# Scotland: Wrong turn

## Foreword

Everyone has the right to self determination and to exercise his or her democratic rights. But there are times when fundamental political decisions have negative consequences far beyond what voters and politicians could have imagined. We feel that we are the threshold of one such moment. A "Yes" vote for Scottish independence on Thursday would go down in history as a political and economic mistake as large as Winston Churchill's decision in 1925 to return the pound to the Gold Standard or the failure of the Federal Reserve to provide sufficient liquidity to the US banking system, which we now know brought on the Great Depression in the US. These decisions – well-intentioned as they were – contributed to years of depression and suffering and could have been avoided had alternative decisions been taken.

Events within the eurozone in recent years offer stark examples of what can happen to countries seen to be on the brink of breaking away from a strong union. Each of these countries from Ireland to Portugal to Spain has suffered recessions, higher taxes, lower public spending and higher interest rates. While it may sound simple and costless for a nation to exit a 300 year-old union, nothing could be further from the truth.

The economic and financial policy making institutions of Whitehall, as imperfect as they may be, have nevertheless created stability and certainty for private economic decision makers. Scottish consumers and investors have benefitted from the credibility of the Bank of England's monetary policy, financial institutions and their clients have benefitted from an equally credible supervisory and regulatory regime, while foreign investors come to Scotland because they rely on a predictable investment environment. All of this comes from a united Great Britain.

A Scotland on its own would not automatically inherit these hard-wrought characteristics of a democratic market environment. Until such time as Scotland has demonstrated a tried and tested ability to govern and administer a modern economy there would be doubts. Residents in Scotland would move their assets to England-based institutions for fear of a forced conversion to a new weaker currency. Financial institutions would move under the umbrella of the Bank of England, investors would, at a minimum, require a higher return of their investments in Scotland to compensate for the increased risk.

Neither would keeping the pound help avoid pain. This would mean being slave to the interest rates set by and for the remainder of the UK. There would be no more consideration of Scottish issues when monetary policy is set. As Scotland's banks would no longer have access to Bank of England support they would have to shore up their balance sheets by reducing their lending. The new Scottish government would have to severely tighten fiscal policy to establish credibility and to have the resources to underwrite the financial system. Scotland would no longer automatically share the benefits of all defence and security services arrangements that exist among the Atlantic Alliance nations.

Most importantly, the world as it is evolving in the 21st century is a highly uncertain place with unstable geopolitics and a stressed economic and financial outlook. Why anyone would want to exit a successful economic and political union with a G-5 country – a union which another part of Europe so desperately seeks to emulate – to go it alone for the benefit of... what exactly, is incomprehensible to this author.

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## Five wrong turns

To an already long list of convincing reasons why Scotland should remain in the Union we wish to add five arguments that have not received due attention but seem important to us. The first is that the symbiotic relationship between Scotland and the rest of the UK is older and deeper than the Yes camp dares to admit. Second, it is wishful thinking to hope that an independent Scotland can replicate the Nordic model. The third argument against separation is a risk of nasty twin deficits in Scotland. Fourthly, it seems to us that the currency debate can only be confined to least-worst options. Finally, we worry about the potential disruption to Scottish trade flows, particularly with the remaining UK.

### Hume came after the Union

Some people say, with justification, that Scotland invented the modern world. What is not mentioned, however, is that the vast majority of Scottish inventions came after the Act of Union in 1707. Of course this was due to the industrial revolution that followed union in the 18th and 19th centuries. But such a technological revolution was only possible because of the synthesis of Scottish brains, English coal fields and British colonial markets. The Scottish Enlightenment, which witnessed the emergence of brilliant figures such as Adam Smith, David Hume and Robert Burns, also followed the Union. Some historians even argue that the mass southward migration of politicians from Scotland helped the remaining intellectual class to flourish.[1] The symbiotic relationship that has solidified over the centuries between Scotland and the rest of the UK cannot be underestimated.

### Scotland is not Nordic

Many planning to vote for independence on Thursday gaze across the North Sea at the supposedly idyllic Nordic countries of Norway, Demark and Sweden. While it is tempting to make comparisons based on similar population sizes and links to oil, these ignore big differences between the economies.

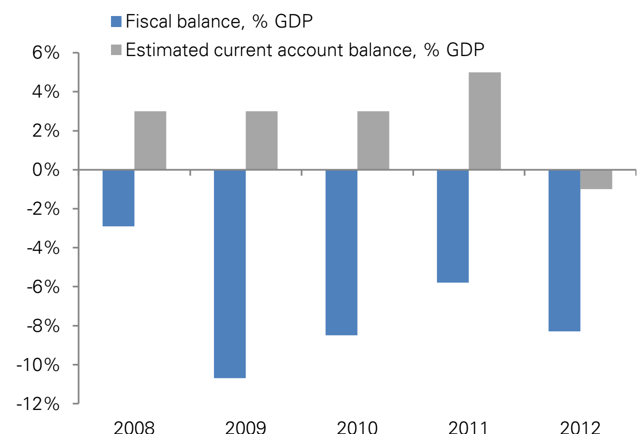
For starters, Norway's economy is utterly dominated by its energy industry, unlike Scotland's. Moreover, Norwegian oil and gas production is not expected to decline over the coming decades, as Scotland's is. Norway also has its own currency, which allows it to manage its economic cycle more easily.

Of course, a floating currency is not essential for a successful economy. Denmark has a pegged exchange rate. But the country makes up for this lack of flexibility by having an economy tilted towards high-value manufacturing, exports of which are less sensitive to relative prices. Denmark also runs a healthy fiscal balance. By contrast, Scotland's economy is more weighted towards oil and finance, which also dominate its exports along with the beverage sector. Scotland is unlikely to resemble the Nordics from a structural perspective any time soon.

### Twin deficits and keeping the pound

Scotland would run a budget deficit worse than the rest of the UK (rUK)[2], and it would likely run a current account deficit. Moreover, both the fiscal and external positions would be hugely dependent on the vagaries of volatile oil prices.

Figure 1: Persistent Budget Deficits, and Now Twin Deficits




*Source: Deutsche Bank, Scottish National Accounts Project, Deutsche Bank estimations*

These twin deficits are problematic if Scotland continues to keep the pound. Without a formal union, the option referred to as sterlingisation[3], Scotland would have no control over money supply, relying on importing pounds through its balance of payments. It would likely have to run trade surpluses, which would require internal adjustment to achieve, depressing domestic demand and crushing growth. Meanwhile, regulatory and political uncertainty would lead to banks shrinking their presence in Scotland. The financial sector, one of the largest in Scotland, would therefore contract with knock-on effects on the construction and the labour market.

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[1] "The Scottish Enlightenment" (2007), Alexander Broadie

[2] See "Scotland: The independence question", 12 May 2014, George Buckley

[3] See "Should auld acquaintance be forgot? Your guide to a new Scottish currency" (13 May 2014), Oliver Harvey

Under a formal currency union Scotland would take on a share of existing UK liabilities. But without control of monetary policy, the Scottish government would be unable to monetise or inflate away its debt, currently in the region of 80-90 per cent of output – large for a small economy. Scotland would therefore have to engage in severe austerity, either by cutting public spending or raising taxes or both, to establish fiscal credibility. In the meantime, Scottish interest rates would also rise.

So independence with twin deficits while keeping the pound would likely result in higher taxes, less public spending, higher interest rates and important industries suffering.

### New currency is no panacea

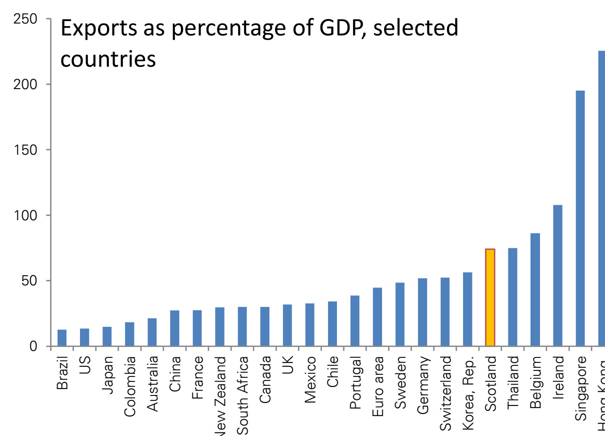
Alternatively Scotland could choose to control monetary policy and introduce a new currency. This would likely be even more destabilising. Scottish residents would surely be tempted to move their assets into rUK-domiciled institutions to avoid losses as a new Scottish currency would almost certainly weaken against the pound. Meanwhile, banks with Scottish mortgage and corporate loan books would be faced with the possibility of assets being exchanged into a less valuable new currency. Finally, rUK banks operating in Scotland would be reluctant to extend new credit, which in turn would harm the Scottish economy.

### Why limit trade?

Today Scotland is one of the most export-oriented economies in the world, with exports over 70 per cent of gross domestic product. Only a handful of countries, such as Hong Kong and Singapore, are more open (see chart below). Most of Scotland's trade is with rUK. But the introduction of any form of border would impede those trade flows.

What is more, the status of Scotland in various international bodies including the EU, WTO and IMF would be come into question. This could potentially reduce trade and foreign investment in Scotland, making the country poorer and putting more pressure on Scotland's current account. To counter this, Scotland could attempt to introduce much lower corporate tax rates to attract investment and jobs. But not only would this

Figure 2: Scotland is Very Export Dependent




Source: Deutsche Bank

likely be challenged by the rUK and EU, it could also increase income inequality as is often the case with small open economies that offer low tax rates, such as Hong Kong.

### Conclusion

The economic and financial arguments against independence are overwhelming. But we prefer to conclude by marveling at the three hundred years in which everyone has benefited from Scotland being part of the Union. The free movement of people has allowed greater innovation as network effects become multiplied. These can be seen, for example, in world-class universities on both sides of the border and in the spillover effect northward of London's financial centre status. Scotland has been able to punch above its weight via the platform of the UK and associated global trade and economic relationships. Finally, Scots have benefited from the sharing of fiscal and monetary risk. To end this relationship is simply a wrong turn.

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# Appendix 1

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