

# Scotland's Independence Referendum: A Potential Surprise for Markets?

On 18 September, Scotland will vote in a referendum on whether to break away from the United Kingdom. The 'Yes' to independence campaign is led by the Scottish Nationalist Party (SNP) and its wily leader Alex Salmond. The 'No' camp is run by a motley collection of UK politicians under the banner of 'Better Together', and led by ex Labour finance minister Alistair Darling, himself a Scot.

While the debate so far has generated more heat than light (mainly in Scotland as the rest of the United Kingdom has no say), it has had surprisingly little discernible impact on the UK's financial markets. This may be due to the consistent lead of 7% to 10% held by the 'No' side for many months until very recently, lulling investors into complacency. But it may in part be due to the uncertainty surrounding what a breakup would look like. That said, should the Scots upset the pollsters and go for independence, the kneejerk reaction would likely be a fall in sterling and sterling-denominated assets, if only because of the high uncertainty that would ensue. Politicians, corporate leaders, and the monetary authorities would face the challenge of executing this divorce in an orderly manner over a couple of years. But they would also need to agree on prompt answers to the many substantive questions that have been left open. And any ensuing bickering would worsen sentiment and place investment plans on hold.

For these reasons, investors should review their level of exposure to UK assets and decide whether they can tolerate a potential short-term drawdown in values (how much is impossible to quantify, but a 5% to 10% fall in sterling, for example, cannot be excluded). For sterling-based investors, these considerations are less pressing insofar as a home bias and sterling base currency mean any drawdowns on local UK assets are likely to be at least partially compensated by gains, currency adjusted, on overseas assets. Contrariwise, the expected 'No' victory could lead to a short-term bounce in sterling and UK assets as the uncertainty is lifted. Arguably, such a bounce could provide an opportunity for US$-based investors to hedge their sterling exposure should it exceed recent highs around £1/$1.72 given the fragile economic and political profile of the United Kingdom.

## It's the Politics, Stupid.

The Scottish Parliament decided by majority vote to join the rest of the United Kingdom in 1707, since when it has sent members of Parliament to London. In 1997, a Scottish Devolution Referendum was held, leading to the creation of a Scottish Parliament and Scottish Executive/Government in 1998, with powers principally over health and education, the environment and other local matters, but not over defense, energy, foreign policy, immigration, or social security, which remain the preserve of the central government of the United Kingdom in London.

Under the present system, the Scottish Parliament has limited tax powers but significant spending powers in areas under its remit, and is largely funded through transfers from London known as the 'block grant' (currently in the region of £30 billion annually). The 2012 Scotland Act passed by the UK Parliament already lays the ground for the Scottish authorities to gain more fiscal powers with the discretion to modify income tax rates by up to 10% by 2016. All leading UK political parties promise to go further in devolving tax matters to Scotland after a 'No' vote, in varying forms of 'independence light'.

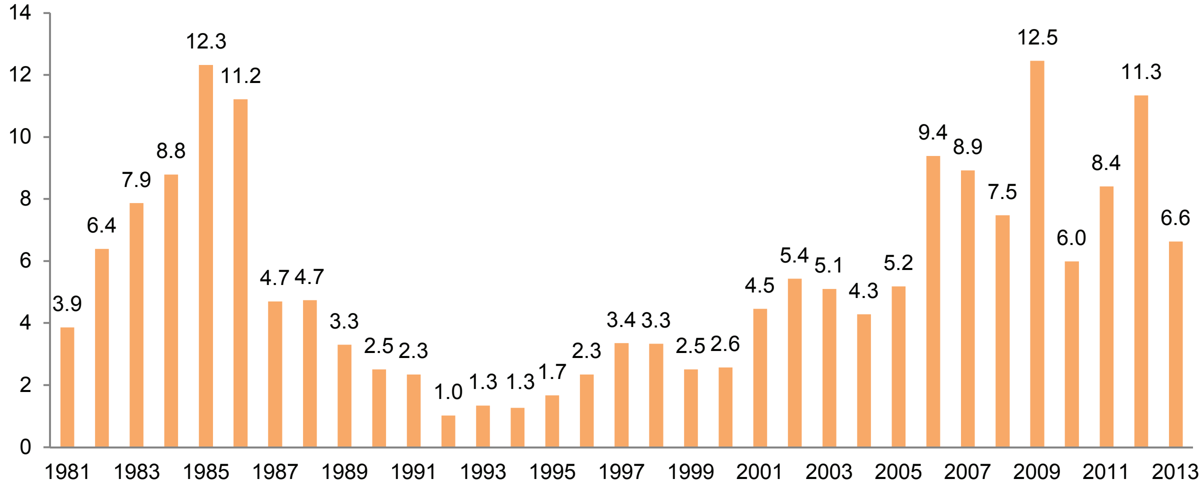
For the SNP and 'Yes' voters, such a promise is simply beside the point. The Scots allegedly crave two things: autonomy to set their own course, principally in domestic matters, and second, to escape from the center-right consensus that has dominated London since Thatcher. With only one conservative UK MP north of the 'border', Scotland is arguably more left-wing than the rest of the United Kingdom and deeply hostile to the English conservatives. Scotland is, according to 'Yes' supporters, the last bastion of British fairness and compassion. As a case in point, suspicious of the trend favoring privatisations that London has pursued, some believe independence is the only guarantee of protection for the state-funded National Health Service. Scottish students, unlike the English, pay no fees to attend Scottish public universities that are wholly funded by the government. There is also a feeling of wanting to escape from the shackles of a declining United Kingdom clinging to postimperial pretensions. With little interest in world power and influence, an independent Scotland would slash defense expenditure down to a minimalist peacekeeping force to be deployed for UN missions, and get rid of 'WMD' nuclear submarines currently based on the Clyde river.

## The Cost of Divorce

In terms of weight, Scotland's GDP is around £150 billion compared to the rest of the UK's £1.45 trillion. There are 5.25 million Scots compared to 63.2 million combined UK citizens (2011 census) and 8.2 million Londoners alone. This makes independence a much bigger deal for Scotland than for the rest of the United Kingdom.

From a *fiscal* point of view, according to the non-partisan Institute of Fiscal Studies, Scotland's declining oil supplies and expensive spending pledges, such as that to provide 600 hours of free childcare to half of two-year-olds, would result in a budget deficit of £8.6 billion in Scotland's first year of independence, or nearly 6% of GDP. That is comparable to the UK budget deficit of about £107 billion or 6.8% of GDP in the fiscal year ended April 2014. It is also considerably less than estimates for the current Scottish budget deficit of around 11% of GDP. Scotland would gain significant North Sea oil tax revenues of about £6.6 billion/year, or roughly 4.5% of its GDP, that currently flows to London but is relatively insignificant to the UK Exchequer. However, this is not the end of the story, as the UK Treasury claims Edinburgh would need to raise taxes by about £1,400 per Scot, to bring down its budget deficit to UK levels over time, given start-up costs and nationalist spending policies. Bottom line, even with North Sea Oil revenues, the Scottish government would probably need to either increase taxes or rein in its public

Total North Sea Oil Tax Revenue
1981–2013 • UK Sterling (billions)



spending ambitions to launch Scotland on a sustainable independent fiscal path. Looking south of the border, the loss of Scotland would likely make little net difference to the United Kingdom and could even be a marginal net positive at the fiscal level.

From a *trade* perspective, North Sea oil sales, estimated at around £27 billion could have more impact on Scotland's trade balance, which is in deficit to the tune of about 8% of GDP now (excluding oil), but could potentially turn into a surplus, other things being equal. The problem is that other things may not stay equal. As a small open economy, Scotland is home to a lot of 'foreign' businesses. The 'Yes' camp claims foreign direct investment would increase, lured by a 3% cut in corporation tax, support for strategic industries, and the country's commitment to the European Union. So far, few companies, outside of banking (about which more below), have provided indications that they would put their Scottish plans on hold, though this may be another sign of complacency about the status quo. Changes in corporate behavior after independence are difficult to predict. Again, for the UK's trade balance, Scottish oil is no longer such a big deal.

## Currency

The banking industry would probably be the most affected by independence, with the Royal Bank of Scotland rumored to have contingency plans to relocate its headquarters to London. This may have little effect in practice on growth or employment, but is inextricably linked to the vexed question of whether Scotland could keep sterling as its currency. All three main UK political parties have ruled out allowing an independent Scotland to maintain monetary union with the United Kingdom. After all, why should the Bank of England continue to act as lender of last resort to Scottish banks (or for that matter a sovereign Scottish government) that might get themselves into financial difficulties. The recent experience of the Eurozone is hardly encouraging, however hard the SNP pitches the common benefits of the status quo.

That does not preclude Scotland simply *using sterling* (sterlingisation) in a way some countries are *dollarised*, but this would partially undermine Scotland's newfound autonomy, to the extent it would become constrained on its budget and external accounts. Any sustained deficits would tend to drain liquidity and brake the economy. That does not mean sterlingisation could not work or would be bad for Scotland or the rest of the United Kingdom. But the 'Yes' camp is neither putting this forward, nor the other option of launching a Scottish currency, as a possible 'plan B'.

For the rump United Kingdom, if Scotland does break away, there will also be the argument over Scotland's share of the UK national debt. If Scotland decides to repudiate its share (perhaps as a negotiating tactic to stay in the monetary union), the short-term gain of the independent nation starting from a clean slate would be offset by deeply soured relations with the remaining United Kingdom whose debt/GDP would rise by nearly 10% at a stroke. In any event, while it won't divulge any details, some reassurance can be gained from the fact that the Bank of England has made contingency plans to provide stability to markets should the Scots decide to surprise the world.

## The Bottom Line

With polling day just a few weeks away, the independence vote appears finally to be gathering some momentum and eroding the "No" camp's 7% to 10% lead amongst declared intentions. Still, a large majority of the 15% to 20% of undecided voters would need to come off the fence on the "Yes" side to confound the pundits. Not impossible, but unlikely, and our best guess at this stage is that the result will be a narrow victory for the "No."

Sterling and sterling-denominated assets are probably building in only a small risk premium associated with this event; a surprise win for independence would likely trigger a kneejerk downward reaction for sterling and sterling-denominated assets. But the relatively neutral impact of separation on the rump United Kingdom means the damage to sterling assets should be short lived. It is far from clear that action should be taken now, except for investors with a low tolerance for short-term volatility, which should consider potential hedging options and costs. Contrariwise, any relief rally in sterling over $1.72 should probably be sold given some estimates of fair value, the UK's questionable fundamentals, and the looming 2015 general election uncertainty. ■

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## Exhibit Notes

**Total North Sea Oil Tax Revenue**
Source: The Scottish Government, *Government Expenditure and Revenue Scotland.*

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