The Governance foundation

# The Bank will decide on Scottish Currency, not Politicians

*Alan Middleton*

August 2014

When the Governor of the Bank of England said he had contingency plans for a Yes vote in the referendum on Scottish independence on 18 September 2014, he was not alone. Mark Carney's job to protect Sterling involves close collaboration with the UK private banking system, including the so-called 'Scottish' banks. They too, as the Clydesdale Bank has already acknowledged, have been involved in contingency planning.

Chancellor George Osborne and his Labour shadow Ed Balls have insisted that, if the Scots vote for independence, they will not be able to retain sterling as their currency. A constant refrain has been the demand that Alex Salmond should set out his Plan B in the event of being unable to use British currency**.**

Contrary to what Westminster politicians are saying, however, Salmond does not need a Plan B for the future of Scottish currency. He doesn't even need a Plan A. Carney's contingency is Plan A.

When politicians on all sides promote themselves as decision-makers in the question of what currency an independent Scotland will use, they are being naïve or misleading. It will not be Alex Salmond or George Osborn who will decide.

The private and partly nationalised banks that are authorised to issue Scottish notes by the Bank of England will act in their own interests to avoid the uncertainty after the referendum, with or without political support. And the outcome will confirm UK Sterling as the Scottish currency.

Buried in this decision, however, lurk serious dangers for the future of an independent Scotland, particularly when the interests of the nation-state come into conflict with those of multi-national corporations. There are lessons to be learned by Scottish politicians about the power of such institutions.

If the decision is Yes, the politicians promise an indeterminate period of uncertainty and confusion, as they wrangle for up to two years before agreement is reached between Edinburgh and Westminster. Both the banks and the customers, however, have other options.

The post-referendum uncertainty would cause the banking system to come under threat of the withdrawal of deposits in Scottish banks, a threat that would infect the whole of the UK banking system.

Bank customers, both north and south of the border, could withdraw their deposits. English depositors in particular would find the uncertainty intolerable. Why would they deposit their Sterling wages, pensions and savings in an institution that could not guarantee that they would be returned as Sterling? In addition, there are a range of building societies and new banks waiting to receive the fleeing customers. In order to protect their money, individuals and businesses would migrate to British institutions such as Nationwide, Virgin, Tesco and Sainsbury.

The Scottish banks would have to act. They too have options to defend themselves from such a run on their funds, but it would involve them giving up their right to print Scottish banknotes. Traditionalists, including Alex Salmond, would of course react with fury at such a suggestion. The banks, on the other hand, operate in a modern world. In this modern world there are four issues that have to be taken into consideration.

First, the 'Scottish' banks are in fact British or international banks. The Bank of Scotland is a subsidiary of Lloyds, 25% of which is owned by the British Government – a share that will eventually be sold on the London Stock Exchange. Clydesdale Bank is owned by the National Australia Bank, who have been trying to sell it off for some time. The Royal Bank of Scotland, the last Scottish bank standing, is 75% owned by the British Government and, like Lloyds, will eventually be divested onto the London Stock Exchange. These banks are less concerned about Scottish tradition.

Second, there is the issue of legal tender. Scottish bank notes are not legal tender. Scots who visit England get upset when shopkeepers refuse to accept them, claiming that 'they are Sterling, they are legal tender'. Wrong. Scottish notes are not legal tender in England and Bank of England notes are not legal tender in Scotland. Scottish notes are not even legal tender in Scotland. If a person pays a debt with Scottish bank notes, s/he can still be taken to court for the recovery of the debt.

However, the concept of legal tenure does not govern whether a banknote is acceptable in transactions. This is essentially a matter of an informal agreement between the parties involved in the purchase and sale of goods, which means that large organisations will generally accept Scottish banknotes while small corner shops need not take them. There are exceptions to this general rule. Tesco Bank in

Birmingham, for example, has refused to accept Scottish notes for the purchase of foreign currency, following an instruction to counter staff. After further discussions within Tesco and some serious questions from Scottish customers about bank policy, transactions can proceed if the purchaser produces a passport or driving licence along with the Scottish notes.

The acceptance of Scottish notes is a purely informal arrangement between buyers and sellers, but it is based on a more legally binding contractual agreement between the Scottish banks and the Bank of England. This agreement is possible because the holder of Scottish banknotes is provided with a level of protection similar to that enjoyed by the holder of a Bank of England note.

Third, in order to achieve this level of protection, the Scottish banks are required to hold sufficient assets with the Bank of England to support the issue of their notes, using a combination of Bank of England notes, UK coin and funds in an interest-bearing account at the Bank of England. The Bank of England banknotes held as backing assets may include £1 million notes (Giants) and £100m notes (Titans), which are held at the Bank and may be used should a Note Exchange Programme need to be implemented.

There are two main circumstances for initiating a Note Exchange Programme: bank insolvency and a bank voluntarily deciding to withdraw its notes.

Before independence became a serious issue, it was assumed that the main reason for a Note Exchange Programme would be bank insolvency. A failed Scottish bank would no longer be allowed to issue notes and the Bank of England would make arrangements for existing notes to be exchanged and permanently removed from circulation.

Another reason for an Note Exchange Programme could be if a Scottish bank decides to stop issuing its own banknotes under what is referred to as ‘voluntary cessation’. In this case, a bank would give a minimum of two months' notice of the cessation and of the arrangements in place to enable banknote holders to exchange their notes. The Bank of England would facilitate the arrangements to enable the holders of Scottish bank notes to exchange them for other notes, including Bank of England notes. After a Yes vote in the referendum, it is highly likely that all the banks authorised to issue Scottish banknotes would apply for voluntary cessation before the setting up of an independent state. It would be wise for all of them to agree to jointly proceed in this way, leaving Bank of England notes as the only banknotes in an independent Scotland.

The Scots have been rightly proud of the independent Scottish banks and their right to produce Scottish bank notes in Sterling. This historical right underpins Alex Salmond's claim that 'It is our Pound too'. However, banking has moved on.

This brings us to our fourth issue: 97% of the money in circulation in the UK is held in deposit accounts. This money is the property of the people who have deposited it and it is mainly managed electronically. Bank transfers flow effortlessly between British banks and into international money markets, irrespective of where the owners of the assets live. It is money that is owed by the banks to individuals and other organisations in the private, public and voluntary sectors - and it is Sterling. This will not change. It is Sterling now and it will be Sterling in the future.

So, in the event of a Yes vote and the prolonged uncertainty that this could create, the most likely outcome, the contingency plan the Mark Carney referred to, is that the so-called Scottish banks would initiate a Note Exchange Programme to protect their interests and the Bank of England would be contractually bound to support this. Politicians, even those responsible for managing the UK Government's investment in the banks, would not dare to intervene.

If politicians did try to intervene in the day-to-day operations of the banks, this would undermine confidence in the Bank of England, the City of London and the whole UK financial system. If the interests of the banks and their customers could be over-ridden by politicians in the case of the Scottish currency, what is to stop it happening again for whatever political reason emerged in the future? This is not just about the regulation of the banks. To instruct the Bank of England that it should not honour the contracts it has with the 'Scottish' banks is well beyond regulation.

Before Scottish Nationalist celebrate, however, there are two other lessons to be learned from this. If the Westminster politicians cannot enforce their will on the banks, there is little chance that those in Edinburgh will be able to do so in the future. The same is likely to be true of oil companies and other multinational conglomerates.

What all of this means for governance in Scotland is, of course, another matter. There is no reason why Scotland could not have a Central Bank to receive oil revenues and exercise control over interest rates for all public sector borrowing at a sub-national level, but that discussion is for another paper.