Scottish Economy: Currency and the Financial Industry

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This paper, (and the original report, here) is also going to be published as a discussion paper by the "Liberal Party" at http://www.liberal.org.uk/

After the yes campaigns bruising in the media, (during the last week of February,) with a plethora of misleading stories about an exodus of Scottish Hedge funds and Banks, I thought it would be a good idea to take a more detailed look at this subject.

One of the things one should remember is that the news papers leading the charge against Independence are English papers, based in England, with an English Editorial board and an overwhelming preponderance of English journalists. Even those with so called Scottish editions are little more than clones of the main English banner and their neutrality is, to say the least, suspect.

This discussion paper hopes to initiate a wider debate on the Pound that the National Papers are clearly trying to spin.

To review background details from my original report on the Scottish economy:

- The Pound is a de-facto reserve currency and this brings "apparent" economic benefits in the form of "Exorbitant Privilege". But it also has some serious downsides, in that it is very destructive to manufacturing and there are serious question as to it's long term sustainability. (Collapse of "Bretton Woods" and the "Triffin Paradox")
- Osborne has more than doubled UK debt since coming to office. At the moment this debt is supportable only because gilt yields are at unrealistically low levels, however as gilt yields recover to historic norms, this debt will become increasingly unsupportable, possibly leading to a either a "debt crisis" or extreme volatility in the currency markets

The Standard and Poor report

You can read the full report at:

- http://www.scribd.com/doc/209646043/Standard-and-Poor-s-Key-Considerations-For-Rating-An-Independent-Scotland

In summary, it said an independent Scotland would benefit from "all the attributes of an investment-grade sovereign credit" due to its "wealthy" economy, skilled workforce and flexible markets.

However, it also raised concerns over Scotland's share of Osborne's debt, the Scottish economy's initial sensitivity to oil prices and how maintaining a strong link with the English Pound would limit Scotland's monetary flexibility.

Pointing out that there would be "volatility" if the banks decided to leave, it added:

- "If this were to happen, it could bring benefits in terms of reducing the size of the Scottish economy's external balance sheet, normalizing the size of its financial sector, and reducing contingent liabilities for the state."

On the currency question it said:

- "Specifically, we think Scotland would be hard-pressed, under a new currency regime, to quickly replicate the deep capital markets it enjoys today as part of the larger UK," but it added. "Nevertheless, with a GDP (including North Sea oil output) only slightly below that of New Zealand, a developed economy and developed financial system, there is no fundamental reason why Scotland could not successfully float a currency."

Overall it suggested:

- "In short, the challenge for Scotland to go it alone would be significant, but not unsurpassable."

Not exactly the way the tabloids are presenting the issue, is it?

What are the implications of the Standard and Poor report?

This is where it gets interesting. While it is fairly clear that Scotland could thrive with an independent Scottish Pound benefiting an export lead economy in areas such as

- Manufacturing
- Tourism
- Energy

There is also the threat of a large scale decampment of our finance industry, currently about 9% of Scotland's regional GVA, excluding oil. (see The financial sector's contribution to the UK economy - Commons Library Standard Note - UK Parliament)

As the Standard and Poor report makes clear, (contrary to press reports,) this rebalancing away from "financial services" would actually be beneficial to the Scottish economy. In fact, current long term Westminster financial planning envisions a similar rebalancing for the UK as a whole as being highly desirable.

- The Government has set out the need to rebalance the economy across sectors and to stimulate exports and inward investment.1 The deputy Prime Minister has said that the Government's pro-growth agenda is about "rebalancing our economy away from an over-reliance on one industry – financial services - and one area – London and the South East". (see above parliamentary note.)

So, regardless of the referendum result, the finance industry is going to become less important to the Scottish economy!

But there is more going on here than meets the eye. The above research note states that, 7.3% of the total financial services contribution to the UK economy is based in Scotland.

If the Scottish finance industry moved on mass south of the border, this would have an incredibly destabilising effect on the English economy. Basically, a much reduced English economy would have to absorb a 7.3% expansion of its financial services.

I think at that point, the BoE and Westminster would have to seriously rethink their positions on maintaining a strong currency union with an Independent Scotland.

More on the UK's debt position

I found a rather interesting papers relevant to the debate UK's debt and the use of the Pound. as a reserve currency, (see my initial post: section on the Pound, here) and whether current Westminster monetary policy is in Scotland's long term best interest.

The paper is from A 2010 release by Office of National statistics. It details our Net International Investment Position or NIIP.

The NIIP is the difference between a country's total, (both public and government,) external financial assets and its liabilities. In other words it is a very accurate indication of countries financial health. While recent research focuses on the importance of the Gross International Investment position, (GIIP,) the NIIP is the preferred traditional measure.

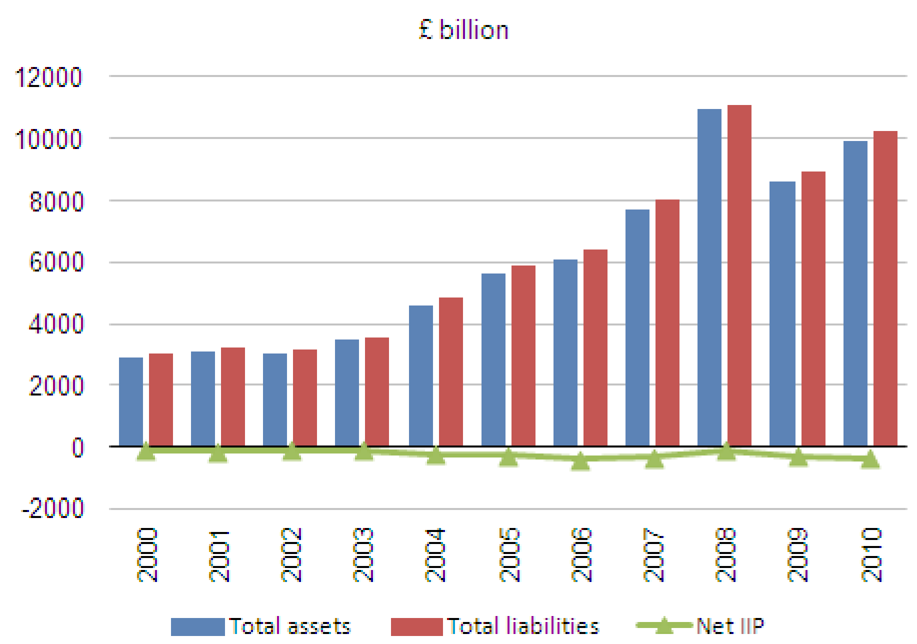
The paper is available here

From the abstract it states:

- This paper describes the path of the UK's international investment position (IIP) with the rest of the world. The paper shows that both UK assets and liabilities grew considerably during the past decade. Liabilities always outstripped assets during this period, mainly reflecting the persistent current account deficits, which meant that the UK consistently ran a net liability position. Although the size of the net liability position increased over the decade, its growth has been volatile.........

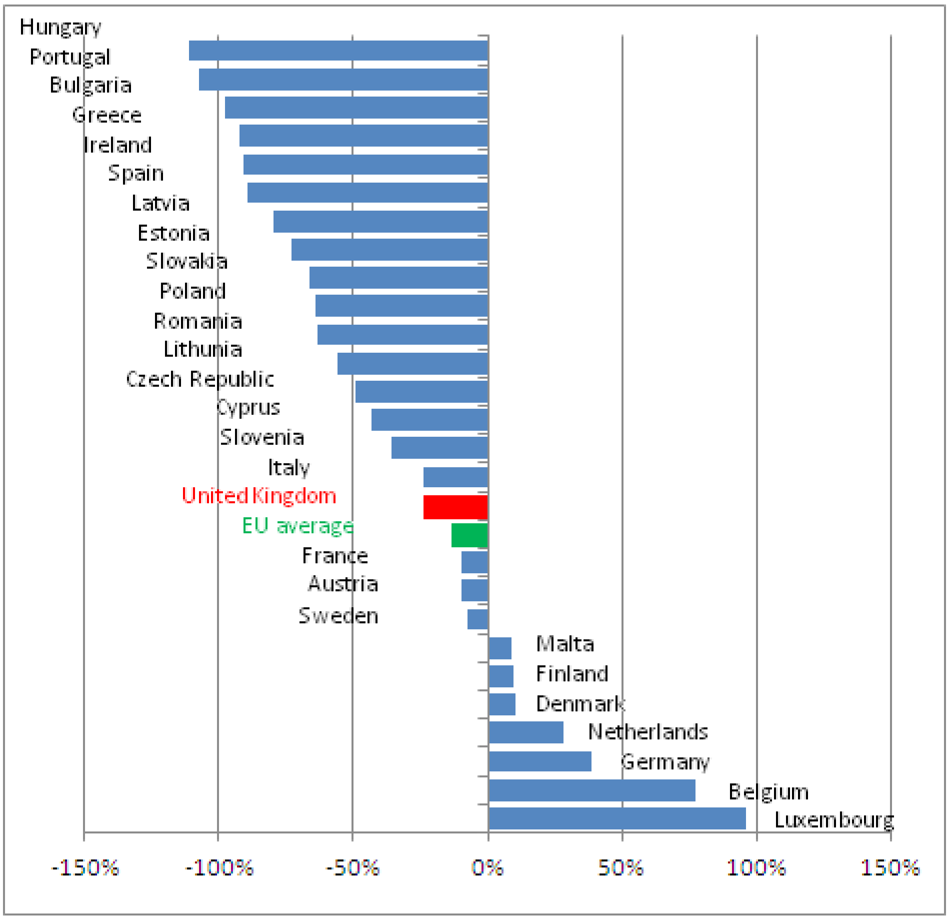
I have reproduced a couple of interesting graphs from the report:

UK's gross assets, liabilities and net IIP (2000-2010)



These figures pre-date Osborne's debt and, as you can see, at that time we were 10% of our GDP in the red.

EU comparisons of the net IIP as a percentage of GDP (2010)



What should be apparent from this graph is that in terms of NIIP, we do not compare very favourable with our main economic competitors inside Europe, (Germany, Netherlands or to a lesser extent, France.) In fact the UK actually comes out below the EU average and is ranked with some of the weakest economies in Europe.

Okay, to be fair, this is the point where “Exorbitant Privilege” seems to make everything okay and the books miraculously balance. But, the long term empirical evidence for “Exorbitant Privilege” is inconclusive with wide disagreement as to its overhaul effect (see http://en.wikipedia.org/wiki/Exorbitant_privilege)

The Triffin Paradox revisited

As I previously pointed out, the Triffin Paradox brings into question the long term sustainability of negative NIIP. After all, Bretton woods did collapse. In fact, the 2008 meltdown brought into question the whole concept of using national currencies as a reserve currency.

To quote the Wikipedia article on the Triffin Paradox:

“In the wake of the financial crisis of 2007–2008, the governor of the People's Bank of China

explicitly named the Triffin Dilemma as the root cause of the economic disorder, in a speech titled Reform the International Monetary System. Zhou Xiaochuan's speech of 29 March 2009 proposed strengthening existing global currency controls, through the IMF.

This would involve a gradual move away from the U.S. dollar as a reserve currency and towards the use of IMF special drawing rights (SDRs) as a global reserve currency.

Zhou argued that part of the reason for the original Bretton Woods system breaking down was the refusal to adopt Keynes' bancor which would have been a special international currency to be used instead of the dollar.

American economists such as Brad DeLong agreed that on almost every point where Keynes was overruled by the Americans during the Bretton Woods negotiations, he was later proved correct by events."

The article goes on to say:

"...... in a November 2009 article published in Foreign Affairs magazine, economist C. Fred Bergsten argued that Zhou's suggestion or a similar change to the International Monetary System would be in the best interests in both the U.S. and the rest of the world...."

And:

"On April 13, 2010, the Strategy, Policy and Review Department of the IMF published a comprehensive report examining these aforementioned problems as well as other world reserve currency considerations, recommending that the world adopt a global currency (bancor) and that a global central bank be established to administer such a currency."

So, as you can see, even if the pound manages to survive its disastrous mismanagement by Cameron and Osborne, its long term future as a reserve currency is in serious doubt. At that point, we have to ask:

1) Would Scotland be better off with a Scottish Pound?
2) Would the English regions be better off with a strong currency union and a strong Independent Scottish voice on UK monetary policy?

Food for thought isn't it!

Irvine
Edinburgh
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