

# **Independence, for and against**

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This paper, (and the follow up report, [here](#)) is also going to be published as a discussion paper by the “Liberal Party” at <http://www.liberal.org.uk/>

## **Table of Contents**

### Scottish GDP

- [What exactly is GDP and why is it important?](#)
- [What's the difference between GDP and GVA?](#)
- [So what is Scotland's GDP?](#)
- [Which of these figures for GDP is correct?](#)
- [In terms of GDP, how poor are we?](#)

### Oil, and energy

- [Shale Gas and Coal Seam Methane?](#)
- [Renewable Energy](#)
- [The North Sea Grid](#)

### Europe

### The Pound

- [As a reserve currency](#)
- [Gilts and bonds - overview](#)
- [Gilts and bonds – Their function in the economy](#)
- [Gilts and bonds – What is a debt crisis?](#)
- [Gilts and bonds – Honestly, how did the UK avoid the recent debt crisis?](#)
- [Gilts and bonds – Okay, what about the future?](#)
- [The Pound: Our share of the Osborne's debt?](#)
- [The Pound: Do we need it? Do we even want it?](#)
- [Summary: advantages of the Pound](#)
- [Summary: disadvantages of the Pound](#)

### Geo-Politics

- [Iceland](#)
- [Cyprus](#)
- [Geo-Politics: summary](#)

### Independence: an economic boost?

- [How much of a boost?](#)

### Final Settlement Negotiations

### Conclusions

# Scottish GDP

## What exactly is GDP and why is it important?

Broadly, GDP attempts to estimate the total value of a country's economic activity. While it is not by any means the only indicator used in economic planning, it is the one that usually hits the headlines since it correlates directly with a country's standard of living.

It is important to note that GDP is always an estimate and the "official figures" are frequently revised, either up or down months, or even years after being released.

## What's the difference between GDP and GVA?

Good question, politicians frequently play fast and loose with the terms GDP and GVA. GVA is a step used to calculate GDP and a simple, (though not entirely accurate,) definition would be

$$\text{GDP} = \text{GVA} - \text{subsidies} + (\text{direct, sales}) \text{ taxes}$$

So when a politician mentions figures for GVA, he is including subsidies. When he talks about GDP, he has taken subsidies out of the equation.

Since we cannot expect a continuation of direct subsidies, it follows that to have real credibility, budget projections for an independent Scotland should ideally be expressed in terms of GDP. Unfortunately, because of the way GDP is calculated from GVA, it is not always practical to draw a distinction between the two and as a result politicians can use the differences between GDP and GVA to spin the economic debate.

## So what is Scotland's GDP?

Including North Sea Oil Wikipedia quotes an estimate of Scottish GDP for 2013 at roughly £150 billion, Scottish office figures for 2012 quote GDP at £147 billion and Google recently estimated our GDP to be about £130 billion.

## Which of these figures for GDP is correct?

They all are. GDP is an estimate and its value will depend not only on what exactly is being counted, but who is doing the counting. Exchange rates also play a role since the figures can frequently go through multiple conversions between Pounds, Dollars and Euros.

## In terms of GDP, how poor are we?

On the basis of the above numbers, our per capita GDP for 2013 is about £28,000 Using estimates quoted by the BBC for 2012:

- |  |                    |
|--|--------------------|
| • per capita GDP including oil: UK = £22,336 | Scotland = £26,424 |
| • per capita GDP excluding oil: UK = £20,873 | Scotland = £20,571 |

# Oil, and energy

Over the next thirty years North sea oil will run down, though, it is generally accepted that improvements in technology will greatly increase recoverable reserves. To what extent? That is the big question. In the long term both Westminster and Holyrood would like to talk up the numbers, the problem for Westminster is that doing so in the short term fuels the Nationalist fire.

### **Shale Gas and Coal Seam Methane?**

This is an important area of energy policy that neither side wishes to bring to the debate. Westminster has made it plain that it views “shale gas” development as an economic priority, though, (probably because of the referendum,) it has restricted talk of current development to England. A review of the recent publications by the Scotsman among others, shows that there is significant potential for Scotland in this area.

While Westminster’s reasons for not bringing this issue to the debate are obvious, the reasons for the “Yes” campaigns reticence are not obvious. Cynics suggest it is because of Salmonds habit of promising “ice cream.” to everybody.

Whatever the results of the referendum, we are going to have to deal with basic unpalatable economic truths about “Shale Gas”. Unfortunately, this leaves voters with the conundrum of :

- “Who do you trust most to develop a policy when neither side is prepared debate the policy issues?”

Important points to remember in any future debate:

- 1) Shale formations that are currently being surveyed are all On-Shore. So, there is room for the possibility of large scale Off-shore “hydro-fracking”.
- 2) The “New York Times” has ran several articles recently pointing out that there is significant geological differences between US and European shale deposits. As a result, with current technology, it is unlikely that European developments will have the same yields as their US counterparts.

### **Renewable Energy**

There is no doubt that Scotland has great potential in the market for renewable energy. There is not only large scale wind and wave power, but great opportunities for micro hydro-electric schemes. A review of the market for Scottish hunting estates shows that a major selling point is their renewable energy potential.. Although this potential is still largely untapped current small estate based hydro schemes are generating revenues of several hundred thousand Pounds per year per estate. (see the brochures for estates currently on the market: Cluny, Auch and Invermearan, Tayinloan..... etc,etc.)

With respect to these micro-hydro projects, once again regardless of the referendum result, we are going to have to face up to some very unpalatable choices. Take for example Auch and Invermearan estate: At the moment it has one large scale hydro-electric project at Loch Lyon which is part of the Breadalbane scheme and a separate privately operated micro-hydro project elsewhere on the estate. The sails brochure lists a further 16 sites around the estate that have hydro-electric potential. I do a lot of my skiing up there, I know the area well and it is truly majestic. On the other hand it is well away from the tourist areas around Cairngorm.

Complicating the issue, the estate straddles the east west rainfall divide and, given official climate projections, a well planned series of hydro projects could mitigate the projected cycles of flooding

and drought. So, what do we do?

- Do we develop major industrial infrastructure in areas of iconic beauty?
- Who do we trust to develop a planning framework for these expected developments?

## The North Sea Grid

One of the more interesting things about long term energy policy is that the next twenty years will see the development of the “North Sea Grid” linking the national grids of countries bordering the North Sea.

The reasons for developing the grid are as much to do with basic engineering problems like “load balancing” of the respective national grids as it is to do with creating a North Sea energy market. The important point to note is that having a large portfolio of small scale generators able to quickly add and subtract power to the grid would make Scotland a powerful player in the operation of this new market.

- Note: The grid will happen regardless of how Scotland votes.

So the questions become :

- 1) Who do you trust to get the best deal for Scotland?
- 2) Why is Westminster currently planning for the connection terminal to be located in the North of England?

## Europe

There is great deal disingenuous posturing about Scotland’s relationship with Europe:

On a UK level senior politicians are gleefully citing EU commission president Barroso about how difficult it would be for an independent Scotland to remain in Europe, while at the same time, those same politicians are planning a referendum of their own to pull the UK, (and Scotland,) out of Europe!

So, let me get this straight, if I want to stay in Europe, who do I vote for ? The Nationalists, who wont be allowed into Europe, or the Unionists who regard the Scottish referendum as distraction from the main goal of getting us, (Scotland included,) out of Europe.

Confused, me too.....

Hyperbole aside, some hard realities:

A number of European Countries, (not limited to Spain,) have restive ethnic groups and view Scotland’s referendum with a great deal of mistrust. Are these countries likely to put up obstacles to Scotland re-joining the European Union? They might, but any serious attempt to impede Scotland from maintaining EU membership would quickly turn around and bite back with a vengeance.

For example, take Spain: Catalonia is the buzzword of the moment but what about Spanish fisherman. They are very militant, with a nasty temper when provoked and make up Europe’s biggest fishing fleet. By international convention Scotland would have an exclusive economic zone

that includes the Spanish fleets favourite fishing grounds.

Scotland's exclusive economic zone would legitimately include areas like: Rockall, Shetland and a very large tranche of the North Sea. This economic zone has a much wider impact than simple fishing and a Scotland outside of Europe would cause serious long term damage to current European development plans. (For example the North Sea Grid above.)

## The Pound

Since Osborne decided to bring up Scotland's relationship with the Pound, it is legitimate to take a long hard look at the Pound itself.

### As a reserve currency

Currently, about 3% of the world's money reserves are held as Pounds thus making the Pound a de-facto reserve currency. Unlike the US there has never been a UK debate about the desirability of having our National currency used by the rest of the world in this manner. We, the UK, have always taken the Westminster line of it being "a good thing" at face value. The truth is that while there are some benefits, there are also some serious downsides and, again, it is an area where Westminster politicians engage in a massive game of smoke and mirrors.

The good points of having a reserve currency come under the term "Exorbitant Privilege". It is a rather dry, technical subject, but, from a feel good, headline point of view, you can summarize the good points as:

- In the short/medium term, interest rates are "usually" lower and imports are cheaper.

Sounds good doesn't it, you can see why Westminster politicians love the idea.

There is a serious downside to this though. To be a reserve currency a national currency needs two main things:

- 1) Stable exchange rates along with low inflation and demurrage.
- 2) Liquidity. There has to be enough of the currency in circulation to facilitate its use.

Taking the first point, the main argument against joining the Euro-Zone currency has always been the freedom to manipulate exchange rate policy. However, to maintain the Pound as a reserve currency we have already sacrificed this freedom. Even worse, supporting the reserve currency can have a seriously detrimental long term effects on interest rates and manufacturing. (Smoke and mirrors)

The second requirement, "Liquidity", is even more important. To provide the liquidity we, the UK, have to run a "current account deficit" which is covered by taking on debt. (As you can see, Cameron and Osborne are again engaging in smoke and mirrors.)

In economics, this liquidity issue has been formalized into the "Triffin Paradox" to quote the relevant article in Wikipedia:

- "The use of a national currency, e.g., the U.S. dollar, as global reserve currency leads to tension between its national and global monetary policy. This is reflected in fundamental

imbalances in the balance of payments specifically the [current account](#): some goals require an overall flow of dollars out of the United States, while others require an overall flow of dollars into the United States. “

You cannot underestimate the importance of this paradox , it is this dichotomy that finally lead to the collapse of Bretton Woods and the Nixon shock. It is also one of the main reasons why the US has always been at best ambivalent about its roll as a de-facto reserve currency, with an active, at times rabidly partisan debate, about its desirability.

So, some good questions for the politicians are:

- 1) How much of a boost would our manufacturing base receive if our national currency was not used as a reserve currency?
- 2) Given the long term damage to the UK economy caused by the use of the Pound as a reserve currency: In the long term, how sustainable is the Pounds current market role?

## Gilts and bonds - overview

Seemingly simple, but so deeply mystifying.

For historical reasons UK government bonds are called gilts, similarly US government bonds are called treasuries. In general, a gilt, (or bond,) has

- 1) **A face value:** the amount the issuer has to pay when the bond reaches maturity.
- 2) **A price:** The amount you would pay to buy a particular bond on the open market.
- 3) **A coupon rate:** a fixed interest rate that is paid on the bonds face value. (The frequency of payments will depend on the terms of the bond issuance.)
- 4) **A yield:** Calculated from the difference between the “face value” and the “price” plus any outstanding coupon payments divided by the time to maturity.
- 5) **A maturity date:** The date when we have to pay back the face value.

The first thing neophytes are confused by is that the yield, moves in opposition to the price:

- If bond prices go up, then yields go down.

## Gilts and bonds – Their function in the economy

In a very simplistic sense, governments issue long term gilts to cover infrastructure costs and short term gilts to smooth out the ups and downs of the current account. Like I say, this is a very simplistic view. In fact gilt prices have an important role to play in regulating the economy and, even if Westminster did not require the money, it would still have to issue enough debt to facilitate this role.

Because of this regulatory role, the high gilt prices, (which translate to lower interest rates,) we have experienced in recent years are not a universally good thing.

For example, if you are a pensioner recently in the market for an annuity pension, you will have discovered that annuity rates are pittance. Currently portfolio managers, not only talk about needing a nest egg in excess of £1 million to fund a decent pension, they also advise against annuities in favour of much riskier balanced stock portfolios. This is just one example of how the

gilt market reaches deeply into every household in the UK.

### **Gilts and bonds – What is a debt crisis?**

Short term debt is cheaper than long term debt and, unfortunately, politicians frequently fall into the trap of using the short term bond market for long term financing. This is what happened with countries like Spain: During the boom years, they took out a lot of short term debt to fund long term financing, continually rolling the debt over into new short term debt as it reached maturation. After the 2008 meltdown, short term debt became much more expensive. When large tranches of debt reached maturation in 2011/12, Spanish bond prices collapsed, yields went through the roof and Spain could no longer afford to roll over its debt.

### **Gilts and bonds – Honestly, how did the UK avoid the recent debt crisis?**

When Gordon Brown was chancellor, he took the opportunity to load up on cheap long term debt. At the time of the 2011/12 crisis, the average time to maturation for UK debt was 14 years, so we simply did not have large tranches of debt up for renewal. Added to this, certain classes of money market funds are legally obliged to invest in “safe” sovereign debt even though, at the time, there was little perceived safety. The final ingredient was “quantitative easing” where the BoE bought UK gilts on the open market, thus raising prices and pushing down yields.

As you can see, Cameron and Osborne do not figure in this story at all. It was just a happy coincidence of a “Canny Scot” and a market bereft of good choices.

(**Sources:** At the time, the New York Times covered this extensively, and unless otherwise indicated you may regard the NYT as my source.)

### **Gilts and bonds – Okay, what about the future?**

This is where it gets scary.

Thanks to Gordon Brown, we do not have to worry about large tranches of his debt coming due for the foreseeable future, however we do have to meet “coupon payments” on this existing debt. Mr “Austerity” Osborne, who took office promising to slash debt has in fact more than doubled our debt load to £1.2 trillion. Whether he has taken the wise course and loaded up with more expensive long term debt, or opted for dangerous cheap short term debt, I have no idea, but would love to find out.

The cracks in the mirror become apparent when you realize how low gilt yields have actually fallen. As I pointed out earlier, gilt yields and annuity rates are directly linked, they rise and fall in tandem. To put gilt yields into everyday terms, if you retired in 1990 you could expect an annuity rate of 15% or 16% if you retired today you would be lucky to get an annuity rate of 5%

Doesn't sound good for pensioners does it, but don't worry, the US is moving away from quantitative easing and, in general, people are talking about a recovery of sorts. The Euro-zone crisis is resolving itself and the investment community is starting to look for higher returns. In other words, barring another global crisis, over the next few years UK gilt yields are set to rise considerably.

This is where the Pound starts to run into serious problems. The scenario goes like this:

- In the two years since taking office Osborne doubled UK debt and projections suggest Osborne's debt load will continue to grow uncontrollably.
- With gilt yields rising, it makes it much more expensive to fund existing debt, never mind taking on the projected new debt.
- This raises a basic question about the UK's solvency leading to a further rise in Gilt yields, raising more questions about our solvency.....

For a more detailed look at this issue, Money Week published an analysis of historical gilt yields called "The End of Britain". It reads like an advertisement and although I do not agree with the overall political sentiment, I think the analysis itself is spot on.

Finally, don't forget that use of the Pound as a reserve currency just adds fuel to the fire.

### **The Pound: Our share of the Osborne's debt?**

Ultimately this will be a question for Lawyers, but, a review of divorce law suggests that although Westminster is responsible for the debt, the size of that debt would be taken into consideration during any final settlement.

In a great many respects, by playing the currency card Osborne has handed the nationalist a trump card that, in the event of a yes vote, can be played during any final settlement negotiations. The truth is Westminster would be in a deep financial bind. UK debt under the Tories is completely out of control and they would desperately need an independent Scotland to take on some of the financial burden. Our willingness to do this, would of course depend on how accommodating Westminster was on other issues.

### **The Pound: Do we need it? Do we even want it?**

The short answer to do we need the Pound is no. The long answer is: starting a new currency from scratch can be a very bruising experience. Exactly how bruising would depend on many things, particularly Westminster. Lets be honest, a vindictive Westminster could make life very difficult for a fledgling Scottish currency. On the other hand, after independence Ireland maintained a currency peg with the UK for over 50 years, only ending the peg in preparation to join the Euro.

One of the things that has not come out in the debate is that, even if Scotland voted to stay with the Pound, things are not going to be plain sailing. There is of course the previously highlighted risk of a debt crisis, but what about the "short sellers"?

I made the graph below in google finance, it shows the historical exchange rates for the Pound against the Dollar and the Euro

At a glance it is apparent that Pound fared very badly during the 2008 meltdown, immediately losing 20% of its value. What is more interesting though is that even at the height of the 2011/12 Euro crisis, when the Tory press was gleefully predicting the collapse of the Euro and Switzerland was making massive currency interventions to contain the rise of the Swiss Franc, the Pound did not regain any of its lost value.



Yes, the big money market funds bought our debt, but only because they had very little choice, sophisticated investors looking for a safe haven to park money avoided the Pound like the plague.

This should give everyone cause for concern, in addition to a high potential for a “UK debt crisis”, there is clearly an underlying mistrust of the Pound in currency markets. As any recovery starts to take hold, and gilt prices rise, it will become ever more difficult to defend the Pounds current position. If the short sellers decide to challenge Westminster monetary policy, given our debt load and relationship with Europe, we would find great difficulty in supporting the Pounds value against a determined attack.

To avoid getting bogged down, have gone into greater detail on the currency question in a follow up discussion paper entitled in “Scottish Economy: Currency and the Financial Industry”, also available at <http://www.liberal.org.uk/>

### **Summary: advantages of the Pound**

- 1) Starting a new currency is not impossible, but the road could be rough.

### **Summary: disadvantages of the Pound**

- 1) For the last forty or fifty years, monetary policy has been run for the benefit of the City of Westminster at the expense of manufacturing and the outlying regions.
- 2) While in the short/medium term current monetary policy brings the benefits of “Exorbitant Privilege”, in the long term it is a policy that is unsustainable, (Triffin Paradox)
- 3) When you strip out the spin and look at the fundamentals, the Pound has serious structural problems and there is no easy way out, neither for England nor Scotland.

## **Geo-Politics**

On the world stage I seriously doubt that there is a single country that is even lukewarm about

Scottish independence and for the most part it is viewed with a great deal of mistrust. While countries will politely claim that Scotland's future is a matter for the Scottish people, many countries have restless regions of their own and greatly fear the consequences of a Scottish yes vote.

For this reason, comments like the one from EU commission president Barroso are to be expected. The thing to remember is that while people like Barroso, (and Osborne,) are very powerful figures, they are speaking as private individuals. In Osborne's case, it is very unlikely he will even be in office when Scotland's use of the Pound comes up for negotiation.

This is an important point, Scotland occupies a very important strategic position both in NATO and in Europe. As a result, in the event of a yes vote, many doors that once seemed closed will miraculously open.

Take two recent examples:

### **Iceland**

When the Icelandic economy collapsed during the 2008 crisis, the Icelandic government quite blatantly played Russia against its European and NATO allies to speedily negotiate a bailout on very favourable terms. Five years later. Iceland is regarded as a success story with three years of economic growth and unemployment around 4.8%. In other words, since 2008 Iceland has broadly outperformed Scotland and the UK. (figures from Wikipedia)

### **Cyprus**

Cyprus also played Russia against its European and NATO allies to its advantage. It is a story that is still being played out and, in all honesty is a real mess. But, in essence, in early 2013, they forced the IMF and Europe to back down from a very punitive bailout.

The Economist said about final bailout deal: "Unfair, short-sighted and self-defeating "

- ..... The bail-out appears to move Europe further away from the institutional reforms that are needed to resolve the crisis once and for all .....

You have to bear in mind here that while the Economist may be correct in its assessment, the initial bailout deal that was rejected would have caused real economic pain to the Cypriot people.

A Der Spiegel article entitled: "'Abject Error': How the Cyprus Deal Hurts EU Strategic Interests":

Had this to say about the final deal

- ..... In strategic terms the EU hurt not only Cyprus and itself, but also the interests of the US and other allies in the West. Europe pushed Cyprus directly into the arms of the Russian government. Not only did this hurt the prospects for its own deal, but it gave leverage to Moscow in the process.....

### **Geo-Politics: summary**

Russia is not the only player in this strategic game. On the global stage the US is even more concerned about China and its open wallet approach to strategic diplomacy. China has negotiated a number of diplomatic deals that US perceives as threatening, particularly those in the US backyard

of South and Central America. I mean even the planned Hinkley Point C nuclear reactor in Somerset is going to be built with Chinese money and expertise.

So as you can see, regardless of hostile statements by powerful individuals, in the event of a yes vote, the game changes substantially and in this new game Scotland will hold a number of trump cards.

## **Independence: an economic boost?**

If Scotland votes yes, then, in effect, the entire country would effectively be emigrating from the UK and this would give a definite economic boost to the Scottish economy. This effect is very well documented in economic journals.

Basically, when a family emigrates, they have jumped out of their comfort zone and local support network into a big wide unknown. They are very strongly motivated to make it a success, they work harder and are much more likely to start new businesses. To see this in action, you just need to look at our Polish population. Ask any Pole and they will have two or three jobs, Walk down Edinburgh's Leith Walk and every other shop is Polish. This is not something that is unique to the Polish, it was the same story with every wave of immigration: Indians/Pakistanis, Chinese, Russian and German Jews all these waves of immigration radically altered our high streets and contributed significantly to new economic growth.

Since we, as a country, would have chosen to emigrate, we would be strongly motivated to make it work and would individually be much more likely to take the chance to start new businesses

### **How much of a boost?**

It is difficult to quantify and a lot would depend on the policies a new Scottish government put in place to exploit and facilitate this effect.

The corollary to emigration is of course immigration of which there have been many studies. A review of recent reports on the effects of immigration suggest the effect could be considerable:

- A recent bipartisan study for the US congress suggested that an aggressive overhaul of immigration could boost growth by 4.8% over twenty years (Usnews.com)
- The conservative-leaning American Action Network , recently suggested that the Senates immigration reforms would create on average 14,000 jobs per congressional district (Usnews.com)
- A recent article published by Reuters quoted figures of 0.8% increase in growth per year.
- The chairman of the UK's Office for Budget Responsibility recently told the commons that restricting immigration would add 20% to the UK's debt load over fifty years. (Sky News)

You have to remember here that although immigration is a corollary to emigration, these studies do not necessarily apply to the question of Scotland emigrating from the UK, but they are indicative of the type of economic boost one might expect.

## **Final Settlement Negotiations**

In the event of a yes vote, Holyrood would open negotiations with Westminster which initially would centre around a timetable towards a Scottish “Independence Day”, followed by a negotiations to resolve the process and timetable for the final independence settlement . The SNP suggests “Independence Day” should be March 2016.

This time-line is naively unrealistic and blatant political opportunism by the SNP!

It is blatant political opportunism because:

- The next Holyrood elections are scheduled for May 2016.

It is naïve because:

- Even assuming the divorce was amicable and negotiations were conducted in friendly and co-operative manner, there is UK national elections scheduled for May 2015. The new incoming Westminster government would undoubtedly want to restart the negotiations from scratch.
- Restarting negotiations with a new Westminster government would actually be in Scotland’s interest, since it is unlikely that Cameron and Osborne will be in office. As a result, previously stated hostile positions taken during this acrimonious debate, for example the Pound and Europe will have no relevance.
- The SNP's timetable is predicated on negotiations between Westminster and former colonies, with little direct claim on the UK. Scotland is not a colony and independence negotiations would be far more wide ranging than either side is currently prepared to admit.
- Given the breadth and scope of any final settlement, to expect to conclude these negotiations in less than 12 months is just plain nonsense. Five years, or one parliamentary term , would be much more realistic and still be a very tight schedule.

## Conclusions

I myself am one of the many undecided voters. On patriotic level, I would love to be able to vote for an independent Scotland on the other hand, I have many doubts. The reasons why I conducted this study was to answer those doubts. One of the things I have found surprising is that, on economic grounds, the argument in favour of an Independent Scotland is a lot stronger than what I initially suspected to be the case. On the other hand the SNP's timetable is just plain pie in sky.

As far as the debate so far is concerned, it is unfortunate that it is being cast in terms of Alex Salmond and the SNP rather than in terms of Scotland and the long term direction of the UK.

Ultimately, I now think that if we vote yes and are prepared to work to make it success, then there is little doubt that an Independent Scotland could thrive.

Balanced against this is a Union, that though iniquitous with respect to things like monetary policy and certain strategic decision making, it is a Union that has survived for over three hundred years. By breaking this Union, like many emigrants before us, we would be taking a big leap into the unknown.

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