House of Commons

Scottish Affairs Committee

The Referendum on Separation for Scotland: no doubt–no currency union

Third Report of Session 2014–15

Report, together with formal minutes relating to the report

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Summary

If Scotland leaves the United Kingdom there will not be a currency union.

The leadership of the three main political parties in the United Kingdom have made statements precluding a currency union, so unequivocal as to leave themselves without any room for manoeuvre. Now, no present or future Chancellor or Government could depart from this policy without totally destroying their credibility. We believe no change to the stated policy of no currency union is possible, either in the run-up to the General Election of 2015 or beyond.

Having taken extensive evidence, we believe this is the correct stance: not only because a joint currency would be against the best interests of both the continuing United Kingdom and a separate Scotland, but also because voters in Scotland deserve to know, before the referendum, what the consequences of their actions will be.

Voters urgently need to be told what the Scottish Government has as a Plan B.

A single currency works today because of the integrated nature of the UK economy and, more importantly, because the nations of the United Kingdom have fiscal, banking and political union.

A separate Scotland entering into a currency union with the continuing UK would mean the Scottish Government handing over control of its monetary policy, including interest rates, and much of its economic policy to a country in which it had no representation.

Similarly, it is difficult to see any benefit to the United Kingdom of accepting the risk of default by Scottish banks and neither side is likely to accept sharing control of their tax and spending policies with what would, by then, be a foreign government.

Thus a currency union would be neither feasible nor desirable for either Scotland or the continuing UK in the event of separation.

The ending of a currency union is likely to have far reaching consequences throughout Scotland but nowhere more so than for Scotland's financial services industry. The Scottish Government must move quickly to provide information as to how it intends to protect the thousands of jobs dependent upon this vital part of the Scottish economy.

Conclusions and recommendations

Currency options

1. The choice of currency has major economic consequences for the future prosperity of Scotland and its people. The Scottish Government's preferred option of a currency union with the continuing UK would require an agreement to be negotiated between the Governments of a separate Scotland and the continuing UK. This has been categorically ruled out by the Chancellor of the Exchequer, the Chief Secretary to the Treasury and the Shadow Chancellor of the Exchequer. A separate Scotland cannot unilaterally impose a shared currency upon the UK and therefore we believe it is essential that the Scottish Government reconsider its position and make public its 'plan B' as a matter of urgency. (Paragraph 43)

2. Even if we leave aside the fact that a shared currency is not in the interests of the continuing UK it is equally clear that the Scottish Government's case for a currency union owes much more to politics than to economics. A formal currency union would mean that there would be substantial and ongoing restrictions on the Scottish Government's levels of Government borrowing and debt, and that Scotland would not have control over its own monetary policy. This is a very strange aspiration for the Scottish Government, which states that the most important decisions about the Scottish economy should be taken by the people of Scotland. This would clearly not be the case in the event of entering a formal currency union with the continuing UK. (Paragraph 44)

3. It is clear from the evidence that we have received, that the Scottish Government's proposal to maintain a currency union while undoing the necessary conditions of fiscal, banking and political union which sustain it, masks the fact that separation would be a hugely significant step that would have major adverse consequences for Scotland and its economy. (Paragraph 45)

4. A separate Scotland could not be prevented from unilaterally adopting sterling. However, sterlingisation would have very serious consequences for Scotland's sophisticated financial services industry, and cannot be presented as being in Scotland's interest. While sterlingisation is therefore not a credible option, it appears to be the Scottish Government's current 'plan B'. We recommend that the Scottish Government should commission and publish work on what sterlingisation would mean in practice. Expert advice, together with the views of the banking and financial services industry, needs to be sought to clarify for Scottish voters the likely impact of any unilateral use of sterling. (Paragraph 51)

5. In the event of separation, a new Scottish State would not be able to satisfy the conditions for membership of the Euro. However, given that a currency union with the continuing UK has been ruled out, a separate Scotland will have to consider seeking to join the Euro and may be obliged to make a commitment to do so as a condition of EU membership. The Scottish Government should therefore clearly set out how it would deal with this conundrum and indicate how and when the convergence criteria are likely to be met. (Paragraph 57)

6. Despite the inherent risks involved, a new Scottish currency would give the Scottish Government the maximum economic leverage required to pursue a separate economic policy–the stated aim of separation. The Scottish Government should therefore explain why a separate currency is not its preferred option, and commission and publish new work on how, and at what cost, a separate currency could be created and the implications for Scotland's fiscal policy. (Paragraph 61)

7. In considering all the advantages and disadvantages of the potential currency options for a separate Scotland, it is clear beyond all doubt that none of the options is as good for Scotland as remaining in the UK, as part of the existing formal currency union as currently configured within the UK state. (Paragraph 63)

Financial services

8. The creation of an international border between Scotland and the continuing UK would put the success of the financial services industry in Scotland at significant risk. We have already seen evidence that significant Scottish financial services companies are preparing to relocate their headquarters, with the consequent effect on Scottish jobs and the Scottish economy, in the event of separation. It is clear from the evidence of contingency planning being undertaken by major finance companies, that the referendum on separation has created uncertainty in the financial services industry. This uncertainty is now unavoidable. However, the more serious effects which may follow in the event of separation can still be avoided. It is important that voters are fully aware of these potential consequences when making their decision. (Paragraph 78)

9. We recommend that the Scottish Government responds to HM Treasury's analysis on regulation of financial services in a separate Scotland and outline how it proposes to address the issues identified, notably how in the absence of a currency union a Scottish system of prudential regulation would work. Otherwise, in the event of a vote for separation, there could be very serious consequences as Scottish firms seek the regulatory certainty they understandably want. We also recommend the Scottish Government details how it would ensure a smooth transition period so as to minimise the impact on business and consumers. (Paragraph 90)

10. The Scottish Government's existing proposals for financial services regulation, and for safeguarding the customers of the financial services industry are unsatisfactory. At present the United Kingdom has a single financial services compensation scheme, which safeguards the savings of Scottish people and those elsewhere in the United Kingdom. This ultimately depends on the resources of the UK taxpayer, and taxpayers' money was used to ensure that the UK Financial Services Compensation Scheme was able to safeguard the savings of all consumers in the recent financial crisis. Given the scale of the Scottish banking sector in relation to the size of Scotland's economy, it is inconceivable that a separate Scotland would be able to offer this degree of security. (Paragraph 94)

11. The Scottish Government should conduct a full impact assessment of the impact of separation on the consumers of financial services in a separate Scotland and the continuing UK, including a quantification of the costs and benefits arising from separation. (Paragraph 95)

1 Introduction

1. A central issue in the debate as to whether or not the people of Scotland should vote in favour of separation on 18 September is the potential impact of separation on the economy of Scotland and the prosperity of its people. Centuries of economic union have meant that the economic fates of both Scotland and the other countries of the United Kingdom are deeply intertwined. Disentangling this union has potentially far reaching economic consequences for everyone in Scotland, as well as for those in the continuing UK.

2. This Report sets out the evidence we have received in relation to two key closely related questions for Scotland's economic future. First, we examine the options available to a separate Scottish State in terms of its choice of currency. Second, we consider the potential implications of separation on the well-established financial services industry in Scotland.

3. The choice of a currency is the single most important economic decision any country makes. It has wide-ranging economic implications. It affects trade with other countries, fiscal policy (government spending and taxation), monetary policy (interest rates and the money supply), inflation and policies relating to financial stability. This affects every resident of Scotland, whether through mortgage payments, prices or wages and is critical for the future of Scottish businesses. The people of Scotland therefore need a comprehensive, realistic and honest assessment of what the options are, what they would mean in practice, and where Scotland's interests lie in making this choice.

4. Today, as part of the United Kingdom, Scotland uses the pound sterling as its currency in a full, formal currency union with the rest of the United Kingdom, as it has done for the last 300 years. The evidence suggests that, today, the United Kingdom forms what economists describe as an "optimal currency area" as it is both an integrated economy and a banking and fiscal union.[1] That means that a single currency and monetary policy are suitable for the whole of the UK. Scotland is currently represented in the Parliament and by the Government which oversees the United Kingdom's monetary institutions, such as HM Treasury and the Bank of England. If Scotland chooses to remain part of the United Kingdom, these arrangements will continue.

5. Were the Scottish people to opt for separation, the new Scottish State would have to make a choice about what currency policy to follow. The Scottish Government continues to state its position that a separate Scotland would retain the use of the pound in a formal currency union with the continuing UK.[2] However, the evidence we have received makes a clear case that this would neither be in Scotland's best interests, nor in the best interests of the continuing UK. A currency union would not be stable in the absence of a fiscal and banking union, and without the long term commitment provided by a political union. A currency union has therefore been explicitly and categorically ruled out by all three major

1 HM Government, Scotland Analysis: Currency and monetary policy, April 2013

2 Scottish Government, Scotland's Future – Your Guide to an Independent Scotland, November 2013

political parties at Westminster[3]. Despite this, Scottish Ministers continue to insist that a currency union would continue after separation and refuse to set out any alternative proposals. It is therefore a matter of deep concern that, a few weeks before the referendum, there is still great uncertainty about one of the most fundamental of issues for any State - what currency it will use. Indeed, the Scottish Government has, to date, been unwilling to acknowledge the reality that a separate Scotland would not have the power to unilaterally impose a shared currency zone on the continuing United Kingdom.

6. This choice has very significant implications for the whole of the Scottish economy, but particularly for Scotland's banking and financial services industry. The financial services industry is crucial to the wider Scottish economy through its contribution to GDP and jobs, both directly and indirectly. HM Treasury argues that the high level of integration across the UK benefits businesses and consumers both in Scotland and in the rest of the UK. Scotland and the rest of the UK benefit from a large domestic market in financial services with no restrictions on buying and selling financial products across the UK.[4]

7. The companies currently based in Scotland who are involved in banking, insurance, savings and other financial services primarily serve markets in the rest of the United Kingdom. Around 200,000 people in Scotland work in this industry.[5] This is, despite recent difficulties, still a Scottish success story, for which the prospect of separation creates a high degree of uncertainty and risks.

8. Financial services is a highly regulated industry. In the event of separation, the Scottish Government would have to create its own regulatory framework. For advocates of separation, this is considered as a potential advantage for the financial services industry. However, the Scottish Government also proposes that those aspects of regulation which deal with the financial stability of the industry should continue to be dealt with at a UK level, by the Bank of England.[6]In the event of separation, the Scottish banking sector would be exceptionally large compared to the size of the Scottish economy, making it more vulnerable to financial shocks than is currently the case as part of the larger UK economy. The exceptionally large and highly concentrated financial services industry of a separate Scotland would be likely to increase the risks, to markets, firms and consumers, of financial services firms operating in a separate Scottish State. Moreover, the loss of a single UK market could have serious consequences for the success of Scotland's financial services industry.

9. We thank all of those who gave oral evidence and submitted written evidence to this inquiry, and in particular to Rt Hon George Osborne, Chancellor of the Exchequer, Rt Hon Danny Alexander, Chief Secretary to the Treasury, and to Ed Balls MP, Shadow Chancellor of the Exchequer. A full list of witnesses is attached in an Annex to this Report.

3 George Osborne, Speech on the prospect of a currency union between an independent Scotland and the continuing UK, 13 February 2014; "Ed Balls: Currency union with Scots 'won't happen'", The Scotsman, 13 February 2014; "For Scotland, separation would be the riskiest step our country has ever taken", 13 February 2014

4 HM Government, Scotland Analysis: Financial services and banking, May 2013

5 http://www.sfe.org.uk/facts.aspx

6 Scottish Government, Scotland's Future – Your Guide to an Independent Scotland, November 2013

2 Currency options

Why does the choice of currency matter?

10. No decision matters more for a country's economy than what currency it uses. It has far reaching economic implications, determining the terms of trade with other countries, and the interest rates paid on borrowing and lending, including, for example, mortgages for homebuyers and loans to businesses seeking to invest. A trusted, stable, currency is one of the greatest assets at country can have.

11. Today, within the United Kingdom, Scotland uses the pound sterling as its currency, in a full economic union with other nations of the UK. In the event of a 'yes' vote on 18 September, a new Scottish State would have to make a choice about what currency to use, as that is a central economic power which would arise from separate statehood.

12. There are four main options in relation to its choice of currency, which would form the basis for the Scottish Government's negotiations with the UK Government:

- using the pound as part of a currency union with the continuing UK;
- using the pound unilaterally ("sterlingisation");
- adopting the Euro; or,
- creating a separate Scottish currency.

13. Each option comes with potential risks and pitfalls, as well as advantages. As Professor John Kay, visiting Professor of Economics, London School of Economics explained, there are three basic choices: currency union with the Euro; currency union with the UK; and an independent Scottish currency.[7] He has subsequently suggested that "sterlingisation", or an 'informal currency union' is also an option.[8]

14. A currency union between countries eliminates transaction costs which arise from having to change currency and removes the risks to trade arising from exchange rate fluctuations. This reduces the costs of trade between countries sharing the same currency.[9] However, membership of a currency union means monetary policy is set for the currency area as a whole and may be less appropriate for an individual part or member of that area. Membership of a currency union would mean accepting constraints on some economic policies in order to maintain the stability of the financial system,[10] and involves accepting

7 Q 358

8 "Scots can be sterling squatters", Financial Times, 8 April 2014

9 "Economic aspects of Scottish independence: currency", House of Commons Library, Standard Note EP/6685, 26 February 2014

10 Ibid.

constraints on the level of government debt and borrowing.[11] It also requires the agreement of the other country or countries involved. These issues are evident in the Eurozone.

15. A separate currency gives a country an extra policy lever through its ability, at least in theory, to run an independent exchange rate and monetary policy. This can give greater flexibility in adapting to economic shocks. It also allows a country to set interest rates in response to its own economic circumstances.[12] Creating a new currency is, however, a major undertaking. It would involve transitional costs, such as the costs of introducing new notes and coins, changing prices and contracts to reflect the new currency, and the costs as businesses and households adapt to the new currency.[13] No estimate of the size of these transitional costs for the establishment of a separate Scottish currency has yet been identified. However, there is the great advantage that a decision to establish a new Scottish currency could be made unilaterally by a separate Scotland.

Currency union

16. The Scottish Government's current stated preferred option is for a formal currency union with the continuing UK, which would mean that, in the event of separation, Scotland would continue to use the pound and the Bank of England would continue to undertake the functions of the central bank of Scotland.[14] A formal currency union could not be decided unilaterally by a separate Scotland but would require the agreement of the UK Government. It would also, assuming Scotland eventually became a Member State of the EU, require the negotiation of special provision in the EU treaties, which state that each Member State must have its own central bank and financial services regulator.[15]

Monetary Policy

17. In terms of monetary policy, the Scottish Government's Fiscal Commission Working Group has argued that economic conditions are similar in both Scotland and the rest of the UK, and that both economies are highly integrated through both trade and migration[16], so a single interest rate and monetary policy would be suitable. The Scottish Government states that, in the event of separation, a formal currency union would be in the best interests of both Scotland and the continuing UK.[17]

18. On 29 January 2014, Mark Carney, Governor of the Bank of England, delivered a lecture in Edinburgh, in which he set out the conditions that are necessary for a successful and stable currency union.[18] He outlined the well-established requirements of an optimal

11 Ibid.

12 Ibid.

13 Ibid.

14 Scottish Government, Scotland's Future – Your Guide to an Independent Scotland, November 2013

15 HM Government, Scotland Analysis: Financial services and banking, May 2013

16 Fiscal Commission Working Group, First Report – Macroeconomic Framework, February 2013

17 Scottish Government, Scotland's Future – Your Guide to an Independent Scotland, November 2013

18 http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech706.pdf

currency area: integrated economies, the free flow of capital and labour and a similar response to external shocks. However, he added that successful currency unions also require both banking and fiscal unions. Banking union is necessary so that problems in the financial system can be resolved quickly and authoritatively, in order to preserve financial stability. Fiscal union is necessary so that taxpayer resources could, where required, support the economies of different parts of the currency union. Drawing on international experience, Mr Carney suggested that stable and successful currency unions require a national authority, operating across the whole union, which has control over funds amounting to around 25% of GDP, comparable in UK terms to about one half of public spending.[19] That last condition would not be met should Scotland become a separate State.

19. The UK Government's analysis[20] points out that as a result of 'border effects', it could be expected that the Scottish and UK economies would gradually diverge post separation, so that the same exchange rate and interest rate policies would not be suitable for either State in the long term. Given the size of the rest of the UK's economy in comparison to Scotland's, monetary policy within a currency union would be more likely to reflect economic conditions in the rest of the UK, rather than conditions in Scotland. In the event of a currency union, post separation, the Scottish Government would, in effect, be handing over control of its monetary policy and hence much of its economic policy, to what would have become another country, in which it had no representation and over whose decisions it would have no say.

20. Sir Nicholas MacPherson, the Permanent Secretary to the UK Treasury, took the unusual step of publishing his advice to Ministers on this issue. He advised against a currency union, and drew particular attention to the problem that it would only be seen to be stable for so long as it was seen to be permanent. Given that the position of the Scottish Government is that currency union was something which could be opted out of at a later date, Sir Nicholas concluded that a currency union between Scotland and the UK would not be in the interests of the continuing UK.[21]

Fiscal Policy

21. The requirement of fiscal union to underpin a currency union is crucial. The Governor of the Bank of England emphasised that currency union without fiscal union was likely to leave parts of the currency union subject to great pressure if the common exchange rate was unsuitable for both economies.[22] This was reinforced in evidence to us by Dr Angus Armstrong, Director of Macroeconomics, National Institute for Social and Economic Research. He explained:

19 Ibid.

20 HM Government, Scotland analysis: Currency and monetary policy, April 2013

21 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/279460/Sir_Nicholas_Macpherson_-_Scotland_and_a_currency_union.pdf

22 http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech706.pdf

> You need to have some fiscal arrangements so that if there is another financial crisis-let's hope there is not another financial crisis one day but they do tend to reoccur-there is a mechanism by which one state could have a claim on the other state […] If you want to have the currency union that is pointed out in the White Paper, it implies that you need to have some sort of banking union, which implies that you need to have some sort of fiscal arrangement between the two sovereign states.[23]

22. The Scottish Government has said voting yes in the referendum would mean that: "the most important decisions about our economy and society will be taken by the people who care most about Scotland, that is by the people of Scotland".[24] Nonetheless, it accepts that a currency union would mean that there would be substantive control over levels of government borrowing and debt, in what it describes as a 'fiscal pact'. The Scottish Government says that although Scotland would not have control over monetary policy, policy levers such as taxation, spending and competition policy would still be available to varying degrees.[25]

23. We cannot envisage a situation in which such economic constraints would be acceptable to a Scotland that had decided to become a separate state; indeed, such constraints could very well be contrary to an independent Scotland's interests. The UK Government has stated:

> A formal currency union between the continuing UK and an independent Scottish state could place a number of demands on fiscal arrangements. It would require a more active fiscal policy to stabilise the economy in response to shocks, in a context where market discipline would reduce the scope for fiscal stabilisation. In addition, it would create important fiscal risks for the continuing UK that it would seek to minimise in any negotiation to form a sterling currency union with an independent Scotland. These conditions would be likely to reduce the sovereignty of the new independent Scottish state over its fiscal choices.[26]

In such a situation, a separate Scotland's interest rates and key aspects of its public finances, tax and spending choices would be decided by a Government and in a Parliament where Scotland was no longer represented.

Financial stability

24. Events of recent years have shown the necessity of stable monetary and financial systems. The Governor of the Bank of England pointed out that there must be well established arrangements for a banking union within any currency union, so that

23 Q 4474

24 Scottish Government, Scotland's Future – Your Guide to an Independent Scotland, November 2013

25 Ibid.

26 HM Government, Scotland Analysis: Currency and monetary policy, April 2013

institutions which get into trouble can, if need be, be rescued and stabilised.[27] The mechanisms for how this process is currently managed in the UK are set out in the UK Government's Scotland Analysis Paper on banking and financial services.[28] These arrangements include a central bank which can provide liquidity to any institution which needs it provided that it is in a position of underlying solvency, a deposit compensation scheme to deal with the possibility that banks may be unable to meet their obligations to customers, and a prudential and customer regulatory framework which is intended to minimise the risks of instability and misconduct.[29] All of these schemes depend ultimately on the resources of government. The Bank of England is backed up by the resources of the UK taxpayer.

25. The House of Lords Economic Affairs Committee has cast doubt on whether the Bank of England would be willing to provide central bank services to financial institutions operating in a separate Scotland.[30] The then Secretary of State for Scotland, Rt Hon Michael Moore MP, told the House of Lords Committee that the Government "would have serious doubts over wanting to provide the lender of last resort facility".[31]

26. Despite this, the Scottish Government maintains that: "it is clearly in the interests of Scotland, and the rest of the UK, for an independent Scotland to share the pound within a monetary union after independence".[32] The UK Government disagrees, noting:

> [...] [T]he economic rationale for the UK to agree to enter a formal sterling union with another state is not clear. The recent experience of the Euro area has shown that it is extremely challenging to sustain a successful formal currency union without close fiscal integration and common arrangements for the resolution of banking sector difficulties. For independent countries to design and agree on such a complex and untested institutional framework would be very challenging.[33]

27. In evidence to us, Dr Angus Armstrong said there are "two fundamental problems" with negotiating a currency union. First, he noted:

> One country is 10 times the size of the other. You can't really get round this thing; it is just a fact. It is conceivable-let's hope it never has to happen-that Scotland could need some support from the rest of the UK one day, but it is pretty inconceivable that Scotland could give support for the rest of the UK. It is just too small.[34]

27 http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech706.pdf

28 HM Government, Scotland Analysis: Financial services and banking, May 2013

29 Ibid.

30 "The Economic Implications for the United Kingdom of Scottish Independence", House of Lords Economic Affairs Committee, 10 April 2013

31 Ibid.

32 Scottish Government, Scotland's Economy: the case for independence, May 2013

33 HM Government, Scotland Analysis: Currency and monetary policy, April 2013

34 Q 4509

Second, he identified that:

> after a yes vote, there would be two independent sovereign states, it means you can pull out at any time. Forming international agreements for countries that can always have a vote and decide the will of the people becomes very difficult. That is why in international law it is so hard to make binding agreements.[35]

28. Furthermore, Ronald MacDonald, Professor of Economics, Glasgow University, argued that a currency union between Scotland and the continuing UK was not the most appropriate regime for an independent country.[36] He explained one of the key reasons for this was that, post separation, Scotland would be allocated a share of the UK's oil. He said: "as soon as you do that, you open the country to what we call "asymmetric shocks," because the rest of the UK is not going to be an oil producer".[37] Any sovereign State requires some way of adjusting to these shocks. Professor MacDonald explained one way is through a transfer mechanism, "which works very well at the moment in the UK because the shocks are internalised within the whole country".[38] However, a separate Scotland would need some mechanism to adjust that. One of the key measures is that the nominal exchange rate would adjust. He said: "If you had a separate currency, your exchange rate would take up the adjustment, but, of course, if you are part of a monetary union, you won't have that".[39]

29. The risks identified are not just potential risks for Scotland, but to the rest of the UK. Professor MacDonald said because Scotland is a relatively small portion of the UK:

> if they were to get the currency arrangements wrong, it could have very significant effects for the rest of the UK. It could lead to a currency crisis. If there was great international unease about the currency arrangements within the UK, speculators and international investors would be inclined to move assets out of sterling, out of the UK basically, which could lead to a very precipitous fall in sterling, with all the consequences that could have for the rest of the economy.[40]

The unsuitability of a currency union

30. A formal currency union works well for Scotland in the United Kingdom today because of the integrated nature of our economy and, most importantly, because the nations of the UK share a fiscal and political union. Our witnesses made clear that these conditions were necessary for a currency union to be stable in the long run. A separate Scotland's economy would be likely to diverge from that of the United Kingdom, and in the absence of a fiscal union, that could mean that the exchange rate for sterling would no

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35 Q 4509

36 Q 4488

37 Ibid.

38 Ibid.

39 Ibid.

40 Q 4490

longer be appropriate for Scotland's economy.[41] Furthermore, Scotland would have no direct influence over the monetary institutions of the rest of the UK, and would tie itself to economic decisions over which it had no influence, so Scotland would have less control over its economic destiny than it has today. For similar reasons, we heard that currency union after separation would not be in the interests of the continuing UK either, as the rest of United Kingdom would be taking on risks from the Scottish economy over which it had no control.[42]

31. The Scottish Government frequently asserts that because Scotland shares a currency within the UK today, sterling is one of the assets of the United Kingdom which must be shared, or shared out, after separation.[43] This argument is, at best, based on a misunderstanding of the nature of our currency and the currency union. The UK's assets and liabilities would have to be shared on a fair and equitable basis in the event of separation, but as Adam Tomkins clearly explained:

> The currency is not an asset; the currency is a means of exchange. The currency does not belong to England any more than it belongs to Scotland. It is not an asset to be apportioned. Individual pound coins or bars of gold, if there are any left in the Bank of England's reserves, are assets that would fall to be apportioned equitably, presumably on a per share of population or something like that, between the two states in the event of independence. […] there is an awful lot of misunderstanding in Scotland around what would happen in the event of a yes vote. There is that misunderstanding in Scotland because Scottish Government Ministers and their supporters routinely confuse the legal position with regard to assets and liabilities with the legal position with regard to institutions.[44]

32. As the Chancellor of the Exchequer also explained: "a currency is much more than the pieces of paper that bank notes are printed on or the metal that is stamped to create a coin. What stands behind it is not a building, like the Bank of England; it is an arrangement. It is 30 million UK taxpayers; it is the monetary framework of the UK. That is what makes for a currency."[45]

33. The First Minister has consistently repeated, however, that "if there is no legal basis for Scotland having a share of the public asset of the Bank of England then there is equally no legal basis for Scotland accepting a share of the public liability of the national debt".[46] Professor Tomkins told us this assertion is based on the Scottish Government's refusal to accept the key distinction between assets and liabilities. He stated that, legally, this was an

41 HM Government, Scotland Analysis: Currency and monetary policy, April 2013

42 Q 4490

43 First Minister Alex Salmond speech, Edinburgh, 17 February 2014 http://news.scotland.gov.uk/Speeches-Briefings/First-Minister-speech-February-17-2014-95a.aspx

44 Q5799

45 Q 5683

46 First Minister Alex Salmond speech, Edinburgh, 17 February 2014 http://news.scotland.gov.uk/Speeches-Briefings/First-Minister-speech-February-17-2014-95a.aspx

"entirely incoherent position" for the Scottish Government to have adopted. He explained, as noted above, "the pound itself, is not an asset to be apportioned, and yet it is frequently, in the Scottish Government's rhetoric, equated with the national debt.[47]

Agreement on currency union ruled out

34. In the light of these clear disadvantages of a currency union for both Scotland and the UK, the three largest UK political parties have ruled out the possibility of a currency union or an agreement to share sterling with a Scotland in the event of separation. Giving a speech in February 2014, Rt Hon George Osborne MP, Chancellor of the Exchequer said:

> If Scotland walks away from the UK, it walks away from the UK pound. […] We have seen how it would be impossible to construct an acceptable banking union, or fiscal union… On this basis, the official advice I have received from civil servants in the Treasury is that they would not recommend a currency union to the Government of the continuing UK. I could not as Chancellor recommend that we could share the pound with an independent Scotland. The evidence shows it wouldn't work. It would cost jobs and cost money. It wouldn't provide economic security for Scotland or for the rest of the UK. The Scottish Government says that if Scotland becomes independent there will be a currency union and Scotland will share the pound. People need to know–that is not going to happen.[48]

35. On the same day, in an article in *The Scotsman*, Rt Hon Ed Balls MP, Shadow Chancellor of the Exchequer, also ruled out the possibility of a currency union:

> I am clear that the next Labour Government cannot enter into a new sterling monetary union to share the pound with an independent Scotland.[…] I want Scotland to stay in the UK. But if Scotland were to vote to break away, then I do not believe a currency union would be in the interests of either an independent Scotland or the rest of the UK.[49]

As part of this co-ordinated response, Rt Hon Danny Alexander MP, Chief Secretary to the Treasury, agreed. He said:

> As a Scot and as Liberal Democrat Chief Secretary to the UK Treasury, on the basis of this analysis, I couldn't recommend a currency union to the people of Scotland and my party couldn't agree to such a proposition for the rest of the UK.
>
> The SNP continue to pretend that an independent Scotland could continue to share the pound. It couldn't, without agreement. […] It simply isn't going

47 Q 5799

48 George Osborne, Speech on the prospect of a currency union between an independent Scotland and the rest of the UK, 13 February 2014

49 "Ed Balls: Currency union with Scots 'won't happen'", The Scotsman, 13 February 2014

> to happen. The SNP now need to work out what their alternative currency proposal is and set it out openly.[50]

36. However, within weeks of these statements, it was reported in *The Guardian* that a "Government minister at [the] heart of [the] pro-union campaign" said "of course there would be a currency union"[51]. The unnamed minister also reportedly said "you simply cannot imagine Westminster abandoning the people of Scotland. Saying no to a currency union is obviously a vital part of the no campaign. But everything would change in the negotiations if there were a yes vote".[52] While the UK Government was quick to deny these claims, the unknown Minister's comments appeared to echo the earlier comments of the First Minister, who reported that Sir Mervyn King, now, Lord King of Lothbury, then Governor of the Bank of England, had told him privately that "your problem is what they (the Treasury) say now, and what they say the day after a Yes vote in the referendum are two entirely different things".[53]

37. Speculation has continued about whether the continuing UK would agree to enter a currency union with a separate Scotland. The Scottish Government asserts that it would be in the interests of the continuing UK to be in a currency union with Scotland, as Scotland is a major trading partner and the exchange rate costs and risk would be damaging for business. In response, the Chancellor of the Exchequer has pointed out that the UK has more trade with the Eurozone than with Scotland, and therefore, on the basis of that argument, Scotland should surely adopt the Euro.[54]. As Professor Ronald McDonald explains, the risks from a collapsing currency union dwarf any gains from reduced transaction costs:

> The certain collapse of such a union would be hugely costly for a Scottish Government and the rest of the UK and create huge uncertainty for all parties involved. The kind of sums that are currently being mentioned as the transactions costs of not re-forming a monetary union with rUK would be small beer indeed compared to the massive costs of the inevitable collapse of the monetary union.[55]

In evidence to us since then, the Chancellor of the Exchequer, Shadow Chancellor of the Exchequer and Chief Secretary to the Treasury categorically and unequivocally ruled out, in very clear and definitive terms, the idea that the continuing UK would enter into a currency union with a separate Scotland.

38. All three senior politicians made this firm commitment to a Parliamentary Committee; that they would not lead the continuing UK into a currency union with Scotland, in any

50 "For Scotland, separation would be the riskiest step our country has ever taken", 13 February 2014
http://www.libdems.org.uk/for_scotland_separation_would_be_the_riskiest_step_our_country_has_ever_taken

Independent Scotland 'may keep pound' to ensure stability", Guardian, 29 March 2014

"Independent Scotland 'may keep pound' to ensure stability", Guardian, 29 March 2014

Alex Salmond pressurises Mark Carney over pound", The Telegraph, 29 January 2014

54 Q 5696

55 www.futureukandscotland.ac.uk/blog/economics-scotlands-currency-choices

circumstances. Despite being given several opportunities to add caveats or conditions to this commitment, all three remained firm that there would be no currency union–thus ruling out any possibility of a currency union being negotiated with a UK Government, whatever its political complexion may be after the 2015 General Election. The Chancellor of the Exchequer stated clearly "the fact is—no ifs, no buts—that Scotland will not be able to share the pound if it votes to become independent".[56] The Chief Secretary to the Treasury stated categorically that a currency union was "off the table"[57], and the Shadow Chancellor of the Exchequer stated that, in the event that he became Chancellor, "It would not happen, it should not happen, and it will not happen if there is a Labour Government".[58] He continued:

> our position is unequivocal: it would not be in the interests of the rest of the UK or Scotland to attempt to negotiate a currency union. It can't be negotiated. It would be flawed, risky and unstable, and I wouldn't embark upon it. No ifs, no buts.[59]

39. The Chancellor of the Exchequer re-emphasised the rationale for this position:

> I have an obligation to put the facts in front of the people of Scotland as they make this decision, and the fact is—no ifs, no buts—that Scotland will not be able to share the pound if it votes to become independent. It is therefore incumbent on those who want Scotland to become independent and who want to take this great economic risk to spell out what their plan is. I have heard no plan.[60]

40. The Chancellor of the Exchequer told us:

> So why is it not in the interests of the rest of the United Kingdom? Because ultimately you would be asking UK taxpayers to provide a safety net to a separate country, which, by the way, has a very large banking system and a much smaller economy. It would be like sharing the bank account and credit card after a divorce.
>
> I do not think that it would be in the interests of the people of Scotland either, because they would be tying themselves to the economic decisions of another country; the interest rate decisions of a Bank of England that they were not involved with anymore; and the tax and spend decisions of this Parliament, where there would not be Scottish Members of Parliament representing their interests. So I do not think that it is in either the UK's or Scotland's interests.[61]

56 Q 5722

57 Q5617

58 Q 5739

59 Q 5753

60 Q 5722

61 Q 5691

41. The Chief Secretary to the Treasury told us:

> The best thing for Scotland is to stay part of the United Kingdom. The best way to keep the pound—in fact the only way to keep the pound—and keep all the benefits of a common currency and all those things is to stay part of the United Kingdom.[62]

42. The Shadow Chancellor of the Exchequer said:

> If Scotland leaves the rest of the UK, Scotland will have fewer jobs, higher interest rates, less investment and less money for public services, and the rest of the UK will lose in terms of jobs and investment too. If, Scotland having left, we then attempted to build back a single currency, it would mean even bigger economic costs for Scotland and the rest of the UK. The UK taxpayer would be in a more vulnerable position; all our standing with international markets would be less secure; and Scotland would pay a bigger price in terms of uncertainty, lost flexibility, more instability and more jobs lost.
>
> I do not want Scotland to leave the Union, but I am absolutely not going to say that if they did we would then do anything that made it worse. Attempting to have a single currency between a newly independent sovereign State called Scotland and the rest of the UK would make things worse, and we won't do it.[63]

43. **The choice of currency has major economic consequences for the future prosperity of Scotland and its people. The Scottish Government's preferred option of a currency union with the continuing UK would require an agreement to be negotiated between the Governments of a separate Scotland and the continuing UK. This has been categorically ruled out by the Chancellor of the Exchequer, the Chief Secretary to the Treasury and the Shadow Chancellor of the Exchequer. A separate Scotland cannot unilaterally impose a shared currency upon the UK and therefore we believe it is essential that the Scottish Government reconsider its position and make public its 'plan B' as a matter of urgency.**

44. **Even if we leave aside the fact that a shared currency is not in the interests of the continuing UK it is equally clear that the Scottish Government's case for a currency union owes much more to politics than to economics. A formal currency union would mean that there would be substantial and ongoing restrictions on the Scottish Government's levels of Government borrowing and debt, and that Scotland would not have control over its own monetary policy. This is a very strange aspiration for the Scottish Government, which states that the most important decisions about the Scottish economy should be taken by the people of Scotland. This would clearly not be the case in the event of entering a formal currency union with the continuing UK.**

62 Q 5628

63 Q 5790

45. **It is clear from the evidence that we have received, that the Scottish Government's proposal to maintain a currency union while undoing the necessary conditions of fiscal, banking and political union which sustain it, masks the fact that separation would be a hugely significant step that would have major adverse consequences for Scotland and its economy.**

Unilateral use of Sterling

46. In the event of a failure to agree a currency union, one option for the Scottish Government would be to continue to use sterling unilaterally–i.e. without a formal agreement with the rest of the UK. This is referred to as "sterlingisation". Based on statements made by Scottish Ministers that the United Kingdom "could not stop" Scotland from using sterling, this may indeed be the Scottish Government's "plan B".[64] There are examples of countries which have opted unilaterally to use another country's currency, for example, Panama which uses the US dollar (referred to as "dollarisation").[65]

47. Adopting another country's currency is a policy often used by countries which have a poor economic record, [66] because linking to another more reputable currency is seen as a way of increasing economic credibility. In evidence to the Committee, Professor MacDonald said the unilateral use of the pound "for a country of Scotland's level of development, […] would certainly be very unusual". [67]

48. The Chancellor of the Exchequer told us:

> I do not think it would be remotely possible for all the great companies that locate and headquarter in Scotland to remain there under the sterlingisation plan. I think there would be challenges for some of those companies to remain even under independence with different currency arrangements, but certainly under sterlingisation. It has never been tried in any economy of anything like the size and sophistication of the Scottish economy, or with anything like the established banking and financial services that Scotland has.[68]

49. The unilateral use of sterling could create problems for Scotland's large financial services industry as it would mean no access to central bank services, such as the Bank of England's role as lender of last resort.[69] As Andrew Bailey, Chief Executive Officer of the Prudential Regulation Authority, explained, "when you come to areas like emergency lending, lending of last resort and anything of a capital nature, it is really the fiscal resources of the state that are being used".[70] Professor Macdonald said that it was "unlikely

64 "Alex Salmond's hints at Plan B on currency: using sterling regardless", The Guardian, 25 February 2014

65 Q 4476

66 John Kay, "Scots who want to leave the UK must be ready to drop sterling", Financial Times, 24 April 2013

67 Q 4514

68 Q 5737

69 "The Economic Implications for the United Kingdom of Scottish Independence", House of Lords Economic Affairs Committee, 10 April 2013

70 Q 4793

that financial markets would view that as a terribly credible regime for an independent Scotland".[71]

50. The Shadow Chancellor of the Exchequer told us if Scotland were to go down the route of sterlingisation, "it would be very short-lived and would quickly end up with Scotland defaulting to its own currency".[72] He explained the needs of the financial system in Scotland would require the sovereign Government essentially to create a currency".[73]

51. **A separate Scotland could not be prevented from unilaterally adopting sterling. However, sterlingisation would have very serious consequences for Scotland's sophisticated financial services industry, and cannot be presented as being in Scotland's interest. While sterlingisation is therefore not a credible option, it appears to be the Scottish Government's current 'plan B'. We recommend that the Scottish Government should commission and publish work on what sterlingisation would mean in practice. Expert advice, together with the views of the banking and financial services industry, needs to be sought to clarify for Scottish voters the likely impact of any unilateral use of sterling.**

Using the Euro

52. Historically, adopting the Euro has been the preferred option of the SNP.[74] The recent problems in the Euro area have made this a less attractive option. John Swinney MSP, the Scottish Government's Finance Minister, said at present he could not "foresee circumstances in which a separate Scotland would want to join the Euro".[75]

53. The potential economic consequences of adopting the Euro are varied and include: the one-off transitional costs related to the introduction of a new currency; an increase in the costs of trade with the continuing UK; lower costs for Scottish businesses trading with other members of the Eurozone; and a greater risk from a fluctuating exchange rate against the pound.[76] If a separate Scotland were to join the Euro, monetary policy would be determined by the European Central Bank (ECB). As the ECB sets interest rates for the Eurozone as a whole, and Scotland would be a small part of the Eurozone, Scottish economic conditions would have a limited influence on the ECB's decisions. This would increase the risk of interest rates being set at an inappropriate level for Scotland.

54. The Scottish Government's Fiscal Commission Working Group has said Scotland's economy is less well aligned with the Eurozone than with the continuing UK.[77] Professor MacDonald told us: "if you are trying to remove the uncertainty of the effects of exchange

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71 Q 4516

72 Q 5763

73 Q 5768

74 "The Economic Implications for the United Kingdom of Scottish Independence", House of Lords Economic Affairs Committee, 10 April 2013

75 Ibid.

76 "Economic aspects of Scottish independence: currency", House of Commons Library, 26 February 2014

77 Fiscal Commission Working Group, First Report – Macroeconomic Framework, February 2013

rates on trade, you are probably better to do it in terms of the continuing UK".[78] When asked about the Euro serving many different economies, Professor MacDonald said:

> If you look at the eurozone, there certainly aren't any net oil exporters within the eurozone. I think I am correct in saying that. The only one that comes close, which has decided to stay outside, is Norway. For me, that would be another reason why you wouldn't want to join the eurozone; an independent Scotland would face these asymmetric shocks which would be very uncomfortable in a one-size-fits-all monetary union of that nature.[79]

55. Dr Armstrong emphasised a different dimension on the issue of joining the Euro. He said:

> What the Euro area will be in the future could look very different from what it has been in the last 15 years, and, in that, there would be fiscal adjustments. Some of these problems of misalignment get dealt with; they are trying to go to this federal system. We don't know if they will get there yet, but if they did one day get there-it is not necessarily optimal because most of the trade is with the UK-maybe you would lose some of that gain from being with sterling, but you get a lot of other advantages. You would become an equal member in a big club and you are no longer next to a guy who is 10 times bigger than you. You are next to 19 other guys all with an equal vote. That is a different structure. Where we are today is a stab in the dark because we don't know what Europe is going to look like.[80]

56. Countries wishing to join the Euro must meet a number of conditions, known as the convergence criteria. Based on the UK Government's existing levels of debt, the likely levels of debt Scotland would inherit, and the borrowing it would immediately have to undertake, it is unlikely that a newly separate Scottish State would meet the convergence criteria for Euro membership.[81] In addition to these formal requirements for Euro membership, countries which wish to join the Euro are required to become members of the European Exchange Rate Mechanism and ensure that the exchange rate between the currency and the Euro is stable for a period of two years so that the currency can be entered at the proper level. Unless Scotland chooses to have its own currency and join the Euro thereafter, it is hard to see how this condition can be met. The Scottish Government will be seeking membership of the EU, and it is likely that one of the conditions set, as for all other new Member States, would be a commitment to join the Euro. If the Scottish Government were to retain its policy of a currency union with the rest of the UK, it is not at all clear how it could give such a commitment in good faith in EU membership negotiations.

57. **In the event of separation, a new Scottish State would not be able to satisfy the conditions for membership of the Euro. However, given that a currency union with the**

78 Q 4532

79 Q 4534

80 Q 4534

81 "Economic aspects of Scottish independence: currency", House of Commons Library, Standard Note EP/6685, 26 February 2014

continuing UK has been ruled out, a separate Scotland will have to consider seeking to join the Euro and may be obliged to make a commitment to do so as a condition of EU membership. The Scottish Government should therefore clearly set out how it would deal with this conundrum and indicate how and when the convergence criteria are likely to be met.

A separate Scottish currency

58. A separate Scotland could decide to introduce its own currency. The main advantage of adopting an independent currency is that it gives Scotland an extra instrument of economic policy - a country with its own currency can adopt its own monetary and exchange rate policy which can help manage the economy. This policy could be tailored exclusively to economic conditions in Scotland. A Report by the Scottish Government's Fiscal Commission Working Group notes that Denmark, New Zealand, Singapore and Norway are all of a similar size to Scotland and all have their own currency.[82]

59. However, there are also disadvantages to an independent currency. Establishing a new currency is a major undertaking, and the principal challenge is to ensure that users of the currency are willing to trust it as a store of value and a means of exchange. First, there would be the one-off costs of introducing the new currency–issuing new notes and coins and the costs of adjustment for households and businesses.[83] The scale of these costs is presently unknown. Second, an independent currency means greater transaction costs when trading with other countries as trade would require currency to be converted and a fluctuating exchange rate would mean greater risk for businesses. This would apply to trade both with the UK and with other countries.[84] Third, large currency fluctuations can cause economic instability. The UK Government has stated a view that a new currency could be at risk of a volatile exchange rate due to Scotland's large oil and gas sector, which would leave the Scottish economy exposed to the fluctuating prices of these commodities and to the unpredictable costs of extraction.[85] Professor MacDonald therefore concluded that it would be in best interest of the continuing UK for Scotland to have its own currency as "it will help to insulate the rest of the UK from bad shocks hitting Scotland".[86]

60. However, a separate currency requires the State to adopt an exchange rate policy. A volatile exchange rate, especially in relation to the UK which is Scotland's biggest trading partner, could result in negative implications for trade. There may therefore be a case for an exchange rate to be fixed or 'pegged' to the pound. Certainly some small States with their own currency seek to keep the rate of exchange stable with a major anchor currency; for example, Denmark does this with the Euro. However, this acts as a major constraint on both fiscal and monetary policy. Currency reserves have to be built up to intervene in currency markets when necessary, and as Professor McDonald explained, monetary policy

82 Fiscal Commission Working Group, First Report – Macroeconomic Framework, February 2013

83 HM Government, Scotland Analysis: Currency and monetary policy, April 2013

84 Ibid.

85 Ibid.

86 Q 4571

is driven by the need to keeping the exchange rate steady rather than by domestic economic policy needs:

> Another option that is currently widely discussed in the media is for an independent Scotland to issue its own currency, through say a newly established monetary authority, but peg the currency to sterling on a parity (one to one) basis. This would in all likelihood have to be set as a currency board arrangement along the lines of the Hong Kong currency board. However such a mechanism is set up it is a form of fixed exchange rate regime. To run and defend a fixed exchange rate regime against speculation you need to have huge foreign exchange reserves.[87]

61. **Despite the inherent risks involved, a new Scottish currency would give the Scottish Government the maximum economic leverage required to pursue a separate economic policy–the stated aim of separation. The Scottish Government should therefore explain why a separate currency is not its preferred option, and commission and publish new work on how, and at what cost, a separate currency could be created and the implications for Scotland's fiscal policy.**

The best option?

62. In summarising the currency options available, Dr Armstrong said clearly that "a non-credible currency proposal" should be avoided.[88] He described going into a referendum with a "currency proposal that nobody thinks is actually going to happen" as "a recipe for capital flight and for all sorts of difficulties".[89] On that basis, he identified a number of currency options:

> one type of currency union is the formal monetary union [...] There are two problems. One is that you can't tie a country down, and the other is that one is so much bigger than the other it means that it is very difficult to negotiate. [...] So you get to another type of currency union, which is the dollarisation or sterlingisation, [...] or your own currency. Between those two, it depends on what could be negotiated around this sterlingisation system to make a hard choice, because you [could] have your own currency, which gives you a lot of economic sovereignty, but [...] you have this very difficult transition period; or you [could] have this sterlingisation, which gives you very little economic sovereignty, but you could manage to put some adjustment factors in to make this easier. It then becomes a choice between those two. My view is that it is no surprise, when you look around the world and see countries the same size of Scotland, with the same sort of wealth as Scotland, that they have their own currency.[90]

87 www.futureukandscotland.ac.uk/blog/economics-scotlands-currency-choices

88 Q 4567

89 Ibid.

90 Ibid.

He concluded that “the worst option is where people are just left with complete uncertainty”.[91] Professor MacDonald agreed:

> There is only one currency option that the economics of currencies suggests will be credible to financial markets and that is an independent currency. That, however, may come at considerable cost and disruption to Scotland in any transition period. But then it would be remiss of an economist not to point out that just as in life so to in currency matters: there is no such thing as a free lunch![92]

63. **In considering all the advantages and disadvantages of the potential currency options for a separate Scotland, it is clear beyond all doubt that none of the options is as good for Scotland as remaining in the UK, as part of the existing formal currency union as currently configured within the UK state.**

91 Q 4569

92 www.futureukandscotland.ac.uk/blog/economics-scotlands-currency-choices

3 Financial services

Scottish financial services as part of the UK

64. Scotland has a strong and competitive financial services industry with a distinct Scottish identity. Scotland's reputation, and the skills of the workforce are often cited as key reasons why businesses choose to locate in Scotland.[93] The financial services industry is crucial to the wider Scottish economy through its contribution to GDP and jobs, both directly and indirectly.

65. Information from Scottish Financial Enterprise (SFE)[94] shows that the financial services industry in Scotland:

- Accounts for 8 % of Scottish GDP;
- Generates around £8 billion for the Scottish economy (more than 8 per cent of Scottish onshore activity);
- Manages over £800 billion of funds;
- Employs almost 100,000 people directly;
- Employs almost 100,00 people indirectly (both together accounting for approximately 7% of Scottish employment); and,
- Accounts for 24 % of all UK employment in life assurance, and 13% of all UK banking employment.

66. Owen Kelly, Chief Executive of Scottish Financial Enterprise, told us:

> Scotland has been a successful international financial services centre for about 300 years, so the pedigree, or history, of the industry in Scotland is certainly an attractive factor for a lot of international investors. In the modern world, perhaps putting the history to one side, what we hear from our members in terms of the attractiveness of Scotland as a place to do business is that it is the skills, the legal and regulatory frameworks-of course, these are UK frameworks-and equally being in the same regulatory and legal frameworks as the largest financial centre in the world, which is London. Clearly, that is a good thing and a good situation to be in. Many international investors and other businesses can operate from Scotland, and yet participate fully in the jurisdiction that contains the largest financial centre in the world.[95]

93 "Scottish financial sector remains resilient", Financial Times, 4 January 2012

94 http://www.sfe.org.uk/facts.aspx

95 Q 4585

67. HM Treasury states that the high level of integration across the UK benefits businesses and consumers both in Scotland and in the rest of the UK. There is a large domestic market in financial services with no restrictions on buying and selling financial products across the UK.[96] The size of the UK market means that firms can spread both funding and risk across a population of 60 million people. More firms and greater competition provide customers with a far greater choice of financial products at a lower cost. SFE estimates that 90% of its members' customers are located in the rest of the UK, and the market is highly integrated for most financial products.[97]

68. Financial services is a highly regulated industry, and although the regulatory framework is a European one, there are separate national regulators. In principle the EU Single Market allows financial services operators legally established in one Member State to establish/provide their services in the other Member States without further authorisation requirements. This is known as "passporting".[98] However, cross-border trade in financial services has not been as successful as envisioned.[99] Professor Ian MacNeil, Professor of Commercial Law, University of Glasgow said:

> The majority of the consumers would be outside Scotland, predominantly in England. Some are in Europe, but we have not had as much branching and passporting business as was originally envisaged in the European model, so there is a big focus on exporting into the English market.[100]

69. When asked about the impact of different regulatory systems on companies based in Scotland wishing to trade with the UK, Andrew Bailey told us:

> Major international firms do not like it, but one of the things they have to put up with is that if they are based in many different jurisdictions-typically they are-they are used to operating under different regulatory regimes.[101]

70. Scottish financial services companies sell freely to consumers throughout the UK as there is a single regulatory and tax framework. Separation would create separate regulatory and tax regimes under two separate Governments. These regimes would be likely to diverge over time, thereby creating barriers to trade that do not currently exist. Experience shows that international borders reduce flows of products, money and people.[102]

71. Some Scottish companies have identified risks from separation and are preparing to move aspects of their business outside Scotland in the event of a vote for separation. For example Standard Life, which employs 5,000 people in Scotland, recently announced that it has started work to "establish additional registered companies to operate outside Scotland,

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96 HM Government, Scotland Analysis: Financial services and banking, May 2013

97 Speech by Owen Kelly, Chief Executive of Scottish Financial Enterprise, at the Scotsman Conference, "A Question of Independence: The Economics of Independence", June 2012

98 http://ec.europa.eu/internal_market/bank/index_en.htm

99 Q 4587

100 Q 4584

101 Q 4785

102 National Borders Matter: Canada-US Regional Trade Patterns, McCallum, 1995

into which we could transfer parts of our operations if it was necessary to do so".[103] Lloyds RBS and the Royal London have made similar statements.[104]

72. Reuters has reported:

> Several banking industry sources have told Reuters that RBS and its part-nationalised rival Lloyds Banking Group, which owns Bank of Scotland and is registered in Edinburgh since it took over HBOS in 2009, are already drawing up contingency plans should the vote on September 18 be for independence.

The main concerns for these Scottish-registered banks are whether they will still be able to count on the Bank of England as a "lender of last resort" and whether their cost of funding would go up if they were downgraded by credit rating agencies because of Scotland's relatively small economy, according to industry sources.[105]

Financial services in a separate Scotland

73. Separation may therefore lead to a markedly smaller financial services market in Scotland, an advantage of which could be specialised firms providing products and services that are tailored and more responsive to the Scottish market.[106] However, the Scottish banking sector would be exceptionally large compared to the overall size of the Scottish economy, making it more vulnerable to financial shocks than is currently the case as part of the larger UK economy. Analysis by HM Treasury shows the assets of the whole UK banking sector (including Scotland's banks) are around 492% of total UK GDP.[107] This is itself large by international standards. Scottish banks have assets totalling around 1,254% of an independent Scotland's GDP.[108] Furthermore, the banking sector in a separate Scotland would be dominated by the two largest banks–HBOS and the Royal Bank of Scotland. As a result, serious questions have been raised about a separate Scotland's ability to stabilise its banking system in the event of a future financial crisis.[109]

74. The Chancellor of the Exchequer explained:

> the Scottish economy—which has been a great success over many decades and it is fantastic that it is growing and creating jobs at the moment—has two very large industries. One is financial services and the other is oil. Sitting within a bigger country like the United Kingdom, we can insulate against increases in the oil price or, more to the point, reductions in the oil price. We can absorb banking crises, even one as big as the near failure of the Royal

103 www.standardlife.com/utility/customer_statement.html

104 Reuters "Analysis - Scottish banks plan quietly as independence debate gets louder", 7 February 2014 http://uk.reuters.com/article/2014/02/07/uk-scotland-independence-banks-analysis-idUKBREA161G020140207

105 Ibid.

106 Q 4586

107 HM Treasury analysis of FSA regulatory data available at www.gov.uk/scotlandanalysis

108 Ibid.

109 HM Government, Scotland Analysis: Financial services and banking, May 2013

> Bank of Scotland. Scotland alone, even in a currency union, would be hugely exposed to one of those things going wrong in the future and have had enough experience in recent years to know that these things are not remote possibilities. They can happen.[110]

The exceptionally large and highly concentrated financial sector of a separate Scotland is therefore likely to increase the risks to financial services markets, firms and consumers in an independent Scotland. As a result, in the event of separation, there are two potential alternative consequences for the financial services industry.

75. In the first scenario, if banks were to make no changes to their group structure and keep their existing headquarters, a separate Scotland would have an exceptionally large financial services industry. In this situation, concerns about financial stability could raise questions for the firms themselves and for markets that finance those firms. There would also be questions for an independent Scotland; it would have to consider what resolution mechanisms–the methods used to sort out financial institutions in crisis or near crisis–to put in place.[111] Alternatively, where banks are faced with greater concentration of risk, they may look to diversify or restructure themselves, for example, so that they are no longer headquartered in Scotland.

76. Owen Kelly told us:

> The idea that you can just unscrew your brass plaque and move it is not quite correct. There are regulatory requirements, certainly in the UK, and I am sure in other jurisdictions. You would have to move a certain amount of decision making and a certain amount of mind and management of the company to show that you were in a position to be subject to the regulation of the UK authorities.[112]

This was supported by evidence from the Chief Secretary to the Treasury who said "the question whether relocation can be achieved simply by moving a "nameplate" without moving job, clearly that is not possible. For financial regulatory purposes the locations of a firm's head office will be determined by the location of the firm's central management and control functions. For practical purposes this usually means the location of a firm's senior management but also central administrative functions such as internal audit and central compliance. So, as a minimum, you would expect to see these high quality jobs transfer with the transfer of a firm's head office".[113]

77. Mr Bailey told us to protect the financial services industry:

110 Q 5695

111 HM Government, Scotland Analysis: Financial services and banking, May 2013

112 Q 4606

113 Letter from Chief Secretary to the Treasury to the Committee, 19 May 2014

> They would need clear answers on the cornerstones of economic policy-currency, fiscal policy, intergovernmental relations and all the things the major financial institutions would naturally look to.[114]

78. **The creation of an international border between Scotland and the continuing UK would put the success of the financial services industry in Scotland at significant risk. We have already seen evidence that significant Scottish financial services companies are preparing to relocate their headquarters, with the consequent effect on Scottish jobs and the Scottish economy, in the event of separation. It is clear from the evidence of contingency planning being undertaken by major finance companies, that the referendum on separation has created uncertainty in the financial services industry. This uncertainty is now unavoidable. However, the more serious effects which may follow in the event of separation can still be avoided. It is important that voters are fully aware of these potential consequences when making their decision.**

Regulation of financial services in a separate Scotland

79. One of the biggest issues in relation to Scottish separation and financial services is regulation. There is currently a single regulatory framework and a number of bodies covering the whole of the UK that include:

- The Prudential Regulation Authority (PRA) which is responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms;
- The Financial Conduct Authority (FCA), a regulator which supervises the behaviour of firms;
- The Financial Services Compensation scheme (FSCS) which compensates eligible depositors, investors and insurance policy holders if a firm fails; and,
- Other bodies including the Pension Protection Fund, The Financial Ombudsman Services and the Money Advice Service.

80. The Scottish Government's analysis in relation to regulation is based on the assumption that Scotland will become a full member of the EU and will retain sterling.[115] While the first assumption is by no means guaranteed, and is only likely to take place after substantial negotiations which presently have an undetermined outcome, the retention of sterling as part of a currency union has been categorically ruled out by the three largest political parties, as discussed in part one of this report. Despite this, the Scottish Government maintains that:

> Membership of the EU and the increasingly integrated single market for financial services will be central to Scotland's continuing success as a leading

114 Q 4846

115 Scottish Government, Scotland's Future – Your Guide to an Independent Scotland, November 2013

> financial centre. We will adopt EU initiatives, just as the UK does at present. The only implication for the rest of Europe, or for multinational companies, is that such rules, regulations and directives will be implemented in 29 countries instead of 28.
>
> Financial products and services (including deposits, mortgages, and pensions) will remain denominated in the same currency. Moreover, as part of the same single market, firms will, in the main, continue to provide products and services to consumers across Scotland and the UK no matter where they are based.[116]

81. As a member of the EU, a separate Scotland would have to have its own financial regulator. A separate Scotland would also need a compensation scheme for depositors, investors and insurance policy holders if a firm fails and it would need to ensure that the compensation scheme is adequately funded.[117] Professor MacNeil told us:

> I think you can analyse the European influence in two aspects. One is what you might call the trade flows in terms of business being done. It is true to say that the cross-border trade flows have not been as great as was originally envisaged when the single market was established. The second aspect is: where do the rules come from? Predominantly, nowadays, the rules come from Europe. That is why I think there is a slightly different picture depending on how you look at Europe as between flow of business and source of rules.[118]

82. The Scottish Government's Fiscal Commission Working Group expressed "a preference for financial stability to be coordinated across Scotland and the UK" and recommended that "key elements of prudential regulation […] be discharged on a consistent basis across the Sterling Zone".[119]

83. On prudential regulation, the Scottish Government says:

> The Fiscal Commission set out that the Bank of England Financial Policy Committee will continue to set macroprudential policy and identify systemic risks across the whole of the Sterling Area. There could be a shared Sterling Area prudential regulatory authority for deposit takers, insurance companies and investment firms. Alternatively this could be undertaken by the regulatory arm of a Scottish Monetary Institute working alongside the equivalent UK authority on a consistent and harmonised basis. The Bank of England, accountable to both countries, will continue to provide lender of last resort facilities and retain its role in dealing with financial institutions which posed a systemic risk.[120]

116 Ibid.

117 HM Government, Scotland Analysis: Financial services and banking, May 2013

118 Q 4587

119 ibid.

120 Scottish Government, Scotland's Future – Your Guide to an Independent Scotland, November 2013

84. The Scottish Government has said the Bank of England will continue to be 'the lender of last resort', saying that where financial resource was required to secure financial stability, there will be shared contributions from both the Scottish and Westminster Governments. This is based on the principle that financial stability is of mutual benefit to consumers in both countries, reflecting the fact that financial institutions both in Scotland and the UK operate with customers in Scotland, England, Wales and Northern Ireland and their stability will benefit all concerned.[121]

85. For conduct regulation, the Scottish Government proposes that this aspect of financial regulation will be discharged by a Scottish regulator which will assume the key responsibilities of the Financial Conduct Authority The Scottish regulator will work on a closely harmonised basis with the UK regulators, delivering an aligned conduct regulatory framework, to retain a broadly integrated market across the Sterling Area.[122]

86. HM Treasury has analysed the Scottish Government's proposals that prudential regulation would be carried out "on a consistent basis across the sterling zone" and conduct regulation would be discharged by a Scottish regulator. It identified problems of accountability where the UK regime is accountable to the UK Government but Scotland would be a separate state. Additionally, it would be difficult to be consistent across the UK and a separate Scotland, with two separate fiscal policies and two sets of macroeconomic conditions. HM Treasury argues that the lack of a consistent framework across the UK would create additional operating burdens for firms and complexity for customers.[123] It further argues that Scottish prudential regulation would lack credibility as it would not have a proven track record; that would mean international counterparties are likely to be more cautious when dealing with Scottish firms, which could potentially harm those firms.[124]

87. When asked about the Scottish Government's proposal that prudential regulation is carried out jointly, Mr Bailey said:

> It is not a system, I think, that is used almost anywhere else in the world. The only possible examples I could find were Greenland and the Faroe Islands, and they are not obvious major financial centres.[125]

He went on to say that this does "not mean to say it could not work".[126] However, Mr Bailey warned that without a currency union, the implications for the regulatory system would be quite considerable, "because you have to regard the regulatory system, particularly the prudential regulatory system, as a structure that is dependent on the choices on currency".[127] The Scottish Government's plans for a mixed system of regulation

121 Ibid.

122 Ibid.

123 HM Government, Scotland Analysis: Financial services and banking, May 2013

124 Ibid.

125 Q 4788

126 Ibid.

127 Q 4816

appear to be an incomplete compromise and, like the proposed currency union, to which they are linked, would work neither for Scotland nor for the UK.

Consumer protection

88. A separate Scottish state would need to establish its own financial consumer protection because of EU requirements that Member States have their own schemes for protecting customers' deposits. A Scottish Government spokesman has been quoted in the Money Observer as saying:

> The Scottish Government would ensure that arrangements for an effective compensation scheme are in place, mirroring the level of protection provided in the UK FSCS, and in line with European harmonised levels of consumer protection.[128]

However, the article also quotes Owen Kelly saying:

> As far as we know, little work has been done on whether or how the FSCS could continue to cover Scottish depositors or savers or, indeed, how or whether a Scottish scheme could cover non-Scottish depositors or savers.[129]

89. Owen Kelly told us:

> [T]he nature of the debate is such that none of the questions business would really like to know the answers to can be answered until after a yes vote, if there is one. If there is a yes vote, we then begin a period of time. The duration is uncertain, although I respect the Scottish Government's statement that it would all be done and dusted quite quickly, or certainly within an 18-month period. There are other views on that, but, even if you accept that 18-month period, it is a period when questions such as what currency we will use and many other things will still not be resolved, so, following a yes vote, inevitably we seem to have to deal with a period of transition and uncertainty.[130]

Professor MacNeil describe the transition period as "the killer".[131] He explained:

> even if firms and customers can envisage the steady state after the transitional period, the risks associated with the transitional period are likely to cause them to make decisions, say, to relocate or not to buy products from that firm, for example in the case of English customers who may be concerned about how the transition is going to work out.[132]

128 Money Observer "Is Scottish independence a financial gamble?" 27 November 2013

129 Ibid.

130 Q 4592

131 Q 4666

132 Q 4667

90. **We recommend that the Scottish Government responds to HM Treasury's analysis on regulation of financial services in a separate Scotland and outline how it proposes to address the issues identified, notably how in the absence of a currency union a Scottish system of prudential regulation would work. Otherwise, in the event of a vote for separation, there could be very serious consequences as Scottish firms seek the regulatory certainty they understandably want. We also recommend the Scottish Government details how it would ensure a smooth transition period so as to minimise the impact on business and consumers.**

Impact on consumers

91. A separate Scotland would be responsible for its own competition and consumer protection, including money advice and financial ombudsman services. HM Treasury analysis indicates that a separate Scotland would create new barriers to business and claims that separation could have a direct impact on individuals' personal finances.[133] Independence would have an impact on customers based in the UK given that 90% of Scotland's financial services industry customers are currently based in the rest of the UK.

92. In the event of separation and the emergence of separate financial jurisdictions, there would be implications for the following financial products:

I. Bank accounts - financial transactions that take place across an international border can create additional costs on both sides, notably because the banks or the states operate different polices.[134]

II. Pensions - 70% of all pension products bought by Scottish consumers are from firms based in the rest of the UK.[135] Analysis by the Institute of Chartered Accountants Scotland shows that if Scotland were to become a separate State, "the potential impact on funding requirements for employers operating defined benefit or hybrid schemes across the UK is likely to be substantial."[136]

III. Mortgages - it is rare for mortgages to be sold across borders given the complications of operating across the differing tax, regulatory and legal systems of different states.

The Shadow Chancellor of the Exchequer told us "Scotland would lose jobs, mortgage rates would be higher, taxes would go up and public spending would be cut. That does not sound very attractive in the short term, unless you believe there is some other benefit."[137]

133 HM Government, Scotland Analysis: Financial services and banking, May 2013

134 Ibid.

135 HM Treasury analysis of FSA product sales data for the financial year ending March 2012, available at www.gov.uk/scotlandanalysi

136 Scotland's Pensions Future: What Pensions Arrangements Would Scotland Need? ICAS, April 2013

137 Q 5762

93. Owen Kelly identified five key questions[138] surrounding separation of relevance for investors and savers, both within Scotland and outside:

- What currency could be used?
- Under what terms could Scotland be a member of the EU?
- What will be the effects of independence on the current single market for financial services in the UK?
- How long would a transition to independence take and how would the process be managed?
- What would be the requirements for financial regulation?

While the Scottish Government has set out its view on these issues in its White Paper, a comprehensive and definitive set of response to these questions has yet to be produced.

94. **The Scottish Government's existing proposals for financial services regulation, and for safeguarding the customers of the financial services industry are unsatisfactory. At present the United Kingdom has a single financial services compensation scheme, which safeguards the savings of Scottish people and those elsewhere in the United Kingdom. This ultimately depends on the resources of the UK taxpayer, and taxpayers' money was used to ensure that the UK Financial Services Compensation Scheme was able to safeguard the savings of all consumers in the recent financial crisis. Given the scale of the Scottish banking sector in relation to the size of Scotland's economy, it is inconceivable that a separate Scotland would be able to offer this degree of security.**

95. **The Scottish Government should conduct a full impact assessment of the impact of separation on the consumers of financial services in a separate Scotland and the continuing UK, including a quantification of the costs and benefits arising from separation.**

138 http://www.scotlandfutureforum.org/assets/library/files/application/Kelly.pdf

4 Conclusion

96. We have emphasised in this report that the economic future of a separate Scotland would be determined, more than by anything else, by its choice of currency. It appears the Scottish Government's proposal for a continued sterling currency union is driven by the political aim of “de-risking" the idea of separation rather than by proper economic analysis of what would be best for Scotland in these circumstances. The issue is too important to be dealt with in this way.

97. The evidence which we have heard suggests very strongly that a currency union between the continuing UK and a separate Scotland would not work well for either country. Scotland would be tied to an exchange rate which became less and less suitable for its economy, and heavily constrained in its economic policy. Without a banking and fiscal union, and the political union which is essential to sustain it, such a currency union would be unstable.

98. It is not too late for the Scottish Government–or for independent analysts and economists–to present to the Scottish people the other options which are available, and as the option which appears to be favoured by Scottish Ministers is simply to use the pound sterling unilaterally, the implications of this should be urgently explored. Nowhere is this more significant than in the case of Scotland's banking and financial services industry, which is a very important part of the Scottish economy, and a historical Scottish success story, founded on selling products and services to customers primarily based elsewhere in the United Kingdom. The uncertainties created by referendum have already begun to affect this industry, with significant Scotland-based companies setting out contingency plans to relocate their headquarters to elsewhere in the UK where most of the customers are. The uncertainties they face are greatly enlarged by the reality of the currency choices a separate Scotland would have to make.

Appendix 1: Correspondence from Rt Hon Danny Alexander MP

Letter from Rt Hon Danny Alexander MP, Chief Secretary to the Treasury, 19 May 2014

The Referendum on Separation for Scotland

At my appearance before your Committee last week, I committed to writing to you setting out my views on mortgage costs, financial regulation and EU fiscal rules if Scotland voted to become independent.

As set out in Scotland analysis: Financial services and banking, the price of mortgages is usually based on an average of retail and wholesale funding costs - known as the "fund transfer price". There are a number of reasons why the fund transfer price and therefore mortgage interest costs would be higher if sovereign debt interest costs rose. This includes the sovereign's role as the fiscal backstop and the role that sovereign debt plays in providing collateral for wholesale funding.

Assessing this relationship for a sample of countries that experienced downgrades over the August 2007 - May 2011 period, the Bank for International Settlements (2011) concluded that 64 per cent of domestic banks in their sample experienced their credit ratings lowered within six months following the sovereign downgrade and this relationship is particularly strong for those countries that experienced a significant deterioration of their sovereign credit risk, such as after a default.

The National Institute of Economic and Social Research have estimated that sovereign borrowing costs in an independent Scotland would be higher than UK borrowing costs by up to 1 .65 per cent. Professor Charles Goodhart found that an independent Scottish state could easily pay an interest premium over the UK rate of above 1 per cent "even if economic events went quite well, potentially spiking far higher, as seen in the euro area, if economic developments should deteriorate". Professor Ronald MacDonald commented that "it is now widely accepted that an independent Scotland would incur a premium on its debt... This premium would be determined by financial markets but is likely to be in the region of 1 - 2 per cent above what HMT would have to pay on similar UK debt". Citigroup and Deutsche Bank have similar estimates.

If sovereign interest rates increased by 1.65 per cent and 75 per cent of this increase were passed through to banks and mortgage holders, the first year's repayments on the average Scottish house, assuming a 75 per cent loan to value mortgage, would increase by £1700.

On financial regulation and the question of whether relocation can be achieved simply by moving a "nameplate" without moving jobs, clearly that is not possible. For financial regulatory purposes the location of a firm's head office will be determined by the location of the firm's central management and control functions. For practical purposes that usually means not only the location of the firm's senior management but also central administrative functions such as internal audit and central compliance. So, as a minimum, you would expect to see these high quality jobs transfer with the transfer of a firm's head office.

More broadly both Standard Life and Alliance Trust have already announced that they are putting in place arrangement to establish companies and functions registered outside of Scotland. It is inevitable that Scottish financial sector jobs would follow. After all up to 90 per cent of financial products sold by Scottish- based firms are sold not to Scotland but to the rest of the UK. The Governor of the Bank of England Mark Carney said to the Treasury Select Committee that, in the event of Scottish independence, it is a distinct possibility that RBS and Lloyds would consider moving head offices to the continuing UK. This is due to EU rules under CRD IV, the BCCI directive.

The Committee also asked about the fiscal rules that an independent Scotland would be subject to as a non-euro area member of the EU, and whether it would be bound to joining the euro. As I noted during the Committee meeting, the Government recently published a 'Scotland analysis' paper on the EU and International Issues which explores these issues. The following extracts from this paper answer the questions that arose:

3.34 *As part of the negotiations of its EU membership, an independent Scottish state would need to resolve the question of euro membership. The EU Treaties oblige EU Member States to adopt the euro upon meeting certain monetary and budgetary convergence criteria; only the UK and Denmark have negotiated exemptions. Under EU enlargement criteria, membership of the single currency is obligatory for all accession states, and all countries that have joined the EU since 1993 have been formally required to commit to adopt the euro in due course.*

3.36 *The current Scottish Government's stated policy of a formal sterling currency union with the rest of the UK is at odds with the formal EU requirement for a commitment to join the euro, as well as acceptance of the Maastricht conditions on deficit and debt, as part of the acquis. Since an independent Scottish state would be a new state and would have to go through some form of accession process to become a member of the EU, it would in principle be required to make a formal commitment to adopt the euro at some time in the future, unless it were able to negotiate a formal opt-out. Such a decision would not be in the hands of the continuing UK or an independent Scottish state but would require the agreement of all 28 EU Member States.*

3.39 *Adopting the euro would result in an independent Scottish state being subject to sanctions and stronger fiscal and economic rules than non-euro area countries under the EU's Stability and Growth Pact and the European Semester. For example, it would be required under Article 126.1 of the Treaty on the Functioning of the European Union (TFEU) to "avoid excessive deficit", defined as a deficit of 3 per cent of Gross Domestic Product (GOP) and a debt of 60 per cent of GOP. The UK, as a result of its opt-out from the euro under Protocol 7 5 of the TFEU, is only required to "endeavour to avoid excessive deficit". The UK cannot face any form of sanctions under the Stability and Growth Pact as a result of Protocol 15, which exempts the UK from coercive measures.*

3.40 *In the event that an independent Scottish state failed to avoid excessive deficit and was placed in the EU's excessive deficit procedure, the European Council would agree recommendations oh correcting the deficit. These would set out the measures that an independent Scottish state should take to get its deficit below the 3 per cent target. In the event that these recommendations were not implemented, the Council of the EU could decide, on the basis of a Commission recommendation, that an independent Scottish state had failed to take effective action to correct the deficit and it could subsequently face annual fines from the EU up to 0.5 per cent of its GOP.*

3.41 *In the event that an independent Scottish state did not have an excessive deficit, it would still be required to make progress towards a Medium-Term Budgetary Objective, which is a deficit well below 3 per cent. Again, in the event of inadequate action to meet this objective, an independent Scottish state could face sanctions under EU rules. Under the recently agreed reform to euro area governance (the Budgetary Monitoring Regulation, commonly known as 'the two pack'), an independent Scottish state would have to submit a draft budgetary plan to the Commission every October for the opinion of the Commission and for discussion by other euro area Member States.*

3.42 *As well as stronger fiscal rules, an independent Scottish state would also face stronger economic surveillance measures if it were to join the euro. Under the EU's new macroeconomic imbalances procedure, an independent Scottish state could face sanctions if an excessive macroeconomic imbalance in its economy was identified by the Council and it failed to correct it in sufficient time. In addition, it could face sanctions in the form of what is known as macro- conditionality, where budget payments would be suspended in the event that it did not comply with economic and fiscal recommendations. The latter would apply even if an independent Scottish state was not a member of the euro. The UK has secured an opt-out from this.*

3.44 *Of course, an independent Scottish state may not be ready to join the euro immediately on joining the EU. Those countries that are committed to join but have not yet met the criteria for doing so have what is called a 'derogation'. Those countries cannot face sanctions before they join the euro (apart from in the form of macro-conditionality as outlined above) but must take steps to meet the convergence criteria to ensure their economies are ready to join the euro. Progress is assessed annually. The UK is not required to prepare to join the euro given its opt-out.*

Additionally, the Committee specifically asked about Croatia's position with regards to its deficit and joining the euro. As mentioned above, all EU Member States are committed to join the euro unless a specific opt-out has been negotiated. This applies for Croatia, which did not negotiate an opt-out as part of its accession process. Moreover, with a deficit of around 5% GDP, Croatia has been placed in the Excessive Deficit Procedure, with a deadline of correcting its deficit to below the EU's 3% deficit to GDP target of 2016. In the event that Croatia fails to meet this target, it would not face euro area only sanctions (as a Member States with a temporary 'derogation'). However, it could face sanctions in the form of 'macro-conditionality' as outlined above.

I am copying this letter to the Chancellor of the Exchequer and the Secretary of State for Scotland.

Danny Alexander

May 2014

Formal Minutes

Wednesday 16 July 2014

Members present:

Mr Ian Davidson, in the Chair

Mike Crockart	Sir Jim Paice
Mark Menzies	Simon Reevell
Graeme Morrice	Mr Alan Reid
Pamela Nash	Lindsay Roy

Draft Report (*The Referendum on Separation for Scotland: no doubt – no currency union*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 98 read and agreed to.

Summary agreed to.

A Paper was appended to the Report as Appendix 1.

Resolved, That the Report be the Third Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Tuesday 5 August at 10.00 a.m.

Witnesses

The following witnesses gave oral evidence. The evidence is available on the Committee's inquiry page at www.parliament.uk/scotaffcom

Wednesday 15 May 2013	*Question number*
Rt Hon Michael Moore MP, Secretary of State for Scotland, **Rt Hon Danny Alexander MP,** Chief Secretary to the Treasury, **Chris Flatt,** Deputy Director, Constitution, Scotland Office, and **Stephen Farrington**, Deputy Director, Economics Group, HM Treasury	Qq3059–3157
Wednesday 12 June 2013	
Dr Angus Armstrong, Director of Macroeconomic Research, National Institute of Economic and Social Research, and **Carl Emmerson**, Deputy Director, Institute for Fiscal Studies	Qq3288–3385
Wednesday 19 June 2013	
Sajid Javid MP, Economic Secretary to the Treasury, **Rt Hon Michael Moore MP,** Secretary of State for Scotland, **Andy Drought,** Financial Services and Economic Engagement Team, Scotland Office, and **Paul Doyle,** Devolved Countries Unit, HM Treasury	Qq3386–3541
Tuesday 10 December 2013	
Paul Johnson, Director, **David Phillips,** Senior Research Economist, and **Gemma Tetlow,** Programme Director, Institute for Fiscal Studies	Qq3964–4041
Wednesday 5 February 2014	
Dr Angus Armstrong, Head of Macroeconomics and Finance Group, National Institute of Economic and Social Research, **Professor David Bell**, Professor of Economics, University of Stirling, and **Professor Ronald MacDonald**, University of Glasgow	Qq4447–4582
Wednesday 26 February 2014	
Owen Kelly, Chief Executive, Scottish Financial Enterprise, and **Iain MacNeil**, Alexander Stone Chair of Commercial Law, University of Glasgow	Qq4583–4861

Wednesday 7 May 2014

Rt Hon Danny Alexander MP, Chief Secretary, HM Treasury
and
Dave Ramsden, Director General, Chief Economic Adviser, HM
Treasury Qq5616–5678

Wednesday 14 May 2014

Rt Hon. George Osborne MP, Chancellor of the Exchequer, and
Sir Nicholas Macpherson, Permanent Secretary to the Treasury Qq5679–5738

Wednesday 18 June 2014

Rt Hon Ed Balls MP, Shadow Chancellor of the Exchequer, and
Cathy Jamieson MP, Shadow Financial Secretary to the
Treasury Qq5739–5790

List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2010–12

First Report	Portal Services in Scotland	HC 669 (HC 884)
Second Report	Video Games Industry in Scotland	HC 400 (Cm 8067)
Third Report	UK Border Agency and Glasgow City Council	HC 733
Fourth Report	The Scotland Bill	HC 775
Fifth Report	Student Immigration System in Scotland	HC 912 (Cm 8192)
Sixth Report	The Referendum on Separation for Scotland: Unanswered Questions	HC 1806
Seventh Report	The Crown Estate in Scotland	HC 1117
Eighth Report	The Referendum on Separation for Scotland: Do you agree this is a biased question?	HC 1942

Session 2012-13

First Report	A Robust Grid for 21st Century Scotland	HC 499
Second Report	The Referendum on Separation for Scotland: making the process legal	HC 542
Third Report	The Referendum on Separation for Scotland: a multi-option question?	HC 543
Fourth Report	The Referendum on Separation for Scotland: Terminating Trident—Days of Decades?	HC 676 (HC 861)
Fifth Report	The Future of HM Coastguard in Scotland	HC 583
Sixth Report	The Referendum on Separation for Scotland: The proposed section 30 Order—Can a player also be the referee?	HC 863
Seventh Report	The Referendum on Separation for Scotland: Separation shuts shipyards	HC 892
Eighth Report	The Referendum on Separation for Scotland: How would Separation affect jobs in the Scottish Defence Industry?	HC 957 (HC 257)
Ninth Report	Blacklisting in Employment: Interim Report	HC 1071

Session 2013–14

First Report	Remploy Marine Fife	HC 454
Second Report	The Referendum on Separation for Scotland: The Need for Truth	HC 828
Third Report	The Referendum on Separation for Scotland: A Defence Force for Scotland-A Conspiracy of Optimism?	HC 842
Fourth Report	The impact of the bedroom Tax in Scotland: Interim Report	HC 288
Fifth Report	The Crown Estate in Scotland: follow up	HC 889
Sixth Report	Blacklisting in Employment: addressing the crimes of the past; moving towards best practice	HC 543
Seventh Report	Referendum on Separation for Scotland: the impact on higher education, research and tuition fees	HC 1144
Eighth Report	Land Reform in Scotland: Interim Report	HC 877
Ninth Report	The impact of the Bedroom Tax in Scotland: Plan B—charges, arrears and refunds; incorporating the Government Response to the Committee's Fourth Report of Session 2013-14	HC 937
Tenth Report	Zero Hours Contracts: Interim Report	HC 654
Eleventh Report	Power Outages and Extreme Weather Conditions in the West of Scotland	HC 484
Twelfth Report	The Referendum on Separation for Scotland: Scotland's membership of the EU	HC 1241
Thirteenth Report	Blacklisting in Employment–Update: Incorporating the Government's Response to the Sixth Report of Session 2013-14	HC 1291
Fourteenth Report	The impact of the Bedroom Tax in Scotland: Developing the DHP cap	HC 1292

Session 2014–15

First Report	The Referendum on Separation for Scotland: Implications for Pensions and Benefits	HC 498
Second Report	Our Borderlands–Our Future	HC 556