Scotland Should Choose the Krone

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One of the questions which Scotland will have to ponder if it regains independence is what to do with its currency.

Scottish banks currently print their own banknotes, but they are British pounds subject to control by the Bank of England. They are not truly a Scottish currency. The simplest thing for Scotland do would be to follow the example of Ireland during its first sixty years of independence. It issued its own currency in 1927, but it was fully backed by British sterling securities and pegged one for one to the British pound until 1979. Irish banknotes were marked "payable in London" until 1961. Ireland abandoned the link to sterling in 1979 and re-pegged to the European Monetary System. Its currency lost value when the British pound rose sharply because of North Sea oil and Margaret Thatcher's hard monetary policies. Ireland joined the European Monetary Union at its creation in 1999 and ceased to have its own currency or monetary policy. This decision proved to be catastrophic because the monetary union lowered interest rates and encouraged a property lending boom. The major Irish banks lent recklessly and the government had to spend sums equaling 30% of GDP to rescue them during 2009-10. The Irish government's borrowing costs skyrocketed and the country was forced to seek a financial rescue program from the IMF and the EU. The Irish central bank could have intervened to restrain bank lending for property, but such policies would have been very unpopular because six years ago because the Irish believed they had achieved an economic miracle.

If Scotland decides to abandon the link with the British pound, it could simply decide to let the currency float freely or seek an alternative peg. As with Ireland, it could decide to give up any notion of having an autonomous currency and join the European Monetary Union. In 2009, Scotland sent £7.7 billion of its £21.1 billion of its non-oil exports to seven eurozone countries. What is unclear is whether it would qualify. If Scotland assumed its share of the British national debt, it could have a debt-to-GDP ratio exceeding 100%. As a result of recent debt problems in Greece, Ireland, and Portugal, it is doubtful that the monetary union would admit any new members until they had a debt-to-GDP ratio below 60%.

As Scotland is heavily dependent upon oil exports, it should consider pegging its currency to the currencies of other commodity-producing countries. Three candidates would stand out: the Russian ruble, the Australian dollar, and the Norwegian krone.

Russia is a major oil exporter and its economy has closely tracked movements in the oil price, but its currency is probably a poor anchor for Scotland because the central bank has allowed inflation to run at double-digit rates during recent years. If Scotland imported Russian monetary policy, it would also have high inflation.

The Australian dollar is a more compelling alternative because Australia is primarily a commodity exporter. The Australian dollar has traditionally tracked movements in commodity prices. It fell sharply with commodity prices during 2008 and 2009 and then rebounded when Chinese demand boosted commodity prices. The major risk posed by the Aussie dollar is its sensitivity to China. Australia now sends close to 25% of its exports there. There are no other countries currently pegging the Australian dollar, but it would be an ideal peg for most southern hemisphere countries because it has a responsible central bank which restrains inflation. If Argentina had pegged to the Aussie dollar rather than the US dollar ten years ago, it would not have had the severe financial crisis which led to a debt default and devaluation, culminating with the president fleeing his palace in a helicopter.

The Norwegian krone could also be a credible candidate for a peg because Norway is an oil producer like Scotland and is about the same size. It is a nation of nearly 5.0 million people and a nominal GDP of just under $480 billion. Scotland has 5.2 million people and a GDP of about $210 billion. Norway produces 2.1 million barrels of oil per day compared to Scotland's 1.3 million barrels. It has 5.7 billion barrels of oil reserves compared to Scotland's estimated 2.7 billion barrels. Scotland sends Norway about £760 million of exports. Norway never joined the European Union, so its monetary policy is totally autonomous. The Norwegian central bank has an inflation target and raised interest rates from 1.25% to 2.25% during 2009, 2010, and 2011 in order to restrain prices. Norway's sound monetary policy and oil wealth has encouraged the krone to appreciate 33% against the British pound since 2000. There would be minimal risks for Scotland in pegging its new currency to the Norwegian krone.

As there is no clear consensus in Scotland about the issue of independence, the government in Edinburgh is unlikely to focus much attention on the issue of exchange rate policy. It would probably be safest to pursue the Irish model and maintain a link to the Pound sterling during the early years of independence. If Scotland continued to be a major oil producer, the government could then consider more imaginative alternatives after it had established a track record of effective economic management.

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