THE SCOTTISH ECONOMY

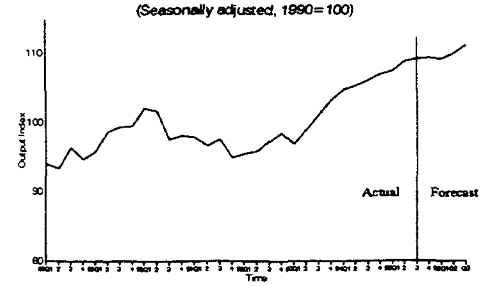
SHORT-TERM FORECASTS*

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

Due to the change from the 1980 SIC to the 1992 SIC, there have been frequent and substantial revisions in the recent official publications of the production index for Scotland. Therefore, the forecasting equation is re-estimated using the latest official data for Scottish manufacturing output. The LBS quarterly forecasts for UK manufacturing output are used in the present Scottish forecasts.

The present forecasting period extends to 1996Q3. Figure 1 depicts the actual growth rates for Scottish manufacturing output from 1988Q1 to 1995Q2 and the forecasts for 1995Q3 to 1996Q3. The revised forecasts show that the momentum of growth in Scottish manufacturing output is not as strong as what was predicted previously. In fact, it is now predicted that the growth will be subdued towards the end of 95 and the start of 96 and will then revive again in the second quarter of 96. For 1995 as a whole, the output of Scottish manufacturing industries is predicted to rise by around 3% over 1994. Further details of growth rates for Scottish manufacturing outputs are presented in the following table.

Figure 1. Output Index for Scottish Manufacturing Industries (Seasonally adjusted, 1990=100)



* 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	0.0
1993/92	3.3
1994/93	5.7
92Q4/91Q4	3.8
93Q4/92Q4	4.8
94/Q4/93Q4	3.6
94Q2/94Q1	0.5
94Q3/94Q2	0.8
94Q4/94Q3	0.8
95Q1/94Q4	0.5
95Q2/95Q1	1.2
Forecast	
95Q3/95Q2	0.3
95Q4/95Q3	0.1
96Q1/95Q4	-0.1
96Q2/95Q1	0.7
96Q3/96Q2	1.1
1995/1994	3.0

SCOTTISH CHAMBERS' BUSINESS SURVEY

Results from the Scottish Chambers' Business Survey (SCBS) for the fourth quarter 1995, based on 898, responses indicated the following main trends:

In Manufacturing, business confidence fell in the fourth quarter. A net balance of 2% of respondents reported that they were *less* optimistic than three months previously, compared with a balance of 12% who were *more* optimistic in the third quarter. In the fourth quarter, Manufacturing respondents continued to be more optimistic than they were a year ago, with a net balance of 7% of respondents reporting higher optimism. However, this compares with the situation in the third quarter where a balance of 20% of respondents were more optimistic than in the same period a year earlier.

In Construction, optimism continues to fall although at a somewhat slower rate than in the third quarter. A net balance of 19% of respondents reported that they were less optimistic than in the third quarter. This compares with a 28% balance of respondents who were less optimistic in the third quarter over the second quarter. A net balance of 18% of respondents reported that they were less optimistic than they were a year ago, a further deterioration on the situation in the third quarter, where a net balance of 8% of respondents were less optimistic than in the same period a year earlier.

In Distribution confidence continues to decline, at much the same rate in Retailing but at a much faster rate in Wholesaling. In Retailing, a net balance of 8% of respondents were less optimistic about the general business situation than they were in the third quarter, which compares with a negative balance of 10% in the third quarter. In Wholesaling, a net balance of 24% were less optimistic than in the third quarter, compared with a negative net balance of 4% in that quarter. Compared with a year ago, both Retail and Wholesale respondents were less optimistic, with net balances of 13% and 23%, respectively.

Optimism among respondents from the Tourism and Leisure sector continued to increase strongly in the fourth quarter. A net balance of 18% of respondents reported that they were more optimistic about the general business situation than they were three months earlier, compared with a balance of 23% in the third quarter. A net balance of 23% of respondents were more optimistic in the fourth quarter than in the same period of 1994.

Orders and Sales

In Manufacturing, orders and sales again increased, at a slower rate for orders and at much the same rate for sales. For orders, a net balance of 4% of respondents reported an increase while, for sales, a balance of 14% of firms experienced a rise. These figures compare with positive balances of 14% and 13%, respectively, in the third quarter. Orders and sales to the domestic Scottish market fell in the fourth quarter, while orders from the rest of the UK continued to fall as sales grew but at a slower rate than in the third quarter. Both export orders and sales continued to grow although both slowed in the fourth quarter, particularly orders.

In Construction, new orders continued their downward trend and at a faster rate than in the third quarter. A net balance of 13% reported a decrease in orders compared with a net balance of 1% reporting a decrease in the third quarter and a negative balance of 13% in the second quarter. Orders from both Central Government and Other Public Sector remain severely depressed. However, orders from the private sector continued to increase with a net balance of 7% of respondents reporting an increase, compared with a positive balance of 10% in the third quarter.

Sales contracted in the Distribution sector in the fourth quarter. A net balance of 5% of retailers reported that sales had fallen, much the same as the 6% balance reporting a decrease in the third quarter. In Wholesaling, sales fell with a net balance of 2% of respondents reporting a decrease. This is in stark contrast to the balance of 18% of respondents reporting an *increase* in the third quarter.

Tourism demand continued to rise in the fourth quarter but at much slower rate than in the third quarter. A net balance of 6% of firms reported an increase compared with a balance of 52% reporting a rise in the three months to September. Demand rose in the domestic Scottish market but fell from the rest of UK and abroad. A clear seasonal element again appears to have been present in the quarter's results.

Stock Adjustments

Stocks of raw materials in Manufacturing continue to fall, while work in progress rose again and stocks of finished goods rose slightly. A net balance of 9% reported a fall in stocks of raw materials, while for finished goods and work in progress the balances reporting an increase were 1% and 9% respectively.

Finance and Investment

In the Financial sector, the demand for personal loans continued to rise, at a faster rate than in the third quarter. A net balance of 44% of respondents reported a rise, compared with the balance of 38% reporting an increase in the third quarter. Advances to the corporate sector are also still rising and at a faster rate. The demand for working capital continues on an upward trend. However, the demand for finance for investment in buildings and for investment in plant and equipment fell slightly in the fourth quarter.

Manufacturing investment intentions in plant and machinery were again revised upwards in the present quarter, with a net balance of 9% reporting an increase and respondents expect to revise these intentions up further again in the first quarter of 1996. The deterioration in manufacturers' investment intentions in land and buildings appears to have halted with a net balance of 9% of respondents reporting an increase, compared with a balance of 1% reporting a decline in the previous survey. However, respondents expectations are for a decrease in buildings investment in the first quarter of 1996. In Retailing and Wholesaling, investment intentions remain significantly positive. Net balances of 12% and 11% of Retail and Wholesale respondents, respectively, reported an upward revision in investment intentions compared to the same period a year ago.

Expectations

The outturn in the fourth quarter was mixed compared with expectations in the third quarter. The outturn for Manufacturing orders, Wholesale sales and Tourism demand was worse than expected in the third quarter. In contrast, the outturn for Manufacturing sales, Construction orders, and Retail sales was better than expected in the third quarter.

Demand conditions are expected to continue to improve in Manufacturing in the first quarter of 1996, at a faster rate for orders but at a slower rate for sales. Wholesalers now expect demand to fall at a faster rate than the unexpected downturn in the fourth quarter, and Retailers also expect the contraction in sales to continue. Construction orders are expected to contract at much the same rate as in the fourth quarter, while the demand for Tourist services is expected to expand at a faster rate than the reduced rate of growth realised in the most recent quarter.

Wages

There were further signs in the fourth quarter of a slight upward pressure on pay rates in Manufacturing, Construction, Wholesale and Tourism.

The average pay increase in Manufacturing rose to 3.8%, and in Construction to 4.2% confirming the impression of a slight upward press on pay during 1995. In the service sector the rate of pay increases rose in both Wholesale and Retail distribution to 4.0%, although in Retail there appear to be few signs of any upward pressure on pay rates.

Average pay increases in Finance fell slightly to 3.1%, although the average increase for 1995 remained higher than for 1994. In Tourism 32% reported increasing pay by an average of 4.3%, average pay increases have now risen for five quarters.

Employment

In Manufacturing respondents have become progressively less confident as to continued rises in employment, and have tended to underestimate the level of employment in the second half of 1995. The previously anticipated decline did not occur, but once again a net of firms are predicting a fall in employment. The decline in Construction employment continued to accelerate, at a faster rate than anticipated.

In Wholesale the upward trend in employment, a feature of 1995, continued, but the upward trend stabilised at a net of 10%. Wholesale respondents have tended to underestimate the rate of increase in employment in 1995, and continue to be cautious as to the rate of increase in employment in the first quarter of 1996.

In Retail the long running downward trend in employment ended, due largely to increased recruitment of temporary staffs. Once again a net of firms expect to reduce employment in the first quarter.

In contrast, the long term decline in employment in the Financial sector continued, much as expected. Once again the overall decline concealed increased use of part time, temporary and agency staffs.

Tourist respondents had expected a decline in employment, but this did not occur, and employment trends remained level. However, a net of 23% expect to reduce employment in the first quarter.

Recruitment

55% of Manufacturing firms sought staff and difficulties were evident in the recruitment of suitable managerial, technical and skilled manual staffs. 44% of Construction firms sought to recruit and activity has remained at broadly the same levels as in 1994. Recruitment activity was mainly directed towards the recruitment of skilled manual staffs.

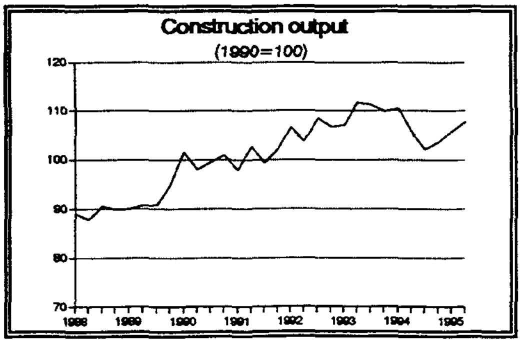
Recruitment activity amongst Wholesale firms tended to be higher in 1995 than in 1994. In the fourth quarter 42% of Wholesale firms sought to recruit and 17% reported increased recruitment problems, mainly in the Glasgow and West of Scotland areas.

Recruitment activity in Retail rose to the highest levels recorded for the past two years, with 52% seeking to recruit staff. Activity was most frequently directed towards the recruitment of part time staffs, and difficulties were most evident in the recruitment of part time staffs.

Recruitment activity eased in Finance with only 20% seeking to recruit staff. 78% of Tourist firms sought to recruit staff, with difficulties reported in the recruitment of suitable managerial, skilled and part time staffs.

CONSTRUCTION

The small rise in the index of construction reported in the first quarter of 1995 continued during the second quarter, with a 1.7% increase to stand at 107.7. However this figure shows a 4.1% fall in the year on year figures. The position in the UK as a whole is the converse with a quarterly fall of 0.6%, to stand at 89.9, and a year on year increase of 2.0%.



The Scottish Chambers' Business Survey provides a more up to date picture and tells that optimism in the Scottish Construction industry during the fourth quarter of 1995 was down for a balance of 19% of respondents and that a net 18% were less optimistic than they were a year ago. This is the third quarter in a row where optimism was negative.

What good news there is for respondents comes from the private sector, where a net 7.0% saw their new orders increase. Public sector orders continue to be down for just under half of respondents, giving an overall negative balance of 13%. Despite a slight improvement in the third quarter capacity utilisation is down to stand at an average 79.4%. It is not likely that this will improve in the first quarter of 1996 as expected order show a very similar pattern, but with even private sector orders expected to fall for a balance of 6% of respondents.

Not surprisingly the trend in total employment is downwards for a net 21% of respondents and a further net 11% expect the trend to continue downwards during the first quarter 1996. Sub-contractors, and to a slightly lesser extent the self employed, full-time and male employment being hardest hit.

Despite the negativity shown by respondents, almost a quarter increased their provisions for training and 44% attempted to recruit during the fourth quarter. A mere 10% reported difficulties in recruiting, although this is most likely a reflection on the levels of unemployment in the industry at present.

The average wage settlement reached by those who settled during the quarter was 4.1%. This is on the high side, perhaps indicating increasing competition for those workers with higher skill levels.

The housing market in Scotland experienced a sharp fall in the third quarter of 1995, Despite cuts to mortgage lending rates by all the big lenders the average price of a house in Scotland dropped by 2.2% in the three months to the end of September 1995, compared with a 1% fall for the UK as a whole.

Interest rates continue to be low in real terms with the NHBC "first time buyers ability to buy index" still at all time record levels. The crisis in the housing market is rather a problem of confidence (or more importantly a lack of confidence), with purchasers reluctant to commit due to fear of negative equity, increasing interest rates or job insecurity.

The NHBC application for housing starts in the third quarter 1995 were at the same level as in the previous quarter in Scotland. The overall GB figures however fell by 13.7% over the same period. Indeed the GB fall was 19% on the third quarter 1994.

Newspaper headlines show that profits are down and tell of job cuts but it is not all bad news. Whilst Taylor Woodrow show sharply lower profits; John Laing and Wimpey announce large job cuts: Morrison Construction on the other hand has seen profits double.

The Chancellor's November budget decision to kick-start the private finance initiative is seen as good news for a number of constructors, helping as it will to ease the restriction in public sector orders. There are a number of design, build, fund and operate projects coming on stream at the moment including the A69 Newcastle to Carlisle road and the Inverness and Fort William sewage treatment plant. These types of projects offer a higher value added aspect, providing better margins, rather than the cut throat large volume work that has predominated the industry recently. Inevitably this type of work favours the large companies, but there is likely to be a substantial amount of sub-contracting as the large companies move more into project management, both internally and externally.

All in all there is perhaps a glimmer of light at the end of the tunnel for Scottish constructors and it is to be hoped that they are able to adapt and thrive in the increasingly dynamic construction industry.

Calls for further cuts in interest rates are not the answer but other initiatives are necessary to improve overall confidence levels and lift up the flagging spirits of the industry.

ENERGY

OIL AND GAS

Oil output in the North Sea is at its highest level for over 10 years. Output peaked at 2.74mbpd in October. The average oil price for Brent crude was $16-55 during the month giving oil revenues of £28M, a 1% increase on September. Production fell by 81,000bpd in November to 2.66mbpd. A 4.5% rise in the Brent crude price and a 1% appreciation in sterling resulted in oil revenues of£28.6M, a 2.1% increase. Gas production was 5679mmcf in October and 8851mmcfd in November. The increase in November was a spectacular 50.6% on last month and 25% on November 1994. In October gas production fell 13.9% over the year reflecting the glut of gas. Gas revenues rose to £10.7M per day in October and to £15.9M per day in November. The latter figure is a 28% increase on an annual basis.

The Royal Bank of Scotland Oil & Gas was 166.5 in October and 185.4 in November. The gas index rose from 167.1 in October to 251 in November. Almost half of the rise in oil production in October was due to Fife, (Amerada Hess), producing 44,000bpd and Birch, (LASMO), producing 21,000bpd. Nelson, Brent and Claymore gave a combined increase of 69,000bpd. Morecambe, (British Gas), Bruce, (BP) and Ravenspurn, (Hamilton) were the gas fields with the largest increases in production during November. Terminal throughput at Cruden Bay and Sullum Voe increased by 64,000bpd and 66,000bpd respectively in October. All the gas terminals saw significant rises in throughput in the last quarter.

The rise in the oil price is due to several factors; extra demand because of the severe weather, uncertainty over OPEC quotas and a reduction in stock levels by producers. The latter has resulted in suppliers experiencing difficulties in meeting extra demand, particularly in the US. This has seen Brent crude rise to $19-20 compared to an annual trading average of $16-18 through most of 1995. Oil production quotas in OPEC remain unchanged at the November meeting. The International Energy Authority has forecast world demand for oil to be 71.3mbpd in 1996. This is a 2.3% rise on 1995. This is to be largely met by non OPEC producers in the North Sea and Latin America. The UK could produce 3.2mbpd from the North Sea in 1996. Over production by some OPEC countries is likely as market share becomes more important.

The UK Government has endorsed the £1.6bn Etap development of seven oil and gas fields 150 miles east of Aberdeen. Production is expected in 1998. UK contractors have already secured a major share of the fabrication work. As predicted in the last QEC, investment in the North Sea will increase this year. Phillips are investing substantially in the Britannia and Amerada gas fields. BP is to announce a 10% increase in capital spending with Shell expected to follow BP's move.

Shetland Island Council will sacrifice £45 in oil revenues to secure the long term future of the terminal. 1996 will be the busiest year for exploration west of Shetland. Both Schiehallion and Foinaven have encountered delays in progressing to production. Both fields are operated by BP.

COAL

The production index for mining and quarrying was almost static for Q2 on Q1 1995 and for the latest four quarters on the preceding four quarters. Output of deep mined coal in the UK has increased 13% since privatisation at the end of 1994. UK coal sales have risen by 18% while imports have fallen by 16%. British Coal has sold British Fuels, its coal and oil distributor, for £60M in a management buyout. It has annual sales in excess of £400M and a staff of 1600.

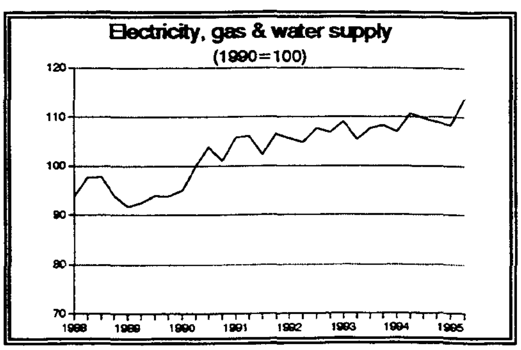
The 158 miners who invested £10,000 each in

Monktonhall Colliery have agreed to sell their stake to Waverly Mining. Waverly refinanced the pit in February, acquiring a 49% stake for £334,000. Waverly will invest £5.5M of its own capital, use a rights issue to raise a further £5.5M and the DTI is to provide a £4.1M subsidy. The money will be used to pay off Monktonhall's debt, including back pay to some miners, invest £6.7M in new mining equipment and £800,000 is to be used to refurbish existing equipment. A further £2.1M will be set aside as a provision against losses. The aim is to introduce two face working, doubling production to 540,000 tonnes per annum by 1997. The move could create 80 jobs.

The Scottish Coal Company faces a £4.2M compensation claim over a pre-privatisation contract to extract 950,000 tonnes of open cast coal. The site is alleged to be 100,000 tonnes short of the target. It is believed that Mining (Scotland) set aside £15M for such claims when it bid for British Coal (Scotland). Coal Investments have gained the support of the banks until it launches a £20M rights issue in February. CI lost out on a lucrative low cost site leading to the suspension of their shares. This will mean a loss of £12M in cashflow and probably £4M from profit. CI owns 30% of Mining (Scotland). If the issue is not successful then the stake in Mining (Scotland) would be an obvious disposal.

ELECTRICITY

The index of production for electricity, gas and water supply in Scotland increased by 4.8% for Q2 on Q1 1995 and by 1.7% for the last four quarters on the preceding four quarters. The respective figures for the UK are 1.6% and 1.1%. The 4.8% increase in Scotland is due largely to electricity.



350 jobs are to be lost at Manweb following Scottish Power's takeover. Prior to the takeover, 1,000 staff had left in two months. This will cut the £97M wage bill by one third. By 1998, £61M of savings should have been achieved, but Scottish Power hopes to make a further saving of £25M. The total cost of mounting and defending the bid is thought to be approximately £60M. Scottish Power have sold Manweb's stake in the National Grid for £168M, representing a paper profit of £30M. Scottish Power has announced a 4% rise in pre tax profits to £128M.

Hydro Electric has failed to buy the pumped storage business, (First Hydro), from the National Grid. Mission Energy, (US), is thought to have secured the bid with £600M compared to Hydro's £450M bid. First Hydro is the generator with the most influence on the electricity pool price after National Power and Powergen.

The sale of the National Grid values the business at £3.8bn with shares trading as high as 240p. Eastern, Scottish Power and Southern Company all have an obligation to sell within one year while another six Recs will distribute their holdings directly to shareholders. A special dividend of £872.5M will be paid to the Recs while a further £66M will be distributed according to the number of customers they have. This is to help pay the £50 rebate to customers. Concerns have been expressed by the Opposition that the sale will result in a reduction in the net tax bill of £320M.

GAS

The introduction of a competitive domestic gas market in 1998 has caused British Gas several problems. Firstly the aggressive competition has reduced BG's market share to below 35% and secondly gas prices have fallen dramatically given the surplus stocks of North Sea gas. BG is obliged to take this gas at the contract spot price which is $2^1/_2$ times the current spot price. Mobil, Alliance and Kinetica all have a market share greater than BG. They also pay for the gas at the current spot price. Ofgas is concerned that if the issue is unresolved then BG's long term financial position will be threatened.

Banks are to be asked to support BG to the tune of £40bn. This would be used to buyout the contracts at a discount of their net present value. A levy on all gas transported in the UK and proceeds of gas sales would pay off these loans. The Government has urged all parties to find a solution.

WATER

The Scottish Secretary has allowed the new Scottish water authorities to have external financing limits of £274M, higher than expected. Charges should not rise by more than 6% in 1996 but the water authorities have warned that in 1996-97 that charges may rise by 10-15%. The authorities are required to achieve a rate of return of 6% on their assets. The new unitary authorities may well be subsidising the water authorities at the expense of other council services. They are to be responsible for collecting water and sewerage charges. They also have a legal obligation to pay the water authorities what is due not what has been collected. Councils will only be able to charge the water authorities a maximum fee of 4%. There is widespread concern that this may not meet the cost of billing and collection.

The water industry in E&W faces severe criticism following the drought restrictions. Ofwat has voiced concern over compensation to consumers, high connection charges and leakage rates. The Government has refused to endorse the Citizens Character of all four companies who applied. Yorkshire Water state they have lost £20M due to the drought. It spent £3M tankering 60,000 tonnes of water per day. This coincided with an increase in pre-profits of 48% to £99.5M. Ofwat state a number of companies have leakage rates in excess of 30%. The industry in an attempt to reduce leaks by 40% is to spend £4bn. The target leakage rate is 15%.

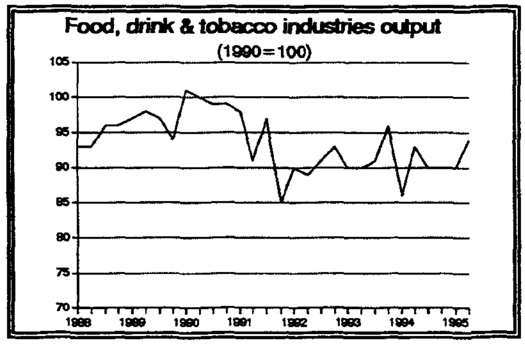
NUCLEAR

British Energy has stated the timetable for privatisation is tight but manageable. Dr Robb, the chairman, dismissed the notion that a rift exists between the Scottish and English companies. BE is to scrap plans for any further building of nuclear plant. They cite overcapacity and low electricity prices especially from gas power stations which have influenced their decision. It is more likely that privatisation will be easier without this millstone. The proceeds are expected to be approximately £3bn.

MANUFACTURING

FOOD, DRINK AND TOBACCO

Output in the Food, Drink and Tobacco (FDT) sector in Scotland increased by 4% in the second quarter of 1995, the second year in succession to show a large second quarter increase. A significant part of the increase is due to the drink sector, where output rose by 6%, but the food industry also grew by 2%. Both sectors therefore outperformed both all manufacturing in Scotland, which grew by 1.2%, and the FDT sector in the UK as a whole which grew by only 1%. However, both sectors have underperformed relative to FDT across the UK over the year to the second quarter. During this period, food and tobacco output in Scotland fell by 2% compared to UK growth of 3%, while drink output in Scotland grew by 2% compared to UK growth of 4%.



The results from the January Scottish Chambers Business Survey (SCBS) show a mixed picture for short-term prospects. The balance of optimism amongst survey respondents (i.e., the net percentage of respondents who felt more rather than less optimistic concerning short-term prospects) was positive, but only by 2%. This is slightly down from the previous survey (when the net figure was 8%), but the main result is that two-thirds of companies saw no change. The increased output in the second quarter discussed above does not therefore appear to have been either substantial enough or to have persisted sufficiently long enough to have made a major impact. In total, respondents reported that the total trend in orders in the three months preceding the survey were flat, and a net of 2% expect orders to fall in the coming three months. Most problems occurred in the home market, with actual Scottish orders in the previous three months down for a net 22% of respondents, and 26% expecting Scottish orders to fall in the short-term. Despite this, export orders continue to perform strongly, with a net of 14% reporting increases in the previous three months and the same figure expecting them to increase in the coming three. However, some 73% of respondents continue to cite a lack of orders or sales as the factor most likely to limit output in the short-term.

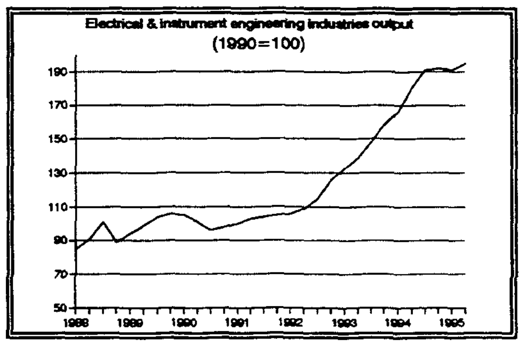
Company news includes the go-ahead for Devro's acquisition of Teepak for £88.4Mn. The American regulatory authority has allowed the bid, which will give Devro an estimated 25-30% of the world market for sausage casings, on condition that it divests its own American operation. Devro describe this as "not onerous" and the acquisition is clearly a significant step forward for what is probably Scotland's most successful food manufacturer.

Another significant Scottish acquisition, Scottish and Newcastle's purchase of Courage, is now expected to bring cost-savings of up to £75Mn, larger than the £40Mn expected when the bid was announced. This is partly due to a good performance by Courage, and also because the company now feels that there is more duplication between the two groups than was previously supposed. So far, about 250 jobs have gone following the merger and more are expected, although no jobs have as yet gone in Scotland.

ELECTRONICS

In the last issue of this Commentary, it was noted that the Index of Production for the electronics sector in Scotland had fallen for two successive quarters. However, the reduction reported in the final quarter of 1994 has now been revised to show a 1% increase, and a 2% rise is now reported for the second quarter of 1995. While these figures are not dramatic, they should ease concern that the industry was beginning to show evidence of a longer term decline. Output has increased by 18% over the year to the second quarter, although the figure will doubtless be revised again and , on an annual basis, electronics remains by far the strongest performing sector of the Scottish economy. Much of the overall annual rise of 1.2% seen across all manufacturing in Scotland is again due to electronics and the industry in Scotland again outperformed its UK counterpart over the year to the second quarter.

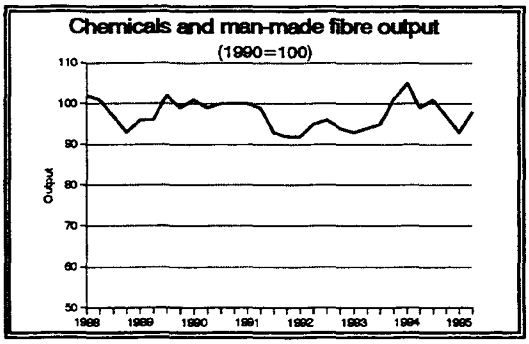
The more recent results from the Scottish Chambers Business Survey (SCBS) show a reasonably healthy picture concerning short-term prospects. A net 11% of respondents to the January survey reported that they felt more optimistic than three months previously, although this does compare to a figure of 16% who reported increased optimism in the previous survey. At least part of this change is due to the trend in export orders, which had fallen for a net 6% of respondents in the previous three months the survey. However, a net 10% now expect export orders to increase in the coming three months and, given the industry's export orientation (see below), this will make a substantial difference to its overall well-being should these orders materialise. A net 15% of respondents also expect export sales to increase. In contrast, UK orders both grew strongly in the three months to the survey and are expected to strengthen further in the coming three months. An even stronger increase in sales to UK customers is also expected in the short term. Scottish orders and sales are also expected to increase. Perhaps the best indicator, however, is that the proportion of companies citing a lack of orders or sales as the factor most likely to restrain output in the short term has fallen significantly from the previous survey, from 70% to 58%. In addition, the trend in total employment rose for a net 13% of companies and is expected to rise in the coming three months for a net 8%. In sum, therefore, there does appear to be some grounds for optimism over the industry's short term outlook.



The importance of the industry to Scotland's overall economic health was again confirmed by the results of the export survey undertaken by the Scottish Council for Development and Industry (SCDI), discussed earlier in the World Economy section. The computer industry was the biggest export earner, and saw total exports rise from £3.7Bn to £4.8Bn between 1994/95, a rise of just over by 30%. In addition, the third largest export sector was electronics excluding computers, which exported £2.12Bn, not far behind Whisky at £2.19Bn, and which saw exports grow by 78%.

CHEMICALS

The Index of Production for the Chemicals and Man Made Fibres sector in Scotland indicates 5% output growth in the second quarter of 1995. However the industry's performance over the year to the second quarter fell by 3%. The corresponding UK figures were slightly better, showing 1% growth in the second quarter and annualised growth of 4%. The SCBS findings echoed this and for a further quarter the rise in business confidence eased, to a net of -3%, the lowest figure recorded over the past two years. With regard to the same quarter of the previous year however, a net of +20% of respondents remained more confident.



Declining confidence reflects net balances for both orders and sales which did not meet respondents expectations. Of those who responded, a net of +23% reported increased total orders whilst a net of +26% reported increased sales, both considerably below those figures forecast. The slowdown in growth of orders and sales is a result of declining orders and sales to the rest of the UK and abroad. Respondents anticipate total orders/sales declining further during the current quarter. Investment intentions in plant/equipment were flat. However a net of +2% revised investment intentions in land/buildings upwards.

Respondents had forecast that the trend in employment would strengthen slightly during the current quarter. However, the increase in employment halted and in actual fact a net of -12% of firms shed staff, although this downward trend is seen as transient.

European pharmaceutical companies are bracing themselves as a decision by the European Commission rejected the demand of seven member states for safeguards against the exports from Spain and Portugal. Drugs groups in northern Europe estimate that they could lose more than $2bn a year once these exports enter their market. Drugs prices are lower in Spain and Portugal as the governments set low maximum prices for drugs. In addition, since prices are set in local currencies, the steady devaluation of the Spanish peseta and Portuguese escudo mean that many drugs are substantially cheaper. However the European Commission said that the economic data supplied by the member sates applying for the safeguards had not "demonstrated that there would be serious difficulties in the pharmaceutical sector as a result of parallel imports". The Commission has also decided to study EU governments' drugs pricing policies in order to resolve such problems in the future.

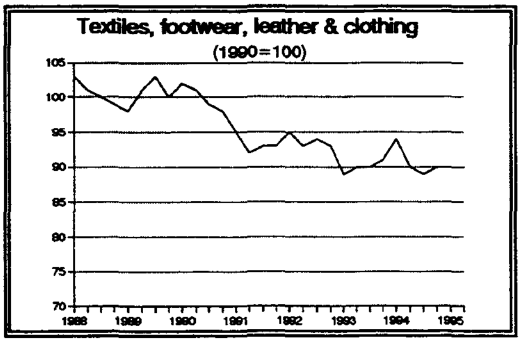
Glaxo Wellcome, the UK pharmaceuticals group, is to sell its interest in Warner Wellcome to Warner Lambert for $1.05 billion. The joint venture with Warner Lambert was formed two years ago, prior to Glaxo's takeover of Wellcome, and established to market Wellcomes non prescription drugs along with some of Warner Lamberts. It will continue to market Zantac and Zovirax, Glaxo Wellcome's over the counter anti ulcer and herpes drugs, and expects future versions of over the counter drugs also to be marketed through Warner Lambert.

Zenecca plans a sharp increase in its spending on drugs research, and on partnerships with bio technology companies. R&D spending is expected to rise faster than inflation, which they hope will result in an increase in the proportion of drugs which pass the medical trials demanded by regulators, to above the industry average. The company hopes a series of new cancer products will move it from number two in the world cancer drug market to the top position by the year 2000.

TEXTILES, FOOTWEAR, LEATHER AND CLOTHING

The Index of Production in the Textiles, Footwear, Leather and Clothing (TFLC) sector in Scotland was unchanged in the second quarter of 1995. However, this is a marginal improvement on its recent quarterly performance, and the Index does show an overall reduction of 2% over the year to the second quarter. Its performance over both the quarterly and annual periods is below that of all manufacturing in Scotland, which saw increases of 1.2% and 3.6% respectively and which also saw a number of individual sectors perform well, notably chemicals (which saw a 5% quarterly increase), Electricity, Gas and Water (4.8%) and Food, Drink and Tobacco (4%). The reduction in annual output of 2% in Scotland contrasts with an unchanged level of output across the industry in the UK as a whole.

Results from the January Scottish Chambers Business Survey (SCBS) continue to show little improvement in short-term prospects. A net 18% of respondents were less optimistic about prospects than three months previously, and the total trend in orders was down for a net of 27%. The largest reduction in orders came from Scottish markets (down for a net 33%) and from other UK (25%). One slight encouragement is that , while the trend in export orders is also down , this affected a net of only 2% of respondents, and 33% saw an increased trend in exports. Sales also fell in the three months preceding the survey, although by slightly smaller amounts. The results quoted above show a deterioration from the results of the previous survey and indicate that little is happening to radically alter the sector's short-term prospects.

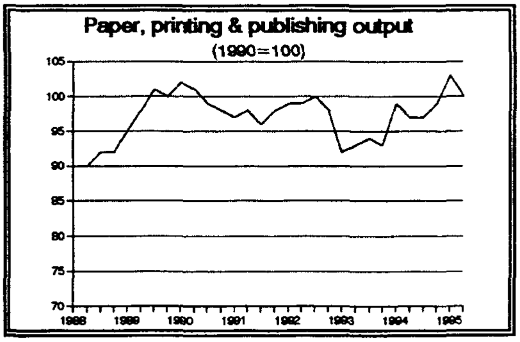


The lack of recent activity in Textiles affected Richards, the Aberdeen-based carpet maker, at the end of last year when it reported a £1.1Mn loss. The company has been affected by the poor housing market and rising raw materials prices, the effect of which were discussed in the last issue of the QEC, and has shed jobs in Northern Ireland as well as in two Scottish factories, in Aberdeen and at Cumnock in Ayrshire. Total employment in the group has now almost halved in the last five years to 1,200.

PAPER, PRINTING & PUBLISHING

The Index of Production and Construction for the Paper, Printing and Publishing industry in Scotland shows output growth of -3% in the second quarter of 1995. Annualised growth stands at 4%. Corresponding UK figures indicate output growth of 1% in the second quarter of 1995 with annualised growth of 1%

The latest Scottish Chambers Business survey reveals that a net -20% of respondents feel less confident about the general business situation in the paper, printing and publishing industry compared with 3 months ago. A net 0% of firms reported an increase in new orders while a net +17% expected new order levels to increase in the next quarter. New Scottish order levels improved for a net +11% of firms with a net +8% expecting the trend to continue into the next quarter. With respect to new UK orders, a net -18% experienced a drop in new orders, although to balance this trend a net +18% expect an increase in the next quarter.



Examining trends in the total volume of sales, in general sales have risen for a net +10% of firms with further increases expected. Specifically, Scottish sales performed best with a net +22% of respondents reporting an increase in total sales. For the UK as a whole sales fell for a net -14% of firms. With respect to export sales, a net +6% experienced a rise in total sales with a net +25% expecting further increases in the next 3 months. Average capacity utilisation for the industry is 74.2%, 7% lower than last quarter.

Investment intentions in plant and equipment have increased for a net +14% of firms with further investment anticipated. However, a net 0% of firms experienced a rise in land and buildings investment with a net -4% expecting a fall in the next quarter.

A net +3% of respondents reported an increase in their total employment, but this trend is expected to reverse, with a net -14% anticipating employment levels to fall in the next quarter.

Dunfermline based paper manufacturer Inveresk has made moves to acquire Weir Paper Holdings to form a new fine paper division of the company. Weir Holdings include a paper mill in Alloa and a paper recycling plant. Inveresk is set to pay out up to £32m on the acquisition from the Pratt Group. This also includes a maximum of £12m to cover the company's current debts. Inveresk's first half year profits were up 5% to £4.72m with sales in the corresponding period increasing by 28% to £47.9m.

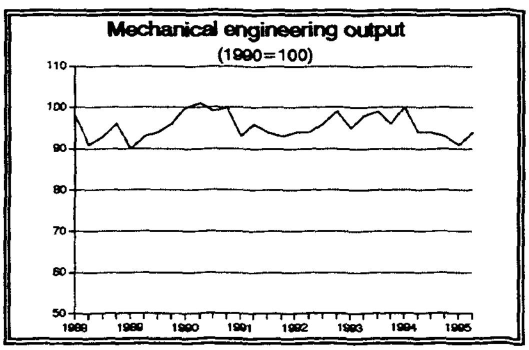
Packaging and oil operator Sidlaw announced that pre-tax profits before exceptional items for the year to 30 September have halved to £7.3m since

September 1994. However after huge costs involved in the disposal of the textile division of the group and the re-organisation of the packaging division, Sidlaw suffered a pre-tax loss of £100,000. This is the first time that the operator has fallen into the red. Much of the losses were attributed to "unprecedented" increases in raw material costs. Chief executive Digby Morrow intimated that raw material costs having peaked were now coming down and coupled with company re-organisation should spell long term benefits for the group.

Johnston Press publishing group is set to expand its East Midlands newspaper holdings with the £20m acquisition of W&J Linney's 11 titles. These include the Mansfield Chronicle Advertiser and the Worksop Guardian. Linney led titles have generated £1m profit and £8m turnover in the year to 31 March. Fred Johnston, the chief executive of Johnston Press believes the acquisition will strengthen the company's market position. The company already have holdings in the East Midlands area and this latest buy will take the Johnston Press total portfolio of newspapers to 92.

MECHANICAL ENGINEERING

Due to the change from the 1980 SIC to the 1992 SIC, there have been quite frequent and substantial revisions in the recent official publications of the index of production and construction for Scotland. However, no matter how contradictory these revisions are, there is clear evidence that the Scottish mechanical engineering industry is still staggering on the road to recovery.



The latest SCBS (10 January 96) records a net of 12% of responding firms showing an improvement in business optimism in Q4 1995, down from 18% in Q3. Compared with the same time a year ago, however, there was a marked improvement in business confidence. The upward trend in total orders in Q4 1995 continued with a net 24% of corresponding firms reporting increases. The increases mainly came from export and UK sources, although Scottish orders were down. Similarly, export and UK orders are expected to continue to increase through Q1 1996, although Scottish orders are not. The upward trend in sales also continued, and is expected to sustain until Q1 1996, although Scottish sales are again an exception.

Work in progress made a rather strong recovery in Q4 1995, and is expected to remain strong in Q1 1996. In keeping with this is a higher capacity utilisation rate, which stood at 83.2% in Q4 1995.

The rise in investment plans for plant/equipment strengthened further and is expected to be sustained in Q1 1996, albeit with eased rates. The main reasons for authorising investment in Q4 1995 were: expanding capacity (25%), replacement (27.3%), increasing efficiency (27.3%), and introducing new projects (9.1%), a similar pattern as in the previous five quarters except that expanding capacity is now the most important factor for authorising investment.

The increase in employment strengthened further in Q2, with a net 33% of firms creating new jobs. Most of the increases were accounted for by full-time male employment. Moreover, such increases are expected to continue in Q1 96. It is worth noting that a net 28.2% of firms experienced difficulty in recruiting skilled employees in the final quarter last year.

SERVICES

DISTRIBUTION

There was little improvement in the distribution sector during the fourth quarter and both wholesale and retail respondents continued to express low levels of optimism. Business confidence amongst Wholesale respondents declined further to a net of -24% compared to the previous quarter, whilst the corresponding figure for retail respondents was -8%.

The sharp decline in Wholesale confidence results from the disappointing trend in sales. Respondents had expected the trend to strengthen whereas in actual fact, based on the same quarter of the previous year, a net of -2% reported a decrease in sales. Respondents expect no improvement during the current quarter. In contrast retail respondents overestimated the decline, a net of -5% reported reduced sales whereas a net of -7% had been forecast.

There was little difference with regard to retail investment plans, a net of +12% revised investment intentions in premises upwards compared with the same fourth quarter of 1994. The rising trend in investment in Wholesale also continued to ease to a net of +11%.

Wholesale respondents continued to increase total employment during the fourth quarter and expect this to continue although the rate of increase is forecast to ease. Contrary to expectations, the decline in retail employment ended [0%] although respondents expect the decline to re-emerge during the current quarter.

Marks and Spencer reported that pre tax profits in the six months to September 30th rose by 8.8% to £385.4 million on sales ahead by 5.7% to £ 3,248 million. However it was as a result of strong growth in food sales as opposed to sales in clothing and footwear where only a modest increase was reported. It was argued that the hot weather in August, September and October had restrained clothing sales but the cold weather had resulted in an immediate increase in clothing sales. The strongest increase was the Financial services division which witnessed an increase in profits of 45% to £26.7 million although such strong growth is not forecast for the second half.

The Edinburgh based group Christian Salvesen announced an 8.7% increase in interim pre tax profits to £45million from £41.1 million. Distribution continued to account for the bulk of group turn over although Aggreko, the power hire and temperature control division grew by 20%. Less satisfying was the performance of food services which has suffered as a result of drought conditions experienced in most of the vegetable growing areas of the UK.

Kwik Save revealed that pre tax profits for the 52 weeks ended 26th August had slipped by 7.4% to £125.5 million, approximately 5 million below City expectations, as a result of bitter competition in the food retailing sector. Sales rose by almost 7% to £3.2 billion however same store sales were actually down by 2.6%.

FINANCIAL SECTOR

Expansion abroad has not been one of the most successful activities of British banks in the last twenty years or so. American acquisitions have been particularly notorious but limited experience elsewhere has not been notable for suggesting that substantial growth or other profitable trading advantages can be gained by expansion overseas. The strategy, when expounded by the bank's officers, has often appeared sensible enough and has typically been either the development of a global bank network able to service the banks customers in major trading locations, or the need to achieve global synergies and economies of scale by expansion abroad. The reality has, unfortunately, been very different with more often than not the acquisition of a problem bank with a problem loan book. It is very difficult for a British bank to realistically appraise competitive conditions in other markets. With the benefit of hindsight there is, in general, little logic in a British bank trying to acquire an extensive branch banking network in other countries where banking conditions are different and the opportunities for synergy are small. There may be an argument for a long term strategy to develop a comprehensive branch network in Europe, although few banks appear to be investing in such possibilities and, even in this case, the strategy might well be overtaken by the technological changes sweeping the industry and the moves in the short term to telephone and in the long term to electronic banking. Synergies from similar domestic banking conditions or lending activities appear to count for little when set against the cultural differences that make the assessment of lending risk country specific. History suggests that the only valid reason for a foreign acquisition of any scale by the UK banking industry is the acquiring of a profitable business that is well managed and will involve the UK head office providing little in the way of managerial time and energy.

Should the acquisition of BankWest from the W. Australian Government by Bank of Scotland be seen then as an investment? The Bank certainly makes no pretence of trying to build a global network. The purchase is of a profitable bank with an established management, a team that has restored profitability to the bank after a series of losses and which should be able to increase profitability further. The Bank of Scotland dresses the acquisition up with the possibility of adding value to the acquisition from its own particular skills, and draws attention to the growth in the Pacific rim, but in essence the purchase represents a profitable investment opportunity. The important question the acquisition raises relates not to fears of some expensive grand global strategy by the Bank's managers but to the conditions that led the Bank to use funds in this way. Investment in BankWest is an admission that the Bank foresees profitability in Western Australia as potentially much greater than profitability in the Scottish and UK market. Rather than invest more in its UK business where it presumably has a great deal of expertise it has invested overseas in an area where its expertise is likely to be slight. It is true that it has some experience in Australasia. It bought, for example, Countryside Banking Corporation of New Zealand in 1992, but it would be rash to attribute too great a knowledge of the region to the bank. Certainly, the stock market was not enamoured by the Bank's decision to invest in Australia. On announcement of the acquisition the shares fell by 7p signalling the markets belief that the Bank paid too much given its existing experience and business. Investment in Australia was not the only option open to the Bank. By investing in BankWest it is signalling that the acquisition offers better prospects than investment in the UK, and that it is more appropriate for the Bank to invest on behalf of shareholders than to allow the shareholders to invest for themselves. One option, after all, was for the Bank to pay out cash to shareholders either by paying a larger dividend or buying back shares in the market. What evidence is there to believe that the Bank is better able to invest than its own shareholders? The profit record of the Bank and its caution in eschewing large grandiose banking expansion suggest that it may be able to invest more profitably than some of its competitors but the evidence of the past two decades of attempted expansion by UK banks does not fill one with too much hope!

A second question of particular interest is why the Bank of Scotland should prefer an Australian to a domestic investment. The most likely possibility is that competition in UK banking is becoming too intense and profitability growth too uncertain. Profits of most UK banks have benefited in recent years by the reduction in provisions for bad debts. At the height of the recent recession the banks felt forced to make very large provisions for debts that were unlikely to be recovered in full from their customers. As the economy has recovered the need for these provisions has been reduced with a consequent rise in profitability. There is naturally a limit to how far this process can continue. Provisions against bad debts are an inevitable requirement of banking and whilst a buoyant economy reduces the size of provisions for bad debts there can be little confidence that this will persist. Better controls on lending can reduce provisions but banking is inherently risky and with the next downturn in the economy, provisions must rise. The need of banks is for organic growth but opportunities for profit growth look slim. One source of increased profitability is cost cutting and the control of costs. A second is increased innovation and introduction of new products and processes. Cost cutting and innovation are, of course, often related. It is unlikely that the scope for cost cutting is as great as in earlier periods, a consequence in large part, of the entry of a number of new, relatively specialised firms into the banking market. The scope for profitable innovation also looks distinctly limited. Innovation in financial products is generally non patentable and easily replicated. Specialist software and expertise gives a company a first mover advantage but it is often difficult to retain that advantage. The Royal Bank provides an example of both the benefits and the problems. The Royal Bank's profitability has benefited significantly from its investment in Direct Line its telephone based financial services subsidiary. However, the number of competitors now offering similar services suggest that profit growth in the future from this source will be significantly slower than in the past. Direct Line will continue to achieve profit growth because the telephone based financial services sector of the market is continuing to expand, fuelled by significantly lower costs, and is still attracting market share from the more traditional forms of selling financial services, but the very rapid growth Direct Line achieved resulting from its position as the only significant telephone based supplier of insurance, is over.

The basic problem for the traditional banks is the greatly increased competition that they now face as a result of changes in the regulatory environment for financial services and, more particularly, will face in the future from the former building society sector. The larger building societies as specialists in the retail sector of the banking market appear to have lower costs than the banks in this market and have, in the past, managed to convey a more user friendly image than the banks with consequent benefits to their marketing. The increasing number of banks as building societies convert into banks will create an even more formidable competitive environment with a number of new entrants benefiting from a relatively low cost base. At the same time, the shedding of mutual status and the acquisition of a stock market quotation, if the experience of privatisation can be taken as a guide, is likely to focus the minds of management more intently on profitability than hitherto. Consequently, the outlook for banks in the retail and small business sector of the market, a natural area for former building societies to expand into, looks poor. One response, as in the case of Bank of Scotland is to invest elsewhere. Another response is to look for synergies and attempt to cut costs. The merger of the TSB and Lloyds must fall within this category as indeed must the mergers of the Halifax and Leeds, and Abbey National and N&P.

In the short term the effects of increased competition in the retail banking sector may well be painful for Scotland. Cost cutting, if it is to be effective, must involve reducing staff and branch costs. The merger of the TSB and Lloyds is unlikely to reduce the number of branches in Scotland too greatly given Lloyds very limited presence, but it is likely to imply significant cuts in other TSB operations in Scotland as duplicated functions are removed. Building society mergers such as of the Halifax and the Leeds are also likely to lead to cuts in employment as branches in Scotland are rationalised and regional offices shut down. The effect on professional employment given the absence of head office functions in Scotland is likely to be small but the overall effect may still be significant.

Where does all this leave the traditional Scottish banks? It is clear that conditions have and will continue to get tighter in their domestic retail market with more intense competition from the former building societies and from other banks. The Scottish banks are also not immune from the need to cut costs further and seek possible savings from rationalisation. These might arise either through the acquisition of one or more small building societies or through their merger with or takeover by a larger entity. Given the substantial shareholding held in Bank of Scotland by Standard Life and the needs of Standard Life for distribution channels for its products, Bank of Scotland is probably safe from takeover threats. The same cannot be said for the Royal Bank.

TRANSPORT

Air

BAA has announced that passenger numbers increased by 5.8% in 1995 with seven airports handling 91.8M passengers. There were increases of 9.1%, 11% and 3.3% for flights to the UK from North America, other long haul flight destinations and from Europe respectively and domestic growth of 8% was assisted by the many new low fares which are now available. Edinburgh and Glasgow airports had an increase of 9.3% and a decrease of 0.6% respectively, in passenger numbers.

Road

The Transport Secretary has agreed to the £2bn road budget being cut by several million pounds. In Scotland 20% of new roads, 77 motorway and trunk road schemes have been withdrawn, which represents a 33% cut in the programme. In addition, all new major roads are to use private finance. Consumer and business organisations have severely criticised the Government's approach to transport policy. In total, 17 schemes totalling £450M were announced by the Scottish Secretary. These included both conventional funding and PFI funding with the latter applying to the M8 gap, M6/M74 links, M74 extension into Glasgow and the M80 gap. Conventional funding is to be used for the A1 at Haddington/Dunbar. The M6/M74 is a Dept of Transport/Scottish Office scheme and four companies will tender for the £190M order. Also, Lanarkshire Development Agency is to spend £12.1M on improving road links to the European Channel Tunnel site.

The European Investment Bank is to consider a loan of £200m to the consortia involved in the first four roads projects. The Centre for Policy Studies suggest that the proposed electronic tolling should be replaced with a charge of £100-£1000 depending on road mileage.

Stagecoach has purchased Cambus, (Cambridge), for £12.6M. The group have 780 staff, 340 buses with pre-tax profits of £1.4M on sales of £22M in 1995 and has net assets of £5M. Stagecoach currently has 13% of the bus sector, with end of year pre-tax profits at £20.7M, a 43% rise on the previous six months. Firstbus has recorded profits of £9.1M, down from £11.9M due to merger costs.

Rail

Scotrail's managers have confirmed they want privatisation north of the border, fearing that if it does not occur then Scotrail will have to operate under restraints which others in the private sector will not encounter. Plans to run services between Glasgow and Edinburgh every 15 mins are still a priority. Electrification has been postponed indefinitely in favour of diesel. Intercity East Coast has several interested parties including; Stagecoach, Sea Containers, London & Continental, Generale des Eaux and a management buyout team. Intercity

East Coast may be the only Scottish rail interest that could be privatised before the next election.

Stagecoach has been awarded the franchise for South West Trains, and one of its first actions will be to run more buses so the railway is more accessible. It is thought Stagecoach secured the franchise with a lower bid than the management buyout team. They have pledged not to reduce services but to improve them. Stagecoach now wants to operate Intercity East Coast and the Docklands Light Railway, again where they have a significant presence in the bus sector. The two other franchises have Scottish backing with Firstbus having a 24.5% stake in Great Western Holdings, where finance is provided by the Royal Bank of Scotland. LTS also Scottish interests. LTS plan to order new trains by 2002 at a cost of several hundred million pounds.

Strathclyde Regional Council have taken legal action to stop the rolling stock companies, Angel Contracts and Everholt, taking the rolling stock elsewhere. SRC paid for these trains and handed them over to Scotrail who ran the services for them. They believe that the rolling stock companies will need their permission to move the units to a location other than where services are being supplied to and consumed by STPE users. The Save Our Railways campaign have taken their case to court where they allege the Franchising Director has acted illegally by stipulating the minimum service requirement below that provided previously. The Transport Secretary has narrowly avoided defeat here by rewriting the rules.

Sea

Forth Ports have acquired the port of Dundee for £10M. Forth has also been named as the preferred consortium bidding for Rosyth Naval Base. This gives Forth a tight grip of east coast ports operations and can only leave Clydeport looking at Tyneside as it is due to be privatised. The Scottish ports do face a threat of losing business through the Channel Tunnel but there is an even greater opportunity to expand shipping operations due to continued upbeat export performance. While Scotland has 8.9% of the UK population and 8.5% of GDP it handles 20% of the UK's seaborne traffic.