Michael Fry: The Best Way to Inspire Confidence in Our Economy? Balance the Books

Michael Fry | 27th June 2017

It was a valuable contribution to the debate about a Scottish currency that came last week from the think tank Common Weal, since this question is likely to prove one of the main battlegrounds in a future referendum on independence, just as it was last time. The report written by Peter Ryan was perhaps a little neurotic on the problem of official reserves, which would be used to back the currency on the international financial markets. These reserves are a bit like an insurance policy. A country will know it has been following the wrong policies if it is forced to run down its reserves in order to defend its preferred exchange rate.

If that exchange rate happens to be a fixed one (like, for example, the one Greece has in the eurozone) it might in the end exhaust its reserves and be forced to turn for aid to other governments or to international institutions – but from that point on its policies will be dictated by them.

With a floating currency the options are less drastic. If things go wrong, its exchange value can just be allowed to sink – as is happening with sterling at the moment – without putting too much pressure on the reserves, though often policies need to be changed anyway. A government in this case retains somewhat more control over what happens next. It is, I expect, the sort of position in which, on present trends, an independent Scotland might find itself.

For any situation short of that, however, the reserves are dead money and the resources they represent cannot be applied to any desirable object of public expenditure. That is why most countries keep reserves of less than the 20 per cent of gross domestic product recommended by Common Weal, as Dr Jim Walker of Hong Kong and Kilmacolm pointed out in his comments on the report.

The independent Scots of the future, it is true, would be the new kids on the block, and might have to work harder to build and maintain international confidence in whatever they set out to do. But that in itself would be a powerful discipline on policy, and in fact more powerful than any mechanistic rule for the reserves.

Fiscal rectitude

Angus Armstrong of the National Institute of Economic and Social Research hit the nail on the head: "The ability of a Scottish central bank to raise the funding and then defend the new Scottish currency will depend on persuading investors that Scotland can defend the exchange rate. There is no reason why any country cannot do this … the easiest way for the Scottish Government to gain credibility with investors is to prove they can run surpluses."

I agree, but think it might be useful to point out that the present policy of the Scottish Government is to run deficits, and to use its borrowing powers "to the max", in the elegant phrase of the Finance Secretary, Derek Mackay. He no doubt wins brownie points from his free-spending colleagues, yet there is no ideological obligation on lefties to act in this way.

The German Social Democrats, for example, are fanatics for fiscal rectitude and at the last general election in 2013 were calling for an even faster reduction in the deficit than Chancellor Angela Merkel planned. They got their wish and today the Federal Republic's books are balanced. The new French President, Emmanuel Macron, sat in the socialist cabinet of his predecessor, François Hollande, but has now resolved to do to the budget within a year what could not be done to it in the previous five years – that is, cut the deficit.

It will be a good example for Scots to watch. Why do European socialists act in this way? Because financial discipline is the key to maintaining national control of national finances. Otherwise the global bankers will take over.

In order to bolster the discipline, it is often convenient for a small country to link its currency in some way to the currency of a bigger country. I have written here before that an independent Scotland would, at the outset, probably maintain a link with sterling, inside or outside a formal currency union. But it need not be permanent and, assuming the new economic sovereignty makes the nation flourish, it would no doubt before long prefer to cast off this last Unionist shackle.

One obvious course for an independent Scotland would then be to shadow the euro, either just to maintain confidence in its currency or else as a prelude to rejoining the EU (in which case eventual adoption of the euro becomes obligatory anyway). That would entail conforming to the so-called Maastricht criteria, the conditions for any country to enter the eurozone. The criteria comprise limits on the rate of inflation, the budget deficit, the public debt and long-term interest rates. These limits have to produce a stable exchange rate over two years before the country can formally adopt the euro.

On inflation and interest rates Scotland already falls within the Maastricht criteria. UK public debt could be a tricky problem, and Scotland's share of it may need to be negotiated between Edinburgh and London. In strict legal terms none of it is owed by Scotland, because we did not contract any of it – but then we might not get any of the UK reserves either.

Tall story

Beyond doubt, however, is that Scotland, as matters stand, far exceeds the limit on the budget deficit, which should run at three per cent of gross domestic product.

I do not accept the Unionist tall story of a 15 per cent deficit, but I do not think it is zero either. It is certainly above three per cent, and will need to be cut. In a country that has been devoted to "maxing out" its deficit, this may come as a sharp surprise. But the alternative will be a falling currency and possible exhaustion of the reserves so painstakingly built up on the ingenious principles set out by Common Weal.

In fact, we should never let ourselves get into this position in the first place. Instead, we should follow Angus Armstrong's sensible proposal for gaining the confidence of the markets, and accept the disciplines of an independent nation long before we need to, or before we are forced to. The fact is independence will not lead us into a never-never land where we can spend whatever we like on any project taking our fancy. It will be a situation not of no discipline but of new discipline. Inside the UK, our actions are limited by the amount of money Westminster deigns to throw into our begging bowl. Outside the UK, we will have to look after ourselves and take good care of our resources, just as every other sensible and well-run nation does. We will turn from clamorous supplicants to prudent custodians of our own affairs.

In doing so, we must transform Scotland from a society of consumption and subsidy into a society of investment and growth: I do not see how, in the long term, it can survive as anything else.

Once we succeed, we can safely leave our exchange rate and our reserves to look after themselves. We will be a grown-up country in a demanding global environment that we may all the same make the best of, as our small European neighbours do.

And this, by the way, is my answer to Carolyn Leckie's outburst against me in yesterday's paper. Idiosyncrasy? No, Carolyn, it's reality I'm talking about, that great enemy of socialism.