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국제학석사학위논문

**Scotland's Potential Independence and the  
Banking System**

스코틀랜드의 독립 가능성과 은행제도

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# **Scotland's Potential Independence and the Banking System**

A thesis presented

By

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## **Abstract**

# **Scotland's Potential Independence and the Banking System**

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Scotland has recently announced the possibility of becoming independent from the United Kingdom in the near future. Although this remains a possibility, if Scotland does indeed decide to go through with this step, they will have to undergo changes to its governmental system.

This thesis investigates the banking system changes that Scotland could experience if it becomes independent. It moreover argues the possibility of Scotland adopting a similar banking system to Hong Kong's Monetary Authority as a good point of reference for Scotland in many ways. There are several reasons why Scotland may consider adopting Hong Kong's banking system, one of the fundamental reasons being that Scotland currently has an adequate foundation to do so where they have three commercial banks producing banknotes. Secondly, adopting Hong Kong's banking system would mean they simply substitute their current central bank to another central bank-like organization. Lastly, if Scotland forms a currency board system and pegs their interest rate to another currency, for example the United Kingdom, this would mean Scotland can minimize the changes to their banking system.

Hong Kong developed their current banking system from the free banking system and Scotland still has features of their previous free banking system present today. Hence, Scotland adopting Hong Kong's developed free banking system may be convenient for an independent Scotland. Therefore, Scotland can instantly begin to use the Hong Kong's banking system as they have established foundations for it.

There are many banking systems available for Scotland and this thesis aims to examine a few of them and compare it with Hong Kong's banking system for Scotland. The aim of this thesis is to provide one possible path for Scotland. Scotland could simply follow the United States and abandon their free banking system completely and form their own central banking system.

Overall, this thesis endeavors to be a suitable guide for the Hong Kong's banking system being used in an independent Scotland and hopes to contribute when Scotland makes a decision with their banking system.

**Keywords: Scotland, Currency, Banking, Independence, Free Banking System**

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## **Abbreviations**

BoE – Bank of England

EU – European Union

FRS – Federal Reserve System

GBP – Great British Pound

HKMA – Hong Kong Monetary Authority

PLC – Publicly Listed Company

SNP – Scottish National Party

U. K. – United Kingdom

U. S. – United States

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# Chapter 1. Introduction

In 2021, Scotland had their Scottish Parliament election and both the Scottish National Party (hereafter SNP) and Scottish Greens campaigned on a manifesto commitment to a second Scottish independence referendum where they managed to win 72 out of 129 seats (Institute for Government, 2021). This implied that many Scottish citizens were in support of the Scottish independence movement. The Scottish government therefore argued that this result called for another Scottish independence referendum – a referendum is a simple ‘yes or no’ voting system on a political matter (Sturgeon, 2021). Their first referendum for Scottish independence was in 2014 where the majority voted to remain in the U. K. (Sturgeon, 2021). If Scotland is to become independent from the United Kingdom (hereafter U. K.), many governmental systems are likely to go through changes, including the banking system. There are various choices when it comes to the banking system for a potentially independent Scotland. However, deciding on which banking system to use will be one of the greatest tasks for Scotland when becoming independent. This thesis aims to discuss how Scotland can select the most ideal banking system in their current situation and argues that Scotland could adopt Hong Kong’s Monetary Authority (hereafter HKMA) system. Hong Kong’s HKMA system was developed from the free banking system in the past and Scotland also used this banking system in the past and was successful with it. The HKMA system still contains certain aspects of the free banking system and these features are also present in today’s Scotland. Therefore, this thesis believes that Scotland could be successful following Hong Kong’s HKMA banking system when becoming independent from the U. K.

A free banking system is a banking system where banks can freely print their own paper currency (banknotes) and compete with each other with no regulations. There are no barriers to entry in the printing of the currency and the supply of the currency is controlled by the free market (Selgin, 1985). Through a competitive banking system, this system forces banks to read the demand of their clients and make sure that they do not over or under supply banknotes. This considers the issue that their clients can always substitute to another bank if they feel that the value of the banknote is unstable. In other words, there is little to no room for any inflation as banks will always attempt to match the supply of their banknotes to the demand of their



clients. This is because if they do not do so they are likely to become excluded from the industry due to substitutes. As long as banks follow these rules, there are no other restrictions in a free banking system (Bordo, 1995). Thus, one of the greatest advantages of the free banking system is that the value of the currency is likely to be the most suitable value for the country as it is secured through the invisible hand (Lee, 1992). Most importantly, banks in a free banking system are always aiming to secure the value of their banknote in order to survive in the industry. Therefore, there are no unnecessary fluctuations in the value of banknotes in a free banking system (Lee, 1990). This free banking system was used by Scotland, Hong Kong, and the United States in the past (Lee, 2009). In present day, we see Scotland and Hong Kong have their commercial banks produce banknotes for the country and these features are from when both countries still used the free banking system. Hong Kong developed their free banking system into their current banking system and Scotland who still has these attributes may also be able to develop their banking system in a similar style to Hong Kong. On the other hand, the United States abandoned the whole system and started their own central banking system today known as the Federal Reserve System which Scotland could also follow. The latter part of this thesis aims to examine the free banking system in all three countries, United States, Hong Kong, and Scotland, and show the pros and cons of the banking system features and how they developed into the banking system the three countries use today. This is in order to provide a perspective on which banking system Scotland should develop into as Scotland has the potential to go select either.

Currently, we see most countries using the central banking system which is a banking system where a single bank is chosen as the central bank of the country and becomes a monopoly for the supply of the banknotes in the country and is often responsible for monetary policies (Segal, 2020). The U. K. central banking system is considered to be the model for most central banking systems across the world (Kenton, 2021). Most central banks are nationalized and for those that are not, their privileges and establishments are protected by law (Segal, 2020). In a central banking system, private commercial banks may be present; nonetheless, they are 'only permitted to issue demand liabilities such as checking deposits' (Segal, 2020). In other words, commercial banks are not permitted to print banknotes in a central banking system unlike the free banking system. In a central banking system, whether the central bank is independent or not, the central bank shares the same goals as the government which is to maximize

employment and secure stable prices (The Federal Reserve, 2021). While many may argue that the central banking system is the most universal banking system and therefore the more stable banking system than the free banking system, several scholars have argued that the central banking system is not used because it has evolved into the most perfect banking system, but a central bank controlling the whole supply of a currency is simply more convenient for governments (Rockoff, 1974). As there is only one bank in control of the whole supply of the national currency, the government can indirectly demand the bank to use monetary policies when they feel it is necessary (Dowd, 1988). Consequently, it has been argued that the central banking system is not superior to the free banking system but simply convenient for governments when executing monetary policies (White, 1990). Scotland and the United States both use the central banking system today. However, Hong Kong has formed their own unique banking system which combines the central and free banking system. Scotland appears to enjoy their current banking system and therefore can select a similar path to the United States or Hong Kong at the same time.

This thesis examines why Scotland may benefit from adopting a similar banking system to Hong Kong if they become independent. Scotland has several options for which banking system to adopt if it becomes independent. For example, they could request the U. K. to have the Bank of England remain as their central bank whilst being independent, they could form their own central bank, they could become a member of the European Union and accept the euro or even re-adopt the free banking system they were once successful with in the past (White, 1984). However, the main aim is to select a realistic banking system that can instantly come to use for an independent Scotland. Furthermore, drastic changes to the banking system may bring negative results both locally and internationally. Hence, Scotland should aim to secure a safe and realistic banking system whilst preventing worry from the global economy. In order to do so, Scotland should first make sure they are utilizing their condition to full capacity and are efficient with their resources. Scotland currently has three commercial banks printing banknotes and the Bank of England as their central bank (Bank of England). The current banking system of Scotland consists of a central bank, which is the Bank of England, and eight banks across the union producing banknotes for the union (Bank of England). The current banking system of Scotland will be further evaluated in section 1.3.

The main aim of Scotland is to adopt a banking system that does not dramatically change their

current system and works at the same time. In 2014, Scotland proposed to seek the Bank of England as their central bank even if they leaved the union. This request was rejected as the U. K. stated Scotland should stay in the union if it wants to seek the benefits of the union (Hardie, 2022). This shows that Scotland does not want to change their banking system too much and therefore accepting the Hong Kong's banking system may be a loop hole for Scotland in minimizing the changes in their banking system. In this case, Scotland can have their three commercial banks producing banknotes but a central bank like organization forming a currency board system and pegging their currency to the U. K. in order to keep their usual interest rates. It is hoped that this thesis will be an important contribution to Scotland if it does decide to become independent and are deciding on what banking system to adopt as it aims to provide a perspective of the Hong Kong's banking system style in an independent Scotland.

Following on from this introductory chapter, the next section will provide a literature review and present some of the options Scotland may have should they decide to become independent. Chapter 2 will examine how the free banking system functioned in all three countries of the United States, Hong Kong, and Scotland in the past and how their systems developed into their current systems. This is in order to show that Scotland can follow either the path the United States and Hong Kong has taken from their past free banking system. Following on, Chapter 3 will show what banking system Scotland can aim to use and why the Hong Kong's banking system may be the most appropriate for Scotland. Then the next part of the chapter will discuss some alternative bank system paths available for an independent Scotland. Before the conclusion, this thesis will present the limitations this thesis holds in hope that later researchers could overcome the limitations through further investigation. Lastly, the concluding chapter will present the final results of this thesis.

## **1.1 Literature review**

The foundational literature for this thesis was Lee Joo Won's *A Study on the Safety of the Free Banking System* in 2009. In his work, Lee defines and examines the free banking system through Scotland, Hong Kong, and the United States and argues that the system is a well-built banking system. Lee furthermore argues that the free banking system does not stand weaker against the central banking system and justifies why he thinks so. Lee's work, examined what

the free banking system was and moreover that the system may still be useable today in an independent Scotland. Therefore, this research referred to Lee's work and the references he had used to build his argument to further research on the free banking system and how Scotland used this system in the past. Through this investigation, it revealed that the free banking system was a solid banking system and that Scotland has the appropriate foundation to re-adopt the system once again if they wanted to in an independent Scotland. Therefore, whilst Lee's work defined the free banking system and presented the potential it had; this research planned to further discuss how the remaining features of the free banking system in Scotland could be used to adopt Hong Kong's banking system that also used the free banking system as foundation to form their current banking system. Additionally, this research endeavors to provide how the free banking system foundation is not always successful through the U. S. case study. This implies that it may be better to completely abandon the foundation of the free banking system and start a totally new banking system.

In order to build a stronger argument, this research collected more data and references on why Scotland may become independent through the Institute for Government website last updated in 2021 which in detail explained why Scotland may become independent. This research also gathered information on what governmental and banking paths Scotland had before them and what the pros and cons of each path were. Then information was gathered on the current banking system of Scotland through the Bank of England website which explained the U. K.'s banking structure and Scotland's situation with their banking in the U. K. Whilst doing so, this research found that the U. K. banking system was more complicated than initially addressed and that Scotland surprisingly had three banks printing banknotes at the moment. Therefore, Scotland could use some of their current conditions to form a more suitable banking system for themselves. Moreover, Scotland had Hong Kong, who also used the free banking system as foundation for their current banking system, to refer to if it wanted to form their independent banking system.

Lastly, in order to form a more convincing argument of how Scotland could adopt a similar banking system to Hong Kong, information was collected on Hong Kong and the United States. This was in order to firstly show how the two countries used and abandoned the system over time. Secondly, to show with the right adjustments the system can be developed into a more solid banking system or be totally ignored when building a new banking system. Information

of both countries and their current banking systems were collected through the official Hong Kong Monetary Authority and Federal Reserve websites. By examining the two countries, I was able to see that both of the countries had benefited and failed with the free banking system. However, through the two countries, I was also able to understand that the free banking system helped them build a more efficient banking system for themselves which Scotland can refer to.

## **1.2 Why Scotland may become independent in the near future**

As noted in the introduction, this thesis is written on the hypothetical condition that Scotland becomes independent from the U. K. Scotland has been a member of Great Britain since 1707 and naturally became a part of the U. K. when it was formed 1922 (Wallenfeldt, 2022). Thus, Scotland shares a long history with the U. K. and many would assume that Scotland becoming independent now may appear odd. However, this is not the first time Scotland has attempted to become independent. If Scotland does decide to have a referendum for independence in the near future, this would be their second attempt since 2014 (Mullen, 2014) when the results rejected independence 55.3 to 44.7 percent. Recently, there have been government polls asking Scottish citizens regarding Scottish independence and the polls reveal that if Scotland is to have another referendum, the results are more likely to lean towards leaving the U. K. (Curtice and Montagu, 2020) and following are the evidence for it.

Since 2016, there have been a chain of events that have made Scotland consider leaving the U. K. For example, in 2016 there was a U. K. referendum regarding the membership on the European Union (hereafter EU). The referendum was based on whether to stay or leave the EU and 62% of the Scottish citizens voted to stay in the EU (McEwen, 2021). Nevertheless, the U. K. decided to leave the EU and the SNP later stated that ‘Scotland is being taken out of the EU against their will’. The result of this referendum made the Scottish citizens question the U. K.’s democracy and the SNP used this opportunity to raise the independence topic once again (Institute for Government, 2021). Furthermore, since the recent global COVID19 Pandemic, some Scottish citizens have stated that the Scottish government have ‘handled the situation better than the U. K. government’ and this led to the 2020 and early 2021 polls favoring Scottish independence where 59% of the citizens supported it (Kings College London, 2021).

Consequently, since 2016, Scotland has been leaning towards independence and in the recent 2019 and 2020 polls, it was revealed that more Scottish citizens desired to leave the U. K. than to remain in the union (Curtice and Montagu, 2020). This implies that if there is to be another Scottish independence referendum, Scotland may leave the union. Therefore, this thesis aims to examine what banking system Scotland may adopted if it decides to become independent.

### **1.3 Scotland's current banking system**

Scotland's current banking system follows the U. K.'s banking system. The U. K.'s banking system consists of a central bank known as the Bank of England (hereafter, BoE) which acts as a government's bank (Kenton, 2021). Although the bank is named after England, the BoE is the central bank of the U. K. meaning that it acts as the central bank for Scotland as well. The BoE issues banknotes and overseas monetary policies and is the U. K.'s equivalent to the Federal Reserve System to the United States meaning that their main goal is to maintain financial stability in the union (Kenton, 2021). The BoE was initially a private bank that loaned money to the English government. However, it was chosen to become the central bank of England in 1694 to fund the war against France (Bank of England, 2021).

Some may question at this point when and why did the BoE become the central bank of the U. K. The BoE was nationalized in 1946 through the labor government's '1964 Bank of England Act' which stated that they wanted to 'make provision with respect to the relations between the Treasury, the Bank of England and other banks (Information Britain, 2012)'. Since 1964, although it has never publicly been announced, the BoE has been the central bank of the U. K. according online sources (Corporate Finance Institute). In 1997, the BoE became an independent body from the government and was as given the authority to set the interest rate of the U. K. (Bank of England, 2021).

For Scotland who has been a part of the U. K. since 1922, a member of Great Britain since 1707 and an unofficial partner of England since 1604 (through King James VI of Scotland also known as King James I of England who was a Scotting King inherited into the English Kingdom) (Little, 2020), it was a natural process that the BoE became the central bank for them as well. Especially considering that England had more to offer to Scotland than Scotland to

England when they formed the U. K. (Little, 2020). Nevertheless, England and Scotland's union of the Great Britain was never fully mutual meaning that both countries were never on full agreement with the U. K. system. As a result, Scotland had to 'relinquish its parliament under the agreement, but it kept Scottish law (Wallenfeldt, 2022)'. This meant that Scottish laws were still present and that Scotland were not in full support of the U. K.'s systems.

Nevertheless, in terms of banking system, we would expect the BoE to be in full control of monetary policies and in control of the supply of banknotes in the U. K. as the BoE is the central bank of the U. K. However, the U. K. has a more complicated banking system than most other countries and their central banking system. One of the many different systems being that the BoE does not fully supply banknotes by itself. In 1844, the 'Bank Charter Act' (which restricted the power of British banks and have exclusive note issuing power to the BoE) was passed giving the BoE monopoly on issuing banknotes for England and Wales (Bank of England, 2021). However, this Act had limitations and only had an impact of England and Wales meaning that it did not affect the banks in Scotland and Northern Ireland. As a result, there are currently three banks in Scotland and four banks in Northern Ireland issuing banknotes (Bank of England). The three Scottish banks issuing banknotes are as follows:

- Bank of Scotland plc
- Clydesdale Bank plc
- The Royal Bank of Scotland plc.

Consequently, there are currently eight types of banknotes in the U. K. and there have been various problems of there being more than one type of banknote, such as some banknotes being preferred than others (BBC, 2020). These small problems lead to political conflicts between the union members and tends to show that the U. K. is not fully united (BBC, 2020).

Hence, differently from most central banking system, the BoE does not control all the supply of banknotes in the U. K. Nevertheless, the BoE still has the responsibility as the central bank of the U. K. for regulating the 'treatment, holding and issuance of commercial banknotes in Scotland' (Bank of England, 2017). This means that although the BoE does not directly interfere with the printing of banknotes in Scotland, they still have the responsibility and right to monitor and guide Scottish banknote printing banks. The BoE derives its responsibilities and powers from 'Part 6 of the Banking Act 2009' which grants the BoE the right to monitor

currency printing banks and make sure they hold backing assets equivalent to all of its banknotes that are in issuance (Bank of England, 2017). This is in order to prevent banks from loaning more than they have as collateral and causing a financial crisis. Additionally, to protect the banknote holder. Furthermore, the BoE's has the power granted by the U. K. parliament to supervise and deliver penalties to banks that perform poorly (Bank of England, 2017). For example, when a bank fails to comply with the regulation and rules. Other than these roles, the BoE is not responsible for other aspects of Scottish banknote issuance such as the design and etc. The banknotes from Scotland and Northern Ireland share the same value as the BoE banknotes and can all be used throughout the U. K. Nonetheless, there are often cases in England where Scottish and Northern Irish banknotes are unrecognized and therefore declined (BBC, 2020) which causes inconveniences for Scotland and Northern Ireland citizens traveling in England. Scottish citizens have been vocal about this situation, expressing their dissatisfaction with the union not solving this problem despite having the ability to do so. They state that this situation is a form of discrimination in the union and that the U. K. has the ability to solve this situation but are not doing so to keep monopoly power in the BoE banknotes (Mcilkenny, 2019). This may be one of the many reasons why Scotland are trying to leave the union.

Overall, Scotland currently shares the U. K.'s central banking system where the BoE is the central bank that decides on monetary policies and provides banknotes for the U. K. However, Scotland also produces their own Scottish banknotes which are monitored by the BoE. Thus, giving Scotland the option of re-adopting the free banking system, adopting a similar banking system to Hong Kong and even disposing the whole system itself. If Scotland wants to do either of the first two, Scotland has the general foundation for it as they already have three banks printing banknotes.

#### **1.4 Optional paths for Scotland with their future and banking system**

As previously mentioned, the majority of Scottish citizens are in support of the independence movement after the U. K. decided to leave the EU despite the majority of Scotland wanting to stay and after specialists stating that the Scottish government have handled the Covid-19 situation more professionally than the U. K. government. However, if Scotland does decide to



leave the U. K. this would mean that their governmental structure since the 16th century will have to go through major changes. Therefore, Scotland must be careful with their decisions regarding their union membership. Thus, this part of the chapter plans to identify some of the optional paths for Scotland with their government and furthermore future banking system.

One of the many paths Scotland could take is to simply remain in the U. K. Despite the recent disappointments from the U. K. government for Scotland, remaining in the U. K. is always an option. This can be reflected in the 2021 Scottish election when the polls started to narrow down again on the subject of Scottish independence (Institute for Government, 2021). This implied that despite all the disappointment Scotland showed towards the U. K., they believe that remaining in the union may be more beneficial. This was also the case for the 2014 Scottish independence referendum which resulted in a 'no' (Institute for Government, 2021). Scotland has been a part of the U. K. since the birth of the union and their system, despite often having different beliefs to the union, has been shaped by the U. K. Thus, remaining in the U. K. could be a possible path for Scotland and this would mean that Scotland remains with their current banking system which will be examined in chapter 3.1. In this case, Scotland may be able to use their situation of almost leaving the union to request a few changes in the union and the banking system. For example, on the condition that Scotland remains in the U. K., Scotland could ask the U. K. to help solve the problem with their banknotes being unrecognizable in the union which will be further explained in chapter 3.1 (BBC, 2020).

On the other hand, if Scotland does decide to leave the union, there are several choices available for Scotland in terms of governmental and banking. One of the governmental and banking paths Scotland could take is to join the European Union. The U. K. leaving the EU was one of the major reasons why Scotland started to seek independence from the union. Furthermore, according to Kristy Hughes, if Scotland legally becomes divorced with the U. K., then Scotland becomes an independent European state meaning that they have the right to join the EU (Hughes, 2021). Additionally, the U. K. was a member of the EU for 47 years and had followed most of the EU laws. This implies that Scotland has also indirectly been following the EU laws and thus Scotland would not have great difficulties accepting the EU laws (Hughes, 2021). Hence, Scotland could join the EU if they were to leave the U. K. and, in this case, Scotland could adopt the euro following the EU banking system. Simply because Scotland is

to join the EU, this does not mean Scotland must accept the euro (Segal, 2021). In the case of the U. K. when they were a part of the EU, they never adopted the euro arguing that the euro did not pass their five economic test criteria. Therefore, if Scotland was not fond of the idea of accepting the euro, they may be able to form their own reasons to reject the euro but still join the EU. In this case, Scotland would be able to be a part of the EU but have their own independent currency and banking system. Depending on whether Scotland adopts the euro or not when joining the EU will act as a major dividing point in their future banking system. If Scotland were to go fully euro this would mean that Scotland would accept the European Central Bank, also known as the ECB, that acts as a central bank for Europe (Hayes, 2020) freeing Scotland from any concerns to do with monetary policies and worrying about the interest rate. Although, there is the downside of the Scottish government not being able to directly interfere with monetary policies and interest rates when in need. On the other hand, if Scotland decides to keep their currency despite joining the EU, Scotland would be able to freely decide on which banking system they want to pursue.

However, the EU also has certain requirements Scotland must be able to accomplish if they were to join the union. Firstly, Scotland must prove to show democratic stability and also show that it has a functioning international market without the U. K. (Hughes, 2021). Secondly, Scotland must accept all new EU laws made since Brexit (Hughes, 2021). However, even if Scotland is able to prove the two foundational requirements above, this does not mean Scotland can join the EU over-night. The general process for a European state to join the EU takes up to 18~24 months and in the case of Scotland, due to their 7% deficit ratio (in order to join the EU a country must have their fiscal deficit below 3%), this process could take up to 5 years according to specialists (Hughes, 2021). There is the possibility of the deficit criteria being changed due to the recent Covid-19 crisis, nevertheless nothing is confirmed for now. Moreover, the ECB becoming the central bank of Scotland would mean that the three commercial banks in Scotland can no longer produce banknotes which perishes their long banknote heritage.

Scotland could become independent from the U. K. but keep their current banking system. In other words, they keep the Bank of England as their central bank and share the banking system with the U. K. In this case, Scotland would be independent but have a shared central bank with the U. K. where the BoE is responsible for 'inflation and for lender of last resort activities across the currency area (Hardie, 2022)'. However, in the 2014, the referendum proposal for

an independent Scotland sharing the central bank with the union was already declined (Hardie, 2022). Thus, it is unlikely the U. K. would share their central bank with Scotland if they become independent.

Scotland could pursue to form their own central bank. However, according to Armstrong and McCarthy Scotland lacks the capacity to form their own currency and manage a central bank (Armstrong and McCarthy, 2014). This means that the Scottish central bank would lack credit from the world (Armstrong and McCarthy, 2014).

Scotland could adopt the free banking system once more as they have the appropriate environment for it (Lee, 2009). However, simply because the system was successful in the past, this does not promise a successful banking system today.

Lastly, and the main argument of this thesis, Scotland could adopt a similar banking system to Hong Kong. Hong Kong's banking system consists of three commercial banks printing banknotes and one central bank like organization (HKMA) guiding the three banks on how many banknotes to produce. This is whilst making sure that the interest rate is pegged to another country (the United States) through their currency board system and stays in a certain range. In this case, Scotland could have their three commercial banks continue to produce banknotes and simply form a central bank like organization that would adopt the role of the Bank of England and peg the Scottish interest rate to another country; most likely the U. K. In this case, there would be little to no change in the Scottish banking system as they have simply substituted the BoE's role with another central bank like organization. Hong Kong modified their free banking system in the 1990s to adapt to their changing governmental system and have showed promising results. Therefore, Scotland may benefit in the banking industry if they follow a success confirmed Hong Kong banking system.

There may be more options for Scotland with their future and banking system. Nonetheless, the options mentioned in this section of the chapter may be considered to be the most popular.

In this section we have discussed the potential options for an independent Scotland regarding their governmental and banking system. This thesis mainly argues that the Hong Kong's banking system would be an appropriate banking system for Scotland and help Scotland become fully independent.

## Chapter 2

This chapter examines the free banking system in both countries (the United States and Hong Kong), and also compares the differences it had with Scotland's free banking system and how their system developed into their current banking systems. This section of the thesis aims to show the potential the free banking system had in the past and provide a wider understanding of the free banking system as a foundational banking system. This is in order to show a less bias perspective of the free banking system when Scotland is using its features to form their own banking system. The purpose of this section is to show that the free banking system was a solid banking system for Scotland and Hong Kong but not for the United States. Hence, to decide whether it is better to keep the characteristics of the free banking system or abandon the whole system when Scotland forms their own banking system.

### 2.1 Free banking and the United States

The United States (hereafter U. S.) was a user of the free banking system between 1837 and 1863 and this time period was referred to as the 'Free Banking Era' in the U. S. (Rolnik and Weber,1982). However, unlike Scotland and Hong Kong, the U. S. was never too successful with the free banking system. During this time period, 18 out of 32 states adopted the free banking law. The rules were simple, anyone could enter the banking industry and provide paper currencies redeemable of gold or silver and 'designated government bonds had to be deposited with a state authority as security for all circulating notes issued by a bank (Rockoff, 1974). The bank was entitled to interests of bonds and if they failed to deliver the bank had to pay with their assets to pay the note holders. However, similarly to Hong Kong which will be explained next, each state had their own unique adjustments to the free banking system and differently to Scotland and Hong Kong, the free banking system in the U. S. was not all successful (Rolnik and Weber,1982). It is difficult to note what these differences were in each bank in each state as they were never recorded properly (Rolnik and Weber,1982). However, according to Rolnik and Weber, in 1863, 48 percent of the banks in the U. S. had left the market which showed negative signs towards the free banking system. Nonetheless, out of the 48 percent of the

closing banks, it was only 15 percent of the banks that closed due to bankruptcy and the other mostly closed for unknown reasons. These results show that the free banking system is not always perfect and does not promise everyone who enters the banking market to gain success. However, Rolnik and Weber also implied that the 1837 to 1863 period was simply not the most economically stable period for the U. S.

The banks during the free banking era were referred to as wildcat banks (Downey, 2021). It was never clear why they referred to banks in this period with the terminology wildcat banks. However, some argue it is because ‘bankers were believed to have set up banks in areas so remote that wildcats roamed there whilst others say the term originated with an early bank that issued currency bearing an image of a wildcat (Downey, 2021). The wildcat banks during the free banking era were never fully free of regulations as mentioned above. Wildcat banks were ‘chartered under applicable state laws and regulated on the state level’ (Downey, 2021), meaning that each state had their own unique law and restriction for their wildcat bank. There are accusations that the free banking era had failed due to wildcat banks being frauds during the free banking era (Surro, 2015). However, according to Chris Surro, this is a false accusation and no other system would have done any better at the time. The free banking system at the time ‘didn’t seem to have any advantages (Surro, 2015)’ and therefore it had little impact on economic efficiency and small to no effect on economic growth. In other words, the results of the free banking system were mediocre and the U. S. ended up perishing the whole system.

The U. S. currently has the Federal Reserve System (hereafter FRS) which is the central bank of the U. S. and independent from the government (Hayes, 2022) and there are no more signs of the free banking system. The FRS shares the same aims as all other central banks across the world which is to maximize employment and secure stable prices (The Federal Reserve). They do this by controlling the supply of money through the ‘Treasury Department's Bureau of Engraving and Printing’ also known as the BEP (The Investopedia Team, 2021). In other words, there is no more presence of the free banking system remaining in the U. S. anymore. The free banking system did not show the most ideal results in the U. S. which shows that the banking system does not always succeed in all cases. However, during the early to mid-18th century, it was not the most economically stable period for the U. S. according to Rolnik and Weber, and therefore they imply the U. S. would have showed similar results with whatever banking

system they used at the time. All in all, the U. S. shows no more sign of the free banking system in their current banking system. This may imply that Scotland could be better off simply abandoning the remaining features of the free banking system and start fresh with the central banking system in an independent Scotland.

## **2.2 Free banking and Hong Kong**

Hong Kong on the other hand was a successor from the free banking system. Hong Kong is also a country that used to use the free banking system in their past and was successful with it unlike the U. S. but also had some different features to Scotland. Hong Kong is a part of China but was also a part of the British empire between 1898 and 1997 as a colony (Little, 2019). During this period, the Hong Kong government adopted the free banking system, but added some conditions to the system. One of the main conditions was that the Hong Kong government only chose and allowed three commercial banks to produce banknotes and supply them (Chu, 1996). Differently from the Scottish free banking system, not all banks were able to produce banknotes as the Hong Kong government chose three and only allowed the three banks to produce banknotes (Chu, 1996). However, other than these features, Hong Kong was able to enjoy the free banking system without any other restrictions between 1935 to 1964 until the Hong Kong government decided to regulate their banking system in 1964 (Chu, 1996). During this period between 1935 to 1964, there was not once a bank default in Hong Kong which showed that the free banking system showed potential as a banking system. As a result, this showed a successful banking period with a somewhat regulated free banking system.

In 1997, Britain released Hong Kong from their colony and Hong Kong was returned to China but on a condition that Hong Kong would have fifty years of a ‘one country two systems’ system in order for Hong Kong to digest and accept their situation (Little, 2019). Hong Kong’s banking system currently has a central banking system structure with remaining free banking system features. Hong Kong developed their free banking system features and formed a Hong Kong Monetary Authority (hereafter HKMA) to act as a central bank institution in 1993 and this system remains today (Delphix). The HKMA was established four years before Hong Kong was released from the British empire and it was in order to promote the ‘one country two system’ philosophy’. As a result, merging the ‘Office of the Exchange Fund and the Office of the

Commissioner of Banking led to the formation of the HKMA' (Delphix). The main purpose of the HKMA is to ensure city stability through monetary policies and banking systems. However, unlike other central banks, the HKMA does not print the Hong Kong banknotes. the HKMA allows three banks in Hong Kong to supply banknotes for Hong Kong and the list of the banks are as follows:

- Standard Chartered Bank
- HSBC
- Bank of China

Nevertheless, the HKMA controls the number of banknotes each bank can supply (Delphix). On the other hand, an interesting system of the HKMA is that they make the three commercial banks buy and resell the banknotes printed by themselves when they want to control interest rates of Hong Kong instead of telling those banks to produce more or less of the banknotes. The HKMA uses 'Linked Exchange Rate System (hereafter LERS)' which is a currency board system where Hong Kong pegs their currency to another country, in Hong Kong's case the U. S. which is the international reserve currency. A currency board is an extreme form of pegged exchange rate (Kenton, 2021). Hong Kong adopted the LERS in 1983, and since 1983, LERS uses this currency board system to secure the Hong Kong's currency to stay in the bank of HK\$7.75-7.85 to one US dollar through making the HKMA buy and sell the Hong Kong banknotes when in need (Hong Kong Monetary Authority). When we examine Hong Kong's current banking system, we see many resemblances to Scotland's current banking system situation where they have commercial banks supplying banknotes but a central bank like organization providing guidance. Hong Kong's current banking system structure tends to resemble Scotland banking system to some extent. Scotland has the BoE as the guide on banknote supply and interest rate decider, while Scotland prints their own banknotes. Thus, it appears that Scotland could substitute the BoE for a central bank like organization such as Hong Kong is doing. Moreover, it could also form a currency board system and choose the U. K. to peg their currency where they follow the U. K. interest rates. In this case, Scotland would simply be continuing their current system with the minimum changes.

Hong Kong was successful with their free banking system in the past and their being no bank default during their free banking period shows statistical evidence for it. Today's Hong Kong's hybrid banking system developed from the free banking system functions remarkably and is considered as one of the world's financial centers (Rafferty, 2021). This implies that the HKMA have proven to be a solid banking system and Scotland may be able to benefit from implementing a similar organization.

Through viewing Hong Kong and the U. S.'s free banking system in the past, we are able to realize that the free banking system is simply another alternative banking system to the central banking system. It may not always be successful as can be seen in the case of the U. S. However, when developed correctly, the system may be appropriate in today's world as we see through Hong Kong. Scotland also showed promising results with the free banking system which can be examined in the next chapter. Thus, Scotland may be able to achieve similar results to Hong Kong if they decide to follow Hong Kong's banking structure. Also, Scotland arguably has a convenient foundation at the moment if they were to adopt Hong Kong's banking system. Therefore, Scotland could consider Hong Kong's banking system if they become independent.

### **2.3 Scotland's Free Banking System in the past**

Scotland's free banking system was in use between the 18<sup>th</sup> century to the early 19<sup>th</sup> century and was viewed to have 'remarkable monetary stability at the time (White, 1984)'. During Scotland's free banking system at the time there was no central bank and anyone could print banknotes and use them as a currency (White, 1984). However, there were certain rules that followed with the free banking system according to White and the list was as follows:

- Firstly, anyone can decide to open a bank if they wanted and this was to promote competition in the banking industry.
- Second, the government subsidized early contenders in the banking industry. This was to provide an incentive to start a bank and to help those in the countryside to also open banks.
- Third, the government was not allowed to borrow loans from the banks. Before Scotland implemented the free banking system Scotland had witnessed the French



government abuse their banks and loan more than they could handle. Thus, the Scottish government added that they will ban themselves from loaning from the banks in order to avoid monetary crises.

- Fourth, as banks could freely enter the industry, banks were to make sure that they kept strict control of banknotes being released into the market making sure they never over supplied banknotes and also hold collateral equal to their banknotes.
- Fifth, banks had unlimited liability, meaning that they could always respond to withdrawals whenever clients requested it.

Other than these conditions, banks remained untouched by the government. According to Kevin, the flexible free banking system of Scotland was surprisingly stable and even when banks throughout the U. K. was facing monetary difficulties, Scotland was not affected as much and Kevin stated this could have been due to their free banking system (Kevin, 1992). Following is a table that shows Scotland’s default rate (the percentage of all outstanding loans the bank has written off as unpaid) throughout 1809 to 1830 by White.

**Table 1 - Scotland’s default rate between 1809 to 1830**

<b>Year</b>	<b>Default rate percentage</b>
1809	0.00
1810	0.00
1811	0.00
1812	0.00
1813	1.43
1814	0.00
1815	0.90
1816	1.41
1817	0.00
1818	0.00

1819	0.00
1820	1.32
1821	0.00
1822	1.30
1823	0.00
1824	0.00
1825	1.20
1826	1.11
1827	0.00
1828	0.00
1829	1.14
1830	0.00
Average	0.04

During this time-period, the U. K.'s default rate was an average of 1.81 whilst Scotland's default rate was 0.4. This shows that Scotland's free banking system was very promising and secure. Following on is the free banking system in Hong Kong and the United States who have also used the free banking system in the past. However, according to Lee Joo Won, Scotland had the purest form of free banking as Hong Kong and the United States implemented certain conditions to their free banking (Kee, 2009). Today we still have three commercial banks producing banknotes in the U. K. This part will be further explained in the next chapter. Nonetheless, the free banking system characteristic of the private banks producing banknotes is still present in today's Scotland. Hence, if Scotland decides to become independent Scotland will always have the options of developing their current free banking system factors or completely changing it. Nevertheless, the greatest advantage of these remaining free banking features is that it gives Scotland a choice whether it is to follow Hong Kong and develop it or the U. S. and dispose it.

### Chapter 3

### **3.1 Independent Scotland and the banking System**

From reviewing Scotland's past free banking system, we are able understand that it was arguably successful at the time and from the current banking system that Scotland has the general foundations to adopt the free banking system if they wanted to and even adopt Hong Kong's banking system. They have three commercial banks supplying banknotes for Scotland (although via strict monitoring by the BoE) and the Scottish citizens are familiar with the Scottish banknotes. Therefore, if Scotland wanted to, they could instantly implement the free banking system or with some work implement a similar banking system to Hong Kong's HKMA. If Scotland were to adopt the free banking system, this would mean that the Scottish government could instantly implement the system and work on other governmental tasks as we can assume a just turned independent Scotland would be very busy. The greatest advantage of using the free banking system in an independent Scotland is that Scotland has used the system in the past and have been very successful with it which can be viewed in table 1. Therefore, this free banking system has already proven its capability and it will not be too difficult to show progress again from Scotland. Although one may argue that the last time Scotland used the free banking system was in 1830 and that there have generally been many changes since then. Thus, we are not sure if the 1830s success will directly be reflected in 2022. The results were rather 'remarkable at the time (White, 1984)' of the 18<sup>th</sup> century and therefore proved that the system did work for Scotland. Scotland has a somewhat convenient foundation to implement the free banking system. Scotland currently has three commercial banks: Bank of Scotland plc, Clydesdale Bank plc, and The Royal Bank of Scotland plc supplying money for Scotland and the U. K. (Bank of England). Thus, the government can instantly use their situation to activate the free banking system. They do not have to subsidize early investors into the banking industry and they can receive instant results. Most countries and their struggles of implementing the free banking system is that it is unprepared to suddenly let the free-market supply banknotes as the concept is new and there is no liability. However, the three commercial banks in Scotland have already proven their ability as banknote supplying banks which implies that the liability is there and the concept familiar to all. Therefore, Scotland, unlike most countries across the world, has a desirable background to implement the free banking system. Nevertheless, it may be difficult

for others to enter the market when there are already three dominant banks in the industry. This defeats the purpose of free banking if there is little competition. Additionally, as mentioned above, the Scottish government can focus on other governmental tasks in a just turned independent Scotland. If Scotland does become independent, there will be various governmental tasks for the Scottish government as they are changing their approximately three-hundred-year system they have been using. Therefore, if Scotland adopts the free banking system, this lightens the burden on the Scottish government as they can focus on other governmental tasks. In other words, it is a promising system for a just turned independent Scotland whether they choose to keep the system for the long-term or not. However, if the system fails to deliver causing monetary struggles for Scotland, this system may be very dangerous for just turned independent Scotland. Also, simply because the free banking system was successful in the 18<sup>th</sup> century, this does not promise a successful banking system today in Scotland.

On the other hand, if Scotland decides to adopt Hong Kong's HKMA system where they form a central bank like organization to monitor Scottish note printing banks and implement a currency board system to peg their interest rate to another country (most likely the U. K.). This banking system may take more work to form than simply re-adopting the free banking system. Nevertheless, there is a chance that this system may be the most appropriate banking system Scotland could adopt at the moment. This banking system would mean that Scotland can simply substitute the BoE's role to another group and require little to no change of the current Scottish banking system. Furthermore, if Scotland pegs their currency to the U. K. there would be little to no difference in the interest rate of Scotland before and after leaving the union. The Hong Kong's banking system appears to be a suitable system for Scotland's current condition if they become independent. The system has shown promising results in Hong Kong and thus Hong Kong itself proves as visual and historical evidence that their banking system is a working system. Furthermore, Scotland who shares many similarities with Hong Kong including land mass size, population, a history with England and etc. (Genuine, 2021) may therefore benefit from adopting Hong Kong's banking system. However, simply because this system worked for Hong Kong, this does not promise this system will be suitable for Scotland.

Scotland initially wanted to keep the BoE as their central bank. However, if Scotland can use a central bank like organization to mimic the BoE's role and secure reasonable inflation via

pegging the interest rate to the U. K., there is no need to ask the BoE to be their central bank. Scotland could simply form a HKMA like organization that acts as a government authority and controls the interest rate via monetary policies by buying and selling banknotes when in need to make sure that they stay in a fixed interest rate bank with the U. K. Drastic changes to the banking system may end up repelling users of the new banking system. Therefore, this HKMA like banking system may be most suitable for an independent Scotland. Moreover, if the Scottish government still wants to join the EU and adopt the euro, this system can buy time until Scotland can reduce their deficit ratio from 7 to 3 percent which is estimated to take up to 5 years (Hughes, 2021). Thus, this system can be used in the short and long run if needed. The HKMA banking system is a banking system that has helped Hong Kong develop into the economic giant it is today (Chan, 2007). The interest rate adjusting mechanism is an automatic system that allows Hong Kong to keep an almost identical interest rate with the U. S. and thus preventing Hong Kong from experiencing unpredictable interest rates. The HKMA system has been present since 1993, and many doubted the system in the past including Nobel prize winning economist Milton Friedman who stated in 1995 that the system would fail in the near future (Chan, 2007). However, the HKMA system managed to achieve a successful result with their mechanism and therefore Scotland could consider adopting this solid banking system.

There is also the path of changing the whole structure of the Scottish banking system where they would dispose their commercial banks printing banknotes system and form their own central bank as the U. S. did and formed the FRS (Hayes, 2022). However, as Armstrong and McCarthy had stated in 2014, this would be a major risk for Scotland and would mean that their now banking culture would be disposed.

There are various alternative systems when it comes to banking system for an independent Scotland. Whatever bank system Scotland decides to adopt there will always be the worry of threat towards it. Therefore, it is up to the Scottish government to make the call on which banking system they want to adopt in an independent Scotland. Nonetheless, I believe that they could consider the HKMA like system as their banking system as it contains potential and may come convenient in the short and possibly the long-term.

## **Chapter 4**

## **4.1 limitations of this thesis**

Overall, in terms of limitations of this thesis, there was the inevitable issue of lack of time and resources, meaning that if more time had been granted, it would have been used to accumulate a wider range of data. Due to the limitations of time and resources, this thesis does not look into specific archival data that may be available to find in other countries such as archived newspaper articles and statistical reports. The entire thesis was written in South Korea, and therefore all the data used in this thesis was collected from South Korea which had limited resources to do with the Scottish independence movement and currency preferences.

## **Conclusion**

This thesis has shown the possibility of Scotland becoming independent and raised the question of what banking system a potentially independent Scotland may adopt. Scotland may become independent in the possible future and have to select a new banking system. This thesis believes a possible choice may be to adopt a similar banking system to Hong Kong. Using the Hong Kong's banking system would solve many problems Scotland is currently facing and the HKMA system itself has shown promising results in Hong Kong since its implementation. This thesis reviewed how certain countries have used the free banking system in the past and have developed or perished the system. Hong Kong developed their free banking system into their current HKMA system when they were experiencing significant government changes which has been very successful. Therefore, this thesis believes that Scotland may also be as successful as Hong Kong if they choose to adopt a similar banking system for both the short or long run. At the end of the day, it is for the Scottish government to decide on which banking system they will implement in an independent Scotland. However, when considering the costs and risks of other banking system, this thesis believes the most – low risk high return banking system appropriate for an independent Scotland is the Hong Kong's HKMA like banking system. Although this thesis does not and cannot contain the significant reasons for why Scotland could consider using the HKMA as their banking system in an independent Scotland, it presented the main arguments made regarding the HKMA like banking system and Scottish independence.

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## 국문초록

### 스코틀랜드의 독립 가능성과 은행제도

스코틀랜드는 최근 가까운 장래에 영국으로부터 독립할 가능성에 대한 정책을 발표했습니다. 이것이 아직은 가능성으로만 언급되는 중이지만, 만약 스코틀랜드가 실제로 영국으로부터 독립을 실행한다면 스코틀랜드 정부 시스템은 많은 변화에 부딪혀야 할 것입니다.

이 논문은 만약 스코틀랜드가 실제로 영국으로부터 독립할 경우 스코틀랜드가 받아들여야 할 은행 시스템 변화를 다룹니다. 그리고 스코틀랜드가 여러 면에서 은행 시스템으로 채택할 가능성이 있다고 보는 홍콩 은행 시스템을 다룹니다. 스코틀랜드가 홍콩의 은행 시스템을 채택할 수도 있다고 보는 이유는 다음과 같습니다. 첫째, 스코틀랜드는 현재 지폐를 생산하는 세 개의 상업 은행을 가지고 있으므로, 이와 비슷한 시스템을 가지고 있는 홍콩의 은행 시스템을 적용할 수 있는 기반이 이미 조성되어 있다는 것입니다. 둘째, 만약 스코틀랜드가 홍콩의 은행 시스템을 채택한다면 현재 스코틀랜드의 중앙은행 시스템이 다른 중앙은행 같은 조직으로 대체되면서 최소한의 변화로 안정적인 은행 시스템이 정착된다는 것입니다. 마지막으로 스코틀랜드가 통화위원회 시스템을 구성하고 이자율을 다른 통화(예: 영국)에 고정하면 스코틀랜드는 지금과 거의 유사한 은행 시스템을 유지하며 변경을 최소화할 수 있습니다.

홍콩은 ‘자율은행 시스템’에서 현재의 은행 시스템을 개발했으며, 스코틀랜드는 오늘날에도 이전 ‘자율은행 시스템’의 기능을 어느 정도 유지하고 있습니다. 따라서 발전된 ‘자율은행 시스템’을 채택하고 있는 홍콩의 은행 시스템을 독립한 스코틀랜드가 도입한다면 큰 변화 없이 안정적으로 은행 시스템을 유지 발전해 나갈 수 있습니다. 즉, 스코틀랜드가 홍콩의 ‘은행 시스템’을 도입한다면 영국에서 독립한다 해도 큰 혼란 없이 은행 시스템이 진행될 수 있다는 것입니다.

홍콩의 ‘은행 시스템’ 이외에도 스코틀랜드는 사용할 수 있는 다양한 은행 시스템이 있습니다. 이 논문은 스코틀랜드의 독립을 가정해 스코틀랜드가 받아들일 수 있는 몇 가지 은행 시스템을 살펴보고, 그 가운데 홍콩의 ‘은행 시스템’과 현재 스코틀랜드의 은행 시스템을 비교해 어떤 은행 시스템을 스코틀랜드가 받아들이면 좋을지를 제안합니다. 그리고 이 논문은 스코틀랜드가 원하면 홍콩의 ‘은행 시스템’을 따를 수도 있음을 보여줍니다. 하지만 이것을 스코틀랜드가 받아들여야 한다는 것을 의미하지는 않습니다. 스코틀랜드는 미국이 했던 것과 같이 ‘자율은행 시스템’의 존재 자체를 폐지할 수도 있습니다, 그리고 스코틀랜드는 자체 중앙은행 시스템을 구성할 수도 있습니다.

전반적으로, 이 논문은 영국으로부터의 독립을 가정하고 스코틀랜드가 채택할 수도 있는 홍콩의 ‘뱅킹 시스템’에 대한 적절한 지침들을 제공하기 위해 노력하고 스코틀랜드가 은행 시스템에 관한 결정을 할 때 이바지하기를 희망합니다.

키워드: 스코틀랜드, 통화, 은행, 독립, 자율 은행 시스템

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