The Common Weal paper basically argues that a newly independent Scottish Central Bank (SCB) could easily and inexpensively generate $40bn of foreign exchange (FX) reserves which would be available to defend the value of a new Scottish currency by intervening in FX markets.

The paper assumes that the new Scottish currency would initially be pegged one to one against sterling (GBP) with the peg at some point being loosened, presumably with a view to eventually allowing the Scottish currency to float freely (ie the exchange rate would then be set by financial markets).

This is important because a pegged currency means the SCB would subordinate monetary policy (setting interest rates and controlling the money supply) to the Bank of England (BoE). That might be an acceptable transitional arrangement, but if independence is to be meaningful the SCB would ultimately need the freedom to diverge from the BoE on monetary policy.

The Common Weal paper lays out four distinct sources that would contribute to the $40bn. Here are the four sources, along with a very brief explanation of what makes them suspect (more detailed explanations follow):

(1.) Scotland's $16bn share of the UK's FX reserves. This is more like $4bn once you net out the corresponding liabilities ignored by Common Weal.

(2.) $2.9bn worth of GBP notes and coins that would be exchanged for notes and coins in the new Scottish currency. This number is plausible, but if the new Scottish currency appeared vulnerable to a devaluation, there would be a rush to convert notes and coins back into GBP and the $2.9bn would probably have disappeared before it could be used to intervene in FX markets.

(3.) $13bn from swap lines with the BoE. This assumes the BoE would implement up front the type of measures used only in times of financial distress.

(4.) $9bn of borrowing is just a plug number to get across the $40bn line. And it's borrowing! Why not borrow the whole $40bn if it's that easy...

So, if we exclude borrowing, which is basically cheating, only $4bn of the Common Weal's $40bn is genuinely likely to be available to defend the value of a new Scottish currency.

Further details

(1.) and (4.) above are relatively straightforward issues that don't need much further explanation. The details of the UK's FX reserves including the liabilities overlooked by Common Weal can be found here.

(2.) and (3.) are a little more complicated, and deserve expanded explanations:

(2.) $2.9bn of GBP notes and coins

Provided the population of a newly independent Scotland was convinced that its new currency and central bank were credible, there is every reason to suppose they would willingly exchange GBP notes and coins for notes and coins in the new Scottish currency, and $2.9bn is not an unreasonable number.

As the Common Weal paper acknowledges, the SCB would probably seek to establish its credibility by initially pegging the currency one to one against GBP.

If the peg were ultimately abandoned and the currency allowed to float freely, it would be foolhardy to assume that the $2.9bn would then be available to intervene in FX markets should the new Scottish currency look vulnerable to a devaluation.

People would see such an event coming, and there would be a rush to exchange notes and coins in the vulnerable Scottish currency for GBP notes and coins. The moment the SCB needed it most, the $2.9bn would be likely to have evaporated before its eyes.

(3.) $13bn of swap lines with the BoE

Central bank swap lines are an esoteric subject. For readers interested in some details, the Federal Reserve (the US central bank) has a useful page explaining the principles.

Broadly speaking there are two kinds of swap line: The first is designed to ease global liquidity at times of financial stress, and the second is "for the purpose of promoting orderly currency exchange markets", typically with key trading partners (Canada and Mexico in the case of the US).

The Common Weal paper appears to conflate the two approaches, and thinks that what are effectively emergency standby mechanisms would be immediately triggered by the BoE in the event of Scottish independence.

The Federal Reserve's liquidity swap lines were a response to the financial crisis of 2007-2009, and are now hardly used at all.

The swap lines envisioned in the Common Weal paper have exchange rate stabilisation in mind, and therefore appear to be of the second type above, and to be modelled on the North American Framework Arrangement (NAFA) swap lines established in 1994 between the Federal Reserve and Canada ($2bn) and the Federal Reserve and Mexico ($3bn).

The Canadian facility has never been used, and the Mexican one was last used in 1995 when Mexico was suffering the effects of a full blown currency crisis ("The Tequila Crisis").

The BoE and SCB might well come up with a similar arrangement to the NAFA swap lines, but it would be a standby measure for use in an emergency, and could not credibly be used as an up front way to generate FX reserves.