United Kingdom?

Should this week's independence referendum in Scotland concern investors? Peter Westaway, Vanguard's head of investment research and chief economist for Europe, gives his thoughts.

On 18 September, Scotland will vote on whether to become an independent country separate from the United Kingdom. What is likely to happen?

Peter Westaway: For a long time, opinion polls had the pro-union camp well in front, but now the result looks much closer.

What are the pros and cons of independence for Scotland?

Peter Westaway: The case for independence rests on a view that Scotland, which is already one of the richest regions within the UK, could become even more prosperous if it's allowed to make its own decisions on economic policy, many of which are now controlled by the UK government in London.

For example, it's generally assumed that the majority of the revenues from North Sea oil would accrue to the newly independent country. But this undoubted benefit would be broadly offset by the need for higher government spending per head in Scotland, as Scotland currently depends on financial transfers from the rest of the UK.

The pro-union camp point out that when North Sea oil eventually runs out—and there is considerable debate over when that will occur—government spending will have to be reined back, or taxes will have to rise. And there is also a danger that some large firms currently headquartered in Scotland may relocate south of the border, which could further erode the new country's tax revenues. If those more pessimistic views hold true, then Scotland could end up worse off. So overall, there is much uncertainty as to whether Scotland will benefit.

Would Scotland continue to use the British pound?

Peter Westaway: This is one of the most important questions in the debate. The pro-independence side wish to carry on using the pound sterling, but the leading political parties in the UK have said this would be impossible. Many commentators, including the Bank of England and the Treasury, have pointed out the practical difficulties with such an arrangement.

For example, in any future financial crisis, the Bank of England would no longer be obliged to provide emergency support to the Scottish banking system. And the example of small countries within the euro area has illustrated that it is problematic to be part of a *monetary* union without also being part of a well-functioning *political* union.

Given these questions, the alternative currency options include Scotland joining the euro or issuing its own currency, both of which would provide their own challenges on timing and cost.

Would Scotland be able to borrow money from capital markets in the same way as the UK?

Peter Westaway: Certainly, as a newly independent economy, Scotland ought to be able to borrow money on international capital markets in the same way as the UK government is able to. But investors are initially at least likely to require an additional risk premium—in other words, demand a higher interest rate on Scottish government bonds—until any questions about Scotland's independent status are resolved and the new country has built up a track record as a sovereign borrower.

What are the political implications if Scotland votes for independence?

Peter Westaway: The implications for the rest of the United Kingdom would be profound. Most important, it would represent the break-up of a union that has been in existence for over 300 years.

It would raise questions about the devolution of powers to Wales, Northern Ireland, and other regions of the UK—some of which will need to be addressed whichever way the vote goes. And it would change the balance of power in the remaining British parliament, as the opposition Labour party has a lot of seats in Scotland, while the Conservative party of Prime Minister David Cameron has a broad base in England.

Arguably, a "yes" vote could also embolden nationalist groups in other parts of Europe to break away from the euro area or the European Union. For example, speculation about the response of the Catalonian independence movement in Spain has already caused Spanish sovereign bond yields to drift up. More generally, this anti-establishment sentiment might have as-yet unforeseen echoes elsewhere.

How should investors respond to these developments, in particular to a "Yes" vote?

Peter Westaway: However the vote falls, it may take many months or even years for the economic and political fallout of the debate to play out. But financial markets are already responding.

The British pound has weakened, partly because of expectations that the balance of payments for the rest of the UK would be weaker if North Sea oil revenues were mainly kept in Scotland. Bank deposits have begun to flow away from Scottish banks. Share and bond prices for Scottish firms or firms with large exposure north of the border have suffered. But it's difficult to anticipate whether these changes are part of a longer-term larger move or whether they will bounce back once the outcome is known and the uncertainty dispelled.

Investors should remember that these moves are relatively insignificant in the context of a global portfolio that is being evaluated over a long-term horizon. Scotland represents less than 10% of the UK's GDP, and the UK stock market itself represents less than 10% of the global stock market.

So, as with so many events that can dominate the headlines for short periods, it's very important that investors do not overreact or alter their overall strategies. "Stay diversified, stay the course" remains our key message.