REBOUND & REMODEL

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Scottish independence
An independent Scottish currency

Following the election of a pro-independence majority in the Scottish Parliament in the May Scottish elections, the likelihood of a second independence referendum has increased. It is likely that, as part of the debate, there will be a focus on what currency might be used in an independent Scotland.

In 2014, Scottish Government proposed a currency union with the remaining UK (**rUK**) but this proposal has been sidelined due to opposition from the UK Government, whose consent would be needed.

This means that the most likely currency options available to an independent Scotland would be (1) continued use of Sterling, (2) "sterlingisation" or (3) a free-floating Scottish currency.

1) Continued use of Sterling

Some countries use another state's currency, (an example being Panama's use of the US Dollar as one of its official currencies) and it is open to Scotland to continue to use Sterling; either on a temporary or long-term basis. The Scottish Growth Commission (**SGC**) which was established by the Scottish First Minister, Nicola Sturgeon, to report on Scotland's economy and public finances, recommended in a 2018 report that the currency of Scotland should remain the Sterling "for a possibly extended transition period", with a transition to an independent Scottish currency to follow at such time as this was considered appropriate for the Scottish economy. On the basis of that recommendation, this may be the Scottish Government's preferred 'day one' option as it would avoid any immediate issues for Scottish consumers and businesses arising from re-denomination, including any divergence in the value of the rUK Pound and a Scottish currency.

However, in the absence of a formal currency union, the use of Sterling would not be without its challenges. In particular, without an agreement with the rUK, a Scottish central bank would have no control over Sterling monetary policy, which would be set by the Bank of England (**BoE**). The BoE's statutory objectives include the maintenance of price stability and the support of the UK government's economic policy. As the BoE is an UK institution then, unless agreed between Scotland and the rUK, the BoE would not take into account the requirements of the Scottish economy or public finances when deciding policy objectives.

2) "sterlingisation"

An alternative option could be for Scotland to establish a new currency that is fixed, or 'pegged', to the Sterling foreign exchange rate, commonly referred to as "sterlingisation". This was broadly the policy pursued by Ireland until 1979.

"Sterlingisation" could provide continuity benefits for Scottish consumers and businesses as it would avoid any divergence in the value of the Scottish and rUK currencies until Scotland was in a position to transition to a floating independent Scottish currency.

However, a Scottish currency fixed to Sterling would have the same issues as the continued unilateral use of Sterling and would also require the use of treasury tools, and the creation and maintenance of a substantial Sterling reserve, to maintain the value of the Scottish currency.

3) A floating independent Scottish currency

Scotland could create a currency which is freely tradeable on the international forex markets, which we refer to below as the Scottish Pound. If so, a number of issues for financial products and loan documentation would need to be resolved, including:

Conversion

Most domestic payment obligations (both consumer and business) are denominated in Sterling and the Scottish Parliament would need to pass legislation converting Sterling at a specified rate. It is anticipated that this would be done after consultation with banks and other interested parties, not only so as to maintain business confidence but also to minimise any possible accusations that the conversion process unfairly prejudices some businesses. It would be open to the Scottish Government to seek to peg the Scottish Pound to Sterling but the viability of such an arrangement is dependent upon market sentiment and the willingness of the Scottish Government to use financial tools such as interest rates to support parity.

The Scottish Government would also need to consider the scope of the conversion process. It is possible that debts between persons and entities situated in Scotland where the obligations are governed by Scots law would be covered by the conversion process whereby amounts payable would be re-denominated in Scottish Pounds but other scenarios are more complex. For instance, if there is a Scottish debtor and a non-Scottish lender, it is possible that such payments would not be covered by the conversion process as the debt is not payable in Scotland; for instance if English law is the governing law of the underlying contract then the English Courts may continue to view Sterling as the "continuing" currency.

Specific Conversion Issues

Politically, it would be in the interests of the Scottish Government to implement a conversion proposal that maintained business confidence and it is feasible that the conversion process could be structured so as to maintain Sterling payments for commercial agreements during their remaining lifetime. In any event, however, there would be "difficult" cases to be resolved.

For instance:

Would payments by Scottish debtors to rUK or foreign banks be viewed as being payable in Scotland?
If the relevant account is in Scotland, then it could be viewed as being a Scottish payment unless the payment is governed by English law.

Would public bodies such as local authorities be obliged to pay in Sterling or Scottish Pounds?
In some ways, it would be logical for such debt obligations to be denominated in Scottish Pounds but it may be the case that if the lender is not resident in Scotland and the loan agreement is governed by English law then there may be potential conflict as the English Courts may view the debt obligations as being denominated in Sterling. It could be that pragmatism will prevail on the basis that the public debt market is limited and any adverse consequences for lenders as a result of redenomination could lead to a drying-up of lending to such public bodies although there could still be a mismatch between the public bodies' revenues and their Sterling obligations; however, this is not without precedent and public bodies in other European states have denominated debt obligations in currencies other than their national currency.

Would consumer credit or mortgage obligations be redenominated?
The Scottish Government would need to consider the impact on consumers if mortgage or other retail payments were still denominated in Sterling whilst the debtor had an income in Scottish Pounds.

Interest Rates

If a contract was redenominated into Scottish Pounds, then the BoE base rate would not apply and interest rate benchmarks for Sterling would no longer be relevant. A new Scottish central bank would set the base rate for the Scottish Pound.

Asset Value and Financial Covenants

Another consequence of redenomination would be the impact of currency fluctuation upon asset valuation. This would be of importance where corporate accounts are stated in Sterling but the company has substantial assets situated in Scotland which are valued in Scottish Pounds. From a banking perspective, even if there was no redenomination of payment obligations, cashflow and asset cover ratios could be impacted where a borrower draws most of its revenue from, or has most of its assets in, Scotland.

Trading consequences

If a Scottish Pound is adopted and there is an adverse fluctuation in the exchange rate, this could impact upon Scottish exporters not only to rUK but to other overseas markets. Some exporters, especially where their costs are primarily in Scottish Pounds, could benefit from such fluctuations but there would be an additional (although common) burden of managing Sterling hedging costs. This could also impact businesses in rUK which sell to Scotland as an independent Scotland would become one of the rUK's largest export markets.

Joining the euro

Scotland in the longer term may plan to join the euro. However, this could not be a 'day one' option, as membership of the euro is conditional on (i) EU membership and (ii) meeting certain economic pre-conditions. Joining the euro would therefore only be possible from a point some time after Scotland became independent.

It would in principle be possible for Scotland to unilaterally adopt the euro, as Montenegro has done but if it did so, Scotland would have no control over the functioning of the euro as it would have no representation at the European Central Bank or the other institutions of the EU. As such, this approach would on the face of it present challenges similar to continuing to use Sterling, or adopting a "sterlingisation" approach, as set out above.

Summary

There are various currency options available to an independent Scotland and we will keep you updated on developments.

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