

# The choice of currency and policies for an independent Scotland: A debate through the lenses of different economic paradigms

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## **Abstract:**

This paper analyses three issues that are widely regarded as key policy decisions of an independent Scotland. The first is the choice of the exchange rate regime. The second is the policies that it may be necessary to adopt given that choice. The third is the characteristics of the transition period to an independent currency and its duration. The analysis, which is based only on economics theory, contrasts the standard orthodox approach to the Post Keynesian and Modern Money Theory frameworks. It shows that progressive policies can be underpinned by heterodox economics theory and, in particular, that the government in an independent Scotland can make choices that give it the policy space to pursue progressive domestic objectives. Whether these objectives are actually attained will naturally depend on the specific political circumstances at the time and on the government's enlightened use of the available policy space, but this is outside the scope of the paper.<sup>1</sup>

**Keywords:** Scottish independence; Post Keynesian economics; Modern Money Theory; independent currency; exchange rate regime; macroeconomic policies

**JEL classifications:** B52; B59; E42; E60

## **1. Introduction**

The choices of a currency and an exchange rate arrangement will be key policy decisions of an independent Scotland. In the meantime, the position of the Scottish National Party on this issue has shifted significantly from that at the time of the first independence referendum: in the Spring of 2019, the party conference agreed that Scotland should have its own independent currency and a floating exchange rate regime. This is a very sensible objective – indeed, according to some, the only sensible objective – since an independent country ought not to use another country's currency or peg to it. This statement is controversial – especially if one

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<sup>1</sup> I wish to thank Robert McMaster for his helpful comments.

considers exclusively arguments in the economic instead of political domain – and is discussed in Section 2.

Another highly contentious matter concerns the policies that Scotland should adopt in the early years of this currency regime even if it is agreed that it is the best arrangement for the country. On the one hand, there are those who stress the importance of external constraints and, accordingly, advocate austerity policies. On the other hand, others downplay the role of external constraints and support more expansionary policies in pursuit of full employment. The contrast between these positions originates from competing economic paradigms. This is addressed in Section 3.

Section 4 addresses specific issues concerning the transition to a flexible exchange rate, namely, the duration of the transition period and the existence of preconditions. For some, such transition should be protracted because the economy should first attain certain preconditions. For others, the required preconditions do not have an economic nature and those that do would be automatically satisfied in the switch to an independent currency.

Accordingly, the transition period can have a short duration. This conflict of opinions results from different views about the possible extent and economic benefits of sovereignty in economic policy. This paper shows that progressive economic policies can be underpinned by heterodox economics theory and not just by purely political considerations.

## **2. An independent floating currency**

There is no definitive consensus on the appropriate choice of an exchange rate regime, either in the mainstream or the heterodox economics literature. Many would argue that, from a purely theoretical perspective, there is no single currency regime that is right for all countries or at all times (see, for example, Frankel, 1999, or Lavoie, 2014). Others take a less relativistic stance and, in any case, newly independent countries are doomed to choose.

The overriding argument in favour of an independent floating currency is that it provides the largest policy space for the government. In particular, domestic fiscal and monetary policies can target the achievement of policy goals. This could be presented in terms of the well-known ‘impossible trinity’, which implies that only a country that floats its exchange rate can enjoy domestic policy independence if capital flows are unconstrained. Modern Money Theory (MMT) – a Post Keynesian strand<sup>2</sup> – highlights that, as there is no need to safeguard the stock of foreign currency reserves, the central bank can set the interest level at the level it chooses, and the government can thus target full employment through expansionary fiscal policy. Should this be accompanied by the accumulation of government debt, a monetary sovereign government would still be able to maintain a stable interest rate. The reason is that, since the authorities can never run out of money, there can be no default risk on their bonds. Even if there was a fall in the demand for government bonds, the central bank can always purchase unlimited amounts of bonds and keep the interest rate stable (Wray, 2015). With a flexible exchange rate, the government does not depend on the will of investors to purchase its bonds denominated in

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<sup>2</sup> Many Post Keynesian and MMT economists emphasise the common elements between the two frameworks. Nevertheless, there are also points of disagreement (Lavoie, 2019).

domestic currency. MMT and Post Keynesian theories concur that neither the loanable funds theory nor the theory of crowding out hold in the real world.<sup>3</sup>

A government that issues its own currency faces no financial constraints and can afford to purchase anything that is for sale in that currency. Consequently, it can *pursue* any objective that it chooses, e.g., full employment; public infrastructure investment; universal access to basic necessities, healthcare and education; transition to sustainable energy; assistance to developing countries; etc. This does not mean that monetary sovereign governments can *achieve* any objective they want. For example, it is possible that the needed real resources may not be available; in these circumstances, government expenditure would generate inflation. A possibly undesirable characteristic of a floating currency is that it causes more uncertainty than 'harder' exchange rate arrangements (such as fixed or managed exchange rate regimes, currency boards, monetary unions). However, the microeconomic costs related to greater uncertainty in the planning decisions of firms are likely outweighed by the benefit of greater freedom in macroeconomic policy setting (see for example Sardoni and Wray, 2007).

Hard exchange rate arrangements limit the fiscal and monetary space available to the government, as domestic policy is constrained by its ability to obtain the foreign currency. Thus, a government would no longer be able to spend as much as needed, for example, to eliminate unemployment. In other words, the government now faces a financial budget constraint, which does not exist under a floating exchange rate arrangement.<sup>4</sup> The unilateral adoption of a foreign currency is the arrangement that provides the least policy space of any exchange rate regime. The constraint on an expansionary conduct of fiscal policy remains in a monetary union since, while currency risk is eliminated, country risk is not, because defaults on debt remain possible. In the absence of a purchaser of last resort for government securities, their interest rates are determined by financial markets. This constrains fiscal policy (Ehnts and Hofgen, 2019).

In his analysis of the currency choices available to an independent Scotland, MacDonald (2014) concurs that an independent currency would be preferable to all other options and voluntary sterling-isation the least desirable. However, MacDonald argues that the transitional costs necessary to establish a credible currency would be extremely large, including the need for strict austerity.<sup>5</sup> This is investigated in the next section.

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<sup>3</sup> According to the loanable funds theory, investment is constrained by savings and the interest rate is determined in the market for loanable funds. As in this framework the financial sector is merely an intermediary between savers and borrowers, there is a limited supply of loanable funds. When the government borrows, it becomes a competitor with private borrowers for loanable funds causing the interest rate to rise which, thus, crowds out private investment.

<sup>4</sup> Fixed exchange rates are characterised by a deflationary bias that falls particularly on the country that runs external deficits. In contrast, countries that enjoy external surpluses can pursue independent monetary and fiscal policies even under a fixed exchange rate regime.

<sup>5</sup> Although written before the 2014 first independence referendum, MacDonald has subsequently reiterated the views expressed in his 2014 paper.

### 3. Appropriate policies in a flexible exchange rate regime

MacDonald (2014) estimates that an independent Scotland would record current account deficits in the order of 2% to 5% of GDP.<sup>6</sup> He argues that this would cause strong pressures for depreciation of the independent Scottish currency and, given the lack of foreign exchange reserves at the outset, there is no alternative but to let the currency float freely. To stem a continuous depreciation of the Scottish currency it is essential that it achieves a 'hard currency' status, which can only be earned by running budgetary surpluses for a number of years. In fact, budgetary surpluses would not only serve the purpose of establishing reputation but would also allow Scotland to build up a pool of about £40bn of foreign exchange reserves, which is seen as essential to run a credible independent currency regime<sup>7</sup> — an amount that is too large to be borrowed on international financial markets.

This argument, which as shown below is based on standard tenets of mainstream international macroeconomics, is analysed from three different angles in this section:

- i. whether the current account is a major determinant of exchange rates;
- ii. whether fiscal surpluses are required to improve the current account balance and accumulate foreign exchange reserves;
- iii. whether external balance is a constraint on the conduct of fiscal policy.

#### 3.1. *The current account and exchange rates*

In mainstream models, the current account is a fundamental determinant of the exchange rate (MacDonald, 2007). This is the case even in models which focus on financial markets and allow for imperfect substitutability of bonds in investors' portfolios. Indeed, the longrun equilibrium position in mainstream models is characterised by a balanced current account. While these models have also been extended to allow for agents' irrationality and non-fundamental movements in exchange rates, these extensions are deemed to have short-run impacts which are essentially superimposed on fundamental effects.

This is not the case in Post Keynesian models. The exponential growth of capital markets since the 1970s and the increasing separation of capital flows from trade-related transactions suggest that portfolio capital flows – far from being the means through which trade flows exert their influence on the exchange rate, as in mainstream models – are independent and indeed the commanding drivers of exchange rate movements.<sup>8</sup> Foreign exchange markets are, thus, dominated by speculative activities. In the Post Keynesian approach, currencies are considered

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<sup>6</sup> Using more recent figures, it has been forecast that the current account deficit could even reach 10% of Scottish GDP.

<sup>7</sup> MacDonald reports that this is the amount of foreign currency reserves which Denmark, Norway and Sweden – three economies of comparable size to Scotland – hold in order to run their currency regimes, which vary from a float, to a fixed rate, and a managed float. This amount is equivalent to about one third of Scotland's GDP.

<sup>8</sup> Data from the Bank for International Settlements show that in 1989 – the first year in which these data were systematically collected in the Triennial Central Bank Survey – foreign exchange market transactions were already about 50 times the amount of world trade. They continued to grow much faster than world trade so that, in 2019, they amounted to over 90 times world trade. Even allowing for covering transactions for exports and imports, it can only be concluded that capital flows, instead of trade flows, account for the vast majority of foreign exchange transactions.

international assets the respective demands for which depend on investors' forecasts of their differential profitability (Harvey, 2009).<sup>9</sup> As in Keynes's analogy between the stock market and a beauty contest, speculators in the foreign exchange market react not so much to their own beliefs about exchange rate movements but to what they believe about the beliefs of other speculators.

This implies that unlike mainstream models, where economic fundamentals determine expectations and, thus, the exchange rate, in Post Keynesian models there are no underlying exchange rate fundamentals, nor *a priori* reasons to select any particular set of indicators over another.<sup>10</sup> Rather, fundamentals are whatever agents expect to be important in a specific context and temporality. Agents try to discover exchange rate determinants in an environment of fundamental (or radical) uncertainty – instead of the mainstream vision characterised at best by probabilistic risk – and, if they decide that any particular variable is of importance in forecasting the exchange rate, it would become so: “for all practical purposes, fundamentals do not exist – except when market participants convince themselves that one or another of the many candidates truly matter” (Taylor, 2004, p. 307). Thus, strong bandwagon (or herding) effects may occur. The focus on capital flows and psychological factors does not restrict their influence only to the short run. In Post Keynesian economics, there is no long-run equilibrium to which the economy converges, but path dependency, whereby the ‘long run’ depends, to some extent, on what has happened in the short run.

As the exchange rate is influenced by movements in portfolio capital flows, there is no expectation in these models that the resulting exchange rate will ensure equilibrium in the current account, not even as a tendency over an extended period (Harvey, 2019). If agents in the foreign exchange market believe that a country's protracted deficits may raise its default risk, it is not inevitable that they will sell that country's currency, and, if they do, the ensuing depreciation may fail to reduce the current account imbalance – let alone eliminate it. A country may be able to carry increasing levels of debt for a protracted period. Or, it is possible that agents in the foreign exchange market do sell the currency causing it to depreciate and that this would restore current account balance. But, if this happens, it will be the result of a change in expectations in the foreign exchange market, rather than an inevitable dynamic set out by the current account imbalance. So-called ‘fundamentals’ – like the current account – are thus nothing more than an *ex post* justification for actual events and they lack, therefore, explanatory power.<sup>11</sup>

Harvey (2009, Chapter 6, and the references cited therein) contends that Post Keynesian theories of exchange rate determination successfully explain what drives exchange rates in an era of large portfolio flows and account for observed exchange rate phenomena, such as their large swings, sudden busts, weak correlations with sets of ‘fundamental’ determinants, and

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<sup>9</sup> For an extension of the model to the case of developing and emerging countries see Kaltenbrunner (2015).

<sup>10</sup> In mainstream models, speculators' expectations have no direct effect on the exchange rate since this is determined by objective fundamentals. The job of speculators is to second-guess the fundamentals. As noted by Harvey (1996), “exchange rate forecasting is then analogous to guessing a dice roll or predicting the weather; the expectations have no effect on the actual outcome” (p. 574). In fact, speculators are not guessing the outcome of some external process but are creating the outcome.

<sup>11</sup> For example, Eichengreen et al (1995) study cases of turbulence affecting both pegged and floating rates and find that the behaviour of the current account (as well as that of other economic fundamentals) is not consistently linked to speculative attacks.

persistent current account imbalances. He contrasts this with the relatively poor performance of mainstream models, which – as also analysed in Harvey (1996) – are unable to present a unified framework for the operation of the foreign exchange market.

It is worth emphasising that, in a Post Keynesian framework, persistent current account imbalances can occur because one price – i.e., the exchange rate – cannot, except by coincidence, equilibrate both speculative capital flows and trade flows. Factors driving capital flows are distinct from those determining trade flows. In mainstream models, since capital flows have no autonomous impact on the exchange rate, the current account tends towards balance.

To summarise, based on Post Keynesian theory, this section questions the existence of a strong link between current account deficits and currency depreciation, which is predicted by mainstream theory. On this ground, MacDonald's argument – that Scotland's current account deficits require corrective action to curb the depreciation of the Scottish currency they would cause – may lack solid foundations. Indeed, some predict that, in the first year of floating, the Scottish currency will appreciate against sterling and remain more or less unchanged against the dollar and the euro (see, for example, Rideout, 2020a).<sup>12</sup>

The expected direction of change in the Scottish currency exchange rate would also be determined by the process through which the currency is introduced. This is described in Rideout (2020b). The key point is that there is no compulsory exchange of sterling for the new currency. All conversions are voluntary – Scottish residents are expected to readily take up the new currency as local and central government taxes and charges for public services would be levied in that currency – and international markets will, at least initially, have no holdings of the Scottish currency. In short, the currency rollout has been designed to minimise – in fact, to avoid – an excess supply of the Scottish currency.<sup>13</sup> In these conditions, there is little reason to expect a rushed sale of the currency or its depreciation. By implication, the point that the Scottish currency needs to attain a hard currency status may become moot. The next two sections further develop this issue.

### *3.2. Fiscal stance, the current account balance and foreign reserves*

This first part of this section discusses the link between a country's current account and the government fiscal balance. It is a proposition of mainstream economics – the so-called 'twin-deficit hypothesis' – that the two move together. It states that austerity policies are required to improve the current account and earn foreign exchange reserves. Since the national accounts show that the financial balances of the private domestic sector, the government sector, and the

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<sup>12</sup> Rideout (2020a) calculates that, ten months from the start of floating, the value of the Scottish currency will have risen from 1 pound sterling to 1.12. In contrast, MacDonald (2021) expects a depreciation of the Scottish currency of up to 30%. The reliability of these calculations is questionable to say the least. As explained above, in the Post Keynesian framework, the real world is characterised by fundamental uncertainty where economic agents do not know how other agents will react. In these circumstances, it is impossible to quantify the expected outcomes of certain processes. Attempting to do so is closer to writing fiction than economic analysis.

<sup>13</sup> Redenomination of debt into the Scottish currency – which is expected to lag the exchange of deposits and cash – might cause depreciation pressure as the currency is sold to redeem sterling denominated debt. However, this could be compensated by the late conversions by individuals who will initially hold on to sterling.

current account deficit sum to zero, the twin deficit hypothesis assumes that the private sector is in balance and that causality runs from the fiscal balance to the external balance.

Neither assumption is easily defensible. Mitchell et al (2019) note that the evidence from many countries is that the private domestic balance is far from stable over time and that no inferences about causality can be made from the accounting identities of the sectoral balances.<sup>14</sup> In fact the sectoral balances have an important implication, namely that current account deficits (as in Scotland) can be compatible with the private domestic sector's overall savings only if the government sector spends more than what it takes out in revenue.<sup>15</sup> The only sustainable position for the private domestic sector is to be in surplus; private sector's deficits can only be sustained for brief periods. It may be noted that this suggests that fiscal deficits may have a crowding in effect, instead of the crowding out effect invariably predicted by mainstream economics.

Any attempt to impose austerity in pursuit of government financial surpluses would cause unemployment to increase.<sup>16</sup> Indeed, using official data for Scotland which show that the private domestic sector is running a small overall deficit but with a low investment ratio, Mitchell (2019a) argues that the fiscal net spending is supporting growth but is too low. More public spending is required to avoid any hint of recession.<sup>17</sup>

The relationship between the current account and the accumulation of foreign exchange reserves also needs to be considered, since mainstream authors see the achievement of current account surpluses as necessary for the latter (e.g., Bernanke, 2005). However, Borio and Disiyatat (2011) highlight that this view is highly misleading since it arbitrarily pairs up a net financial flow (the current account) with a specific gross capital flow (the change in foreign reserves). Gross flows are much larger than net flows and bear little relationship to them. The current account records the net financial flows that arise from trade in real goods and services (and income transfers) but excludes, among other things, purely financial transactions, such as the accumulation of foreign exchange reserves. This automatically generates an offsetting gross flow and, thus, leaves the current account unchanged.<sup>18</sup> Borio and Disiyatat argue that the root of the problem is in the theoretical framework of mainstream economics, as it

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<sup>14</sup> Once the private domestic balance is allowed to vary, the link between the government fiscal balance and the current account would disappear. For example, even if the government sector is in balance, there would be a current account deficit if the private sector spent in excess of its income. And, even if the private domestic sector were in balance, causality could run from the current account to the fiscal balance.

<sup>15</sup> This point is consistent with Kalecki's macroeconomic theory of income distribution, which states that private sector's profits are positively related to government deficits and the trade balance (see Lavoie, 2014, for an extensive discussion).

<sup>16</sup> Moreover, the operation of automatic stabilisers might prevent policies of fiscal restraint from reducing budget deficits.

<sup>17</sup> Murphy (2021a) among others has pointed out that the official Government Expenditure and Revenue Scotland (GERS) statistics do not provide a meaningful account of the Scottish Government's fiscal position. The procedures employed in the construction of GERS tend to result in large fiscal deficits that do not reflect the actions of the Scottish Government, which is in fact required to set a balanced budget each year.

<sup>18</sup> Borio and Disiyatat (2011) explain that the view that current account surpluses are necessary to accumulate foreign reserves harks back to a world of strict capital controls – in which agents were required to surrender scarce foreign exchange – but is inappropriate when, following the lifting of restrictions, the central bank is just one of a myriad of domestic agents acquiring foreign assets at any given time.

disregards monetary factors and, in so doing, it fails to distinguish clearly between saving and financing and, in an open economy context, between net and gross capital flows. They note that in fact the empirical relationship between current account positions and changes in foreign reserve is in general very weak. Indeed, countries can accumulate reserves even when recording large current account deficits. Moreover, the causality between current account positions and changes in foreign reserves can run in the opposite direction to that expected in the standard framework.

This section has argued so far that the adoption of austerity policies to improve the current account and build up a stock of foreign exchange reserves may fail to achieve those objectives or may have undesirable consequences. But another important observation is that the concern that Scotland may lack an adequate pool of foreign exchange reserves may be misplaced. This matter is related to the design of the currency rollout. As mentioned in the previous section, all exchanges of sterling for the new Scottish currency would be voluntary. Moreover, the new currency is not obtained for free; rather, each unit of the new currency is paid for with an equivalent amount of sterling as residents in Scotland swap their bank deposits to the new currency.<sup>19</sup> This would thus automatically start with 100% backing of foreign currency (sterling). Depending on different estimates of the exchanges into the Scottish currency, the amount of foreign currency reserves in possession of the Scottish central bank is in the range of £40bn to £70bn, i.e., a very significant amount (Rideout, 2019 and 2020c).<sup>20</sup>

### *3.3. External balance constraints*

As mentioned in part 1, the ultimate reason for preferring a flexible exchange rate regime over others is that it allows the government to retain control over the use of fiscal policy. With a flexible exchange rate, the government can keep its spending at the level that would buy all goods and services that the country can produce, thus eliminating unemployment. According to this principle – which is part of the so-called “functional finance” – an appropriate fiscal policy stance is one that sustains demand at full employment, rather than one that targets an arbitrary fiscal balance over a particular time period (Lerner, 1943). Similarly, Kalecki (1944) gave priority to the achievement of full employment over “sound finance” and regarded a long-term budget deficit as the key component in securing full employment, keeping account of possible resource constraints. The argument that, even under a flexible exchange rate regime, a country may need to strive for budgetary surpluses – as, for example, in MacDonald (2014) – implicitly reveals a different view about the strength of the external balance constraint on the conduct of domestic macroeconomic policies. We now turn to this discussion.

Mainstream international macroeconomics suggests that the maintenance of full employment might face an external constraint in the presence of current account deficits. The pursuit of full employment by means of expansionary fiscal policy might lead to higher wage demands, loss of competitiveness and increases in imports. The currency may thus depreciate and lead to an

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<sup>19</sup> This one-to-one exchange rate is applied for an initial exchange period that is expected to last one month or two. Subsequently, foreign exchange fees will be added to the market-determined exchange rate.

<sup>20</sup> Moreover, Mitchell (2019b) argued that the Scottish central bank’s stock of net foreign exchange assets would be augmented as a result of the settlement on Scotland’s share of the UK’s official gold and foreign exchange reserves. However, this is a disputed point as Scotland may choose not to claim any share of these assets as a counterpart of not taking on any of the UK’s liabilities.

acceleration of inflation. It could even encourage destabilising currency speculation. In this situation, deflationary policies are inevitable. Thus, it is claimed that fiscal expansion is an ineffective policy to achieve full employment in an open economy even under flexible exchange rates.

This argument is not without criticism. MMT emphasises that, in a flexible exchange rate regime, current account deficits are 'balanced' by capital account surpluses and will persist as long as the foreign sector desires to accumulate local currency-denominated assets. It is possible – particularly if the deficit country is not a reserve currency issuer – that there could be a sudden shift of international investors' sentiment against assets denominated in the deficit country's currency, which could lead to currency depreciation. While strictly speaking, this does not reduce the government's capacity to purchase whatever is for sale in the domestic currency and to continue to pursue full employment, the extent of the depreciation may be a matter for concern. Even in this case, though, this does not imply that corrective austerity policies are the only available or the most sensible option.<sup>21</sup>

In the first place, fiscal restraint may fail to eliminate the fiscal deficit because it shrinks the tax base. If the fiscal contraction occurs, its effect on inflation is the result of the excess capacity and unemployment it generates, which may be unnecessary costs. Indeed, an approach to exchange rate stabilisation that may be superior to orthodox stabilisation programmes based on restrictive fiscal and monetary policies is to pursue high employment and price stability by means of productivity-enhancing investments that could generate sustainable growth and raise the ability to service foreign debt. There are no obvious reasons to expect that international investors, despite the need to diversify their portfolios, would stop demanding the assets of a country that enjoys full employment, stable political and economic environments and is able to service its debt.<sup>22</sup> Moreover, in such an economy, cooperation between government and industry is likely to be conducive to the development of productive activities and the formation of highly skilled labour. This would be expected to attract foreign direct investment and make current account deficits more sustainable. It is plausible that foreign firms would also be attracted to an independent Scotland because English is its first language and, particularly, if it acquires EU membership. Moreover, Murphy (2021b) alludes to the possibility that Scotland may be an attractive prospect for high energy consumption firms, given that the country is almost self-sufficient in electricity from renewable sources.

Secondly, even if the fiscal expansion were associated with currency depreciation, the impact on domestic inflation might in fact be quite limited. The inflationary effect of depreciation – which reflects the impact of depreciation on import prices, and the weight of the price of imported goods and services in domestic prices – depends on a variety of factors including expectations of further depreciation, whether the economy is growing or contracting, the elasticity of substitution between imported and domestic goods, the substitution among foreign suppliers (i.e., the degree of trade integration), the extent of competition in the domestic market, etc. Thus, both the extent of imported inflation and the length of the period for depreciation to result in higher domestic inflation may be highly variable. Overall, the empirical evidence has found weak and irregular effects that are at odds with textbook expectations (Bailliu et al., 2010;

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<sup>21</sup> For a discussion concerning how the existence of a currency hierarchy may limit the policy space available to developing and emerging market economies see Bonizzi et al (2019).

<sup>22</sup> In contrast to public debt, the service of private sector's debt is always subject to default risk. The likelihood of default is diminished through successful productive investment.

Forbes, 2016; Ortega and Osbat, 2020). As to speculative attacks, there is equally little empirical evidence to suggest that flexible exchange rate regimes may be particularly vulnerable to them. In fact, given the lack of commitment to any given parity, the opposite may be expected. More generally, Mitchell et al. (2019) point out that, in the research literature, there is no evidence linking fiscal deficits and large exchange rate depreciations in countries with flexible exchange rates.

In case of significant depreciation pressures, a country could also resort to capital controls as a means of protecting the exchange rate while pursuing domestic policy independence (Wray, 2015). There is increasing acceptance, even within mainstream economists and institutions such as the International Monetary Fund, that capital controls have an important role to play to limit short-term and speculative financial flows – in either direction – and to maintain monetary and financial stability (for example, see Ostry et al, 2016). Indeed, Mitchell (2016) advocates the use of capital controls – together with other capital account regulation – as an integral part of a progressive policy package. Capital controls and regulation are in fact necessary tools to maintain independence of domestic policy making (Rebucci and Ma, 2019). Rey (2013) points out that the volume and high volatility of global capital flows have transformed the trilemma facing domestic policy makers into a dilemma, as a result of which flexible exchange rates cannot insulate domestic economies when capital is mobile. Rather, independent policies are only possible if the capital account is managed, regardless of the exchange rate regime.

The policy space available for the pursuit of domestic policy objectives is reduced by the accumulation of public and private sector's debt denominated in foreign currency. The service of this debt requires adequate foreign currency earning capacity and/or foreign currency reserves. MacDonald (2014) argues that, because of the amount of debt that an independent Scotland would inherit from the remaining UK (rUK) – which he estimated to be 86% of Scotland's oil-inclusive GDP – a stabilisation plan is necessary to reassure investors and avert a currency/debt crisis.

However, at least on practical grounds, these concerns may not be justified. Indeed, in January 2014, the UK Treasury unilaterally declared that no part of the British government's debt would be transferred to an independent Scotland. This declaration had an obvious logic: by taking responsibility for all the currency liabilities, rUK asserted at the same time its ownership right over the British pound. Two implications can be drawn. The first is that the declaration by the Treasury is not a negotiating ploy and the Treasury's position is not going to change in future. The second is that whether Scotland makes a contribution to rUK – for example towards interest costs – and the extent of this contribution will be the result of negotiations and will be based purely on good will. Murphy (2020) estimates that, in the worst-case scenario, the debt service burden on Scotland is likely to amount to less than £600m per year – this is less than 1% of government expenditure.

Moreover, it has been argued that the application of the so-called “Lex Monetae” principle would allow the Scottish government to redenominate the interest obligations on any debt it inherits from rUK into the new currency (Mitchell, 2019b). According to the same principle, private contracts can also be redenominated in the new currency. Where the lender is not a Scottish entity, they would be required to enable such conversion as part of their banking licence to operate in Scotland. In practice, therefore, the foreign debt of the Scottish public and private sectors can be expected to be small and it would not impose any significant constraint on the pursuit of full employment. As pointed out by MacDonald, a necessary condition for a currency

to be regarded as ‘hard’ is that the currency issuer’s solvency is beyond doubt. For the reasons explained above, on this score, Scotland’s credit rating on financial markets should be favourably affected and it may be expected that Scottish government securities would become part of internationally diversified portfolios.

This does not mean that current account deficits do not matter. They do if local producers – current and/or potential – are squeezed out by foreign producers. This requires government action to minimise the associated social costs and help the transition of workers and entrepreneurial resources into growing sectors. In conclusion, the main argument in this section is that, in the specific circumstances of Scotland after independence, external balance considerations would not constitute significant constraints on its government’s actions. In particular, supported by the choice of a flexible exchange rate regime, the government would be able to pursue domestic policy objectives.

#### **4. The transition to a flexible exchange rate regime**

The Sustainable Growth Commission (SGC) – established by the First Minister of Scotland – published a report that, among many other issues concerning the future of the Scottish economy in a post-independence vote scenario, also considered the matter of the currency appropriate for an independent Scotland (SGC, 2018). Its recommendation is that the currency should remain the pound sterling. It proposes six tests that, if met, could justify the subsequent introduction of a separate Scottish currency. The SGC anticipates that the Scottish economy would not be able to meet the six tests “until towards the end of the first decade following a successful independent vote” (point C2.8).

However, the 2019 Spring Conference of the SNP voted in favour of the so-called Amendment D, which mandates the party to introduce a new Scottish currency “as soon as practicable after Independence Day.” It has been argued that the endorsement of Amendment D also implies a rejection of the SGC’s six tests, but in fact this is a controversial point since the conference delegates rejected Amendment B, which intended to explicitly remove the six tests as the relevant criteria guiding the transition to an independent currency. Moreover, the SNP leadership seems to continue to regard them as crucial. The current status of the six tests is thus somewhat unclear.

The six tests concern (1) fiscal sustainability; (2) central bank credibility and stability of debt issuance; (3) financial requirements of Scottish residents and businesses; (4) sufficiency of foreign exchange and financial reserves; (5) fit to trade and investment patterns; (6) correlation of economic and trade cycle with rUK and other main trade partners. While the report gives no information about the reasons for selecting these particular tests, there is no doubt that the report is heavily influenced by principles and theories of standard mainstream economics.<sup>23</sup> The six tests have been closely scrutinised and heavily criticised by some authors. For example, Mitchell (2019b) stresses their neoliberal nature and argues that they are designed

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<sup>23</sup> This can be inferred for example from the definition of a credible and sustainable fiscal framework as one where the fiscal deficit falls below 3% of GDP and the national debt does not increase beyond 50% of GDP, or the recommendation that the government should abide by the golden rule and borrow over the economic cycle only to fund public investment, or the rejection of capital controls on the basis of their ineffectiveness. Many other examples could be made. These here have been chosen because this paper has already presented alternative perspectives on these topics.

to keep Scotland on the pound indefinitely and thus curb any real independence. The present paper has little to add to these analyses of individual tests but focuses on the tests as a set.

The contrast between this set and the set of tests proposed by Rideout (2019) – the mover of Amendment D and member of the SNP’s Policy Development Committee – is very sharp. The tests in the latter set are: (1) Is the Bill to establish a Scottish Reserve Bank drafted and ready? (2) Will new notes and coins be ready on time? (3) Have we designed, implemented and tested a new Scottish Bank payment system? (4) Have we designed/executed a Public Information Campaign? (5) Are the premises, staff, infrastructure, etc., for the Scottish Reserve Bank in place? (6) Have we identified and developed a plan for the financial regulation that will be needed for our financial institutions, etc.? (7) Has a (sterling) Pensioner Guarantee been established?

While the SGC’s tests embody the view that the move to a new currency should be made conditional on the achievement of economic preconditions – with the implication that the transition period might have a long duration – Rideout’s tests have a mere practical nature concerning legal and institutional arrangements. None of these tests point to economic preconditions. Consequently, the transition period can be much shorter.

This prompts the question whether there are lessons that can be learned from the experience of countries that left a monetary union. Currency breakups are not rare events: Rose (2007) reports that there have been 69 such cases since the end of WWII. His study searches for macroeconomic patterns around the time of currency union exits. Rose finds that the criteria identified by the optimum currency area (OCA) literature – such as, for example, the size of the government sector/spending or trade openness – or other aggregate macroeconomic features are poor predictors of breakups or continuing monetary unions. There is remarkably little macroeconomic volatility before, during, or after currency union dissolutions. In particular, exits have not been followed by precipitous drops in output. Nitsch (2004) also searches for stylised facts associated with the breakup of currency unions but using a different approach in the treatment of cases.<sup>24</sup> He considers insights from the literature on OCAs and that on currency crises, thus deploying a much broader set of variables than Rose (2007). Similar to Rose, Nitsch (2004) finds no tight links between currency union dissolutions and their theoretical determinants, especially macroeconomic fundamentals. He sees little evidence that the degree of symmetry in output movements and the occurrence of shocks or the extent of similarity in fiscal stances are associated with breakups in currency unions or their continuation. A more positive result is that dissolutions are often related to changes in political status (i.e., the attainment of political independence): a split in political union is quickly followed by currency union dissolutions. Three recent examples are the breakups of the Soviet Union, Yugoslavia and Czechoslovakia. In particular, the experiences of Estonia, Croatia and especially Slovakia have been used as evidence – relevant to Scotland – that a successful introduction of national currencies can be rapid (The National, 2021).

Estonia was the first of the former Soviet republics to issue its own fully convertible currency, the Kroon. The country became independent in August 1991 and the Kroon was introduced within ten months, having the central bank been set up a year before independence. Croatia declared itself independent in June 1991 and the Croatian Dinar was introduced in December.

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<sup>24</sup> Unlike those in Rose (2007), the data are arranged in pairwise form. This results in the identification of 245 currency unions and 128 dissolutions.

The National Bank of Croatia, which had been part of Yugoslavia's federal system of monetary authorities since the 1970s, was designated as the country's central bank in December 1990. Skreb (1998) recounts that the introduction of the Dinar proceeded surprisingly smoothly, despite the war brought by the rest of Yugoslavia against Croatia. Czechoslovakia split into two independent countries – namely, the Czech and the Slovak Republics – on 1 January 1993, within six months of the 1992 parliamentary elections. It was initially decided that the Koruna would be maintained as the common currency. In fact, the monetary union broke down in a matter of weeks. After secret negotiations between the two sides, monetary separation was announced on 2 February and became effective on 8 February. Fidrmuc et al (1999) attribute the collapse of the monetary union to the combination of its poor design and the lack of political commitment.<sup>25</sup> Despite this 'unplanned' development, this currency breakup has been described as the most successful, fastest and least eventful ever.

The extent to which all these historical precedents can be relevant to the case of Scotland is doubtful. The introduction of the new currency in Estonia occurred in the context of a 'shock therapy transition' to a market economy in which there was virtually no provision for discretionary economic policy (Hoag and Kasoff, 1999). In Croatia, the new currency was introduced in a context of near-hyperinflation and was thus a crucial element of stabilisation policy. Estonia, Croatia, the Czech Republic and Slovakia were all relatively closed economies both commercially and financially. The cases of currency exits in the datasets used by Rose (2007) and Nitsch (2004) include countries that gained political independence in the process of decolonisation. Nevertheless, a conclusion that can be drawn is that currency separation can be accomplished quickly.

It seems also reasonable to expect that the economic costs involved in the breakup of Scotland from sterling will depend on the agreed procedures and especially on the political will of both parties to cooperate and minimise costs. The SGC's six tests and its recommendation to retain sterling for an extended period are based on the assumption that there is a strong economic case for sterling retention because Scotland and rUK are a close approximation to an OCA and will continue to be so at least for the short and medium term. The SGC also assumes that the benefit of issuing a new independent currency is outweighed by the economic benefits of staying in the OCA as well as the benefit, in terms of stability, of maintaining the status quo.

As a response, it could be pointed out that there is no consensus in the literature on whether the UK meets the OCA conditions (e.g., Cuthbert, 2014; Schelkle, 2014). Consideration of the endogenous version of the OCA theory – according to which economic convergence, for example, develops dynamically as an effect of policies of cooperation and integration – would likely fail to strengthen the consensus, as it can be argued that the policies undertaken by the UK government have been responsible for the growing divide between UK regions (Cumbers, 2014). Brexit is a case in point, since it impacts differentially on UK industries and regions. Figus et al (2017) suggest that the direct impact on Scotland from leaving the EU would be compounded by strong indirect and induced spillover effects arising from the economic importance of rUK for Scotland. Thus, Scottish independence – if buttressed by the economic policy space that would result from monetary sovereignty and would allow Scotland to pursue

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<sup>25</sup> The monetary union lacked a single monetary authority. In its place it had a Monetary Committee composed of representatives of the two national central banks who were widely expected to pursue the interests of their respective countries rather than those of the union. This induced mounting speculative transactions.

economic objectives and strategies different from those in rUK – may be an important determining factor of how Brexit will impact on the Scottish economy and may affect the relative economic performance of Scotland and rUK (Blyth, 2021).

In any case, regardless of whether the UK is an OCA, the empirical evidence reviewed in this section suggests that the outcome of currency breakups may not be particularly affected by conditions related to OCA criteria. Even if the economic outcomes of such historical precedents are not regarded relevant for Scotland, the breakout themselves suggest that policymakers in newly independent countries have tended to privilege political decisions over considerations based purely on economic calculations. It is not altogether clear why Scottish policymakers should behave differently.

A possible answer is that the SGC might see the benefits of a new currency as rather limited, perhaps more of a political and symbolic nature than economic. To be fair, this interpretation of the SGC's view is only by deduction since, when assessing the costs and benefits of retaining sterling or issuing a new currency, the SGC does not make explicit what the advantages of a new currency might be. Nonetheless, their report stresses that the capacity of Scotland to conduct an independent monetary policy and set the interest rate autonomously is constrained by the small size of its economy compared to that of global capital markets. Similarly, the conduct of fiscal policy by an independent government is constrained by the need to ensure that capital markets remain willing to finance its fiscal deficit. To this end, the report recommends that an independent Scottish government should reduce public deficits and debt to "healthy and sustainable" levels primarily by keeping public expenditure growth below that of GDP. In this framework, therefore, there is little that independent monetary and fiscal policies can achieve. In contrast, in the Post Keynesian/MMT framework presented in this paper, sovereignty in macroeconomic policy setting is possible and highly beneficial.

## **5. Conclusions**

This paper has argued that an independent Scotland should introduce a new currency and adopt a flexible exchange rate regime. It has rejected the view that in the early years of this regime the conduct of macroeconomic policy should be constrained by externally imposed considerations. It has expressed the view that the transition to a flexible exchange rate after Independence Day can be rapid as it does not need to be delayed by the need to achieve significant economic preconditions.

These arguments have not been made by weighing contrasting political and economic considerations but purely on the basis of economic considerations derived from the perspective of heterodox economics frameworks, especially Post Keynesian and Modern Money Theory. Too often progressive economic policies are delegitimised by the appeal to an alleged economic reality which in fact is not reality at all but only a distorted vision that reflects the organising principles and framework of mainstream economics.

It is worth highlighting the complementarity between this paper and Dow et al (2018) on the 2014 Scottish referendum. They lament that both sides of the debate – those advocating political independence and those opposing it – over-relied on arguments framed in terms of mainstream economics. Dow et al contend that mainstream economics – due to its equilibrium setting and its limited conceptualisations of institutions, power, knowledge, and uncertainty – is

particularly unsuited to address issues related to constitutional and institutional change. They argue that, in contrast, a political economy approach can much better analyse the nature and consequences of dynamic changes on institutions, social structures and behaviour. This paper makes the point that the debate about post-independence economic policies is also fought on arguments based on theories and perspectives that are typical of mainstream economics, despite the fact that its predictive capabilities and explanatory framework have both been found inadequate. Post Keynesian economics and Modern Money Theory offer alternative and arguably superior perspectives for such debate and, compared with mainstream economics, they are a much more solid foundation for progressive policies.

Unfortunately, mainstream economics remains the only approach to economics taught in many economics departments. Stronger support for heterodox economics together with more widespread knowledge of its principles and frameworks can enhance our understanding of the real world and improve decision making. The agenda for research and change is long.

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