

THE SCOTTISH ECONOMY

SHORT-TERM FORECASTS*

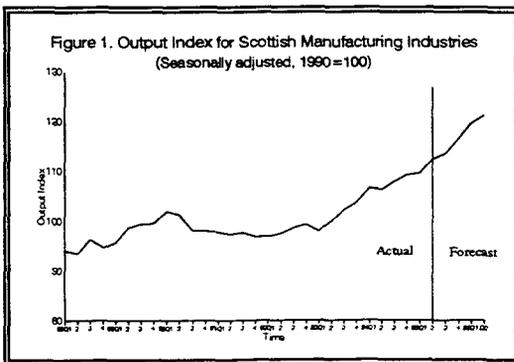
This section presents short-term forecasts for the quarterly growth rates of Scottish manufacturing (Division D of the 1992 SIC) output.

The present forecasting period extends to 1996Q2. Figure 1 depicts the actual growth rates for Scottish manufacturing output from 1988Q1 to 1995Q1 and the forecasts for 1995Q2 to 1996Q2. Since there is substantial revision in the latest official data release of Scottish output indices, the present forecasting results also differ from our previous forecasts.

It is predicted that the growth in Scottish manufacturing output will be sustained until the first half of 1996. The growth will be particularly strong towards the end of 1995 and the beginning of 1996. However, this strong growth trend will begin to ease by the second quarter of 1996. For 1995 as a whole, the output of Scottish manufacturing industries is predicted to rise by around 4.7% over 1994. Further details of growth rates for Scottish manufacturing outputs are presented in the following table.

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

1992/91	0.6
1993/92	2.9
1994/93	6.6
91Q4/90Q4	-1.0
92Q4/91Q4	2.5
93Q4/92Q4	4.4
94Q4/93Q4	5.4
94Q2/94Q1	-0.4
94Q3/94Q2	2.0
94Q4/94Q3	0.9
95Q1/94Q4	0.4
Forecast	
95Q2/95Q1	1.6
95Q3/95Q2	0.8
95Q4/95Q3	3.3
96Q1/95Q4	3.1
96Q2/95Q1	1.3
1995/1994	4.7



SCOTTISH CHAMBERS' BUSINESS SURVEY

The 1001 responses to the Scottish Chambers' Business Survey (SCBS) for the second quarter 1995 indicated confidence levels remaining unchanged in Manufacturing and Wholesaling, but falling in Construction and continuing to decline in Retailing. However, Tourism/Leisure respondents reported rising optimism.

In Manufacturing the rising trend in business confidence, a net of 5% in quarter one, ended and a level trend was reported. The year trend in business confidence continued to rise, but the rate of increase eased from a balance of 23% in quarter one to a net of 14% in quarter two.

In Construction, optimism began to fall with a net balance of 14% of respondents reporting that they

* 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.

were *less* optimistic than in the first quarter. This compares with a 3% balance of respondents who were *more* optimistic in the first quarter over the fourth quarter 1994. A net balance of 2% of respondents reported that they were *less* optimistic than they were a year ago, a significant deterioration on the situation in the first quarter where a net balance of 25% of respondents were *more* optimistic than in the same period a year earlier.

In Distribution, confidence continues to decline in Retailing and at a faster rate, while in Wholesaling optimism remained unchanged over the first quarter. In Retailing, a net balance of 20% of respondents were less optimistic about the general business situation compared with a year ago than they were in the first quarter, which compares with a negative balance of 11% in the fourth quarter. In Wholesaling, the numbers more optimistic compared with a year ago were exactly balanced by those reporting that they were less optimistic. This can be contrasted with the first quarter where a net balance of 14% reported that they were *more* confident than they were a year ago.

Optimism among respondents from the Tourism/Leisure sector continued to rise and at a slightly faster rate than in the first quarter. A net balance of 33% of respondents reported that they were more optimistic about the general business situation than they were three months earlier, compared with a balance of 30% in the first quarter. A net balance of 40% of respondents were more optimistic in the second quarter than in the same period of 1994, a rise of 14 percentage points on the response in the first quarter.

In Manufacturing, orders and sales again increased, although at a slower rate than in the previous quarter. For orders, a net balance of 11% of respondents reported an increase while, for sales, a balance of 13% of firms also experienced a rise. These figures compare with positive balances of 21% and 16%, respectively, in the first quarter. Orders and sales continued to grow to markets outside Scotland, with exports buoyant. Export orders appeared to have increased at much the same rate as in the first quarter, while export sales grew more quickly. However, there appeared to have been a downturn in the demand for manufacturing goods from within the Scottish economy. A net balance of 4% reported a *decline* in domestic orders, compared to a net balance of 1% reporting an increase in the first quarter. For sales, the number reporting an increase in domestic sales was

exactly balanced by those reporting a decrease. This can be contrasted with the situation in the first quarter where a net balance of 23% of manufacturing respondents reported an increase in sales to the domestic Scottish market.

In Construction, new orders exhibited a sharp contraction compared with the first quarter. A net balance of 13% reported a *decrease* in orders compared with a net balance of 24% reporting an *increase* in the first quarter. A marked contraction in orders from the private sector appeared to have been the main source of the downturn. A net balance of 2% reported a *fall* in orders from the private sector compared with a net balance of 17% reporting an *increase* in the first quarter. Orders from both Central Government and Other Public Sector were severely depressed. Moreover, there appeared to have been a significant deterioration in the demand from both these markets, particularly Other Public Sector.

Retail sales again fell in the second quarter, and at a faster rate than in the first quarter of the year. A net balance of 15% of retailers reported that sales had fallen, compared with a balance of 3% reporting a decrease in the first quarter. In Wholesaling, sales rose at much the same rate as in the first quarter. A net balance of 5% of respondents reported a rise in sales, compared with a balance of 7% reporting an increase in the last survey.

Tourism/Leisure demand rose again in the second quarter, and at a faster rate than in the first quarter. A net balance of 36% of companies reported an increase compared with a balance of 28% reporting a rise in the three months to March. Demand rose in all markets, with demand from abroad showing a marked improvement.

Stocks of finished goods in Manufacturing continued to fall, at much the same rate as in the first quarter. A net balance of -3% reported a fall, compared with 2% in the first quarter. Stocks of raw materials also continued to be run down, while work in progress rose again.

In the Financial sector, the demand for personal loans continued to rise, and again at a faster rate. A net balance of 58% of respondents reported a rise, compared with the balance of 44% reporting an increase in the first quarter. Advances to the corporate sector were also still rising but at the same rate as in the previous quarter. The demand for working capital remained on an upward trend,

at the same rate as in the first quarter. The demand for finance for investment in buildings continued to rise and appears to have accelerated, while the demand for finance for investment in plant and equipment continues to rise strongly.

Manufacturing investment intentions in plant and machinery were again revised upwards in the second quarter, with a net balance of 10% reporting an increase. However, respondents expect to revise these intentions down again in the third quarter of 1995. There was a further deterioration in manufacturers' investment intentions in land and buildings, and a net balance of 6% of respondents reported a decline. In Retailing and Wholesaling, investment intentions continued to be positive, although somewhat weaker than in the first quarter. Net balances of 5% and 11% of Retail Distribution and Wholesale Distribution respondents, respectively, reported an upward revision in investment intentions compared to the second quarter of 1994. The investment intentions of Construction respondents remain unfavourable for both plant and equipment, and for investment in buildings. Moreover, there appears to have been some deterioration compared with the first quarter.

The outturn in the second quarter was generally worse than expected in the first quarter.

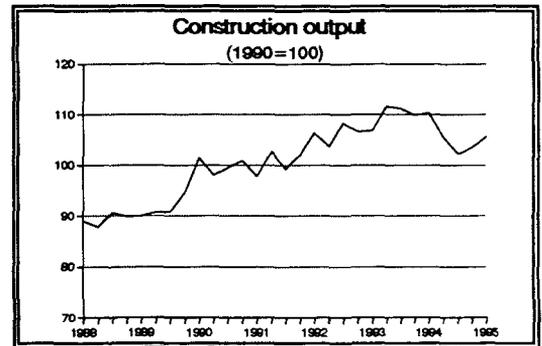
Demand conditions are expected to continue to improve in manufacturing in the third quarter of 1995, although at a slower rate. Wholesalers expect further growth in demand, while in Tourism/Leisure the strong growth of demand is also expected to continue into the third quarter. However, in Construction and Retailing demand is expected to deteriorate further.

CONSTRUCTION

The Scottish Index of Construction, for the first quarter of 1995 was 105.7, an increase of 2.0% on the previous quarter. However the year on year comparison shows a 6.0% fall. The upwards revision of the fourth quarter's figure, means that this is the second consecutive quarter to show an increase.

The Scottish construction index continues to display no strong trends, unlike the UK construction index where a pattern is usually more discernable. However, the UK index exhibited a 0.9% fall during the first quarter to stand at 90.5; the first fall since the second quarter of 1993. Even with this

fall the year on year figure is still showing a 3.3% increase, a reminder that the low point in the present cycle was now two years ago and the trend has been upwards since then.



The Department of the Environment's summary of contracts obtained by contractors in the building industry shows that, at £755 million during the first quarter 1995, the overall Scottish total is above any quarter in 1994 (even allowing for inflation). This figure splits down to £254 million from the public sector and £501 million from the private sector. New housing orders shares a similar split with £51 million being public and housing association and £161 million being private.

Infrastructure spending (of which 69% is on roads) is dominated by the public sector with £84 million of orders compared with £16 million from the private sector.

Public sector provision of factories and warehouses is poor with £8 million and £1 million respectively of new orders, compared with private sector respective orders of £169 million and £45 million. This shows an extremely high level of private industrial orders with the first quarter total (including oil steel and coal) of £215 million being more than the collective total of £1299 for 1994 as a whole.

The Scottish Chambers' Business Survey for the second quarter of 1995 shows that 14% of respondents are less optimistic about the general business situation than they were in the first quarter. Only 2% were less optimistic than they were a year ago.

The trend in total new orders is down for a net 13% of respondents, with most respondents finding public sector orders responsible. A lesser 8.4% balance expect the volume of new orders to be down in the third quarter, with once again, public

sector orders being held most responsible, indeed private sector new orders are expected to increase for a net 2.3% of respondents.

Current capacity utilisation is 80.2%, which is marginally down on the previous quarter. Apart from orders or sales, the most likely limiting factor to output over the next three months (for 7% of respondents) is a shortage of skilled labour. This is further evidence of emerging skill shortages and the Construction Industry Training Board (CITB) would do well to take heed.

Investment intentions in both plant and equipment and buildings are being revised downwards for balances of 19% and 17% respectively and the situation in the second quarter is likely to show little improvement. Over half of those investing are doing so in order to replace existing investments, however, almost 18% are investing to increase efficiency, 12.5% to expand capacity and 8.9% to introduce new technology.

Downsizing is still the dominant trend amongst respondents with net balances of 4% and 12% reducing employment in the second quarter and expecting to reduce in quarter three, respectively. The average increase in employee remuneration was 3.4% up from the previous quarter's 2.6%.

A net 18.3% of respondents expect to increase their provision for training and 12.2% (net) of respondents who attempted to recruit experienced increasing difficulties. Three fifths of respondents found difficulty in finding suitable employees for particular occupations. The most problematic areas were skilled manual, technical and professional/managerial.

The SCBS shows that the continued low level of public sector orders is still depressing the Scottish construction industry.

House prices in Scotland continue to buck the trend in the rest of the United Kingdom, rising by an average of 3.4% in the second quarter of 1995. The rise in the UK over the three months was 0.4% in what is traditionally one of the most active parts of the year. The Halifax Building Society showed annual house price inflation running at 1.4% in Scotland whilst in the UK as a whole the figures showed a decrease of 1.6%. The relative confidence of Scottish first time buyers is shown by their 2.3% increase over the same period last year, compared with a UK reduction of 0.5%. This is reflected in the fact that an average new house in

Scotland costs £77,826, ahead of the UK figure of £66,747 which indicates the very healthy state of the new housing market in Scotland, in turn reflecting the confidence of both buyers and buildings, according to the Halifax.

The continuing spectre of negative equity, however real south of the border is hotly disputed here in Scotland. The housing market is beginning to gain momentum as confidence increases and continuing scare stories about negative equity are having a detrimental effect. Claims in June from the DoE that as many as 53,000 homes in Scotland with a total value of £80 million could be in negative equity have been hotly denied by the Scottish Office and Scottish property experts. What falls in price there have been in Scotland have been very slight, the main problem has been the sluggish nature of the market with no equity gain, as for a number of people the years from 1989 to the present have seen the value of some properties fail to increase, however these people and houses are in the minority. For the main part house prices in Scotland have risen, albeit only slightly.

A sign of the continuing problems in the UK housing market is that of Tarmac (Britain's second largest house builder, behind Wimpey) quitting the housing sector and intending to float or sell off its housing division for around £400 million to concentrate on its building products, aggregates and contracting activities. The housing division includes the Scottish McLean Homes subsidiary based in Paisley and one possibility is that it will be spun off into a joint venture.

It is clear that the future of the construction industry in Scotland could go either way and the key is still confidence. However there is evidence that confidence is increasing and that the way ahead is up.

ENERGY

OIL AND GAS

North Sea oil output fell to a two year low just below the 2mbpd level for the first time since June 1993. The Royal Bank of Scotland oil and gas index was at its lowest level since August 1993. In July gas output dropped to 3,899mmcf/d but this is 5% higher than the output in July 1994. The oil price had fallen to \$15.83 in July, the lowest this year. This has given average daily oil revenue of £25.3M and an average daily oil and gas revenue of

£32.6M

The reductions in production and revenues in June are almost entirely due to planned maintenance shutdowns. Seventeen oil fields had decreases in production of more than 10,000bpd. The major falls were in Elf's Enterprise Piper, BP's Miller, Amerada Hess's Scott and Shell's Brent. The oil terminals which had the largest decline in throughput were Cruden Bay and Flotta. Of the Gas terminals, Bacton and St. Fergus suffered the largest declines but most oil and gas terminals have recovered sharply after the maintenance periods.

Oil prices have recovered to approximately \$16.50. The possibility that Venezuela has exceeded its OPEC quota has raised the suggestion that OPEC will increase its quotas which has therefore hold down prices, although no decision will be made until the OPEC meeting in November. The situation in Iraq has had little effect on oil prices. Non OPEC production is higher than expected and is estimated to rise next year. It is forecast that non OPEC production will be 43.6mbpd in 1996, a rise of 1.3mbpd from 1995.

The rise in the oil price has helped several oil companies with higher than expected profits. BP reported a 53% rise in profits, increasing their dividend from 2.5p to 4.0p beyond forecast levels. Shell's profits saw a 70% rise in the first half of the year up to £2.58bn. Other companies including Enterprise, Clyde, Goal, OGC and Premier also reported higher than expected profits but increased productivity and new work were major contributory factors.

Capital spending on UK oil and gas fields is to grow sharply next year despite uncertainty over prices. The forecast for 1996 is a rise of 13% taking investment to £4.4bn. Investment should remain stable in 1997 but will gradually decline towards the end of the decade. BP is to develop a new field in the Moray Firth at a cost of £350M.

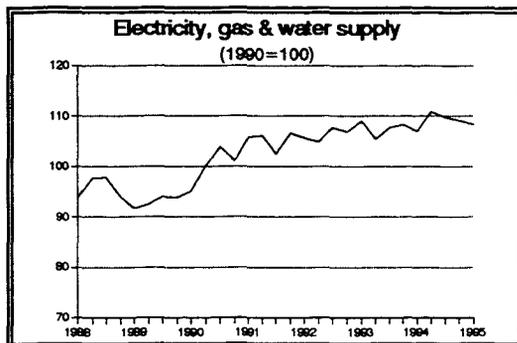
The glut of gas, the planned abolition of British Gas's monopoly markets and the delay in getting several gas fired power stations on stream have taken the UK gas market out of balance. Spot prices for gas have fallen from 25p/therm to below 10p/therm. Several gas field developments have been deferred. Both BP and Mobil could be severely affected by declining gas revenues by 1998. British Gas is to slice £100M off of full year profits due to a 20% surplus in supply. The company bought the gas for £700M giving an

average contract price of 19-20p/therm.

The Cost Reduction Initiative for the New Era, (CRINE), campaign to reduce operating costs by 30% has led to oil companies using less contractors and dealing only with a prime contractor. The smaller contractors working in the North Sea allege they are being squeezed out by larger firms. A major problem here is that it is the smaller companies which are the more innovative, a vital factor in the oil industry. The CRINE campaign will continue as costs in the North Sea are four times those in the Gulf of Mexico and in the Pacific Rim.

COAL

The production index for coal in Scotland fell by 13.1% for Q1 1995 on Q4 1994 with a 0.8% decline for the latest four quarters on the preceding four quarters. Open cast coal mining in Scotland is normally relatively stable therefore it is surprising that it has declined by 12.9% over the quarter. There is no obvious explanation for this although the milder winter and a run down of stocks may have contributed to it.



Coal investments made a pre tax loss of £18.3M, higher than expected despite increased turnover. The group has a 33% stake in British Coal's Scottish assets and expects to be in profit by November.

ELECTRICITY

The index for production for electricity, gas and water supply fell by 0.7% in Scotland for Q1 1995 on Q4 1994 compared to a 3.0% increase in the UK. For the last four quarters on the preceding four quarters Scotland and the UK had similar increases, 2.2% and 1.9% respectively.

The past quarter has seen a flurry of bids for English Regional Electricity Companies, (Recs); the Trafalgar bid for Northern, Scottish Power tabled a hostile £1.1bn bid for Manweb, Hanson's £2.5bn bid for Eastern and Southern Company bidding for Southern Electric. Finally North West Water has had negotiations with Norweb over a dual utility merger. The Scottish Power and North West Water bids bring particular problems; increased concentration within the industry and greater vertical integration in the former while the latter has two main problems; a geographic monopoly and complicated regulatory issues. There are some advantages; savings on administration, economies of scope and the latter presents a tax haven for the large profits Recs generate. The government has, unsurprisingly, rejected the director general's recommendation for these bids to be referred to the MMC. Scottish Power will be required however to accept restrictions in their licence agreement if their bid is successful. Clearly this signals to other generators that they too can acquire a Rec. Ian Lang did state that 'an accumulation of mergers may impede the regulator ... because of loss of comparative function'. Eventually a bid will be referred to the MMC but only on competitive grounds. Following the Secretary of State's announcement US utilities have bid for Manweb and Powergen is having talks with Midland electricity about a takeover bid which would be controversial to say the least. There will be more of these bids in the future but surely Manweb's independent days must be numbered.

The National Grid sale is to be completed by the end of this year when the pump storage business is sold for £350M-£400M. The Recs will share in the proceeds of the sale. The £4bn Grid floatation will also take place at a similar time. Capital gains tax of £1bn is to be funded largely by a technical dividend of approximately £850M. Customers are to get back a £35 rebate although critics state £50 is a more appropriate figure.

Hydro Electric has seen profits in England rise by 11%, up to £30M. The MMC propose reducing Hydro's price cut imposed by the regulator from 10% to 8.5% and increasing their investment allowance to £247M for five years, a rise of £22M. Also their return on assets should be allowed to rise from 2% to 7%. Hydro remains an unlikely takeover target.

The regulators review of price controls on Recs gives £1.25bn back to consumers over four years. The announcement was leaked to the stock market

causing electricity shares to rise by £1bn. Critics say the review does not go far enough. The regulators credibility was further reduced when it was announced that National Power and Powergen may lease the 6,000MW of capacity they were ordered to sell by the end of the year.

WATER

Both Scotland and England have seen water supply restrictions over the last quarter. In England the problems have been much worse and the situation is compounded by the water companies who have underspent by £398M in infrastructure renewals. Figures from pipe manufactures show that pipe supply was below 1991 levels. The result is that up to 20-25% of water is lost through leakage. Ofwat has also criticised the poor management of the water companies.

Consumers in the East of Scotland face large increases in water charges to meet a £300M shortfall in investment over the next five years. The new water authorities aim to have a 6.5% return on investment. The East of Scotland Water Authority stated that 'private investment was not enough and the customer will have to fund it one way or another'.

NUCLEAR

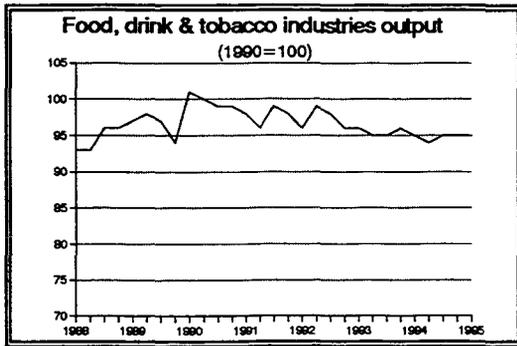
The cost of decommissioning the UK's atomic research facilities has fallen from £8.2bn to £7.5bn largely due to private contracting. Only a year ago the government announced its liabilities had risen from £3.4bn to £8.2bn. Similarly BNFL have announced a £900M fall in decommissioning costs from £11.6bn to £10.7bn.

The sell off of the nuclear industry as British Energy came under fresh criticism from the Inspector of Nuclear Installations over the short timetable allowed for safety checks. Nuclear Electric did little to allay safety fears when they were fined a record £250,000 for a 9 hour delay in shutting down a reactor into which a piece of crane had fallen causing an obstruction. The incident was described as a near meltdown and the safety inspectorate had stated it was the most serious they had encountered. Electricity prices will be cut by approximately 10% as the fossil fuel levy is abolished in March 1996. This will be a saving of £1bn in the production of electricity but is merely a sweetener to help privatisation of the industry.

MANUFACTURING

FOOD, DRINK AND TOBACCO

Output in the Food, Drink and Tobacco (FDT) industry in Scotland was unchanged over the first quarter of 1995 and over the year to the first quarter, this for the second period in succession. Once again, there is no discernible change in the trend, either upwards or downward in the sector, a situation which has persisted since 1992. Although the UK industry has not significantly outperformed Scotland over the longer term, industry output across the UK increased by 3% in the year to the first quarter. FDT also underperformed relative to all manufacturing in Scotland, which recorded growth of 5.1% in the year to the first quarter.



The July Scottish Chambers Business Survey (SCBS) results for FDT does give some very slight hope of improved short term prospects, but only in that the balance of optimism (the net percentage of respondents who felt more rather than less optimistic about business prospects compared to the April survey) had increased to 8% from 3% in April, hardly a major shift. This is despite a strong trend in new orders from both the UK (except Scotland) where a net of 10% of firms reported an increased trend in new orders and a net 18% reporting an increase in exports. The trend in Scottish orders was however down for a net 14% and this must explain a large part of the limited increase in overall optimism. Investment intentions for both plant and equipment and buildings both fell the trend in employment was also down, for a net 13% of companies. A lack of orders, cited by 70% of respondents, was again felt to be the factor most likely to limit output in the next three months.

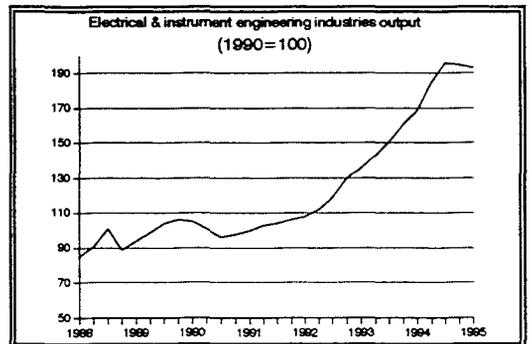
The Scottish and Newcastle take-over of Courage will not now be referred to the Monopolies Commission following an agreement with the

authorities that it will sell over 100 pubs and will limit its number of tied houses. S&N is now therefore the UK's biggest brewer with around 10,000 employees and over 25% of the UK market. There are possibilities of job losses however, as a review of operations is to be undertaken and one reason for the deal was to seek scale economies via rationalisation. The company has in fact refused to rule out that closure will result from the review. Meanwhile, its annual report for last year reported record profits of £250m.

Jobs are also under threat at the Tate and Lyle plant at Greenock which the company has announced it wants to close at the end of 1997, which would involve 200 redundancies. The cost of upgrading Greenock, put at £15m, compares unfavourably with the £7m involved in upgrading its London refinery where it wants to centralise production. However, the unions at Greenock are apparently willing to fight the closure and the company has said that it is willing to listen sympathetically to any rescue plans which they can propose, so there may be future developments on this matter.

ELECTRONICS

The fall in output in electronics in the final quarter of 1994 noted in the last issue of this Commentary has not been revised and, more importantly, was followed by a further reduction of a further 1%, in the first quarter of this year. That there should be two such successive reductions begins to look more like a cause for concern given the importance of the industry to the manufacturing sector in Scotland, more so as they follow periods of very strong growth with, for example, an increase of 11% in the third quarter of 1994. The increase in production in the year to the first quarter totals 23%. There is no obvious explanation for these reductions and we await the figures for the second quarter with interest.



The Scottish Chambers Business Survey (SCBS) results for July also show some deterioration in the industry's position. While a net 16% of respondents to the July survey felt more optimistic about immediate prospects than three months previously, this is a reduction on the net 24% whose optimism had increased at the time of the April survey. Similarly, while a net 24% felt more optimistic than one year previously, this is also down from the April survey. This is despite orders having increased in the three months to July for a net 19% of companies, with both UK and export orders up in a net 16% of cases, which would appear to suggest that while orders may have risen, they are not increasing at the rate shown in previous periods. Almost 70% of companies cited a lack of orders as the factor most likely to limit output in the next three months, a further indication that the slowdown noted above may be continuing.

In the company sector, control of one of Scotland's largest indigenously-owned companies, Spider Systems of Edinburgh, which employs over 200 people, has passed to the United States with its purchase by Shiva. The main reasons appears to be the lack of size. Managers have commented on the fact that it is difficult to build a global company from a Scottish base - a factor which has been noted previously in the case of companies such as Rodime - and particularly that about half the company's sales were to the American market. No jobs are to go in Edinburgh, however, and Shiva have also pledged that they will retain the company's R&D facilities, the basis of its success in local area networks.

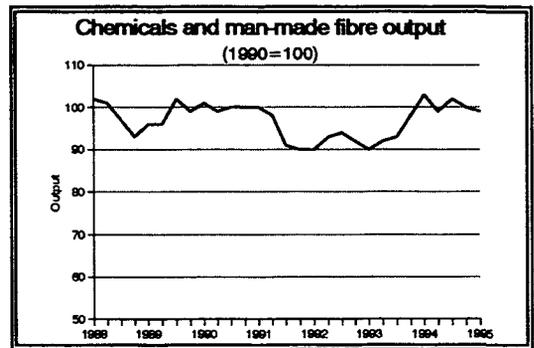
Elsewhere, Motorola are to begin production of semiconductors for telephones at the South Queensferry plant purchased from Digital earlier this year, which will add 500 new jobs at the plant. Motorola believe that the use of semiconductors in home appliances will rise from an average of 70 to nearer 200 over the next five years and is increasing capacity to be ready to cope with this.

Finally, the computer consultancy Dataquest has published a study showing that Compaq remained the world's leading manufacturer of personal computers during the second quarter of this year, followed by IBM, Apple and NEC. Three of these four manufacture in Scotland, illustrating the importance of the industry to the local economy.

CHEMICALS

The Index of Production for the Chemicals and

Man Made Fibres sector in Scotland fell by 1% over the first quarter of 1995 although output increased by 4% over the past year. The corresponding UK figures are slightly better, 2% growth in the first quarter and annualised growth of 5%. Findings from the latest Scottish Chambers Business Survey confirm this, the rise in business confidence expressed by Chemicals respondents continued to ease in the three months to June, reflecting poorer than anticipated trends in orders and sales however a net of +28% indicated that they were more optimistic about the general business situation than in the previous quarter.



Against expectations the rate of increase in demand eased during the three months to June due mainly to a fall in the level of Scottish orders and sales and a weakening in rest of UK orders and sales. Despite a continuing fall in Scottish demand however, an improvement in total orders and sales is forecast for the current quarter. Export activity continues to exhibit a strong upward trend.

Respondents were utilising, on average, 76% of available capacity, a fractional increase on the previous quarter, however, the proportion of respondents citing the low level of demand as the factor thought most likely to restrict activity during the current quarter rose marginally.

Investment authorised during the second quarter continued to be directed away from replacement and more towards expansion and introduction of new projects. Respondents continued to revise investment intentions in plant/equipment and land/buildings upwards and expect these trends to strengthen during the current quarter.

As forecast overtime and employment trends rose and these increases are predicted to continue. There remains considerable variation in employment trends however, with a third of respondents reporting no change, 35% an increase and 30% a

decline.

Selfcare International, based in Boston Massachusetts, is to invest £9.6m in a project to produce medical diagnostics in Inverness which could lead to the creation of 500 jobs within five years (375 jobs + 100 spin off jobs). The £3.6 million plant is to be built at the Beechwood Business park by HIE and then leased back to Selfcare International. HIE is to invest a further £2.8 million while Selfcare International will contribute a further £3.3 million. This is the first major investment in health care for HIE. The subsidiary, Inverness Medical, will produce products which include screening tests for lead poisoning in children and home pregnancy/fertility tests for women, the products are to be shipped worldwide. It is hoped that small scale production will begin in the near future with full scale production forecast to begin early next year. Selfcare International had considered Ireland and Israel however it is thought that the proximity to Raigmore Hospital was an attraction offering the company the chance to build close relationships with the medical community.

A £1.9m regional selective assistance grant was instrumental in attracting a £50m investment to Wilton, Teeside instead of Louisiana. ICI said that the investment had been considered prior to the Department of Trade and Industry initiative and so is seen as a windfall rather than a direct consequence of the scheme. ICI plans to double the capacity of its aniline plant in Wilton to around 400,000 tonnes creating an extra 60 jobs and will also invest in a plant to produce nitrobenzene, the raw material used in production of cimiline (used to make MDI which is used to make polyurethane, a flexible plastic used to make rigid insulation for fridges, buildings and cars. The DTI now hope to persuade DuPont to reverse an earlier decision to close down some of its plants in the area, helping to build up a critical mass of chemical manufacturers on Teeside.

The merger of Sweden's Pharmacia and Upjohn of the United States will create one of the worlds top 10 drugs companies achieving cost savings from cutting 4000 jobs from the 34,500 workforce. The advantage for Pharmacia is that it will gain access to Upjohn's US distribution network while Upjohn will be bolstered by Pharmacia's stronger European presence. The merger fuels speculation lately that there is little future for medium sized, broadly based drugs companies and that those which do not merge will become targets for hostile takeover bids

from ambitious larger companies. This is illustrated by the case of Rhone-Poulenc-Rover, the US based drugs group controlled by Rhone Poulenc of France, which launched a £1.7 billion cash hostile bid for UK rival Fisons. RPR is likely to warn Fisons shareholders that the strategy of selling divisions to fund its transformation into a sales and marketing dominated operation is unsound. RPR would like to exploit the UK group's asthma and allergy products, as well as the technology in asthma inhalers making it the fourth largest company in the asthma and allergy treatment sector. The common view is that in the future the Healthcare industry will be dominated by around a dozen industries. The reasons for this include customers changing, life expectancy is longer and the range of curable illnesses has increased. This had led to "managed healthcare", there are incentives to hold down costs eg negotiating drug prices with pharmaceutical companies. Also the slowing down of new drugs launches, profits growth has more of less slowed down across the board (patents expiring). Bigger companies equals lower costs, governments and insurers have become increasingly aggressive about ensuring they get value for money and so economies of scale and marketing clout are essential.

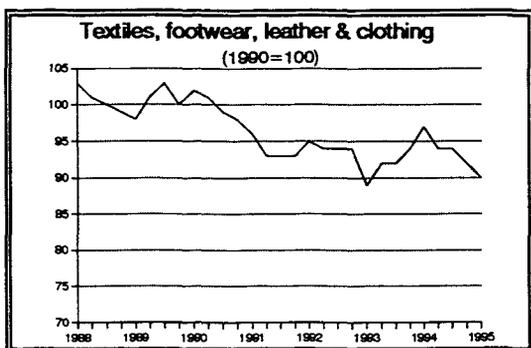
Zeneca announced at the beginning of August that pre tax profits had risen by 44% to £506 million; pharmaceutical remained the company's biggest business and sales for the first six months were £1.03 billion. Its drug portfolio now includes Casodex, used for the treatment of prostate cancer, launched in the UK in May, and Tomidex and Aramidex, both cancer treatments and cleared by UK regulators in record time (just 17 weeks).

TEXTILES, FOOTWEAR, LEATHER AND CLOTHING

The Index of Production in the Textiles, Footwear, Leather and Clothing (TFLC) industry in Scotland fell by a further 3% in the first quarter of this year following a 2% reduction in the final quarter of 1994, indicating a continuation of the longer term downward trend noted in the last issue of this Commentary. While the longer term trend in Scotland is similar to that across the UK as a whole, Scottish firms underperformed slightly in the year to the first quarter with output falling by 1% in Scotland compared to a 1% rise in the UK. The industry's performance in the year to the first quarter is also below that of all manufacturing which grew by 5.1%, where Electricity, Gas and

Water, Chemicals and especially Electronics all grew.

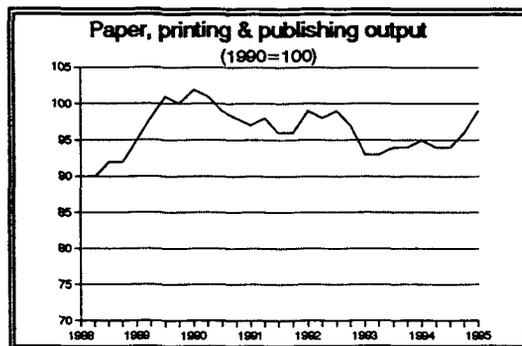
The July Scottish Chambers Business Survey (SCBS) shows little evidence of any short term, improvement in the industry's prospects. A net 23% of respondents to the July survey felt that the general business had deteriorated in the preceding three months (a deterioration from the position in the April survey where a net 13% were less optimistic), although only 6% felt less optimistic than at the same point in 1994. A net 13% reported a downward trend in new orders in the three months to July, with the trend in orders from Scotland falling fastest, down for a net 25% of respondents, with other UK orders falling for a net 16% but only 2% for export orders. Investment intentions for plant and equipment were flat, which is not surprising given the above and the fact that 70% of respondents cited a lack of orders or sales as the factor most likely to limit output in the near term, while the overall trend in total employment was down for a net 4% of firms.



In the company sector, Courtaulds, the UK's largest textile group, believes that pressure on raw materials prices will ease in the latter half of this year and that the squeeze on profit margins will ease. The company had found it difficult to pass on raw-material price increases - particularly for synthetics where prices had risen by up to 10% - due to the fragile economic situation in its major markets, and the summer heatwave had also depressed sales in the UK. The chairman now feels that profits will improve, particularly if his prayers for a "early, cold and long autumn" are answered. In Scotland, Don and Low announced the closure of its factory in Perth with the loss of 80 jobs. The company is to consolidate its polypropylene operations at its two factories in Forfar in order to reduce its cost base, a move prompted by increased international competition.

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.

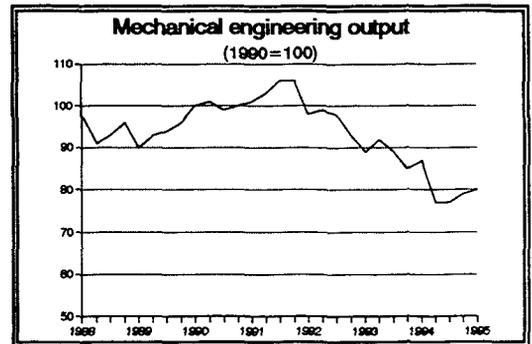
The American Publishing Company headed by Conrad Black is set to make a takeover bid for The Telegraph. Conrad Black who already holds 58.5% of shares in the newspaper through holding company Hollinger announced that the deal could be completed by July. A perceived benefit of the takeover deal would 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 31 March 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

As was suspected, the previous official data release underestimated the growth of the Scottish mechanical engineering industry towards the end of the last year. The latest official data release shows a 2.6% growth in Q4 1994 and a further 1% growth in Q1 1995 in this industry, indicating the long-expected materialization of an up-turn in this industry.



The latest SBS records a net of 18% of corresponding firms showing increased business optimism in Q2, compared with 32% in Q1. Optimism remained level for larger firms [200 - 499 employees]. The upward trend in total orders continued with a net of 38% of corresponding firms reporting increases. The increases came from all sources and, except Scottish orders, are expected to continue through Q3, but to ease notably. The upward trend in sales strengthened further to a net of +39%, but the rate of increase is expected to be halved in Q3. However, the rate of growth in Scottish sales moderated notably in Q2, and is expected to contract in Q3. Increases in export orders and sales remained the strongest and are expected to be so in Q3.

The rise in investment plans for plant/equipment continued and is expected to be sustained, albeit with eased rates. Investment in land/building remained level in Q2 but is expected to decline again in Q3. The main reasons for authorising investment in Q2 are: replacement (33%), increasing efficiency (27%), expanding capacity (25%) and introducing new projects (10%), a similar pattern to the previous four quarters. The increase in employment strengthened further in Q2, with a net of 20% of firms creating new jobs. However, such increases are expected to halt in Q3.

In summary, the Scottish mechanical engineering industry is expected to enjoy a cautious further recovery and growth in quarter two this year. However, considering the moderated business optimism in Q2 and particularly Q3 of this year, the prospects towards the end of the year look pretty uncertain.

SERVICES

DISTRIBUTION

Evidence from the latest SCBS indicates a continuation and steepening of the decline in business confidence amongst both wholesale and retail respondents. Nevertheless, in wholesale the upward trend in sales continued and is expected to be more broadly based in the third quarter. In contrast the decline in retail sales continued and fell further to a net of -15%.

The upward trend in wholesale sales continued, somewhat below expectations, at a net of +5%, and this rate is expected to improve in the third quarter. However, consistently in 1995 respondents have overestimated the rise in sales. Retail respondents had expected a slight rise in sales during the second quarter, but this did not occur, and a net of -15% reported declining sales. There was marked variation in the pattern of sales, with the sharpest falls being recorded by the smallest firms, whilst a net balance of the larger firms reported increased sales. Through 1995 respondents have tended to overestimate the trend in sales, significantly for the first time in 1995 a net of respondents were predicting a fall in sales in quarter three.

The rising trends in investment in wholesale and retail continued, but both eased again to nets of +11% in wholesale and +5% in retail.

Wholesale respondents had forecast a slight decline in total employment. However contrary to expectations a net of +5% increased total employment during the second quarter and expect this to continue, though the rate of increase should ease slightly with only a net decrease in part time employment. Respondents continued to cut back on overtime working and expected this trend to continue through the third quarter. The decline in retail employment continued [-3%] although the rate of decline eased somewhat compared to the previous quarter [-8%]. This decline concealed a slight increase in part time employment [+8%]. The decline in total employment is forecast to weaken

again during the third quarter with a slight increase in part time and temporary employment.

In wholesale the average wage increase rose marginally to 3.7%, a third of respondents increased wages/salaries during the second quarter. In retail the average wage increase rose slightly to 3.4%, marginally higher than the previous quarter.

Recruitment activity in wholesale remained fairly constant at 45% although there was an increase in the percentage of respondents experiencing increased recruitment difficulties which were reported in most categories. Recruitment activity in retail increased during the three months to June, 46% of respondents attempting to recruit with only 11% noting an increase in recruitment difficulties.

FINANCIAL SECTOR

Frequent predictions of the early demise of the branch networks of the established banks (and building societies) or at the very least a substantial reduction in their scale, together with reports of substantial job cuts in the levels of staff that banks currently employ have resulted in a rather gloomy picture of the outlook for the banking sector. A Deloitte, Touche, Tohmatsu International report on Retail Banking, for example, points out that the four main UK Clearing banks have cut 59,000 posts since 1990 and argues that the spread of telephone banking (reportedly costing only two fifths of the costs of a similar service through a bank's branch network), automated teller machines, and other new developments would jeopardise 9,000 branches at a cost of 50,000 jobs. The report suggests that in the US only 25% of transactions will be handled through branches by the year 2000 compared to 40% in 1993, and argues that similar trends will be observable in the UK. Leaving aside the not insubstantial difficulty of making comparisons between UK and US banking (not least the many thousands of banks providing consumer banking services in the US) it is apparent that some UK banks have been affected by similar trends. The Royal Bank, for example, through its Project Columbus has been working towards shedding 3500 staff by 1997, and announced earlier in the year the loss of 250 managerial posts. It is unlikely to be the last major UK bank to make such cuts.

Despite prospects of further job losses in banking, Scottish banking (or more correctly the Scottish based banks) has in general, been doing well and has displayed substantial improvement in relative terms vis a vis other British banks. Particular

evidence of this strengthening is displayed by the Bank of Scotland's recent Accounts with a substantial leap in profits and an increase in the number of employees, but stronger evidence is provided by comparisons of Scottish to British Clearing Bank statistics (Table 1).

Table 1 Relative Position of Scottish Banks

	1983	1986	1990	1994
Total Assets	10%	10%	13%	15%
Pre Tax Profits	8%	9%	20%	13%
Shareholders Funds	10%	10%	13%	15%
Total Capital Base	9%	9%	12%	14%
Advances	19%	17%	18%	20%
Deposit balances	11%	11%	14%	14%
Number of UK employees	13%	12%	14%	17%

The (adjusted) figures are not completely compatible since the data from the British Bankers Association (Annual Abstract of Banking Statistics 1995) is not always consistent and has been subject to a number of definitional changes, but despite such problems the trends are robust and clear. Irrespective of how we measure relative growth, the position of the Scottish banks has strengthened since 1983. Total Assets, pre-tax profits, shareholders funds, the total capital base, deposit balances and number of employees, all show substantial growth. The extent of the achievement can perhaps best be gauged by considering absolute employment in British and Scottish banks over the same years (Table 2).

Table 2 Employment

	1983	1986	1990	1994
British Banks	280,700	314,700	342,000	277,600
UK employees				
Scottish Banks	36,016	39,294	49,329	46,658
UK employees				

Employment in Scottish banking has fallen since 1990 but is still considerably greater than in 1983, a position that is in sharp contrast to the picture for British banks as a whole. The reasons for the strong relative performance of the Scottish banks are open to debate. Three causes spring readily to mind. Firstly, the milder recession in Scotland compared particularly to London and the South led to a more favourable bad debt experience for the Scottish banks with a consequent relative strengthening of their ratios. Secondly, the general improvement in the management of the Scottish banks as a result of the changes in ownership, notably the sale by Barclays of its 35% shareholding in Bank of

Scotland, the sale of the Clydesdale to the National Australian Bank group, the reorganisation of the TSB following the privatisation type sale, and changes at the Royal Bank following the abortive takeover attempts in the early 1980's changes which gave the banks access to fresh capital, staff and ideas. Thirdly, the Scottish banks have had greater opportunities for expansion as a result of their restricted geographic market coverage. Irrespective of the correctness of these possible explanations, and they are probably all correct, at least in part, it remains true that the Scottish banks have been successful in improving their relative position. The interesting questions, however, relate not so much to their past performance but to the outlook for the future and the possibility of their continued success. Mindful of its tercentenary the Bank of Scotland has supported the publication of a history by Alan Cameron of its first three hundred years. Readers of the history cannot fail to be struck by an apparent irregular cycle in which the bank on a number of occasions increases its risk to boost its profitability, only to find the risk uncomfortable or even dangerous to its existence leading to retrenchment and low risk strategies. Safety and caution, desirable attributes of any bank, however, lead to slower growth and a decline in relative size as competitors grow and develop. Risky strategies, overlending or lending to too many inadequately financed or secure enterprises, often lead to crisis and subsequent retrenchment as the enterprises fail and the growth disappears. The difficulty for any bank is to eschew the more risky enterprises and yet to be bold and innovative since this is where profits lie. In recent years the Scottish banks have managed this process well. This is not to say that it has necessarily been deliberate and intended, although to some extent this is probably true, or that they have been particularly innovative. The Bank of Scotland did pioneer home banking and the Royal Bank direct sales of car insurance but its not clear that home banking was particularly successful or that the Royal's investment in Direct Line was other than a fortunate business decision with little input from the bank. The success of Scottish banking has come, at least in part, from not being too involved in international lending in the early 1980's, the unkind would say because the banks hadn't realised the potential profits, and from not being too dependent on England, particularly the South, in the recent recession. By not being too involved with either event the Scottish banks did not suffer in the same way as their counterparts based in London leaving them in a much stronger relative position. It is difficult, if not impossible to predict where the next crisis in banking will occur.

It could be that resurgent growth in Europe provides a continued period of prosperity and generous growing profits for the banks. More likely however, history will repeat itself in some form or other. As recovery continues the banks will overlend on the prospect of large profits, profits that will turn out in the longer term to be a chimera, and will in turn precipitate a banking crisis so that retrenchment follows.

The three hundredth year of the Bank of Scotland is a good time to reflect on the potential pitfalls for the banks particularly the likely causes of poorly secured lending of the late 1990's. The Scottish banks should resolve to restrain their lending to risky projects perhaps by systematically diversifying their portfolios or by accepting lower profits on lending, and in future to attempt to seek higher profits by innovation and change. History suggests that excess profits from lending are a result of taking on high risk. Over a long period of time that risk cannot be avoided. Safety and caution look altogether better strategies.

TRANSPORT

Air

Edinburgh airport continues to attract passengers at the expense of Glasgow airport with a 11.7% increase in passenger numbers over the last quarter compared to a 1.5% increase at Glasgow airport. BAAs pre-tax profits rose to £127M from £111M, with passenger numbers rising by 8% to 22.1M. Income from retailing continues to have stronger growth than all other areas of business.

British Midland, (BM), flights to Europe have lost a small amount of passengers to competition from the Channel Tunnel, in comparison with all airlines on the Channel routes who lost 13%. BM say overall passenger traffic grow by 13% compared to 8% for British Airways. BM regards itself as a European airline now with 56% of revenues coming from European routes.

Road

Further cuts in the road programme are proposed by the Dept. of Transport. The £1.7bn road building programme is to be cut by £200M over the next three years. Last year a £300M cut was made. Maintenance work will decline by £39M to £326M. There is serious concern expressed by analysts who believe that large reductions in road spending will be detrimental to the infrastructure in the long run.

Growth in new car registrations is almost static for the period January-August 1995. Fleet registrations were the main reason that August 1995 showed a 3.6% improvement on August 1994. It is unlikely that by the end of the year more than 2M cars will be sold. The growth in commercial vehicles for January-August 1995 over January-August 1994 is 11.6%. Although growth is likely to continue until the end of next year the pace of growth is forecast to fall.

Rail

The Fort William sleeper service won a reprieve from Office of Passenger Rail Franchising, (OPRAF), when they announced that two sleeper services will run from London to Scotland; one to Glasgow and Edinburgh, the other to Aberdeen-Inverness and Fort William. This is a compromise which is hoped will satisfy all parties. The subsidy level is estimated to be approximately £70 for a one way journey compared to £4 for other Scotrail journeys.

Rail privatisation suffered a further setback when the West Coast Main Line, (WCML), and Scotrail sales were delayed. The aim was to have 51% of the companies in the private sector by April 1996. The West Coast delay is due to uncertainty over the planned £1bn upgrading of track and signals. As it is the largest franchise with a turnover of £221M the postponement is particularly embarrassing for the government. The Scotrail sale has been delayed because of a dispute with Strathclyde Passenger Transport Executive who are unhappy with fares and levels of service. The government will now try to privatise WCML and Scotrail by April 1997. They have also brought forward the sale of South East Trains and the Chiltern Line. This is unlikely to be completed in six months however.

Further delays have occurred with the sale of Inter City Great Western, South West Trains and LTS Rail. The bids have caused some concern as they do not fully meet the OPRAF guidelines. These and other privatisation problems mean that only 20% of passenger operations, in revenue terms, will be sold according to the timetable. Privatisation is estimated to have cost the taxpayer £500M-£700M to maintain existing service levels. Red Star Parcels are to be sold for the nominal sum of £1 but BR will cover a £7M redundancy bill for 700 staff.

Railtrack made a profit of £189M in its first year despite the signal workers dispute. There are severe doubts about Railtracks management of safety. An

internal source estimated that it may take 18 months before Railtrack can manage safety effectively. A major concern is the plethora of outside contractors who are bidding for work with Railtrack. Railtrack is to spend £400M on improving 7,000 bridges to take 40 tonne lorries. Because of this other areas of the infrastructure will have to forego investment. Railtrack has already spent £400M on 800 projects and capital expenditure is set to rise by 10% next year.

Sea

A £10M ferry terminal is to be built at Stranraer for the new high speed service to Belfast. The investment in the ferry will be £65M. Objective 1 funding is to provide £1.3M for a ferry service between Argyll and Northern Ireland.

All Channel Tunnel operators, including Channel Tunnel, now report a rise in business. Stena had lost 10% of their passengers over the summer while P&O lost only 5-6%. Price cutting has hit the revenues of ferry operators as they compete with the tunnel.

UK ports are undergoing an unprecedented period of growth following deregulation. They have low costs, increased productivity and generate profits. Exports through the ports have risen to 179M tonnes last year, an increase of 14%. Forth Ports has bought Tilbury for £132M while several other takeovers have occurred. Clydeport and Forth Ports are two of the top four ports in the country. Both are bidding for the Port of Dundee and the Rosyth Naval Base.