

Scotland need never be beholden to financial markets

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I have had several enquiries this morning (mainly by email) [about the article I have in The National](#) in Scotland this morning. This is typical:

Is there any risks from attacks on a Scottish currency in international money markets if, say, Scotland was running a big deficit? If the supply of money is independent of that process then presumably there isn't a direct threat, but the currency could still be devalued sufficiently on international foreign currency markets to destabilise the currency couldn't it?

My answer to this is that there is none, but the reasoning needs to be worked through.

Remember currency attacks only work if a government is determined to hold an aspect of its currency management fixed and speculators want to exploit that determination by forcing a change in that aspect of the currency onto the government in a way that will inevitably involve a price change to their advantage. They're not doing this for any other reason, after all.

Let me unpack that a bit. The two things that a government may want to hold fixed with regard to its currency are its value, reflected in the exchange rate, and its interest rate. The third dependent variable is the amount of debt in circulation, which used to be considered a matter largely beyond its control. I'll return to this third point in a moment and stick with the first two for now.

A government might want to fix an exchange rate for three reasons. First is the old fashioned one of national pride. This departed the scene with floating exchange rates in the 70s. The second is because it has agreed to do so. This was why the UK was vulnerable to attack 1992: it had agreed semi-fixed exchange rates with Europe that speculators knew were economically unsustainable on the basis of trade fundamentals. It laid itself wide open to attack as a result. The third reason is to control inflation. This is pretty much a forlorn hope in exchange rate management: if trade indicates that the currency needs to fall in value come what may it will. A government needs to let that happen and address the domestic issues that necessitated the move in value (lack of

investment, poor products, poor productivity) instead of wasting money supporting the currency. It would also better tackle inflation with changes in domestic tax rates than intervene in international markets. The important point is that if it agrees on all these three things it cannot be held to ransom on the exchange rate. The risk disappears.

On interest rates the threat is from the bond markets that might refuse to buy new bonds issues unless the rate rises. This threat was possible when it was thought a government had to sell its bonds come what may - effectively the third, uncontrolled, variable noted above. But this risk no longer exists because QE now eliminates it. If there was now a market based attack on interest rates it would require the sale of bonds already in existence to force their price down. And the answer to that now is that a government would just buy those bonds back and so neuter the attack using QE. The weapon the attackers used - that there was no other buyer for debt and so governments were beholden to markets - has gone because the government can itself be a buyer. The interest rate weapon is history.

To put it another way, Scotland will not be beholden to markets if it chooses not to be so. But it has to have its own central bank and currency to achieve that. Nothing less will do.