



## An Independent Scotland?

JOHN MAULDIN | September 10, 2014

The United States is just starting to think about the upcoming elections (for whatever reason, the vast majority of people don't focus on politics until after Labor Day), but there is another election happening "over the pond," where the polls have just made everybody do a double-take. I am of course referring to the referendum on Scottish independence, which will be held next week. Voters opposing the measure were a clear majority for months, but their numbers began slipping a few weeks ago; and as of last few days the contest is basically even, with the election probably to be decided by the undecided.

A "yes" outcome would have significant ramifications not just for the United Kingdom but for all of Europe. Can a region of a country just decide it wants to be independent? You take a vote and that's it? To everyone's credit in the United Kingdom, they are being quite civilized about it. However, I imagine if Scotland votes to leave, the negotiations will be rather less cultured. There will be a big bill to be paid before everybody gets to leave the restaurant. Just who ran up what part of the tab over the last 300 years is an issue that has the potential to turn into a rowdy soccer – pardon me, football – match.

In today's *Outside the Box* we explore a few aspects of the potential break-up. And not just what it would mean for the United Kingdom (it would not be good) but for all of Europe. Note that Spanish bonds are beginning to fall as people wonder what it might mean for Scotland to be allowed to declare independence. There are a couple regions in Spain that would very much like to do the same. And frankly, the Catalan region has a much better economic rationale for being on its own than Scotland does. (From this side of the pond, I cannot see what Scotland would have to gain economically from independence. They are a net consumer of taxes. But the whole independence thing is clearly about more than just economics, so this is one bar fight among friends where I think I'll just retreat to my corner and watch.)

First, let's look at a few [comments from Bloomberg](#):

Spain's government bonds fell, undermined by the Catalan region's crescendoing push for independence, as polls 1,000 miles away in Scotland showed increased support for its own bid to break from the U.K....

"It's a question of raising the flag to more event risk," Harvinder Sian, a fixed-income strategist at Royal Bank of Scotland Group Plc in London, said today by phone. "Where the U.K. government has decided to guarantee all government debt, the Catalonia region is too large for the rest of Spain to absorb. It's a much more problematic issue for Spain with regard to its debt markets..."

"If Catalonia were to become independent it would be a strong drag on Spain's growth and doubts would resurface regarding the sustainability of Spanish public debt," said Marius Daheim, a Munich-based senior fixed-income strategist at [Bayerische Landesbank](#). "Liquidity rules."

Today's OTB features a piece by Stratfor's George Friedman on the implications of an independent Scotland. Do the Belgians get to split their country in two? Which regions of Spain might move for independence? How about the Northern League in Italy? What about the rest of the world? Can parts of Ukraine simply take a vote and leave? Where does it end?

Then Anatole Kaletsky over at GaveKal thinks about the implications for British politics. You could have the odd situation of Scotland's representatives in Parliament, who are overwhelmingly from the Labour Party, voting with a possible labor majority to put into place a very liberal policy agenda and then leaving Parliament after less than a year, which might then leave the Conservatives in the majority. Were those votes really legitimate if it was already known that Scotland was leaving? Exactly how does that work?

Before putting you in George and Anatole's capable hands, let me offer two additional links, from opposite sides of the political spectrum. The first is from my friend Niall Ferguson, [here](#), musing back in 2007 on the question of what it takes to make a nation-state. Then, I offer [this link](#) to Paul Krugman's blog in the New York Times. Paul gets my vote for best line I've read so far about the election:

Well, I have a message for the Scots: Be afraid, be very afraid. The risks of going it alone are huge. You may think that Scotland can become another Canada, but it's all too likely that it would end up becoming Spain without the sunshine.

Spain without the sunshine, indeed. This may be one of the few occasions on which you will find Niall Ferguson and Paul Krugman in agreement.

Right now the London bookies still think the vote for independence will fail. I think that conclusion is largely based on the assumption that many Scottish citizens who say they are "yes" voters today will go into the polling booth and realize at the last moment that their personal economic interests lie in remaining in the union. But as of today, it looks to be very close. Just the fact that they can take a vote on such a question is really rather remarkable. I don't remember there being a vote in the movie *Braveheart*.

My father told me that our family was kicked out of Scotland and then kicked out of Ireland before we made it to the colonies (back when they were still colonies). The name was Muldoon in Scotland and Ireland and was Americanized when we hit these shores. We can't find any records to prove the family legend, and it's been a few centuries since anyone in the family had the right to vote over there. But there's a part of me that might be looking at the numbers a wee bit sentimentally, so let me close by wishing my Scottish friends [Go n-éirí an bóthar leat!](#) (That's Gaelic, which is as close to an ancient Scottish language is there is, though it's more commonly thought of as Irish.)

Your wondering if I'll need a passport to see Edinburgh again analyst,



John Mauldin, Editor  
Outside the Box

## Scottish Independence Would Shake Up the Global System

By George Friedman, Stratfor

September 9, 2014

Polls released today showed for the first time that a majority – an extremely small majority, but a majority nonetheless – of Scots favor independence, although other polls suggest the no camp remains in the lead. A poll is not the election, which will be held Sept. 18, but it is still a warning that something extraordinary might happen very soon. The political union between Scotland and England might be abolished after 300 years. The implications of this are enormous and generally ignored.

Obviously, this raises a host of questions about how such a divorce might take place, whether the expected time frame – divorce by 2016 – will be adhered to, and how state property might be divided. It also raises the question of Scottish foreign policy. Will Scotland remain in NATO? Will it have membership in the European Union? Will it continue to use the pound sterling, and if not, how will it roll out its own currency?

These are important questions, but far more important issues will follow. One of the principles of the postwar world was the inviolability of Europe's borders. Border disputes were the origin of centuries of war, and so Europe's borders were frozen after World War II to avoid discussion. This may have left some people of one nationality on the wrong side of a border, but this was accepted since the risk of opening the door to border redefinition was considered far greater than any discomforts stemming from the borders that were locked in place.

This principle has been weakened since the end of the Cold War. Still, though the disintegration of the Soviet Union created fully independent states, these were recognized republics within the context of the Soviet Union. One could argue that this did not in fact represent border change. Later, the "Velvet Divorce" of Czechoslovakia into Czech and Slovak successor countries represented another shift, but in a country that had only existed since the end of World War I. The separation of Kosovo from Serbia was a more radical shift but was justified by claims of Serbian oppression. Though each shift weakened the principle of inviolable borders, each came with an asterisk – that is, each had an aspect that stopped it from being the definitive case.

Scotland separating from England, by contrast, can't be minimized. If that centuries-old union can be revised, then anything can be revised. Scottish separatists' reason for splitting is that they are a separate nation, that each nation has the right to its own state and the right to determine its own destiny, and that they no longer choose to be in union. But if they have the right to determine this, why shouldn't others in Europe enjoy the same right?

For example, modern Spain is an amalgam of regions. One, the Catalan region – which contains Barcelona – has a strong separatist movement. If Scotland can leave the United Kingdom, then why shouldn't Catalonia be allowed to leave Spain? Farther east, the Treaty of Trianon gave Romania and then-Czechoslovakia large portions of Hungary along with the Hungarians living there. Why shouldn't Hungarians living in those territories have the right to rejoin Hungary? Meanwhile, if French-speaking Belgians and Dutch-speaking Belgians wish to part ways and return their two regions to their respective countries of origin, why should they not be allowed to? And why shouldn't the eastern part of Ukraine be allowed to secede and join Russia?

Raising the stakes, this is an issue that goes far beyond Europe. There are seemingly innumerable separatist movements in India, China, Africa and so forth. If Scotland has the right to leave the nation-state it is part of and form a new one based on ethnic identity, why can't anyone follow suit? And if anyone can do it, but they are blocked by the state they wish to leave, is resorting to violence in pursuit of independence legitimate?

The Scottish issue – the claim that the Scots are a separate nation and that all nations have a right to self-determination – simply cannot be asterisked. Having this happen in the heart of Western Europe would set a clear precedent that would expand geographically and conceptually. It would legitimize similar movements globally and force a reconsideration of what a nation is. Ultimately, a nation would be whatever the majority says it is.

It is doubtful that the Scottish precedent could be contained in Europe. And it is hard to imagine how this precedent might not lead to conflict somewhere, not in the British Isles but somewhere where the existing state would be less inclined to grant the right of self-determination to a separatist movement.

Of course, the separatists in Scotland may well lose, sentiment might change in the post-election negotiations, and so on. But if England and Scotland divorce, the right to separate will become an integral part of international custom – and it will arouse other movements.

## The UK Now Faces Years Of Volatility

By Anatole Kaletsky, Gavekal

The probability that the United Kingdom will break apart now appears to be at least 50%. The weekend's crop of opinion polls agree with each other, and support last Tuesday's poll showing a powerful swing in favor of a 'Yes' vote in next week's referendum on Scottish independence. Given that up until last Tuesday most investors and analysts (including me) saw no more than a 10%-20% probability of independence, what has happened in the past few days amounts to a genuine exogenous shock of seismic proportions. In response to such a shock it is reasonable to expect further large market movements, especially in the pound, which has now fallen 2.4% against the US dollar in just one week

The biggest risk to the pound sterling and gilts lies not in the economic uncertainties that will be generated by future arguments about Scotland's relationship to sterling, the sharing of the UK's national debt, or the distribution of North Sea oil revenues. These are all issues with relatively marginal investment impact, which will only be felt in the long term.

Much more important are three political questions, not about abstract ideology, but of a kind that is highly relevant to investors:

- 1) What will a Scottish independence vote mean for British politics and economic management in the next nine months?
- 2) What will be the impact on the 2015 UK general election and subsequent economic policies, especially taxation?
- 3) What will all this imply for Britain's membership of the European Union?

The answers to all three questions are more alarming than almost anyone would have predicted a week ago:

1) If the Scots vote for independence it is likely that David Cameron will feel forced to take responsibility and resign as prime minister. If he fails to stand down, a putsch against him by right wing Tories is almost certain. A mutiny may or may not succeed, but Conservative Party politics is extremely febrile and ruthless, and the risk to Cameron's position is not remotely discounted in the markets. In September 1990 nobody imagined that Margaret Thatcher was vulnerable; less than two months later she was ousted by her closest supporters. Whether Cameron is replaced or not, Britain's government will be reduced to lame duck status between now and the May 2015 election. The only issues on the political agenda will be the terms of Scottish separation and apportioning blame for the referendum debacle.

2) The sense of shock and national failure resulting from an independence vote would make it much more difficult for the present coalition to win the 2015 election. The probability of a Labour-led government would rise from 40%-50% today to something like 70%. This prospect should be very alarming to investors in sterling. Labour will campaign on a platform of higher taxes and public spending, a tougher property tax regime, hobbling and shrinking the City of London, and abolishing the concessions to foreign residents which make Britain one of the world's most effective tax havens. If anything, the Liberal Democrats, who would probably be Labour's coalition partners, would be even tougher both in terms of personal tax reform and in their antagonism to the financial sector. To make matters worse, a Labour or Lab-Lib government would lack the political legitimacy to enact the measures promised in its manifesto, since the government's majority would rely on Scottish members due for expulsion from the English parliament in 2016. A constitutional crisis would therefore ensue. Presumably Labour would respond by promising another general election in mid-2016, immediately after the Scottish secession. The result would be two years of unprecedented political and fiscal uncertainty for all businesses and investors in Britain.

3) Even in the unlikely event that the Conservative Party or a Conservative-Liberal coalition is re-elected in a 2015 election after a Scottish independence vote next week, the political consequences would be dire. In the event of such an unexpected victory, the Conservative Party would regard its hold on power as assured following the expulsion of Scotland's 59 members of parliament (only one of whom is Conservative). As a result, the party would swing decisively towards the Euro-skepticism favored by its grassroots activists. A referendum on EU membership would be held in 2017 in which the new prime minister (who might conceivably even be David Cameron after a Damascene conversion to Euro-skepticism) would either adopt a neutral position or actively campaign for an exit. Either way, the odds on the UK leaving the EU would climb above 50%.

In the more probable scenario discussed in option (2)—that a Scottish independence vote would lead to a Labour-Liberal victory in the May 2015 general election—there would be no EU referendum in 2017 as promised by the Conservatives. At first that might seem to offer some relief on the European front. In reality, however, it would do nothing to secure Britain's EU membership. On the contrary, a Lab-Lib government would have to call another general election immediately after Scottish secession in 2016; an election in which EU membership would be straight back on the agenda. The Conservatives, emboldened by their 'natural' majority in the UK-minus-Scotland would swing towards outright Euro-skepticism and campaign for an immediate post-election referendum, laying down conditions for renegotiating EU membership which Brussels, France and even Germany would be sure to reject.

Thus a Conservative victory in a 2016 election would make Brexit almost certain a year later. If, as is quite possible, the Euro-skeptics overplayed their hand and the Tories lost the 2016 election, the UK would be saddled with a high tax Labour-Liberal government until 2021.

As a result, if Scotland does vote for independence next week, it is hard to come up with a positive scenario for British assets, whatever happens subsequently. Of course, there is always the hope that the polls may be wrong or the Scots will change their minds at the last moment once they realize what a Pandora's box of political uncertainties they are about to open. But hope is not a strategy. We recommend selling sterling and other British assets, apart from those such as resource shares which have little exposure to British politics and which benefit directly from a weak pound.

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