluctuation in the exchange rate of the dong or the value of bitcoin.

How much changes if the payments are in bawbees? If, as described above, the bawbee is to be used only in agreements made after its introduction, it is not apparent that businesses and households would have much desire to make such agreements. On Independence Day, almost every adult in Scotland would have a fistful of pound notes and a sterling bank account, many would have a credit card agreement denominated in sterling. Every business operating in Scotland would have a sterling bank account. Some would want to change these to bawbees out of patriotic fervour; others might take the opposite view. And many, uninterested in political statements, might simply prefer the familiar to the new.

Police Constable Rabbie Burns, receiving his pay in his newly established bawbee account, might want to celebrate the monetary transition with a wee dram. Most transactions in shops and places of refreshment would, as now, be made using plastic cards and the existence of more than one currency would accelerate the displacement of cash. The tickets on shop shelves might be labelled in pounds or bawbees or, as in the eurozone for several years, in both. And at online retail sites, be quoted in whatever currency the buyers chose.

But how much would Constable Burns receive? (The bulk of Sir Walter Scott's royalties would continue to be paid in sterling, and the manager of the Hawick Woollen Mill might sensibly wait to see how the transition evolved.) The Scottish Government would presumably determine an initial exchange rate, say ten bawbees to the pound, so that PC Burns' £25000 annual salary might become BB 250000. And the Scottish Government might also offer to sell ten bawbees in return for a pound.

But would it also offer to buy them at that or a similar rate? Counter-intuitively, the demand for bawbees might initially exceed supply, since although Scottish Government expenditure would exceed tax payments, much of that expenditure - pensions, payments to contractors, etc. - would continue to be denominated in sterling. Situations in which demand exceeds supply in the short run but the balance is likely to be reversed in the long run are those for which financial speculation was invented. Either the Scottish Central Bank is willing to buy bawbees at ten to the pound, in which case it may have to buy rather a lot of them, or it is not, and Constable Burns is at the mercy of global finance. Recall that in 1992 George Soros and a few other private individuals successfully broke the Bank of England (established 1694).

This is only a preliminary sketch of the kinds of problems involved in a currency transition. Such transitions are not impossible but most of these transitions are in the distant past , drawn from economies far less developed than modern Scotland and a global financial system far less complex than exists today. The lesson is that successful transition is inevitably and sensibly be very gradual, and this would necessarily be true of any transition to the bawbee. Abrupt and botched transition can cause considerable economic damage and personal distress.

The wag who said the Scottish currency should be called the thistle - lovely to look at but not to hold - made a serious point. There is a real possibility that a premature and ill-planned introduction of a Scottish currency would be an embarrassing fiasco, ignored by most of the world and unappreciated by Scottish residents.

Assessment

For better and worse, most decisions about currency, money and banking in an independent Scotland will not be made by a Scottish Government or Central Bank but by individual businesses and households, by international banks, by foreign exchange markets controlled by no one at all, by the Federal Reserve and the European Central Bank, and by the influential Central Bank of Scotland's larger neighbour and principal trading partner.

Nevertheless, the circulation of ideas that are poorly thought through, even if they are not implemented, can damage the credibility of a future Scottish government and the reputation of a financial services sector which is an essential contributor to the Scottish economy. It is not the case that an independent Scotland could be free of constraints on public expenditure because it could print its own money. Nor is it plausible that the Sauchiehall St branch of a London-based bank could supply its customers with dollars or euros or, with a few days notice, Vietnamese dongs but would be unable to provide them with sterling. (Both arguments have been presented, evidently seriously, by protagonists in the currency debate.) But if people think these things might happen, they will take steps to protect themselves against them, actions which may be costly to them as individuals and detrimental to the Scottish economy. And while there may be good arguments against separatism, the assertion that countries need to be big so that they can rescue too big to fail banks is not one of them.

The recommendation of the Sustainable Growth Commission that an independent Scottish government should continue to use sterling as its unit of account for the foreseeable future, with the consequence that its citizens would continue to use sterling as the medium of exchange (to the steadily diminishing extent that they use any currency as medium of exchange) is a prudent and feasible approach. Once an independent Scottish government has established its credentials for fiscal responsibility with its own population and the international financial community, once trading patterns have adapted to new constitutional arrangements, these arrangements could be reviewed. But there is little to gain and much to lose from precipitate change - or the threat of it.