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ECONOMIC PERSPECTIVE 2

A FINANCE POLICY FOR SCOTLAND

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At the national level, monetary policy is regarded as an important tool for government influence on the economy; this importance has been highlighted in the debate over the future of UK monetary policy in a European monetary union. The relevant (interrelated) questions are: how would the UK economy fare with monetary policy applied on a uniform basis across Europe, and with the full integration of national capital markets, and what would be the relative costs and benefits for the UK of a single European currency?

These questions are equally valid with respect to the Scottish economy, as part of a single currency area, with a significant degree of financial integration, and with uniform UK monetary policy. It is particularly apposite at this time to consider these questions again for Scotland. Institutional change is proceeding apace within the UK financial sector, both with respect to the organisation and behaviour of the private sector, and also with respect to the policy environment within which it operates. In addition, the devolution debate raises questions about the desirability of policy-making at the Scottish level with respect to the financial sector, either within the present constitutional environment, or within the range of alternative environments under consideration.

The first question to address is whether there is any justification for a separate policy with respect to the financial sector in Scotland. A common currency, freedom of entry for financial institutions and free capital flows would create what is often referred to as a 'level playing field' for financial institutions. This level playing field, it can be argued, means equal competitive conditions which produce the most efficient allocation of borrowing and lending. In particular, an economy which does not generate enough saving to finance investment can borrow from elsewhere, either from outside institutions, or through the books of a UK wide branch banking system. Similarly, an economy without sufficient productive outlets for saving can lend outside the economy, earning a competitive return. The more integrated are financial systems, it is argued, the more freely and efficiently can this process operate.

The case for deliberately differentiating policy for the financial sector in Scotland need not involve rejecting the above argument. It is possible that UK monetary policy has differential regional impacts which need to be taken into account. Some sectors are more responsive to

interest rate changes than others; a region whose economy is particularly dependent on such sectors will be particularly badly hit by a rise in national interest rates.

More generally, if tight monetary policy is designed to dampen demand which is too high only in certain regions, an unnecessary degree of unemployment will be created in other regions. This argument has been made recently with respect to tight UK monetary policy aimed at curing the over-heating of the South-East, but which unnecessarily dampened already weak demand elsewhere.

While at one time Scottish banks could be treated differently in terms of national monetary policy in the form of credit controls, the scope for differential policy in this sense is now virtually eliminated by the fact that the banking sector is so highly integrated within the UK.

This integration almost certainly rules out any possibility of differential interest rates, since it would be too difficult to police categorisation of deposits and advances according to region.

Nevertheless it may be argued that national monetary policy may also have differential effects across regions because there is still some regional segmentation of financial markets. Thus, if local households and businesses in a region are dependent on a local banking system which is limited in its credit-creating capacity, tight monetary policy may have a disproportionately constraining effect on credit creation in the region. Given the high degree of integration of banks in Scotland with the UK (and international) banking system, this argument must in itself have limited force. To the extent that it does have force, however, whether the cure lies in accelerating financial integration or not depends on whether or not one accepts the argument about the inevitably beneficial effects of financial integration in the first place.

If this argument is rejected, then there is a case for policy to preserve and/or promote segmentation of financial markets. It may be, as has been suggested in the past with respect to Scotland, that regionally-specific banks can provide better access to credit than banks headquartered elsewhere, because of long-established client relationships and local knowledge, even though the reserve base may be relatively constrained. (The banks do not provide the information necessary for assessing whether this is currently the case.) But if capital flows were freed up by further integration of financial markets,

outflows from Scotland could be encouraged even more than inflows. Then the reserves constraint on local banks would be increased, limiting credit creation for small local firms.

With an integrated financial sector, however, local banks can borrow reserves. Credit creation is in fact more constrained now by capital base than reserves; local banks are then limited by the market's valuation of their assets. But if local banks concentrate their lending on the local economy, they are dependent on the market's valuation of the region's assets. In the same way, allocation of credit to Scottish firms by banks headquartered elsewhere will depend on a valuation of assets. To consider the process of credit creation in Scotland, therefore, we need to consider the state of the economy more generally, the state of confidence in it among decision-makers within Scotland and elsewhere, the resulting financial behaviour of all sectors, and what all this implies for the valuation of Scottish assets.

The Scottish economy is weaker than the rest of the UK taken as a whole: lower real income per capita, higher unemployment, relative reliance on natural resources, for which markets are relatively volatile, a declining heavy industry sector, and relatively high outside ownership of industry. These are common characteristics of peripheral economies; though Scotland has the unusual characteristic of a relatively strong financial sector. Long experience of economic vulnerability would imply the type of financial behaviour which could be categorised as defensive: relative unwillingness to spend on consumer goods and capital goods, unwillingness to borrow rather than use existing savings, and unwillingness to put saving into relatively risky assets. Evidence that Scottish households and firms do indeed behave in this way is presented in a recent report (Dow, 1991a)

The outcome of this kind of defensive behaviour is relatively low consumer spending, low investment and a preference for safe assets, which in general would be supplied outside the region. This reinforces the economy's relative weakness, holding down actual and expected asset prices, making it more difficult for those firms which wish to do so to acquire credit; what is regarded as credit-worthy ultimately depends on a subjective evaluation of assets.

The picture being presented here, elaborated in another recent report (Dow, 1991b), is not simply one of problems with credit supply. It is one of financial and real behaviour in all sectors of the Scottish economy which seems to make sense for each household, firm, or bank in isolation, but which does not make sense at the economy level; as a result individual households, firms and banks may find that their defensive behaviour is insufficient to protect them. Just as defensive behaviour can create a vicious circle of economic weakness, so expansive financial behaviour (within reason) can create a virtuous circle of economic expansion. Because there is a difference between what seems to make sense at the

individual level and what actually makes sense when the economy-level view is taken, there is a strong case for policy action to break the circle.

The first policy recommendation that follows from this analysis is made at the fundamental level: more and better information needs to be collected and analysed in order for a more fully-informed view to be taken of the nature of financial behaviour in Scotland. The major gap refers to the behaviour of financial institutions in Scotland. Most institutions operate UK-wide (or in some cases, world-wide), and data are not made available on the Scottish-non-Scottish breakdown of their assets and liabilities. There are some indications that financial institutions in Scotland act defensively, but there is not enough information to say more. More information is also required on the financial behaviour of Scottish firms; to what extent is there a credit gap, and to what extent are firms hanging back from putting forward loan applications, or from share issues?

The second fundamental requirement is that a public body be charged with responsibility for forming a view of financial behaviour in Scotland and its consequences.

The remit would be broader than that adopted by Scottish Financial Enterprise; promoting the health of the financial sector itself is important in its own right, but does not address the economy-wide issues raised here. Similarly, Scottish Enterprise is concerned among other things with credit gaps and other requirements of business, but this does not address the full interdependencies of financial and real economic behaviour throughout the economy. The policy issues, and the associated data requirements, require a view to be taken by the body with responsibility for all aspects of the Scottish economy and their interdependencies: the Scottish Office under current constitutional arrangements, or an Assembly or Parliament under the new constitutional arrangements being contemplated.

The ideal policy package from any perspective would depend very much on what was revealed by further investigation and new data sources. In the meantime, thought can be given to some possibilities. In particular, much can be learned from the policies introduced by regions in other countries. Here some ideas are drawn from the policies of some of the provincial governments in Canada (introduced incidentally by administrations which spanned the political spectrum).

Some provinces (most particularly Quebec, but also British Columbia) have introduced measures to promote their financial sectors as international financial centres. The aim is partly to boost the sector for its own sake, but partly also to generate the critical mass of financial activity required to sustain a local financial centre in order to meet local financial needs. Since the incentive for international business to be conducted in Montreal and Vancouver rests on tax incentives, there would have to be a consensus on differential tax treatment within the UK for such a policy to be implemented here.

A wider range of provinces have introduced stock savings plans. These involve credits against provincial income tax for residents who purchase stocks in local companies. The conditions attached to the credits are designed to ensure that the companies are genuinely local. Again this policy requires some Scottish control over income taxation. The policy is attractive for a range of reasons: it attracts finance to local companies, easing any credit gap; it encourages local firms to go public; and it provides a local outlet for local savings, if financial behaviour is defensive, which limits the damage to the local economy.

There are additional measures which could be considered for harnessing local financial resources. The public sector could issue savings instruments specifically to finance development projects. If borrowing powers were part of the devolution package, the Assembly or Parliament itself could borrow in the same way as the Canadian provinces. They use a variety of instruments, including savings offices, non-negotiable savings bonds for residents and negotiable bonds issued on the international market. Borrowing powers would be an appropriate adjunct to taxing powers; the economic growth generated by the use of borrowed funds would generate the tax revenue to fund the debt. Further, some Canadian provinces have Heritage Funds to gather natural resource revenues in good years, to support general revenues in bad years, and to promote a long-term restructuring of the economy.

As far as Scotland is concerned, if there is an economic case for devolution, then it must be anticipated that there is untapped growth potential; if additional expenditure allows that potential to be achieved, the debt can be funded. In the meantime, whether borrowing or not, an Assembly or Parliament would at any time have considerable financial resources at its disposal. The City of Burlington, Vermont could provide inspiration as to the disposal of these balances. The City has introduced a linked deposits scheme whereby it deposits its balances only with banks which meet certain criteria as to the allocation of credit. All banks are required to provide information on the breakdown of credit allocation.

These are simply some possibilities for a finance policy for Scotland which have been tried elsewhere. The ideal policy package for Scotland would be tailored to the particular requirements of Scotland. Before such a package could sensibly be designed, there is a great need for public debate on the subject. But that debate in turn needs to be informed. As a priority, it is up to companies to indicate their financial needs, and for banks and other financial institutions to provide better information on their activities in Scotland. But, ultimately, it is up to the Scottish Office to provide the leadership in ensuring that these information requirements are met.

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