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Key Considerations For Rating An Independent Scotland

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Key Considerations For Rating An Independent Scotland

Scotland's electorate will go to the polls to vote in a referendum on independence on Sept. 18, 2014. If the "yes" vote wins, the new government of Scotland and the remaining U.K. will enter negotiations on issues such as the allocation of liabilities and assets and the monetary regime, among others. Standard & Poor's Ratings Services is often asked how we would rate a newly independent sovereign Scotland. Our views on the capacity of any sovereign state to pay its commercial debt on time and in full reflect five key factors detailed in our criteria, "Sovereign Government Rating Methodology And Assumptions," published June 24, 2013, on RatingsDirect. These factors are: institutional and government effectiveness, economic structure and growth prospects, external liquidity and international investment, fiscal performance and flexibility, and monetary flexibility.

Standard & Poor's credit ratings are determined by rating committees. The views expressed herein have not been determined by a rating committee and do not constitute a rating or an indication of any potential Standard & Poor's rating on an independent sovereign Scotland. Standard & Poor's takes no position in the debate on the pros and cons of Scottish independence.

Although we recognize that the debate is still in its early stages, we can draw a few broad conclusions about the creditworthiness of an independent Scotland:

- The macroeconomic profile of the wealthy and open Scottish economy conforms with the typical profile of sovereigns rated in investment-grade categories (i.e., 'BBB-' or higher).
- A successful agreement on Scotland's membership of a monetary union negotiated with either the U.K. or the eurozone (European Economic and Monetary Union) would provide considerable support for the rating on a sovereign Scotland.
- Alternatively, a decision by a sovereign Scotland to issue its own new and untested currency or to unilaterally adopt the currency of another sovereign--without gaining access to that currency's lender of last resort--could pose some initial risks to external financing, in our opinion. Specifically, we think Scotland would be hard-pressed, under a new currency regime, to quickly replicate the deep capital markets it enjoys today as part of the larger U.K.
- Nevertheless, with a GDP (including North Sea oil output) only slightly below that of New Zealand, a developed economy and developed financial system, there is no fundamental reason why Scotland could not successfully float a currency.
- The composition of Scotland's external balance sheet is as yet hypothetical, but our initial observation is that the Scottish financial sector is unusually large, with total assets estimated at 12.5x GDP. We would therefore likely view the financial sector as a significant contingent risk to the state. At the same time, a large part of this activity could be re-domiciled to the U.K.

Peer Comparison For An Independent Scotland

2014 estimated data

	Rating	Per capita GDP (US\$)	GG debt/GDP (%)	Current account receipts/GDP (%)	Estimated current account GDP (%)	Total domestic banking assets/GDP (%)
Ireland	BBB+	48,053	133	149	1.5	5.2

Peer Comparison For An Independent Scotland (cont.)						
Scotland (Geographical)*	N.R.	47,369	77	45	(1.1)	12.5
Germany	AAA	43,855	79	63	6.3	2.8
U.K.	AAA	41,006	94	43	(3.0)	4.6
Scotland (Population)§	N.R.	39,913	92	42	(4.6)	12.5
New Zealand	AA-	39,840	36	33	(5.1)	1.6
Slovenia	A-	22,733	73	87	6.7	1.3
Chile	AA-	17,826	8	37	(4.3)	1.1

*North Sea oil distributed according to geography. §North Sea oil distributed according to population. GG debt--General government debt. N.R.--Not rated.

Economic Structure And Growth Prospects: A Rich, Diversified Country

The Scottish economy is rich and relatively diversified, with 2014 per capita GDP estimated to be US\$47,369 (based on the Scottish government's estimates, which include Scotland's geographic share of North Sea output, abbreviated as Scotland (Geographical) in the table above). Scottish wealth levels are comparable to that of the U.K. ('AAA'), Germany ('AAA'), Ireland ('BBB+'), and New Zealand ('AA-'). Even excluding North Sea output and calculating per capita GDP only by looking at onshore income, Scotland would qualify for our highest economic assessment. Higher GDP per capita, in our view, gives a country a broader potential tax and funding base to draw from, which supports creditworthiness.

We view Scotland's trend growth as closely matching that of the U.K. While North Sea output (again on a geographical, rather than population-derived basis) accounts for 16% of Scottish GDP (calculated using data from the Scottish government's experimental national accounts project), this does not, under our methodology, lead us to conclude that the economy is excessively concentrated. We typically only adjust for excess economic concentration should a single sector exceed one-fifth of a country's GDP.

Nevertheless, Scotland's economic performance would be subject to several potential adjustment risks during its early years as an independent state. First, at 8% of GDP, and employing 7% of the workforce, Scotland's financial sector is large and closely integrated into the U.K. Re-domiciling of these international banks to the remaining U.K. could exert a drag on the size of Scottish GDP, though less so on gross national product, which excludes income from foreign-owned companies. Second, Scotland also has a natural dependency on merchandise and business services trade with the rest of the U.K., the destination for an estimated 49% of Scottish exports; independence may lead to a partial reversal of that integration, with economic consequences. Third, the public sector is sizable, accounting for nearly one-quarter of the total workforce. This is considerably higher than the U.K. average. In our opinion, shifting post-independence to a lower public sector employment rate could weigh on Scotland's initial growth performance. Fourth, at 16% of GDP the oil sector is also large. Indeed, a secular decline in oil production in the North Sea has been a significant factor in the U.K.'s below-par growth and productivity performance since 2008 and would be proportionally a larger drag on Scotland's future GDP performance unless the decline in volume energy output could be reversed. However, redressing the long-term decline in oil production might also carry fiscal implications if it

involved lowering taxes on the energy sector.

External Liquidity And International Investment Position: An Open Economy

The Scottish economy is relatively open, with exports of goods and services for 2012 contributing an estimated 45% of GDP (based on estimates from the Scottish government's national accounts project of current market value GDP, including North Sea oil). Based on experimental national accounts data published by the Scottish government, the amount of Scotland's exports as a share of GDP somewhat exceeds New Zealand's but is considerably less than Ireland's. Under our methodology for determining sovereign ratings, we measure debt servicing capacity as a percentage of current account receipts; therefore, this relative openness would likely benefit our external assessment of Scotland. Estimates provided by the Scottish government suggest an average trade deficit of around 1% of GDP between Scotland and the rest of the world, once North Sea energy and financial sector exports are included, although U.K. government data actually imply a slight surplus. Overall, then, from a balance of payments perspective, there is little evidence that Scotland depends on the rest of the world to finance a large share of its annual GDP. In other words, net external financing on an annual basis appears to be relatively low--again, based on the critical assumption that foreign currency receipts from all oil exports and financial sector activity accrue to the Scottish economy. However, were Scottish commercial banks to leave Scotland, its services exports would decline to a considerable degree. This could reveal an underlying dependency of the Scottish economy on net external financing flows--though without better data, it is difficult to say so with any certainty.

While Scotland's net external financing needs seem relatively modest, gross external financing requirements appear substantial. This would indeed imply vulnerability of the open and highly intermediated Scottish economy to the external environment, so caution is warranted, in our view. We do not have access to data on Scotland's net international investment position with the rest of the world--a key input into our rating on a sovereign--so we cannot reach any sweeping conclusions about an independent Scotland's external vulnerabilities. One thing, however, appears clear to us: the financial sector is large and makes up a significant proportion of Scotland's GDP. Scottish banks borrow from abroad to finance their operations both in Scotland and overseas. The assets of Scotland's banks and building societies--including Royal Bank of Scotland, Bank of Scotland (part of the Lloyds banking group), and Clydesdale--account for about 12.5x Scotland's mainland GDP versus an estimated 5.2x in Ireland, 4.6x in the U.K., and an average of 3.5x GDP across the EU. The capacity to finance banking operations via borrowing from nonresidents could become more challenging should Scotland be unable to retain its current monetary arrangement with the U.K, and hence lose access to financing from its lender of last resort, the Bank of England.

Monetary Flexibility: The Challenges Of An Independent Regime

As stated above, the framework for Scotland's monetary regime will be a key consideration in assessing its creditworthiness, according to our published criteria. If Scotland were not to join a monetary union then Scottish financial institutions would not have access to lending facilities from a major central bank such as the European Central Bank (ECB) or the Bank of England in a crisis. Under our methodology, we would likely assume initially that any newly launched Scottish currency would not be used in financial transactions outside Scottish borders. A unilateral

assumption of a global reserve currency such as the British pound sterling or the euro would not address the absence of access to liquidity support from the Bank of England or the ECB, unless a treaty arrangement along the lines of that between Lichtenstein and Switzerland could be reached. In our view, this would leave investors more reluctant to lend to Scotland's banks in a new currency that may not benefit initially from deep capital markets. Consequently, we would likely view a new independent monetary regime for Scotland as a constraint, relative to the U.K.'s monetary flexibility--primarily because active trading in the currency would, at least initially, be unlikely. Our 'AAA' rating on the U.K. is supported by the country's power to issue a global reserve currency and the depth of its local capital markets, denominated in this currency.

Fiscal Performance And Flexibility: Sensitive To Oil Revenues, But Free To Set Tax Rates

Based on data released by the Scottish government, we understand that Scotland's budgetary deficit had narrowed to about 5% of GDP (data for the fiscal year to March 31, 2012) from a peak of 10.4% of GDP in the fiscal year to March 31, 2010. The pace of consolidation appears to have been slightly more rapid than that in the U.K. as a whole. However, Scotland's higher dependency on oil and gas revenues could limit its fiscal flexibility in the absence of a fund set up to preserve these, similar to Norway's Fiscal Stabilization Fund. A new Scottish state would presumably begin life with a high stock of government debt and revenues highly sensitive to the price of oil.

That said, an independent Scotland with fiscal sovereignty would benefit from the ability to set corporate tax rates and other policies to attract foreign investment inflows. In fact, Scotland already has considerable fiscal independence. At present, about 60% of the total spending allocation for Scotland is already devolved from the U.K. treasury to the Scottish government and local authorities, while only 7% of the tax receipts of Scotland's regional government are raised by Edinburgh. Our understanding is that under the Scotland Act, 2012, this ratio is set to rise to 16%. Scotland's share of public spending, at 9.3%, is above its share of the U.K. population at 8.4%, with the biggest outlays in social protection, transport, health, and housing.

In terms of its share of the U.K.'s outstanding debt, how much an independent Scotland would assume would depend on negotiations between the two parties. On a per capita basis, its share of general government debt would amount to £116 billion for fiscal year 2012, or 8.4% of the total. Assuming that North Sea oil was allocated on a geographical basis, the ratio of Scottish debt to GDP would be about 77%. If the oil were allocated on a population basis, the figure would rise to 92% of GDP. This measure excludes future U.K. liabilities, such as payments of public sector pensions in Scotland, private finance initiatives, and the decommissioning of nuclear power stations. Compared with peers--excluding Chile and New Zealand, which have considerably less leveraged public sectors--these figures are roughly in line with high European averages (see table 1).

In brief, we would expect Scotland to benefit from all the attributes of an investment-grade sovereign credit characterized by its wealthy economy (roughly the size of New Zealand's), high-quality human capital, flexible product and labor markets, and transparent institutions. Nevertheless, the newly formed sovereign state would begin life with comparatively high levels of public debt, sensitivity to oil prices, and, depending on the nature of arrangements with the EU or U.K., potentially limited monetary flexibility. At the same time, Scotland's external position in terms of

liquidity and investment could be subject to volatility should banks leave. On the other hand, if this were to happen, it could bring benefits in terms of reducing the size of the Scottish economy's external balance sheet, normalizing the size of its financial sector, and reducing contingent liabilities for the state. In short, the challenge for Scotland to go it alone would be significant, but not unsurpassable.

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