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# SCOTTISH DEVOLUTION AND THE FINANCIAL SECTOR

**SHEILA C DOW**

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## ABSTRACT

The Scottish financial sector has always displayed a consciousness of its distinctive Scottishness, which has a basis in its distinctive history and its current cohesiveness. The purpose of the paper is to elucidate the nature and implications of this distinctiveness, to discuss the role of the financial sector in the Scottish economy, and to discuss the future of the financial sector in a devolved Scotland. In particular, possibilities are discussed of new opportunities which devolution might offer the Scottish financial sector, and opportunities which the distinctiveness of the Scottish financial sector might offer a Scottish Assembly.

*Department of Economics*
*University of Stirling*
*Stirling FK9 4LA*
*UK*
*Fax: 01786-467469*
*e-mail: S.C.Dow@stirling.ac.uk*

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## INTRODUCTION

The case for devolution in Scotland is based not just on the appropriate level at which government policy is designed and implemented, but on a sense that there are distinctive elements to Scotland which warrant distinctive policy design. The financial sector is one of the many areas in which distinctiveness may be identified. Further the financial sector plays an important part in the Scottish economy and its behaviour is therefore of interest when considering the likely economic consequences of devolution. Indeed policy towards the financial sector itself could form an important element in a Scottish Assembly's economic policy, while the establishment of an Assembly could provide the Scottish financial sector with new opportunities.

The purpose of this paper is to consider these propositions in detail. First we examine the proposition that the Scottish financial sector is distinctive, building on an account of the distinctive history of banking in Scotland. Second we examine the proposition that the financial sector located in a region is important for the economy of that region. Third we consider the opportunities offered to a Scottish Assembly by the distinctiveness of the Scottish financial sector and the opportunities offered to the financial sector by the establishment of an Assembly.

## THE DISTINCTIVENESS OF THE SCOTTISH FINANCIAL SECTOR

Scottish banking, as the core of the financial sector, derives much of its distinctiveness from its origins (see Checkland, 1975). Scottish banking emerged in the seventeenth century in response to the commercial needs of an economy lacking both in coinage and in wealth. Trade was being hampered by lack of means of payment and production by lack of finance. The early receptiveness of the populace to the idea of using bank notes rather than coin to meet the needs of trade, allowed the banks to create credit to finance production in advance of saving. This encouraged economic growth which generated wealth, which in turn further supported the growth of banking.

The first two banks (the Bank of Scotland and the Royal Bank of Scotland) initially competed fiercely with each other, but later agreed to cooperate in the interests of the stability of banking in Scotland, and in their own interests. In the absence of a formally-appointed central bank, the two old banks (and later the British Linen Co.) took upon themselves the role of a central bank (see Dow and Smithin, 1992). They initiated a note exchange, managed the Scots pound in foreign exchange (refusing credit to exporters of specie in times of deficit, for example), disciplined banks overextending credit, made representations on behalf of the Scottish banks to Westminster and attempted to stabilise the banking system in times of crisis. The other banks in turn treated the old banks like a central bank, holding deposits with them as reserves. The general acceptance of this arrangement among the banks reflected a more general understanding that the interests of each bank depended on the confidence held in the system as a whole.

The cooperative approach which thus evolved in the Scottish banking system can be regarded as one of its distinctive features. It may be that the Scottish financial system and the Scottish economy were small enough for individual banks to be aware of the overall picture, and thus of their interdependence. This cooperative approach was representative of a more general cooperative ethos characteristic of Scottish society (see Bell and Dow, 1995).

Awareness of this interdependence must also have been heightened by the vulnerability of the Scottish banks. Specie continued to be in short supply, so that it was held in bank reserves in negligible proportions in all types of bank. For example, cash reserves fell from 4% of total Bank of Scotland assets in 1700 to only 1 or 2% through the rest of the century (see Checkland, 1975, 737)  and had reached similar proportions of provincial bank assets in the nineteenth century (Munn, 1981, 141). Notes and deposits formed the bulk of reserves. There has been some debate as to whether the Scottish banking system was relatively stable (see White, 1984, chapter 2 in favour, and Sechrest, 1988, against). But even if it is concluded that the banking system was no more stable than elsewhere, it is notable that a conventional level of stability was achieved with such low specie reserves. While the cooperative approach of Scottish banking, and the stabilising efforts of the old banks, must have served to reduce any sense of vulnerability, nevertheless bankers would have been aware of the implications for borrowers' credit-worthiness of being in a small open economy like Scotland, while the banks held such small reserves of specie.

The view taken by the old banks about appropriate rates of credit expansion was based on the real bills doctrine, ie on an understanding of the credit requirements of the economy relative to the capacity of the banks to meet them without risk of insolvency. The banks themselves were regarded as being well-placed, with their detailed local knowledge, of the character of borrowers as well as economic conditions, to judge when credit creation was appropriate at the micro level, while the old banks took the macro view. The emphasis on the credit decision may well go some way to explaining the reputation for caution enjoyed by the Scottish banks. But the reputation for caution stems even more from the change which occurred with the 1845 banking legislation which substituted official monetary policy based on the Currency School doctrine for the unofficial monetary policy of the old banks based on the real bills doctrine. The banks were now subject to a strict requirement for note issue to be tied to stocks of specie, rather than the counterpart to credit requirements.

Given the previous Scottish economising over specie, allowed by the greater willingness of the population to use notes as money, this legislation unduly restricted the scope for credit creation by the Scottish banks, and altered the whole tenor of banking in Scotland.

Scottish banking history contrasts with that of England, which was dominated by the Bank of England, which had been set up to finance wars rather than to finance trade. In contrast to the mutually supportive banking system in Scotland, the English banking system was segmented between the Bank of England, the London banks which served the needs of the large merchants, and the country banks. The country banks were subject to severe limitations in order to prevent them from competing with the Bank of England, and also reflecting the prevalence of the currency school approach to monetary control. So, although they acted so as to meet credit and note needs, their capacity to do so was effectively limited. The Bank of England note issue, in turn, was in large denominations, making it unsuitable for commerce, other than for large concerns. That the country banks so successfully financed economic development is a credit to their ability to cope with the limitations placed on them, rather than a natural consequence of the structure of English banking. It was also a consequence of the greater initial wealth in England, which allowed for relatively greater holding of specie relative to credit and made the banks and their economic base less vulnerable.

The banks form only a part of the financial system. But they are a crucial part, in that their liabilities are the means of payment; it is this in turn which allows banks to create credit. The distinctiveness of the Scottish banking system was mirrored in the distinctiveness of other elements of the financial sector, as in the development of a Scottish market in stocks (see Michie, 1981) and the subsequent development of investment firms. The insurance sector too has developed as a strong element in the Scottish financial sector.

While the Scottish banks came under British banking legislation in 1844 and 1845, the case may be made that they have retained to this day distinctiveness in a variety of respects. This distinctiveness is over and above the conventional view that the Scottish banks have their own note issue and the attendant specifics of the requirements for backing by Bank of England notes, and is part and parcel of a more general distinctiveness of the Scottish financial sector.

First, as far as the banks are concerned, the most obvious possibility to investigate is differences in portfolio behaviour. In particular, regional monetary theory would suggest a relative unwillingness to go illiquid in regions whose economies are vulnerable (see Dow, 1991b). The Scottish banks, which evolved practices designed to protect themselves against such vulnerability, would accordingly be expected to display defensive portfolio behaviour. But it is very difficult to establish categoric evidence for or against such a proposition for a variety of reasons. Evidence of such behaviour would be relatively slow credit growth, for example. But if that is associated with slower economic growth, in which direction does the causal arrow run? However, in a study which attempted without notable success to elicit information on the portfolio behaviour of banks, it was found that the portfolio behaviour of the household and company sectors in Scotland displayed defensiveness (see Dow, 1991a). One corollary of such defensiveness is weak demand for credit; this would be consistent with the argument put forward by the Scottish banks that the problem is one of weak demand rather than restricted supply.

A second possible sign of distinctiveness would be differences in their charging of interest and fees. In terms of the structure of the Scottish banking sector, McKillop and Hutchinson (1990) identified the segmentation of two kinds, which allow differences in charges and fees. First, the small company sector faces financial market segmentation, in that the same merchant bank may charge different fees to companies in different regions because of different transactions costs, information-gathering costs, etc. This segmentation has allowed local clearing banks and merchant banks to dominate the local market in Scotland. The decline of merchant banking in Scotland due to takeovers has increased the significance of this segmentation, and thus the capacity to charge higher fees in Scotland. The retail banking sector is institutionally segmented, because of the organisational independence of the Scottish banks. This has allowed relatively high bank charges in Scotland, even though interest charges as such have been converging to a UK norm as the Scottish banks increasingly operate in the UK market as a whole.

Third, it is significant that the banks see themselves as distinctive. Expression is given to this sentiment whenever there is the possibility of a Scottish bank losing its identity in a takeover. Thus, for example, Bain and Reid (1984) and Leigh-Pemberton (1987) have asserted the benefits of the Scottish banking sector for Scottish industry. (See also Committee of Scottish Clearing Banks, 1980) But the banks have not themselves produced adequate concrete evidence of their distinctiveness to justify this view. Nevertheless the strength of feeling, and the collectivity of the defense of Scottish banks is itself strong support of the thesis that the Scottish banks are distinctive, and that they continue to adopt a cooperative stance. Anyone familiar with the Scottish financial sector will be aware of the cohesiveness of the sector.

This spirit of cooperation is also evident in some of the institutional arrangements for the Scottish financial sector. The existence of Scottish Financial Enterprise as a lobbying body for the Scottish financial sector, the concern of Scottish

Enterprise with organising finance for small firms, and the cooperative spirit which exists between these agencies and the Scottish Office are concrete expression of a concern with the macro view which has nothing to do with conventional monetary policy. There have as a result been various initiatives to promote cooperation within the financial sector particularly in providing financial services to the small firm sector. Finally, a particular source of the cohesiveness of the Scottish banking community may well be the common elements in bank training, as administered by the Chartered Institute of Bankers in Scotland. This training instills a particular ethos, as well as the more practical aspects of banking.

Finally, the distinctiveness of the Scottish financial sector can be seen in its capacity to resist the powerful forces towards concentration and centralisation in the financial sector. Whatever form the distinctiveness takes, it has given the Scottish financial sector a competitive advantage which outweighs the strong pull towards the City of London (see Gentle, 1993).

## THE ROLE OF THE FINANCIAL SECTOR IN THE SCOTTISH ECONOMY

The distinctiveness of the Scottish financial sector has allowed the sector to be a significant contributor to output and employment. The sector is thus important in its own right. But what has been less explored is the indirect contribution of the financial sector to the Scottish economy by means of its relationship with industry. A focus on this economic role of the financial sector is consistent with the Scottish banking tradition, which focused as we have seen on the credit creation process. This focus in turn suggests a policy approach to the financial sector which emphasises the financing of economic activity rather than control of monetary aggregates, ie the asset rather than the liability side of the banks' balance sheets.

The evolution of banking systems certainly stems from the acceptance of their liabilities as means of payment. But otherwise it can be seen as an increasing capacity to create credit as confidence in bank liabilities increases (see Chick, 1986). Now credit creation by banks is no longer constrained by reserves, but rather by capital adequacy ratios. But these ratios are only binding constraints if the stock market is unwilling to provide additional capital. It is thus ultimately up to the stock market to determine the volume of credit creation, although central banks' interest rate policy obviously has some influence.

The economic significance of banks lies in their capacity to finance investment in anticipation of saving. The Scottish banks were such a significant contributor to economic development (noted at the time, for example, by Adam Smith) because they were much less constrained than other banking systems by the stock of specie. They were able to do so because of the mutual support through interbank lending, and the capacity, and willingness, of the old banks to take the macro view and take action when aggregate credit was excessive relative to economic activity.

Similarly today, the significance of the banks is in providing credit for new investment. Banks now engage in a range of other activities in the financial services area, but it is credit creation which distinguishes them, and which generates the wealth to fund other financial activity. Further, it is not a matter of how a stock of credit is allocated, but how much in total, and how that is made up. The more conservative is bank behaviour, the less credit will be created since it exposes the bank to risk.

However, the closer the banks are to potential borrowers, the better their knowledge and thus the better their capacity to assess risk. Thus, even if their lending behaviour is conservative, the Scottish banks can more effectively promote economic development in Scotland because of their superior knowledge base. (There is further scope for discussion in terms of the implications of reorganisation within the banking sector, in terms of location of decision-making and mechanisms for risk-appraisal.)

This forms the basis for the argument for the segmentation of banking systems (see Chick and Dow, 1988, Porteous, 1995). In the face of competition from other financial institutions, the banks maintain a comparative advantage in knowledge. That word is used advisedly, in contrast to information, which refers to the knd of knowledge which can be encompassed in a financial report. Risk assessment cannot fully be subjected to quantification (because there can never be full, even probabilistic), knowledge of the future, and must ultimately be based on qualitative knowledge. A cohesive banking system within a cohesive society is bound to have a comparative advantage in local knowledge, and it is this ultimately which justifies the banks' assertion of being of particular benefit to Scottish business.

These advantages of a segmented financial system are under threat from the centralising tendencies evident in the financial services sector. These tendencies are a natural feature of the financial sector, reflecting the economies of scale in the generation of the confidence in bank liabilities which allows the credit creation in the first place. But they are reinforced by policy measures in Europe designed to promote European financial integration. These policy measures are designed to make the European market in financial services freely competitive, as for example with the Second Banking Directive which institutes a single European banking licence. Given the diversity of banking within Europe, particularly between banking systems at different stages of banking development, competition is bound to lead to concentration. This appears to be happening primarily through concentration within national banking sectors and by relationships built up between banks in different national systems, rather than through cross-border acquisition or branching (see Gardener and Molyneux, 1990).

Concentration within national banking systems is bound to impact most on smaller regional banks, like the Scottish banks. They have survived so far because of flight to quality in times of particular uncertainty about bank assets; because of their more cautiouslending policies the banks had avoided the severe overvaluation of assets which had caught out the bolder large banks in the 1980s. But when expectations are more optimistic generrally about asset values, the cautious approach of the Scottish banks makes them a less attractive investment and therefore increases the risk of takeover. The European Commission’s (1990) report on research on monetary integration acknowledged the competitive disadvantage of regional banks in an open European market, but concluded, without supporting argument, that they would eventually reassert themselves.

It is unlikely that this eventual equilibration in banking will occur. The competitive advantage is held by banks which maintain sufficient liquidity to take advantage of high gains and avoid losses. The way in which banks have dealt with the fallout of excessive lending in the 1970s, the instabiltiy of asset values in the 1980s, and the imposition of capital adequacy ratios to prevent a recurrence of the 1970s has been to securitise lending, to increase off-balance sheet activity in derivative markets, and to shift from conventional lending to the provision of services as a source of income (see Gardener, 1988). Even the German banks, which are noted for their long-term commitment to industry, have been turning increasingly in this direction. In other words, it is the move away from conventional banking activity which has the competitive edge in Europe, for all the advantages of the German banking system for the economy.

These trends also put the Scottish banks at a competitive disadvantage. The traditional emphasis on lending to the local economy, founded on superior knowledge of that economy, cannot provide the liquidity necessary for the Scottish banks to earn returns comparable to the big London banks. To the extent that the lending practices of the Scottish banks have benefitted the Scottish economy, these competitive pressures will disadvantage the economy.

It is only small and medium-sized enterprises which are dependent on local provision of finance. The large company sector, which consists significantly of companies owned outside Scotland, has access to national and international banks, and thus the distinctiveness of Scottish banks is of much lesser significance for them. The outcome of free competition in banking is therefore significant not only for the banks themselves, but also for the structure of industry in Scotland. The implicaiton of the arguments presented above are that industrial concentration accompanies financial concentration. As a corollary, if promoting small and medium-sized locally-owned companies is a priority for industrial policy, then attention needs to be paid to the structure of banking.

There have been arguments that the Scottish banks have not in fact benefitted the Scottish economy as much as they could have done, because of their overly cautious lending practices. But it must be said that the Scottish banks in this respect are in tune with financial behaviour in the economy in general. Households and firms too engage in defensive financial behaviour, because they too have been conscious of economic vulnerability (see Dow, 1991a). So, while more expansive lending practices by the Scottish banks could encourage economic growth, it would need to be accompanied by an increased willingness to borrow, spend and invest. This gestalt switch from a virtuous circle of defensive financial behaviour to a virtuous circle of confident financial behaviour is one possible outcome of constitutional change which could lend an important new dynamic to the Scottish economy. We turn in the next section to consider the opportunities the financial sector and an Assembly might create for each other, and for the Scottish economy, under devolution.

## OPPORTUNITIES CREATED BY DEVOLUTION

Constitutional change in the form of a devolved Assembly would therefore offer new opportunities for the financial sector; the distinctive Scottish financial sector in turn would offer opportunities to the Assembly. These opportunities are interdependent, but let us start with opportunities for the financial sector.

### Opportunities for the Financial Sector

First, there is the practical question of where the Assembly placed its funds. The most likely form of funding is a Block Grant (possibly augmented by up to 3 points on income tax) (see Bell et al, 1996). The transfers to the Scottish Office are currently held in Westminster until expenditure occurs, although the Scottish Office could in principle hold the sums in its own bank accounts. An Assembly might well choose to hold its funds in accounts with the Scottish banks, and use the banks for a range of financial services. The additional business which this would bring to the Scottish banks would add to profitability.

Second, while the possibility of Assembly borrowing has so far been rejected, there are good reasons for this to be allowed (see Bell et al, 1996):

- Since the funding mechanism could not possibly be as flexible as it is for the Scottish Office, there would need to be provision for short-term borrowing to cover mismatching of income and expenditure.
- Second, since an Assembly might not balance its budget within the financial year, some provision would be required to fund any deficit. Such a deficit might arise unintentionally, again because of the inevitably greater rigidity of the funding mechanism. But it might also be a deliberate response of the Assembly to economic conditions in Scotland which differed from those in the rest of the UK. Westminster could not allow much latitude in this direction, because of its own macroeconomic policy and the constraints imposed by European Monetary Union. But it would not be unreasonable to allow differences in fiscal policy in Scotland, as long as it averaged out to UK fiscal policy over a five-year period, say.
- Third, there may be particular capital projects, which would yield increased current revenue in the future, but which require capital borrowing to finance them in the meantime. This could be controlled in a way similar to local authority capital spending. But an Assembly might choose to issue its own borrowing instruments rather than borrow through Westminster.

Direct lending by the banks, or the administration of such lending (as in issues of savings bonds) would provide additional business for the banks.

Third, the Scottish banking system would benefit from a return to something like the old cooperative approach, whereby the banks cooperated with institutions taking the macro view of credit creation in Scotland. The difference would be that it would be the Assembly and its agencies which took the macro view, rather than the old banks. An Assembly would have much more latitude than the Scottish Office to pursue a distinctive industrial policy. The cohesiveness of the financial sector, as institutionalised in Scottish Financial Enterprise, would allow for a corporatist approach to industrial policy (which would also involve other interest groups in society). This would be to the advantage of the Scottish banks in that credit worthiness is a function not only of individual projects but also of their macro setting. By having an involvement in the determination of the macro setting, the banks would benefit from reduced credit risk and the emergence of new lending opportunities. The banks in Germany and Japan have benefited from a similar approach.

But anything other than short-term involvement in industry reduces competitiveness in modern banking conditions. If the Assembly recognised the mutuality of interest in supporting the financial sector, then the Assembly could introduce particular measures to allow the financial sector to maintain its identity in spite of competitive threats. The scope for such measures is limited by the single market rules for Europe, and by the limitations placed on Assembly powers. But support can take many forms, and it is clear that the European banking sector is not integrating nearly as fast as originally envisaged because of a panoply of barriers to entry which are difficult to identify and prohibit.

**Opportunities for the Assembly**

The opportunities which a strong Scottish financial sector offers to an Assembly correspond to the opportunities which the financial sector itself would enjoy. Scotland is most unusual in maintaining a strong financial sector in spite of economic peripherality. Other regions contemplating devolution have to consider dramatic measures to build up a strong regional financial sector. Just as the banks would benefit from the effect on loan-risk of a distinctive Scottish industrial policy, so the Assembly would benefit from a cohesive financial sector with which there is every prospect that it could build up a strong relationship. Knowledge and consultation on both sides is crucial to a successful combination of industrial policy and loan policy. The existence of a financial sector with a history of cooperation and cohesiveness provides an excellent starting-point for generating good knowledge and consultative mechanisms. Industrial policy would accordingly be more effective, while a more successful industrial policy benefits the lending banks.

The old banks were able to discipline other banks which created excessive amounts of credit. An Assembly too could exert discipline, particularly if it held its funds in accounts with the Scottish banks. These accounts could be used as leverage for ensuring the cooperation of the banks. Such an approach has been adopted in Burlington, Vermont (as advocated by Knodell and Murray, 1989). This is a deposit linking scheme whereby the City of Burlington establishes priorities for lending within the city; banks who do not conform to the guidelines are penalised by withdrawal of deposits. With this example in mind, the Assembly might therefore favour holding funds with the Scottish banks not only to support them, but also to give it leverage over the banks' lending policies.

An Assembly would not have any jurisdiction over monetary policy of the sort now conventionally discussed, ie over control of monetary aggregates or of base interest rates. Indeed, if the UK proceeds with European Monetary Union, the Bank of England will not have such jurisdiction. But the discussion so far of opportunities available to the Assembly are a form of monetary policy, but approaching it through the asset side of the balance sheet. It would constitute a reassertion of the real bills doctrine, relative to the currency school approach to monetary policy adopted by the UK government and the EU. In other words, it would constitute a return to the nonstatutory approach to monetary policy adopted as a matter of necessity by the old banks before 1845. This monetary policy allowed the Scottish banking system to flourish in spite of low specie and low wealth. The changes in banking since then, rather than rendering that approach outdated, in fact support its reintroduction. Given the banks' capacity to evade control through reserves control or capital adequacy ratios (as long as the stock market supply of share capital allows), and a diffusion of assets performing money functions, a return to focusing on the lending policies of banks is long overdue.

Thus, while many argue that even an independent Scotland could not conduct an independent monetary policy, it has been argued here that an Assembly would have considerable scope for pursuing a credit policy which would in any case be much more effective than attempts at monetary control. The two possibilities which would be open to an independent Scotland but not to an Assembly would be a separate currency and the scope to develop a distinctive approach to bank supervision (which would further encourage flight to quality) (see Bell and Dow, 1995).

## CONCLUSION

The case of Scotland is unique, when considering the economics of devolution, because of the strength and distinctiveness of the financial sector, most notably the banking sector. This distinctiveness and strength are both products of Scottish banking history, which in turn reflected economic conditions in Scotland. The banking system evolved within the private sector, but generated its own unofficial central banking system in the actions of the old banks. Banking practices reflected the needs of the economy, providing notes for conducting transactions and credit to finance investment. Similarly central banking practices reflected the needs of the banking system, which were for bank supervision and collective action to ensure stability in spite of the small base of specie and the vulnerability of a small economy with a low base of wealth. These central banking practices focused on the provision of credit needs rather than the total of notes and deposits relative to specie reserves.

The imposition of Currency School restrictions in 1844-45 put an end to this internal dynamic. Nevertheless, the Scottish banking sector retains its distinctiveness in its cautious lending practices, and in its cohesiveness. This would provide the ideal basis for a reintroduction of the type of monetary policy implemented by the old banks before 1844. Such a reintroduction would be warranted by developments in banking which have made monetary control much more difficult than in 1844. An Assembly and the financial sector could thus work together (with other interest groups), in their mutual interests, in designing and implementing industrial policy. This in turn would be to the benefit of the Scottish economy, where bank credit is often the key to facilitating new investment. In this way, and in other ways, the Assembly could support the financial sector in its attempts to retain a distinctive lending policy while fending off competition from other banks which put much more emphasis on maintaining liquidity.

Finally, the Assembly will have needs for financial services which the Scottish banks could provide. This would particularly be the case if the Assembly were given borrowing powers.

To summarise, the main point of this paper is that an Assembly and the financial sector could forge a constructive relationship, to the benefit of all, which was in the spirit of Scottish banking history, and which allowed an Assembly latitude in terms of monetary policy. If, along with devolution, there evolved a more confident financial behaviour on the part of all sectors in the Scottish economy, there would emerge a virtuous circle of investment, borrowing and growth.

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