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Financial & Fiscal Features Newsletter

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SCOTLAND, CATALONIA & EUROPE'S FINANCIAL CRISIS

by Gordon Kerr and John Butler, with Enrico Colombatto

Although Scotland voted in September to remain in the United Kingdom, both sides hailed the high voter turnout as recognition of democratic engagement and growing European dissatisfaction with over-centralised, bureaucratic, seemingly unaccountable government. The effect has been to raise morale in Catalonia and a handful of other potential breakaway regions. This is bad news for Europe's leaders.

(Continue reading overleaf)

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Catalonia

On September 29 Spain's Constitutional Court triggered uproar and street scuffles in Catalonia by suspending the regional government's decision to hold a non-binding referendum on independence. In fact, the court made no substantive legal decision, it merely held that a full trial of the issues should take place in five months' time. In so deciding, the judges agreed with the plaintiff (the national government) who argued that not only the referendum, but also the law under which it had been called, must be suspended pending trial on 'sub judice' grounds. Was that legally correct? The Catalan administration thought it had avoided this risk by deeming the November 9th referendum 'non-binding,' merely a consultation exercise.

Whatever the legal merits of the suspension, the Sep 29 news provoked international criticism on two grounds. Firstly, the aims of Spain stand at odds with a July 2004 resolution of the International Court of Justice, which held that the right of self-determination is a "norm erga omnes", a universal right owed by states towards everyone. Secondly, mainstream commentators point to evidence of political interference from Madrid. Spain's Prime Minister Rajoy recently said: "I want to tell you with all clarity that this consultation will not take place. Any discussion or debate on this is out of the question". Judging by this rhetoric, pro-independence Catalans know they face a titanic battle, irrespective of the final outcome of the court's ruminations.

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Another consequence of the Spanish government's invocation of the legal process is that, by openly seeking to ban freedom of expression, it has swung public opinion and boosted the independence movement. Reputable polls in early September showed the independence movement trailing by a margin of 5 points at 35% for independence and 40% against; but at the end of the month the balance swung in favour of independence (45%), with only 23% against it.

Why, therefore, did Spain's leaders choose to risk international odium by denying fundamental human rights, **and** to stimulate the strongest pro-

independence surge in any of Europe's separatist-minded regions? Are they stupid? No, they just appear to be desperate. Furthermore, these steps have almost certainly been taken after consultation with, and assurances of strong support from, the highest European authorities.

Scotland

When the Westminster government agreed to the already-devolved Scottish Parliament's request for a referendum, little did they think that they would open wide the Overton window. If only the Scottish nationalists had attempted to jump through it, the result might have been different. A prime example was the national debt. British politicians never discuss the national debt, they only ever speak about the deficit: the annual increase by which the debt has grown. The lack of any coherent currency and banking plan, as much as historic cultural ties, was probably the nationalists' undoing.

Both sides agreed to frame the debate around three dubious assumptions:

1) the crisis is behind us;
2) banks have been reformed;
3) the UK recovery is powering ahead.

Both sides therefore claimed that sterling is a solid currency which the Scots would be better off retaining.

The pro-independence (Yes) campaign argued that they could demand a 'currency union' with the rump of the UK. The No campaign thought it had won the fight months ago on this sole issue. Westminster has the power to refuse to 'share' sterling, and they categorically asserted such refusal back in March. That strategy backfired. It fuelled the argument that London's arrogant political classes have scant regard for Scotland's economy.

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As September 18th approached, the No campaign panicked and threw everything at the Scots. As well as the carrots, a notable stick was currency fear. Without a currency union, any 'new' currency would immediately depreciate and Scottish home-

owners would face mortgage payment rises of around 10%. Pensioners future entitlements would be received in this new and depreciating currency.

The Yes campaign could easily have debunked this nonsense by proposing a Currency Board; an independent new institution that would ensure convertibility of any new Scottish currency with sterling. Such a Currency Board would be entirely different from currency 'fixes', 'pegs' or other weak links whose labels were confusingly peppered all over the debate. A pertinent present day example of a Currency Board is Bulgaria's, an EU country with one of the smallest economies in Europe whose attempts to operate their own tiny Leva currency spectacularly collapsed in 1997. Today, in a country otherwise riven by political upheaval, the Currency Board remains Bulgaria's most popular and trusted national institution, constitutionally immune from political manipulation.

In the course of time, an independent Scotland might conclude that to continue with sterling and, by extension, a banking system run and regulated by the Bank of England would be a mistake. Policies such as quantitative easing have only succeeded in inflating yet another property bubble, threatening another UK banking crisis. With a Currency Board an independent Scotland could at any future point easily break with sterling.

(…"Scotland" continued.)

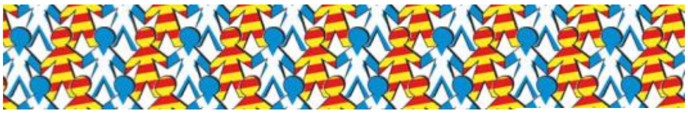
Therefore a Currency Board would provide interim stability with full future flexibility for Scotland. Why did the independence campaign not pursue this attractive option? It was certainly not a matter of ignorance. The Yes campaign published hundreds of pages of currency advice from a board of international economists, including two Nobel laureates. When Westminster's opposition to currency "sharing" was reinforced by the Bank of England (on purely technical grounds, of course), several major Newspapers published articles pointing out that no permissions at all were needed for Scotland to retain sterling. And yet steadfastly the Scottish independence movement ignored the subject. Why?

(Credit: Spanish Sphere)

Crisis

The answer seems inescapably obvious: **under a currency board system it would be impossible for Scotland to print money unilaterally to bail out its banks.** The leading Edinburgh campaigners not only had much personal political capital invested in bank bailouts and support of policies like quantitative easing that continue to prop up unreformed UK banks, but also they fear that the banks are about to blow up again.

Mindful that Ireland and Iceland could not support banking systems whose bank asset to GDP ratios were 900%, the Scottish domicile of both Lloyds Bank and Royal Bank of Scotland meant that the equivalent ratio for an independent Scotland would have been around 1,100%. Nationalists, therefore, overtly campaigned to remain under the umbrella of the Bank of England, not only for currency sharing, but also for future support of failed banks. This aspiration should never have even attracted the label "independence". All that Edinburgh ever wanted was more devolved power to its already established regional administration hub.



Conclusion

Many European federalists today view the crisis of 2008 as a stroke of luck. Governments of countries whose loyalty to EU had been doubted, such as Ireland and Greece, now extol their allegiance to the European project and remain grateful for their bailouts and the continuing support that such packages entail.

International confidence in the Euro as a truly established currency has increased. Slovakia ('09), Estonia ('11) and Latvia ('14) have joined the Eurozone since the crisis. Whilst events in Ukraine have caused EU enlargement to pause, institutional integration among the Eurozone has flourished. National budgets now require central approval, German questioning of ECB decisions is muted, and banking union hovers on the horizon.

Many international economists, including the writers of this Newsletter, believe that the sovereign debt levels of most European countries are reaching the point at which EU will once again be tipped into crisis. However, there are few visible signs, as the bulk of the solvency problems are obfuscated by a range of deceptive accounting practices and various liquidity facilities provided by the ECB. These practices, together with the malaise of international cur-rency and financial market actors, have combined to marginalize criticisms.

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So, with national governments marching in European lockstep and markets becalmed, what is the worst fear of European federalists? The answer is simple: regional breakaways, in particular of wealthy regions such as Catalonia. Leaving aside the usual 'one nation' and constitutional arguments that were also deployed in the Scotland campaign, Catalonia's riches and wealth generating capacity have already led to very different economic arguments.

Spain's leaders argue that they need to continue to tax the whole of the country to maintain the country's debt service and economic recovery. Catalans happily retort that national finances are on an unsustainable course and, rather than allow themselves to be dragged under with the downdraft, Catalonia should cut its ties and look after its own, rather healthier financial position. At the EU level leaders pretend that the issue is a minor distraction, and publicly counsel that Catalans should think very carefully as a new independent state would have to leave and reapply to join the EU. Privately, EU finance chiefs fear that if Barcelona even schedules a referendum, concerns about EU finances in general will visibly flare up again, with direct unpleasant consequences for debt financing dynamics.

If Spanish wealthiest region divorces itself from pan-EU debt mutualisation, the strained models used to claim that sovereign finances are under control will become even less credible.

Catalonia is therefore much more important in the context of European finance than Scotland. The UK is not part of the Eurozone, and Scottish nationalists never really wanted full financial independence. Catalonian separatists genuinely do. If the wealthiest region of Spain divorces itself from pan European debt mutualisation, others may follow. The already strained financial models used by the authorities to claim that sovereign finances are under control will become even less credible in their forecasts of solvency.

Spanish and European leaders are thus far from stupid. They know that every ounce of effort and power they have must be expended in eliminating the seed of separatism before it germinates. The only remaining question is whether germination has already taken place.

(Data: Scottish gov't, ONS, INE, Eurostat)

	CATALONIA IN SPAIN		SCOTLAND IN THE UK	
	REGIONAL	STRUCTURAL PERCENTAGE	REGIONAL	STRUCTURAL PERCENTAGE
POPULATION (2013)	7,553,650	16.2%	5,313,600	8,3%
AREA	32,106 km²	6.3%	78,387 km²	32,1%
NOMINAL GDP (2012)	€192.5 billion £159.7 billion	18,7%	€180.7 billion £150 billion	9,3%

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