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MACROCOSM

The Untied Kingdom

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Donald Luskin with research input from **Lorcan Roche Kelly**

Worst case without Scotland: gilts get slightly junked. But no currency crisis, no contagion.

If Scotland separates from the United Kingdom, as polls indicate that it very well might in next week's referendum, there will follow a prolonged period of uncertainty overhanging sterling asset markets.

- Recent sterling weakness could indicate a whiff of that fear.
- But we think that's more a dollar phenomenon. The dollar has been strengthening against *all* major floating currencies, not just sterling (sterling hasn't particularly weakened versus the euro -- and as far as we know Scotland isn't planning on separating from Japan). The dollar strength probably says more about next week's FOMC meeting and the path of US short-term rates, not next week's Scottish referendum.

The Scottish referendum next Thursday asks voters to answer yes or no to the question, "Should Scotland be an independent country?" Only a simple majority is required.

- The most recent YouGov poll shows "yes" with 47% of the vote and "no" with 45%. The 8% that are "undecided" are greater than the difference, so it could go either way -- but "yes" appears to be on an upward trend.
- If the vote is "yes," then there would be an 18-month period of negotiations on the exact terms of separation, none of which is currently agreed.
- So a "yes" vote is the equivalent of simply saying, "Honey, I want a divorce." The long process afterward of divvying up the assets, the liabilities and the kids is the hard part that comes later, leading over 18 months to a planned Scottish Independence Day. The negotiations could potentially be acrimonious, and involve some brinksmanship that could rattle markets.

Ahead of the vote, there are rumors of various sorts of capital flight from Scotland. Rumors are to be expected, and perhaps some realities, too -- much as there was something of a preference for liquidity in late 1999 as the overhyped Y2K rollover date neared. So it is now in the run-up to the Scottish referendum, with UK officials alternately trying to charm the

Update to strategic view

EUROPE MACRO, EUROPE BONDS, FX: A "yes" vote for Scottish independence next week would usher in a period of uncertainty for sterling assets, while Scotland and the UK negotiate difficult matters of separation -- especially how outstanding gilts are to be honored. The worst case is that gilts would get slightly "junked," if the UK ends up liable for Scotland's share of national debt with no compensation. The UK's position now is that an independent Scotland won't be welcome to use sterling, and the EU has said that membership won't be automatic, so it can't use the euro either. A simple currency board -- not unlike today's practice for Scottish banknotes -- is a ready alternative. We see no potential here for financial contagion.

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Scottish electorate with promised concessions, and scare it with dire predictions of economic doom.

But for markets, the issue with scale and bite is the matter of dealing with the UK's shared liabilities with Scotland. Obligations undertaken by the UK with third parties -- notably sovereign debt, that is, gilts -- would presumably have to be honored by the UK ex-Scotland, even if Scotland were to refuse to compensate the UK for its share. Such a situation would make the UK less creditworthy by leaving its indebtedness unchanged, while reducing its GDP to the extent of lost Scottish output, something on the close order of 10%. It would likely not be a feasible option for the UK to "spin out" some fraction of each government bond as a separate obligation of Scotland. We see this as the biggest potential issue -- one over which the UK and Scotland might play hardball during the negotiating period, to the great discomfort of gilt investors.

- *But the worst case here is that gilts would get slightly "junked." This is not the stuff of sovereign debt crises.*

The negotiations over liabilities -- and North Sea oil revenues, and siting ballistic nuclear missiles, and a million other matters -- might have be carried out in a fraught political environment. That might begin with a mutiny within the governing Conservative Party against Prime Minister David Cameron, branded as the man who lost the United Kingdom. This would be highly ironic. The exit of Scotland's 59 members from the House of Commons -- mostly Liberals and Labourites -- would leave Cameron's Conservatives with a parliamentary majority they don't have today.

We are not especially worried about what an independent Scotland would do for money.

- The Scottish separatists wish to continue to use sterling -- though yesterday Bank of England Governor Mark Carney admonished Scotland that a sterling currency union would "incompatible with sovereignty." One would think that an independent Scotland and the UK would qualify in anyone's book as an "optimal currency area." Be that as it may, all three UK parties have taken the position that an independent Scotland will not be permitted to use sterling -- or at least that is today's negotiating position.
- But an independent Scotland, as a tiny nation of 5.3 million people struggling to create all the institutions of nationhood, isn't in an optimal position to go it alone with a new currency.
- Scotland's simplest alternative would be a "currency board," in which it accumulates sterling and issues an equivalent amount of Scottish currency, at a fixed 1:1 exchange rate. A very successful European experience with a currency board was the newly independent Estonia's peg to the deutschemark in the early 1990s, after its independence from the USSR.
- Something very much like a currency board already exists today in Scotland. Scottish pound banknotes in circulation today -- distinct from UK pound banknotes -- are issued by the three largest

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Recommended Reading

From Crisis to Confidence: Macroeconomics after the Crash
Roger Koppl
Institute of Economic Affairs
August 15, 2014

So Bill Gates Has This Idea for a History Class...
Andrew Ross Sorkin
New York Times Magazine
September 7, 2014

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Scottish banks, and are not legal tender in the UK outside of Scotland. They are backed pound-for-pound by deposits with the Bank of England.

- It's a non-starter for an independent Scotland to join the euro currency union. To do that, it would have to first be a member of the European Union. There is no precedent for national separation within the EU -- but EU leadership has made it clear that an independent Scotland should not regard membership in the EU -- nor NATO -- as automatic. Indeed, with an active separatist movement in Catalonia aggravating Spain's difficult return to growth, the EU has no motive to send the signal that breakaway nations will be welcome.
- *In the darkest days of the euro currency crisis of 2010-2012, the possible exit by any individual member of the currency union opened up the risk of a chaotic 17-way break-up, entailing widespread bank runs, sovereign defaults and capital controls. We don't see an analogous situation in Scotland's potentially exiting sterling. When one member leaves a union of two members, that event itself is the maximum of contagion, leaving at most the single other member with an unwanted situation -- there is no third, fourth or seventeenth member to become infected.*

Unwelcome in the EU, the euro area, the sterling area, and NATO -- we don't see how this sets the stage for the tiny new nation of independent Scotland to flourish. But that's no matter to the world economy. The key question is whether Scottish separation opens the door to the kind of financial contagion that Europe experienced so intensely in 2010-2012. On *that* referendum, we are confident the vote will be "no."

Bottom line

A "yes" vote for Scottish independence next week would usher in a period of uncertainty for sterling assets, while Scotland and the UK negotiate difficult matters of separation -- especially how outstanding gilts are to be honored. The worst case is that gilts would get slightly "junked," if the UK ends up liable for Scotland's share of national debt with no compensation. The UK's position now is that an independent Scotland won't be welcome to use sterling, and the EU has said that membership won't be automatic, so it can't use the euro either. A simple currency board -- not unlike today's practice for Scottish banknotes -- is a ready alternative. We see no potential here for financial contagion.