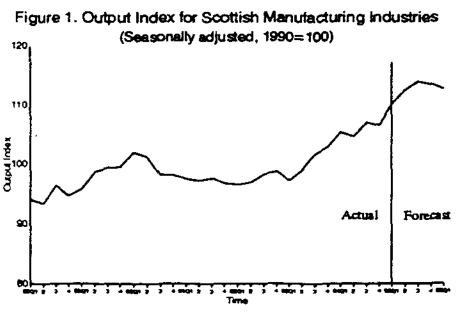
THE SCOTTISH ECONOMY

SHORT-TERM FORECASTS*

This section presents short-term forecasts for the quarterly growth rates of Scottish manufacturing (Division D of the 1992 SIC) output.

The present forecasting period extends to 1996Q1. Figure 1 depicts the actual growth rates for Scottish manufacturing output from 1988Q1 to 1994Q4 and the forecasts for 1995Q1 to 1996Q1. Although the actual output index for the final quarter last year was a slight fall, in contrast to our prediction of a slight increase, we still maintain the prediction that the growth in Scottish manufacturing output will gather momentum in the beginning of this year and this trend will be sustained until the third quarter this year. However, the growth rates will gradually ease through the year, and towards the end of the year the growth trend will be reversed. The prediction for the first quarter in 1996 is also weak. For 1994 as a whole, the output of Scottish manufacturing industries is predicted to rise by around 3.1% over 1993, and for 1995, by 3.7%. Further details of growth rates for Scottish manufacturing outputs are presented in the following table.



* Development of the short-term model of the economy was made possible by the funding of a three-year research fellowship by TSB Bank Scotland.

TABLE 1. QUARTERLY GROWTH OF SCOTTISH MANUFACTURING OUTPUT (%)

1992/91	0.2
1993/92	2.6
91Q4/90Q4	-1.3
92Q4/91Q4	1.9
93Q4/92Q4	4.0
94Q1/93Q4	2.3
94Q2/94Q1	-0.7
94Q3/94Q2	2.3
94Q4/94Q3	-0.5
Forecast	
95Q1/94Q4	3.4
95Q2/95Q1	2.1
95Q3/95Q2	1.3
95Q4/95Q3	-0.5
96Q1/95Q4	-0.7
1994/93	3.1
1995/1994	3.7

THE SCOTTISH CHAMBERS' BUSINESS SURVEY - FIRST QUARTER 1995

The Scottish Chambers' Business Survey (SCBS) is conducted by Strathclyde University's Fraser of Allander Institute together with the Chambers of Commerce of Aberdeen, Central, Dundee, Edinburgh, Fife and Glasgow. It is the largest and most comprehensive regular survey of business, employment and other issues affecting the Scottish business community. In the present survey, which was conducted during the first three weeks of March, 1018 firms responded to the questionnaire. The main conclusions from the latest SCBS are discussed below.

Business Confidence

In Manufacturing, business confidence continued to rise but at a slower rate than in the fourth quarter 1994. A net balance of 5% of respondents reported that they were more optimistic than three months previously, compared with a net balance of 16% who were more optimistic in the fourth quarter. In the first quarter of this year, Manufacturing respondents were more optimistic than they were in the same period a year ago, with a net balance of 23% of respondents reporting higher optimism. This compares with the situation in the fourth quarter where a balance of 33% of respondents were more optimistic than in the same period a year earlier.

In Construction, optimism continues to rise but at a slower rate than in the fourth quarter. A net balance of 3% of respondents reported that they were more optimistic than in the previous quarter. This compares with an 8% balance of respondents who were more optimistic in the fourth quarter over the third quarter 1994. A net balance of 25% of respondents reported that they were more optimistic than they were a year ago, much the same as the response in the fourth quarter.

In Distribution, confidence continues to fall in Retailing although at a slower rate, while in Wholesaling optimism also fell, all be it slightly. In Retailing, a net balance of 11% of respondents were *less* optimistic about the general business situation than they were in the fourth quarter, which compares with a negative balance of 17% in the fourth quarter. In Wholesaling, a net balance of 2% reported that they were *less* optimistic. This can be compared with a positive net balance of 2% in the previous quarter. A net balance of 14% of wholesalers reported that they were more confident than they were a year ago, while a net balance of 11% of retailers were *less* confident.

Optimism among respondents from the Tourism and Leisure sector continues to rise and at a faster rate than in the fourth quarter. A net balance of 30% of respondents reported that they were more optimistic about the general business situation than they were three months earlier, compared with a balance of 17% in the fourth quarter. A net balance of 26% of respondents were more optimistic in the first quarter than in the same period of 1994, a rise of 10 percentage points on the response in the fourth quarter.

Orders and Sales

In Manufacturing, orders and sales again increased, although at a slower rate than in the previous quarter. For orders, a net balance of 21% of respondents reported an increase while, for sales, a balance of 16% of firms also experienced a rise. These figures compare with positive balances of 28% and 31%, respectively, in the fourth quarter. Orders and sales from all principal markets continue to grow, although there was a considerable slowing down of demand from rest of UK markets. Export sales and orders remain buoyant, despite a slowdown in their rate of growth. The growth of orders, but not sales, from the domestic Scottish market also appear to have slowed down.

In Construction, new orders continued to rise and at faster rate than in the fourth quarter. A net balance of 24% reported an increase in orders compared with 11% in the fourth quarter. Orders from the private sector continue to be the source of growth in demand, while orders from Central Government continue to be severely depressed, and there was no improvement in orders from elsewhere in the public sector.

Retail sales again fell in the first quarter, although at a slower rate than in the final quarter of last year. A net balance of 3% of retailers reported that sales had fallen, compared with the a balance of 15% reporting a decrease in the fourth quarter. In Wholesaling, sales rose at a slower rate than in the fourth quarter. A net balance of 7% of respondents reported a rise in sales, compared with a balance of 24% reporting an increase in the last survey.

Tourism demand turned round completely in the most recent quarter, after falling slightly in the fourth quarter. A net balance of 28% of companies reported an increase compared with a balance of 2% reporting a decrease in the three months to December. Demand increased from all markets, with Scottish and rest of UK demand particularly strong.

Stock Adjustments

Stocks of finished goods in Manufacturing fell again in the current quarter, although at a slower rate. A net balance of 2% reported a fall, compared with 7% in the fourth quarter. Stocks of raw materials also continue to be run down, but work in progress rose.

Finance and Investment

In the Financial sector, the demand for personal loans continued to rise, and at a faster rate. A net balance of 44% of respondents reported a rise, compared with the balance of 31% reporting an increase in the fourth quarter. Advances to the corporate sector are also still rising and at a faster rate than in the previous quarter. The demand for working capital remains on an upward trend, at much the same as in the fourth quarter. The demand for finance for investment in buildings rose this time after falling in the fourth quarter, while the demand for finance for investment in plant and equipment appears to have begun to rise strongly again.

Manufacturing investment intentions in plant and machinery were again revised upwards in the present quarter and respondents expect to revise them up further in the second quarter of 1995. There was a further deterioration in manufacturers' investment intentions in land and buildings, with a net balance of 2% of respondents reporting a decline. In Retailing and Wholesaling, investment intentions continue to be positive. Net balances of 7% and 15% of retail and wholesale respondents, respectively, reported an upward revision in investment intentions compared to the same period a year ago. The investment intentions of Construction respondents remain unfavourable for plant and equipment, and continue to further decline for investment in buildings. However, expectations are for an increase in plant and equipment investment in the second quarter.

Expectations

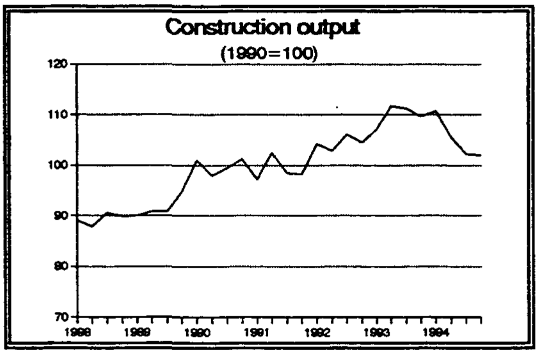
The outturn in the first quarter was mixed compared with the expectations of respondents in the fourth quarter. In Retailing, Wholesaling and Manufacturing sales, the outturn was worse than expected at the end of last year. However, in Construction, Manufacturing orders and Tourism demand, the outturn in the first quarter was better than expected.

Demand conditions are expected to improve further in the second quarter of 1995, in Manufacturing sales, Wholesale, and Retailing. However, in Manufacturing orders and Construction a slow down in the rate of growth of demand is expected, while in Tourism the rate of growth of demand is expected to be much the same as in the first quarter.

CONSTRUCTION

During the fourth quarter of 1994 the Scottish index of construction fell by 0.2% to stand at 102.0. This represents a 4.4% fall when comparing 1994 with 1993. While the Scottish index does vacillate to a large degree, the general trend in recent quarters has been downward.

The index for the UK as a whole, as discussed in previous Commentaries, continues to increase and ended 1994 at 90.8, an increase of 0.4% from the previous quarter. Comparing 1994 with 1993 shows an increase of 3.4%. The UK index has now had its sixth consecutive quarterly increase.



The Scottish Chambers' Business Survey for the first quarter of 1995 showed that a balance of 3.1% of respondents were more optimistic about the current business situation than they were in the previous quarter. Comparing the first quarter 1995 with the first quarter a year ago there is a net improvement of 24.8% for all respondents.

The private sector continues to be the only rising force in new orders for a balance of 16.8% of respondents; total new orders are up for a net 24.5% of respondents. Net falls of 25.3% and 5.3% were recorded for central government and other public sector orders respectively. This trend is expected to continue in the second quarter.

Work in progress is up for a net 7.4% of respondents. Capacity utilisation stood at 80.8% during the first quarter, which was up for a balance of 23.6% of respondents on the same period one year ago.

While 81.6% of respondents cited orders or sales as the main limiting factor to output in the second quarter, 12.9% saw a shortage of skilled labour as the main limiting factor.

Investment intentions in new plant and equipment have been revised downwards for a net 3.6% of respondents. However a net 2.3% revised the intentions to invest in buildings upwards during the first quarter 1995. There is evidence from respondents that investment is being authorised not just for replacement (56.8%) but in order to expand capacity (13.8%) and increase efficiency (12.4%).

Seasonal factors are kicking in to play with actual employment in the first quarter up for a net 4.9% of respondents and a balance of 10.2% foresee this continuing into the second quarter. Male and full-time employment increased for balances of 3.8% and 7.1% respectively, while female and part-time employment declined for balances of 3.5% and 4.3%. The fact that this goes against the general national trend is likely because the construction industry is so historically male dominated. Respondents also reported increases in sub-contracting and the self employed.

A further encouraging sign is the reported increase in overtime for a balance of 10.9% and the net decrease in short-time working for 10.2%. Almost a quarter of respondents awarded pay increases during the first quarter, with an average increase of 2.6%.

Of the 43.2% of respondents who attempted to recruit staff during the first quarter difficulties have been experienced by 84.8% of respondents in securing suitable employees in particular occupations. Almost 80% of recruiters stated that difficulties had not changed during the first quarter, however for a net 10.3% of respondents difficulties increased. Technical staff was the most problematic occupation to fill during the period.

NHBC housing completions for the first quarter of 1995 increased by 200 to 4,000, an increase of 5.2%, while in Great Britain as a whole they fell by 2.2% to stand at 40,800. Housing starts in Scotland were 4,100 which was an increase of 10.8%. This sizeable increase is however less than the 15.3% increase experienced by Great Britain as a whole.

The NHBC first time buyers ability to buy index continues to conquer new peaks, now standing at 120, the highest recorded level, indicating that the ability to buy has never been greater. And yet the housing market is still in the doldrums, according to recent press reports. The latest Halifax house price index for the first quarter which shows that, in Scotland, house prices fell by a further 0.7% following a 2.0% fall in the fourth quarter 1994 causing the annual inflation rate to go negative for the first time since mid 1993.

Other press reports say that, in Scotland, there is not quite so much stagnation in the market and indeed there are signs that the market is picking up. People are reluctant to commit to a larger mortgage as they are concerned about the risk of a fall in the value of the property, and that combined with increased job insecurity is causing the market to be sticky.

The mortgage market is characterised by many competitive deals from lenders backed up by cash back offers and free valuations. There is a broad mixture of house types and locations in Scotland and it is fair to say that these differing market segments are reacting in opposite directions. Despite the glut of properties in the first time buyers market there is some movement. There is usually a strong seasonal upswing in this (first time buyers) market at this time of year but across central Scotland the market has remained weak.

The Jarves property and building group has expanded its operations into Scotland after acquiring the loss-making construction division of Shanks and McEwan for a nominal £1. Shanks and McEwan have parted with the two Glasgow based subsidiaries in order to concentrate more on their core activity of waste management.

Jarvis which is based in Romford, Essex is not concerned at taking on such a loss making concern (losses of £1.4 million on sales of £14 million in the last report) and see it as an opportunity to expand into Scotland.

Last year saw a return to the black for Tarmac after painful restructuring 1992 and 1993 with pre-tax profits of £107.2 million in 1994. Scotland's largest privately owned construction group; Edinburgh based Miller Group also returned to the black with pre-tax profits of £4 million, from £4.4 million losses last year.

ENERGY

Of special interest to the electricity and water industry will be the recent calls by Sir Bryan Carsberg and the Labour Party to have the Office of Fair Trading and the Monopolies and Mergers Commission merged as recommended by the Trade and Industry Select Committee, who have also called for extended powers of investigation with regard to trading law. If implemented, the new body would have powers and a remit similar to the German Federal Cartel Office bringing the UK into line with European practice, where a much tougher stance is taken on anti-competitive behaviour.

OIL AND GAS

Average oil production in the North Sea was

2.7mbpd for Q4 1994, up 7.9% on the Q3 1993 value of 2.5mbpd and up 15.4% on Q4 1993 when the production level was 2.3mbpd. This output level is just below the January 1985 production figure of 2.8mbpd, which was the highest monthly average. Oil output increases are mainly from the Beryl, Brent and Forties fields and also the additional output of Total from their two new fields, Dunbar and Ellon, which came on stream in December. Unadjusted gas production figures continue to rise with a 76.3% increase for Q4 1994 on Q3 1994 but comparing Q4 1994 against the same quarter for 1993 there is a fall of 11.9%, due primarily to milder weather.

The Royal Bank of Scotland/Radio Scotland Combined Index was 176.1 for Q4 1994, a 23.6% increase on Q3 1994 and a 4.9% increase on Q4 1993. The Oil Index increased 7.9% for Q4 1994 on Q3 1994 and 15.4% for Q4 1994 on Q4 1993. The Gas Index rose 76.3% for Q4 1994 on Q3 1994 but fell 11.8% for Q4 1994 on Q4 1993.

The rise in the Royal Bank of Scotland/Radio Scotland index for January this year is completely due to gas production, which reached 10,611mmcfd, only the second time that gas production has averaged more than 10,000mmcfd. In January the Oil Index fell by 4% to 158.4 as oil production slipped by 100,00bpd from the December level.

Oil and gas revenues rose from £34.2M in Q3 1994 to £41.0M in Q4 1994, an increase of 19.9% and over the year increased 6.8% from £38.4M. The major effects on revenues were the change in the $/£ exchange rate, the fall in the average dollar price for Brent crude which both led to lower sterling revenues for a barrel of Brent crude. While oil production continued to rise over Q4 1994, the price fell below the November level, which was the best month. In contrast gas revenues have risen each of the three months of Q4 1994 as gas production has increased and is the major contributor to the increase in oil and gas revenues.

Tanker uplift, Sullum Voe and Cruden Bay all showed net increases in throughput for Q4 1994 while Flotta and Nigg had net decreases in throughput. Tanker uplift reached its highest level for the year during Q4 1994 at 530,000bpd and Cruden Bay did likewise at 975,000bpd, the highest recorded since 1983. All the gas terminals increased throughput except Teeside, with Bacton, Barrow and St Fergus having net increases of 1171mmcfd, 953mmcfd and 566mmcfd respectively in Q4 1994.

For 1994 as a whole oil production reached 2.5mbpd, the highest level of output since 1986. This is in large due to the new fields which came on stream in the past two years. Also reaching a record high, since 1985, were the oil and gas revenues averaging £37M per day. Sterling revenues rose 11% compared to the previous year and oil revenue rose by 15% to £25.7M. Although oil revenue increased oil production rose by 25% and the expectations for oil revenue was greater. The main reason for the smaller than expected rise in oil revenue was the fall in crude prices when North Sea oil production was increasing. Brent crude fell to £15.90, an all time low since 1988. Consequently the sterling price of Brent was averaging £10.30 which is the lowest it has been for six years. Gas revenue increased by 3% to an average of £11.8M in 1994.

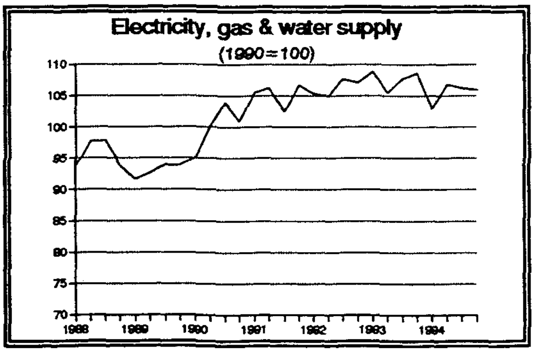
The weakness in the oil price is due to a complexity of factors but the main issues are the possibility of the lifting of sanctions against Iraq and a global surplus of oil coupled to weak demand for oil.

The outlook is that growth in 1995 will be difficult and cost reductions will become a major theme in the industry. Investment is however probably going to be higher with the DTI announcing a 23% increase on last year. Many companies are thought to have underestimated the extent of the reserves and therefore the North Sea has a more promising future than industry analysts suggest. 40% of the UK's oil reserves have been discovered but few have actually been fully developed. New technology is making it possible to run platforms with fewer personnel and more gas is being extracted than ever before. More recently the Iraqi rejection of the UN initiative has increased oil prices and that in the short term, (April 1995 - June 1995), they will stay at their present level, good news for oil companies. World forecasts still show that supply exceeds demand but they also indicate that demand will rise but primarily in America, Asia and Japan with little growth in Europe. A recent forecast for the North Sea shows 30 years of profits from the oil and gas but with gas production levels doubling their present level by the year 2020 while oil production levels would continue at their present levels until 2010.

A major issue in the Scottish economy is the future of the £2bn Sullum Voe oil terminal where both Shell and Cheveron, who are the main users are actively examining offshore loading with a view to cost reduction. If Shell were to exit Sullum Voe then it would be difficult for Cheveron and its partners to maintain operations and they are likely to follow. Also the US wants to export Alaskan oil to Asia leaving a gap in the home market which will probably be filled by oil from the North Sea. Sullum Voe can also accommodate Ultra Large Crude Tankers, which carry five times more oil, more cheaply than the smaller tankers used in offshore loading. Local unemployment, currently at 3-4%, would jump to 10% or more as almost 1,000 jobs would be lost if closure came about. The great uncertainty about offshore loading is the weather, even with storm interruptions, Sullum Voe has produced a steady supply of oil and has never run out of spare capacity. Indeed many believe there is a case for the BP Foinaven field production to be handled out of Sullum Voe.

Coal

The production index for Scotland for mining and quarrying industries for Q4 1994 on Q3 1994 rose by 1.2%, the same relative rise as the UK with a 0.3% fall for the latest four quarters on the preceding four quarters, whereas the UK had an 18.4% rise.



British Coal is to divest the British Fuels Group which Mining Scotland Ltd may be interested in. Other divestments include CIN and CINVen, the venture capital group. Employment in British Coal will drop to below 100 by next year.

The Scottish coal industry will benefit by £40M per annum if Scottish Power's plans to export electricity south of the border are approved. Coal demand will rise from 2.2M tonnes to 5M tonnes by the end of the century as the east coast lines are upgraded primarily benefitting Longannet and Cockenzie. Coal Investments has increased its share in Scottish Coal to 34.1% acquiring a further 1M shares at 143p per share.

Electricity

In Scotland the production index for electricity, gas and water supply for Q4 1994 on Q3 1994 has fallen by 0.3% while the latest four quarters on the preceding four quarters demonstrates a fall of 2%. The respective figures for the UK are -1.4% and 3.0% indicating poorer relative performance over a year but considerable improvement in the last quarter.

If the planned improvement on the east coast interconnector, from 1600MW to 2200MW, goes ahead, at a cost of £52M, almost one third of Scottish Powers electricity sales will be in the form of exports, which are currently only 15%. Objectors include Power Gen and Eastern Group who advocate that there is sufficient capacity in England and Wales. Scottish Power have opened a power station in North Yorkshire, an investment of £30M, and is bidding for an Australian Regional Electricity Company which is to be sold for £400-£500M. The strategy of Scottish Power is clearly to be a strong multi utility business.

Cuts in electricity prices are being accelerated due to two factors; companies are anxious not to be harshly treated by the regulator following his decision to review electricity prices and the abolition of the fossil fuel levy which is to contribute to the costs of decommissioning nuclear power stations. It is thought the overall prices will fall by approximately 10% if the fossil fuel levy is abolished in March 1996. This will act as a sweetener for nuclear privatisation. The agreement for 1995-96 for electricity companies will require them to cut prices by 11%-17%.

Water

The government is under heavy criticism after forcing domestic and business customers to pay more than is necessary for improvements in water and sewerage works. The controversy surrounds 15 'BOO', (build, own and operate),schemes where costs may be as high as 50% more than what local authorities would have to pay to build and operate themselves. The government has not backed down, stating that the private finance initiatives will drive down costs. Many English companies are entering the Scottish market for BOO schemes which together are worth £550M.

European standards on water to be introduced soon will be costly for the three new unitary water authorities. The estimated cost for Scotland is that

£800M of £1bn will have to be met by the boards.

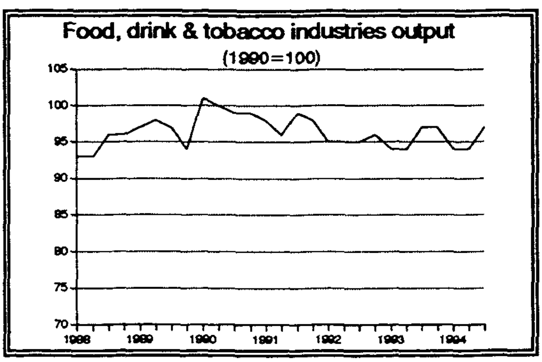
Nuclear

The nuclear industry can be sold off under legislation passed in the late 1980s which privatised the electricity industry. The sale would raise £2-3bn. The basis for a successful privatisation is that the Magnox reactors are to be kept in the public sector under BNFL management (making them a significant force in the generating industry) because of their unknown decommissioning liabilities. This will leave eight nuclear power stations in the private sector in one company. The argument against retaining Scottish Nuclear as a separate company was that it was two small to attract investors and the four and four option meant the DTI and HSE did not have time to transfer licences from Nuclear Electric to its Scottish counterpart in time for privatisation. This goes against the advice of a leading merchant bank. The two companies will maintain separate identities with no loss of HQ functions and the parent company will be located in Edinburgh. It is expected the flotation will take place before the next general election.

MANUFACTURING

FOOD, DRINK AND TOBACCO

The Index of Production for the Food, Drink and Tobacco (FDT) sector in Scotland showed no change over the fourth quarter of 1994, and no change in the year to the fourth quarter. This is very much in line with the industry's performance in recent years (see graph) where real output has been around 95-96% of the 1990 level for the last few years. The 1994 Q4 result is slightly better than that seen across the UK as a whole, where real output fell by 1%, although the UK sector has generally performed the Scottish sector, either holding or slightly increasing its 1990 output level over the same time period.



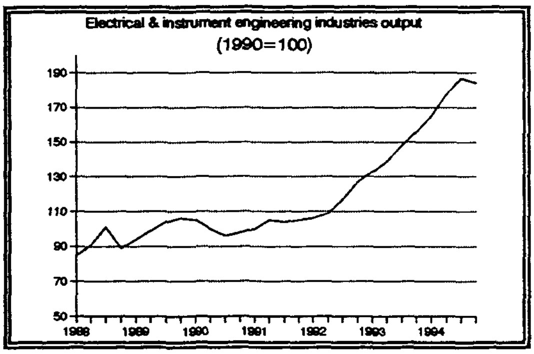
The April results from the Scottish Chambers Business Survey (SCBS) also show little change on the overall business outlook. The general level of optimism in the industry was positive in the three months to April, but only for a net 3% of respondents. This is despite a slight decrease in the trend in total orders, although the balance of firms experiencing a decreased trend was again small at 2%. The largest net fall, 15%, was in orders from Scotland and UK orders increased for a net 6%. Net export orders fell by a small amount, 2%. Two thirds of respondents felt that a lack of orders was the most likely constraint on output over the next three months, although longer term prospects may be brighter as investment intentions increased for a net 12% of companies for plant and equipment and for 6% for land and buildings.

Among Scottish companies, the major development is the acquisition of Courage by Scottish and Newcastle (S&N) for £425Mn making the Scottish company the UK market leader in brewing. The deal was initially under question pending an Office of Fair Trading investigation into the industry's pricing practices and, having cleared this hurdle (the OFT felt that it was fair practice for brewers to charge more to tied houses because of the supports it provides), another one may have to be dealt with as the combined group now owns over 25% of the UK market. It is therefore likely that S&N will have to divest itself of some assets or face a Monopolies Commission investigation as its market share is above the 25% level which usually triggers an investigation. The incentive for S&N to acquire Courage is both the size benefits of a combined group and also that the two companies cover different areas, S&N being strong in Scotland and the North of England while Courage's main markets were in Yorkshire and the South.

ELECTRONICS

The Index of Production for Electrical and Electronic Engineering in Scotland fell by 2% in the final quarter of last year, although this is hardly a source of concern given its strong growth over recent years (see graph) and the fact that it rose by over 24% over the whole of 1994. Assuming that the fourth quarter figures are a blip (and they may yet be revised when the next Index is published in August), the sector continues to massively outperform all others in Scotland and this has been the position since about 1990.

The blip possibility appears to be confirmed by the results of the April Scottish Chambers Business Survey (SCBS).Optimism throughout the industry is still high , with a net of 24% of respondents to the April survey feeling more optimistic that three months previously (although, possibly reflecting the fourth quarter result discussed above, the net balance is substantially down from the figure one year previously when it stood at 46%). Nonetheless, the overall trend in new orders is positive , with a net 32% of respondents experiencing an increase, mainly from the sectors main export markets. A net 12% of companies had increased capacity utilisation which stood at 78% and investment plans had been revised upward in a small number of companies. The trend in total employment was also upward, although for only a net 4% of respondents, with most companies using overtime to meet any increases in demand.

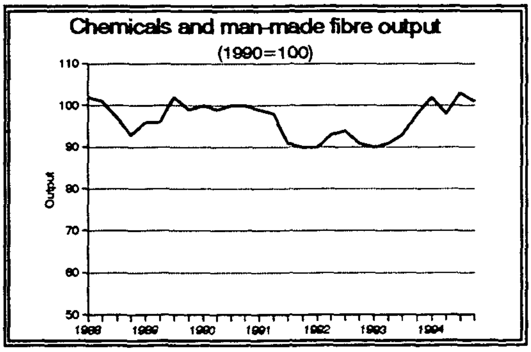


There have been a couple of promising developments in the small indigenously-owned sector in Scotland. The Greenock company Lithgow Electronics is to create 100 new jobs following a management buy-out. The new company which has been bought from the Lithgow family was supported by 3i who will initially hold a 49% stake. And in Edinburgh, the Vision Group which started as a university spin-off is set to obtain a stock market listing. The company manufactures an electronic "smart" video camera system which has already sold 100,000 units. Elsewhere, the PCB manufacturer Exacta is set to merge with an English-based company, Forward Circuits. The intention is to create a larger company to take advantage of growth in the PCB market. This may involve the loss of some control functions outside of Scotland, but due to Scotland's very strong position in electronics, it is likely that much decision making autonomy within the larger company will remain local.

Finally, two American-owned companies have announced plans to further invest in their Scottish operations. AMP, again at Greenock, will create around 200 jobs with a £13Mn investment which will increase the product range of the plant and create, for the fist time, a design and marketing department. Sun Microsystems at Linlithgow are also to invest in increasing the plant's product range.

CHEMICALS

The Index of Production for Chemicals and Man-made Fibres in Scotland decreased by 3% during the fourth quarter of 1994. However output increased by 9% over the year to the fourth quarter. This compares with an increase at 10% output growth in the fourth quarter and 6% annualised growth for UK industry.



In contrast in the latest SCBS survey Chemical respondents continued to report increased confidence during the first quarter reflecting the continued improvement in orders/sales. Respondents had forecast an easing in the upward trends in orders/sales but, contrary to expectations, the trends were stronger than anticipated. Total orders rose for a net of +56% of respondents, reflecting increased orders from all areas, especially export orders The strong rates of increase are forecast to continue. The rising trend in total sales, a net of 62% was almost twice the anticipated level reflecting strong increases in rest of UK and export sales, and again is forecast to continue.

Average capacity utilisation used again rose marginally to 75%. Overall, the proportion citing the low level of demand as the factor most likely to restrict activity during the current quarter rose slightly to 67% whilst the proportion citing inadequate capacity rose to the highest level reported (27%).

Respondents continued to revise upwards investment intentions in plant and equipment and began to do so for land and buildings. Investment authorised during the first quarter was most commonly directed towards expansion (42%).

The anticipated rise in employment did not occur, and the decline (-6%) continued. However, overtime levels rose sharply, and employment is forecast to rise during the current quarter.

Evidence from the SCBS has been reinforced by news that whilst the chemicals industry continues to grow (by an estimated 6% during 1994) employment within the industry continues to fall (6.3% during 1994), owing to the fact that companies are able to draw on slack capacity in orders to meet the increase in demand. This was highlighted by the announcement by BP Chemicals in April of plans to invest approximately £20 million in a near 30% expansion in capacity of its plant in Grangemouth. BP hopes that the plant which cracks gas into first stage chemicals, will become a leading European centre for producing raw materials for plastics. The move will not create any new permanent jobs although 1,000 construction jobs will be created for a few weeks during the summers of 1996/97 in order to install new equipment.

BP closed its other cracking plant in Belgan Bay, South Wales, last year as a result of an oversupplied market. However, temporary closures in the US have increased demand from Europe for ethylene and high and low density polythene.

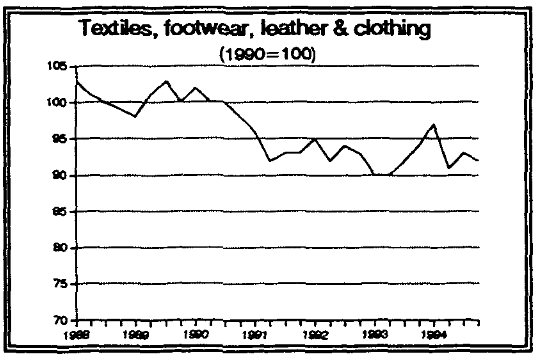
Employment is set to increase in two areas of Scotland, Birklays Plastics, a leading producer of plastic moulding for the electronics and automobile industries, announced that it was to open a manufacturing plant in Fife. The move which will last approximately £1.5 million will bring 100 jobs to the area and will offer the company the chance to enhance the service it provide in addition to providing the opportunity to pursue new business opportunities.

Secondly, BPI announced plans of a £2 million investment in Dumfries on a site acquired from Nestle. It will develop a recycling plant creating up to 50 jobs. The plant which will become the second recycling operation for agricultural scrap, will mirror its first recycling plant in Ardeer.

TEXTILES, FOOTWEAR, LEATHER AND CLOTHING

The Index of Production for Textiles, Footwear Leather and Clothing (TFLC) for Scotland fell by 2% over the fourth quarter of last year, a continuation of its erratic behaviour in recent quarters. However, output is now around 8% below the level recorded some four years ago when the index was rebased and (see graph) the long-term trend in real output is clearly downward. The industry across the UK has performed similarly over the same period (the index for the industry in the UK fell from 100 in 1990 to 91 in 1994), the figures indicating the problems which the UK industry is suffering mainly from international competition in TFLC.

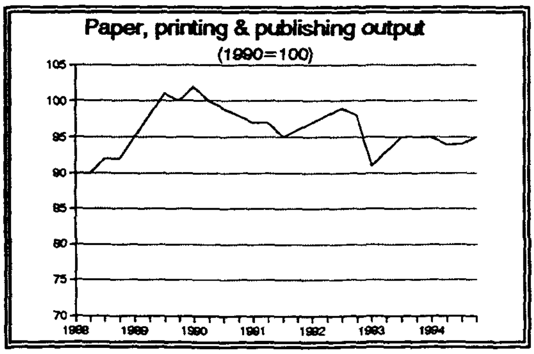
The more recent results from the Scottish Chambers Business Survey (SCBS) for April of this year unfortunately indicate that there is little evidence of any immediate change. A net 13% of TFLC respondents to the April survey were less optimistic about immediate business prospects than three months previously, although this was an improvement on the feeling one year previously. The lack of optimism seems to stem mainly from reduced orders in the home market, with a net of 28% of respondents reporting a drop in Scottish orders in the last three months, while the figure for orders from the rest of the UK showed a net fall of 17%. While export orders have increased overall, for a net 8% of companies, this has failed to compensate for the UK reduction and an overall 9% of companies reported a reduced trend in new orders. A lack of new orders is still felt to be the factor most likely to restrain output in the short run, cited by 56%, although 23% cited problems with skilled labour.



The major development in the sector in recent months has been the problems at Scotland's major textiles company Dawson International. Following a series of problems with its US acquisitions and the attempted diversification of the Pringle brand name, the chairman and managing director have both resigned and the group is to return to its former core strategy, concentrating on high quality knitwear. The need to cut costs and refocus will also result in the closure of its contract knitwear factory in Arbroath where 200 jobs will go, the closure of a carpet yarn plant in Kilwinning (140 jobs) and the loss of 50 jobs at a knitting plant in Hawick. Part of the problem is the poor performance of the US business's - it has so far failed to find a buyer for one business and the company had to raise $45Mn in a rights issue. However, the major problem appears to be that Dawson found it increasingly difficult to manage a diverse set of activities, and this is the major reason why it has decided to return to its core area of high quality knitwear. Although jobs have been lost as a result of recent problems, this strategy, which saw Dawson grow to one of Scotland's major companies, is probably its best chance of returning to profitability and allowing it to make the most of its reputation for high-quality Scottish products.

PAPER, PRINTING AND PUBLISHING

The Index of Production for the Paper, Printing and Publishing sector in Scotland indicates 2% output growth in the fourth quarter of 1994 with annualised growth of 1%. The corresponding UK figures show UK output growth of 1% in the fourth quarter of 1994 and annualised growth of 3%.



The latest Scottish Chambers Business Survey shows a continuing upward trend in levels of business confidence. A net 12% of respondent firms are more confident about the current business situation compared to 3 months ago, with a net 40% feeling more confident than 1 year ago.

In terms of orders, a net 29% of firms experienced a rise in the total volume of new orders, with a net 22% expecting the upward trend to continue into the next quarter. Specifically, a net 22% of firms reported an increase in the volume of new Scottish orders while a net 24% experienced a higher volume of UK orders. The level of new export orders increased in the last quarter for a net 19% of firms. With respect to the total volume of sales, a net 41% of firms have experienced a rise. The most buoyant market appears to be the UK market, where a net 35% of respondents reported a rise in total sales, with a net 22% expecting this trend to continue in the next 3 months.

Average capacity utilisation in the sector remained at 81%.

Investment intentions have been revised upwards in both plant & equipment and land & buildings investment, with net balances of +27% and +9% respectively. Modest increases in investment in both areas are also expected in the next quarter.

Expectations of improvements in employment, anticipated in the last quarter, have materialised with employment figures continuing to show signs of recovery. A net 10% of firms have increased employment levels in the last 3 months, with a net 9% expecting this upward trend to continue into the next quarter.

The European Union has launched an investigation into price increases in the newsprint industry and is seeking evidence of possible collusion among newsprint producers in order to keep prices artificially high. Between September 1994 and January 1995 newsprint prices in Europe have risen, on average, by over 20% with further increases expected. Producers are unconvinced by theories of collusion and put price rises down to prevailing market conditions. Demand for newsprint has risen, particularly in US where there has been rapid economic growth. Growth has led to an increase in demand for paper. Secondly, raw material costs have risen. Director General of the British Paper & Board Industry Federation Jeffrey Barlett said that the cost of wood pulp and waste paper, both components of newsprint, have more than doubled in the last year. Therefore higher prices are a reflection of higher costs. EU's competition directorate DG4 is currently investigating 40 newsprint producers for evidence of collusion and has announced that the investigation could take up to 6 months.

Glasgow based book and journal printers Bell & Bain has been acquired by Irish company Droyhurst, a subsidiary of Inishtech. Bell & Bain which has annual turnover of approximately £3.5 m and had pre-tax profits of £850,000 in 1994 was purchased for £3 m.

The American Publishing Company headed by Conrad Black is set to make a takeover bid for The Telegraph. Conrad Black who already holds 58.5% of shares in the newspaper through holding company Hollinger announced that the deal could be completed by July. A perceived benefit of the takeover deal would be that Mr Black could shield the finances of The Telegraph under the umbrella organisation of the American Publishing Company away from the public glare of UK newspaper price wars.

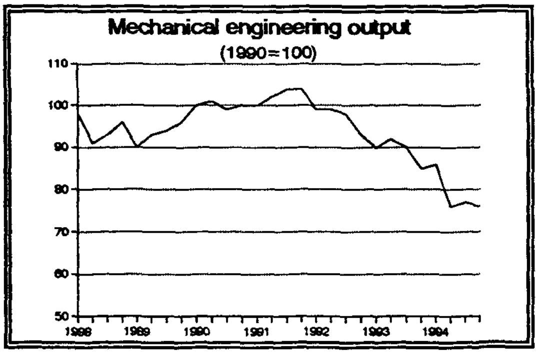
Profits of Edinburgh based packaging and oil company Sidlaw for the 6 months to March 31st have fallen by £3 m to £5.8 m, compared with 1994. While operating profits in Sidlaw's oil division have risen slightly, profits in the packaging division have more than halved from £5.5 m to £2.5 m. Chief executive Digby Morrow accounted for this trend partly by having "experienced severe pressures on selling prices compounded by steep rises in raw material costs".

MECHANICAL ENGINEERING

Despite all the continuing evidence in the previous three Scottish Business Surveys (SBS) indicating an up-turning point in the business cycle for the Scottish mechanical engineering industry, the latest official data release showed a slight fall in its output in the final quarter last year. This is broadly in line with the rather poor performance across the Scottish industries towards the end of last year. Compared with 1993 as a whole, the annual Scottish mechanical engineering output fell by a massive 11%. This is seen against the background of a 4% increase in the UK mechanical engineering output as a whole over the 94/93 period, reflecting the very fragile nature of the recovery north of the border.

Notwithstanding the disappointing performance in the past year, business confidence in this industry continues to rise. The latest SBS (May 1995) shows that confidence rose for a net of firms in all size bands, but was stronger in small (20-99) to medium (100-199) firms.

The upward trend in total orders further strengthened with a net of 46% of corresponding firms reporting increases. The increases came from all sources and are expected to continue through the second quarter, but to ease slightly to a net of 35%. The upward trend in sales strengthened further and well above expectations to a net of +38%, and this rate is expected to be sustained in quarter two. The rise in Scottish sales, a net of +52%, was well above expected level, but this rate is seen as only temporary. Increases in export orders and sales remained the strongest and are expected to be so in quarter two.



The rise in investment plans for plant/equipment continued and is expected to be sustained. The decline in investment in land/building ended and no change is anticipated for quarter two. The main reasons for authorising investment in the first quarter are: replacement (33%), increasing efficiency (20%), expanding capacity (17%) and introducing new projects (17%), a similar pattern as in the previous three or four quarters.

The anticipated increase in employment materialised in the first quarter, with a net of 14% of firms creating new jobs and the increases are expected to continue. However, these increases in jobs mainly came from small firms, whereas the medium- to large-sized firms reported further job cuts.

Since last year's poor performance was largely attributed to plant closure or capacity reduction in the medium and large firms, any genuine recovery and sustainable growth will hinge on a strong growth in the medium and large firms. The evidence in the latest SBS depicted an encouraging picture for the medium and large firms. On the whole, the situation was much improved. The increases in total new orders and sales were strongest in the medium and large firms, and business confidence was also improving. Moreover, the sluggishness in investment intentions by medium and large firms also ended. Combined with the business optimism expressed by small firms, the Scottish mechanical engineering industry is expected to recover in the first quarter. However, the employment prospect is still uncertain, as the medium and large firms are still cutting jobs. The outlook for quarter two is a cautioned further recovery and development.

SERVICES

DISTRIBUTION

Results from the Scottish Chambers' Business Survey indicate that wholesale respondents continued to express a low level of confidence, a net of -2% were less confident than in the fourth quarter. However, compared to the same quarter of 1994 a net of +14% indicated that they were more optimistic about the general business situation. Retail respondents continued to express a low level of confidence during the first quarter of 1995, a net of -11% reported being less confident than in the fourth quarter whilst a net of -11% indicated that they were less confident than had been the case in the first quarter of 1994.

The upward trend in wholesale sales continued but eased to a net of +7%, further than had been expected. However respondents do expect the trend to strengthen during the second quarter. One reason for the low level of confidence expressed by retail respondents is undoubtedly lower than forecast sales. Respondents had expected a level trend whereas in actual fact a net of -3% was reported. Retailers expect the trend to improve during the current quarter.

There was little difference with regard to wholesale investment plans, a net of +15% revising investment intentions in premises upwards compared to the first quarter of 1994, this compares with a net of +17% in the previous quarter. Compared to the same period one year ago, a balance of +7% of retail respondents have revised their investment intentions in premises upwards.

Watson & Philip bought 18 Presto & Galbraith stores predominately in the West of Scotland in a deal worth £1.8 million thus saving hundreds of Scottish retail jobs.

Total Home Entertainment, a division of the John Menzies Group, paid £24.9 million for a 37% stake in Funsoft with an option to buy a further 14% before the end of 1997 giving Menzies a controlling interest. Funsoft is a German publisher and distributor of CD-ROM and other multimedia software.

During the year to the end of February 1995, Kwik-Fit reported a rise in pre-tax profits from £25.4 million to £29.3 million. It is expected that the 80 outlets acquired form Shell UK will begin contribution to profits during the second half of 1995. The group now has 580 UK outlets up from 491 last year and the company believes the UK market can sustain 800 before it becomes saturated.

Kwik Save, the UK's largest discount supermarket chain, announced its first fall in profits in its 30 year history. The fall in profits was attributed to rising costs, rapid UK expansion of European discounters and price cutting by superstores. Sainsbury remained the UK's most successful retailer last year when it announced £12 billion of sales with pre tax profits of £808.2 million. Sainsbury has 11.7% of the market compared to Tesco at 11.4%.

The joint venture company between Marks & Spencer and Sainsbury, Braehead Park, has had planning permission to build a 625,000 sq ft retail development turned down by Strathclyde Regional Council. However, the developer has already received planning permission in 1990 for a scheme almost 40% larger and has pledged that it will go ahead with these plans.

FINANCIAL SECTOR

Will banks ever be the same again? Michael Blackburn, chief executive of the Halifax, in a recent interview[1] speaks of his unhappiness with the term bank both because of its poor image in the eyes of many customers and because of its loose descriptiveness since it covers many activities the merged and converted Halifax does not intend to be involved with. Meanwhile at a recent conference Lord Younger, Chairman of the Royal Bank of Scotland, is reported as admitting that technological change threatens the banks abilities to retain dominance of their core business. Is the outlook for banks and particularly Scottish banks particularly bleak at the moment?

In itself the poor perception of banking discussed by Michael Blackburn should not be a problem. Consumers have a poor perception of many services but continue to use them. Public transport, one suspects, is such a service. The new merged Halifax may have decided to specialise in personal finance and as such attempt to differentiate itself from other banks and it may even adopt a nomenclature that distinguishes it from its competitors but, at the end of the day, the choice

---

1 *EuroBusiness* May 1995, "Keep it personal".

for consumers between different banks or personal finance companies will come down to a trade-off between convenience and monetary cost. Consumers will take on a mortgage or other loan that involves the least effort or cost.

The problem, as outlined by Lord Younger, is that banks, at least as far as the consumer is concerned, offer services which are standardised, simple and easily providable by other suppliers. At the risk of extreme generalisation banking involves two main activities; the making of payments; and the business of borrowing money from one group of people (whether directly from customers in the form of deposits or via bond issues in the financial markets) and lending money to another (or even in some cases the same) group of people. Of course, banks also offer many other services but the two crucial ones are where the banks receive money from customers which is then either lent out to others (and for which the bank earns a fee in the form of interest differential between the deposit and lending rates) or is used for the making of payments.

In the past banking involved the physical movement of cash or its equivalent in cheques. Banks were recipients of this cash and settled debts for their clients or used their detailed knowledge to decide which customers were suitable recipients of loans. Any such physical functions have now largely gone. Loans are now often made on the basis of credit scoring techniques and the financial history of customers, whilst the deposit and movement of cash is declining relative to other forms of money transfer. Cheques are also being superseded by electronic forms of money transfer. These changes imply that the present structure of banks with many retail branches may not be best suited to their present functions and may be very vulnerable to increase competition. Core personal banking activities do not on the whole need branches; they need specialised software. The banks, in common with many other financial service providers, find themselves with a distribution structure that may be profitable and desirable but almost certainly is no longer necessary. What then do banks offer to the consumer that is unique? Certainly they own brand names and reputations (albeit according to the Halifax with a somewhat poor image!) but their main asset is presumably their proprietary software and specialised banking skills of relevance to the consumer sector. Neither of these is likely to be an insurmountable barrier to overcome. Exact replicas of the software are no doubt unavailable but acquisition of similar information systems from specialist software houses or from other banks is generally feasible. At the same time banking skills can either be bought, perhaps by the acquisition of a smaller financial institution (a building society?) or learned slowly by building up operations over time.

Inevitably, the process is more complex than we are suggesting and pitfalls undoubtedly exist. Nor have branch networks entirely lost their charm since otherwise the scramble for the N & P that we are currently witnessing would not be taking place, but it does not seem too far from reality to believe that barriers to the entry of new firms into banking are falling, particularly if the new firms are themselves involved in financial services, are retail institutions that can provide a ready made distribution service, or are electronic service providers who have mastery of the software side and can deliver financial services without the expensive branch network and hence overheads of current providers.

How long will it take for us to see major changes in the banking industry? The banks are not, of course, unaware of the technological developments. Part of their strategy is to diversify their branches so that they provide a focus for all consumer financial product services, and to replace the money handling role of branches with an advisory role. This process has been going on for more than ten years with the transformation of some branches and considerable change in bank structures but it is difficult to believe that it has been notably successful. The rise of Direct Line and its competitors reveals that many customers want convenience and cheapness; its not clear that the financial advisory/services shop provides either. Of course, some consumer bank business still require a physical transaction. Foreign exchange is an obvious example and has no doubt been a profitable earner with the growth of tourism, both inward and outward, but consumer preferences for the convenience of ATM's and telephone based services suggest that the share of the banking products market taken by bank branches has fallen and is set to continue to fall for a number of years yet.

It is also easy to underestimate the size of the investment and technological sophistication required to get electronic financial products services easily available and on-line to consumers. The first ATM was installed in 1967 but it was more than ten years before a reasonably comprehensive network was in place and considerably longer than that before there was widespread acceptance of ATM's. Electronic home banking has also been available for more than ten years but its penetration remains slight. For all the talk of Internet shopping, problems such as encryption of messages to provide reasonable security remain and delay its widespread adoption for financial services.

The scenario outlined above raises a myriad of issues for the banks. Foremost amongst these must be both their ability to compete and to increase the barriers to entry of new firms into the industry. One strategy would be for them to ruthlessly prune and become low cost producers of banking and financial services. Whilst cost cutting is obviously important and we seem likely to witness a further reduction in employment in banks, it is unlikely to be enough given the banks substantial commitment to the branch network. They will always fall prey to the low cost providers such as Direct Line and its competitors. Another strategy, of which Direct Line is itself an example, is for the banks to provide two or more levels of services and to increase choice. There is a danger, however, that such a strategy will simply increase competition and reduce margins for everyone. The ideal must be to find a way of keeping competitors out of the market by making entry to the market difficult and profitability uncertain. Massive investment might be one way perhaps by the provision of specialised software or hardware to consumers. It is also important to recognise the bank's role as part of the payments mechanism. The settlement of debts and credits between individuals and companies is likely to be a growth industry for the foreseeable future. Given the entrenched position of existing institutions it is unlikely that there will be major changes in the way this operates. Technology will expedite the process but the procedures will remain much the same. With increased automation costs may be expected to drop and the unbundling of transactions account and deposit services to continue so that consumers pay for the services they actually use. Given the significant difficulties for new firms of entering this market the payments mechanism is likely to be a profitable earner for the banks despite claims to the contrary. The payments mechanism also provides banks with an entry point for the sale of other financial services. For some consumers lack of information and convenience will mean that this remains an important method of buying financial services and so provide the banks with useful business.

Where does all this leave Scottish banks? First it's important to emphasise that the threats we are considering relate to consumer or retail banking. There are many other problems for the wholesale banking sector but they haven't been considered here. The second point to make is that there are large profits for successful innovators as the profitability of Direct Line testifies, but these excess profits do not go on forever as competitors imitate and innovate. Thirdly, there is no reason to believe that the changes will occur particularly fast or rapidly or that the future will leave us with an industry that is all electronic or all branch banking. Fourthly, the impact of inertia and the barriers to entry of new firms can be understated. Ten years ago M & S was seen as an important new competitor in the financial product market. It has undoubtedly had an impact but nowhere near as dramatic as some commentators foresaw. Fifthly, investment in electronic systems looks set to increase for the foreseeable future. Continued cost cutting in the more traditional banking sector to generate profitability to fund this investment seems essential. Technological sophistication in itself sells to a relatively few customers. Convenience and lower prices enabled by better technology attract customers and market share and profit. This has to be the goal for the Scottish bank. Finally, it is worth emphasising that if banks can free themselves from over dependence on their branch networks and yet retain barriers to the entry of new firms, the whole of the UK or perhaps even Europe can become their market place. The potential rewards are substantial.

TRANSPORT

Roads

The last quarter has seen much debate about road policy, with several reports either outlining the concerns of environmentalists or arguing the case for developing the infrastructure to promote economic growth in Scotland. The Scottish Office has cut road expenditure by 13.5% in real terms over the next three years but by the year 2000 40% of the Scottish motorway network will become congested unless spare capacity is provided. It is clear that the Scottish Office requires to balance an improved infrastructure to sustain economic growth with the externalities of environmental damage - a task easier said than done.

FirstBus has been created out of Badgerline and GRT making it Britain's second largest bus operator with a market capitalisation of £265M, turnover of £348M and a market share of 13.5% as it moves to compete with Stagecoach. It does however mean the loss of a headquarters office in Scotland as it will be located in Weston-Super-Mare. This means the largest three companies control 45% of the market. Stagecoach is not sitting still with an expansion into Europe and likely involvement in public/private finance for roads, especially those with bus lanes, and rail franchises.

The cost of repairing the Kingston Bridge has more than doubled to £17M and it will probably have to be replaced before its 120 year lifespan. Already £11.5M has been spent on repairs on a bridge which cost £9M to build in 1970. It may be more cost effective to build a new bridge sooner rather than later.

Rail

95% of rail services in Scotland will be guaranteed into the next century according to Office Passenger Rail Franchising, (OPRAF), after privatisation. This does not include services subsidised by SPTE, sleeper, motorail and night seating services. Existing overnight services to London are said to lose £4M, (excluding Railtrack access charges).

The Fort William sleeper and motorail service were due to be withdrawn on 28 May by BR but the legal action of Highland Regional Council has prevented this. The subsidy for these services is £4.1M while BR claims savings of £7M would result if the services were terminated. The £2.5M savings may have to be made elsewhere, primarily on staffing and service efficiency measures on East coast rural services, following BR's failure to win an appeal. This introduces further uncertainty to the privatisation process as franchisees will be unwilling to be forced to maintain large loss making services. It is ironic that the government found an extra £46M subsidy to limit fare increases and loss of service in the South East. OPRAF puts the Fort William subsidy at £157, while BR have a range of £180-£540. Motorail services have been cut as they have no protection under the 1993 Railways Act.

More good news for rail travellers as the Secretary of State for Transport is to limit the rise in rail fares to inflation over the next three years. This does not apply to 40% of fares which remain unregulated, causing concern that regulated and unregulated fares will soon be out of balance with each other and serious anomalies will arise. The existing stations which deal in through ticketing will continue to do so according to the rail regulator, after considerable public pressure. The increasing regulatory burden on railways makes privatisation successes look more unlikely.

37 organisations have registered to run franchises when BR is privatised. This means there will be 160 applicants for the first eight franchises. This is fewer than government estimates but slightly more than industry analysts expected.

Sea

Clydeport has effectively been sold for £600,000 following the sale of Braehead for £11M to a M&S/Sainsbury consortium. Two of the company's senior directors both hold shares worth £5M after an investment of £75,00 each. Profits of £4.2M for 1994 were up 70% on that of 1993. Clydeport is expected to bid jointly with the management of Dundee for the port of Dundee which will probably be sold for £15M, after profits of £800,000 on a £5M turnover in 1993.