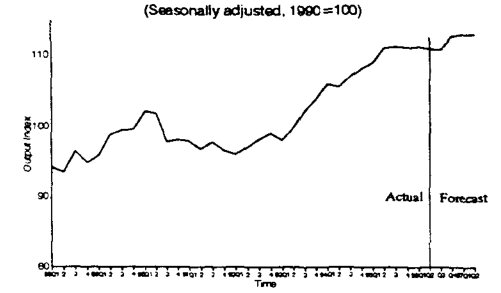
THE SCOTTISH ECONOMY

SHORT-TERM FORECASTS*

This section presents short-term forecasts for the quarterly growth rates of Scottish manufacturing (Division D of the 1992 SIC) output. In the last forecast, we predicted a 0.2% growth rate in the output of Scottish manufacturing industries in Q1 96, this coincided with the actual growth rate as reported in the latest Scottish Office News Release (7 August 1996).

The present forecasting period extends to 1997 Q2, and the National Institute's quarterly forecasts for UK manufacturing output are used in deriving the Scottish forecasts. Figure 1 depicts the actual growth rates for Scottish manufacturing output from 1988Q1 to 1996Q1 and the forecasts for 1996Q2 to 1997Q2. The forecasts show that the performance of Scottish manufacturing industries will remain rather weak until the final quarter of 96 and then start to revive again. However, this growth process will be subdued in Q2 97. For 1996 as a whole, the output of Scottish manufacturing industries is predicted to rise by around 2.1% over 1995. 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	0.3
1993/92	3.5
1994/93	5.6
1995/94	3.6
93Q4/92Q4	4.8
94Q4/93Q4	4.1
95Q4/94Q4	2.6
94Q3/94Q2	1.3
94Q4/94Q3	1.1
95Q1/94Q4	0.7
95Q2/94Q1	1.8
95Q3/95Q2	0.2
95Q4/95Q3	-0.2
96Q1/95Q4	0.2
Forecast	
96Q2/96Q1	-0.2
96Q3/96Q2	0.0
96Q4/96Q3	1.7
97Q1/96Q4	0.3
97Q2/97Q1	0.0
1996/1995	2.1

THE DELOITTE AND TOUCHE SCOTTISH CHAMBERS' BUSINESS SURVEY

The Deloitte and Touche Scottish Chambers' Business Survey, which is conducted by Strathclyde University's Fraser of Allander Institute together with the Chambers of Commerce of Aberdeen, Central, Dundee, Edinburgh, Fife and Glasgow, is the largest and most comprehensive regular survey of business, employment and other issues affecting the Scottish business community. The results below are for the second quarter of 1996 and are based on 837 responses.

Business Confidence

In Manufacturing, business confidence has begun to rise again. A net balance of 3% of respondents reported that they were more optimistic than three months previously, compared with a balance of 1% who were less optimistic in the first quarter. In the second quarter, Manufacturing respondents continued to be more optimistic than they were a year ago, with a net balance of 2% of respondents reporting higher optimism.

In Construction, optimism continues to fall and at a slightly faster rate than in the first quarter. A net balance of 14% of respondents reported that they were less optimistic than in the first quarter. This compares with a 13% balance of respondents who were less optimistic in the first quarter over the fourth quarter 1995. A net balance of 14% of respondents reported that they were less optimistic than they were a year ago, compared with the situation in the first quarter where a net balance of 12% of respondents were less optimistic than in the same period a year earlier

In Distribution confidence increased further in Retailing, while in Wholesaling optimism continues to decline. In Retailing, a net balance of 14% of respondents were more optimistic about the general business situation than they were in the first quarter, which compares with the 10% balance who were more optimistic in the previous quarter. In Wholesaling, a net balance of 6% were less optimistic than in the first quarter, much the same as the negative net balance of 5% in that quarter. Compared with a year ago, while Wholesale respondents were again less optimistic, registering a negative net balance of 6%, in Retailing, a net balance of 16% were more optimistic.

Respondents in the Tourism and Leisure sector reported a further considerable increase in confidence. In the second quarter, a net balance of 44% of respondents indicated that they were more optimistic about the general business situation than they were three months earlier, compared with a balance of 26% in the first quarter. A net balance of 60% of respondents were more optimistic in the second quarter than in the second three months of 1995.

Orders and Sales

In Manufacturing, orders and sales continue to rise, but at a much slower rate for orders and at a slightly slower rate for sales. For orders, a net balance of 1% of respondents reported an increase while, for sales, a balance of 9% of firms experienced a rise. These figures compare with positive balances of 10% for both orders and sales in the first quarter. Orders and sales from the domestic Scottish market continued to fall, while orders from the rest of the UK picked up again. Export orders and sales continued to grow quite strongly, at much the same rate as in the first quarter.

In Construction, new orders continued on a downward trend but at a slower rate than in the previous quarter. A net balance of 5% reported a decrease in orders compared with a net balance of 16% reporting a decrease in the first quarter. Orders from both Central Government and Other Public Sector continue to be severely depressed, but orders from the private sector are now rising again; a net balance of 7% of respondents reported an increase in private sector orders, compared with a negative balance of 3% in the first quarter.

Sales growth in Distribution differed appreciably between the two key sectors in the second quarter. A net balance of 24% of Retailers reported that sales had risen, compared with the 15% balance reporting an increase in the first quarter. In Wholesaling sales fell, a net balance of 3% of respondents reported a decrease, compared to the balance of 2% of respondents reporting an *increase* in the fourth quarter.

Tourism demand increased further in the second quarter and at a much faster rate than in the first quarter. A net balance of 56% of firms reported an increase compared with a balance of 19% reporting a rise in the three months to March. Demand increased strongly in all markets particularly from abroad.

Stock Adjustments

Stocks of raw materials and finished goods in Manufacturing continued to fall, while work in progress remained unchanged. A net balance of 9% reported a fall in stocks of raw materials, while for finished goods the negative net balance was 4%.

Finance and Investment

In the Financial sector, the demand for personal loans continued to rise and at a faster rate than in the first quarter. A net balance of 42% of respondents reported a rise, compared with the balance of 29% reporting an increase in the first quarter. Advances to the corporate sector are also rising at a faster rate, while the demand for working capital continues on an strong upward trend. In addition, the demand for finance for investment in buildings and for investment in plant and equipment is now showing quite strong growth.

Manufacturing investment intentions in plant and machinery were again revised upwards in the present quarter, with a net balance of 3% reporting an increase and respondents expect to revise these intentions up further again in the third quarter of 1996. The deterioration in manufacturers' investment intentions in land and buildings continues. A net balance of 3% of respondents reported a decrease, compared with a balance of 4% reporting a decrease in the previous survey. Respondents also expect a slight further decrease in buildings investment in the third quarter of this year. In Construction, investment intentions continue to decline, while in Retailing and Wholesaling, investment intentions remain significantly positive. Net balances of 15% and 18% of Retail and Wholesale respondents, respectively, reported an upward revision in investment intentions compared to the same period a year ago.

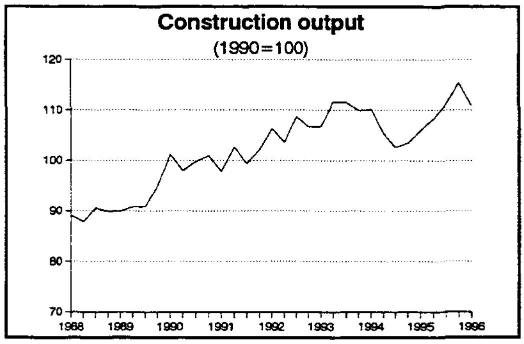
Expectations

With the exception of Retailing and Construction, the outturn in the second quarter was *worse* than expected by respondents in the first quarter. In Construction, the decline in orders was less strong than expected, while in Retailing the growth of sales was appreciably stronger than anticipated. In Manufacturing, the outturn was appreciably down on first quarter expectations.

Demand conditions are expected to improve in the third quarter in Manufacturing and Retail. In Construction, a further worsening of demand conditions is expected and falling sales is also expected in Wholesaling.

CONSTRUCTION

Despite a 3.9% fall over the first quarter of 1996 the Scottish Index of Construction at 110.8 is 21.8 higher than the index for the UK as a whole. These figures show the first fall in Scottish construction for six quarters, however, comparing the latest four quarters with the preceding four shows a growth of 6.8%.



The UK as a whole on the other hand is exhibiting the vacillation one associated more with the Scottish index in the past. The year on year figures for the UK show a 1.5% fall while at 89.2 the first quarter figure is 0.5% down on the fourth quarter of 1995.

The latest Deloitte and Touche Scottish Chambers' Business Survey for the second quarter of 1996 shows that a balance of 14.3% of respondents were less optimistic about the general business situation than they were in the first quarter. Comparing the second quarter with the same quarter a year ago shows that an almost identical percentage (14.5) were less optimistic.

A balance of almost 5% of respondents saw the trend in the total volume of new orders falling during the second quarter. However, this figure is expected to increase to almost 15% in the third quarter.

Over half of respondents see orders from central government and orders from the remainder of the public sector as having fallen over the quarter. This fall is expected to continue albeit for a smaller balance, during the third quarter.

There still exists spare capacity in the Scottish construction industry with respondents reporting just over 80% capacity utilisation. However, this is down on the same period last year for a net of 14% of respondents. Unsurprisingly, the single most important factor limiting output in the third quarter is forecast to be orders or sales.

Investment intentions continue to be revised downwards for plant and equipment and for buildings with balances of 8.8% and 7.1% respectively. New investment authorised was mainly for replacement, with almost 60% of respondents (who authorised new investment) citing this as the reason. Almost a fifth, however, cited increasing efficiency as the reason for new investment.

Employment in the Scottish construction industry declined for a balance of almost 12% of respondents. This is present across all the components of employment and is expected to continue during the third quarter. Overtime and short time working are both reported as falling for a respective balance of -23% and -15% of respondents.

Just over a fifth of respondents increased wages and salaries over the quarter, with an average percentage increase of 3.8%. Recruitment is, however, broadly stable with the vast majority of the 50% of respondents who attempted to recruit, experiencing no difficulties.

Plans to upgrade the M8 between Glasgow and Edinburgh to a six lane motorway, adding an extra lane in each direction are to be funded by the private finance initiative (PFI). Contractors will be invited to design, build, finance and operate the motorway. However, the contractors will be paid not with tolls but through an annual payment from the taxpayer dependent on the level of traffic. The upgrading and extension of the M8 will test the government's sincerity in claiming that it will put railway modernisation on the same footing as road schemes.

The PFI system is also intended to be used for a £43 million extension of the M6 north of Carlisle and for the proposed completion of the M80 at Cumbernauld. After this will come the £130 million upgrade of the A8 and M8 to three lanes in each direction between Ballieston and Junction 5 near Shotts.

During July, house prices rose at their highest rate for almost seven years according to the Halifax Building Society. Prices for all type of homes were 5.3% ahead of July last year, the fastest pace of increase since October 1989 and up from 4.0% in June. The Halifax states that this is consistent with their forecast of a UK rise of 5% in house prices over the whole of 1996.

However, builders are having to suppress margins in order to obtain what limited new build work that is available. As a result of the tight market at home, construction companies are increasingly competing in overseas markets. Last year the value of overseas orders increased by 45% to £5.5 billion. Hong Kong and North America are two areas where UK companies have been most successful.

Having had time to assess its purchase of McLean Homes from Tarmac; Wimpey are reporting encouraging trends in trading performance. Operating at the cheaper end of the market, Wimpey homes have experienced the fierce competition in that sector. The McLean Homes business showed a healthy profit of £10.6 million in the few months since the takeover. Wimpey's pre tax losses of £8.6 million have been attributed to the discontinued activities shed earlier in the year. Sales in recent months have been running well ahead of last year.

Despite indications of poor overall performance, from the available information there are still grounds for optimism and the second half of 1996 is starting to show signs of improvement for the Scottish construction industry.

ENERGY

PRODUCTION

The last quarter, (Q2), saw oil and gas production rise by 8.7% over the same period last year despite its seasonal decline. For Q2 average daily oil and gas production was 2.44mbpd and 7020mmcfd respectively. Average oil and gas revenues grew by 17.7% over the same period, attributed mainly to the high oil price. Growing global stocks, OPEC over production and the Iraqi oil deal will see prices fall in the medium term. Due to the recent military action in the Gulf oil prices rose by $1.28 to $22. The UN delay on the $2bn Iraqi oil deal will, in the short term, maintain current price levels. A short delay will coincide with increased North Sea production and rising demand in the Northern hemisphere, thus will be less disruptive to market prices.

Comparing Q2 to Q1 the Royal Bank of Scotland combined oil and gas index fell by 24.7%. Most of this was due to the 63.8% decline in gas production whereas oil production only fell by 4.9%. Other than seasonal declines, the start of summer maintenance has disrupted production. The signs are that in Q3 and Q4 both oil and gas production will rise significantly.

The average price for Brent crude has fallen steadily since April from $20.85 to $18.43 in June. Average sterling values for oil peaked at £33.5m in April 1996, a rise of 8.4% on an annual basis. Gas revenues have fallen to their lowest level, £9.7m, since August 1995 and conversely are expected to fall further.

At various points during the quarter, monthly output figures show that significant falls in oil production occurred in Shell's Brent, Tern and Osprey fields; BP's Forties and Magnus; Enterprise's Nelson and in Mobil's Beryl. However, monthly figures also indicate that the largest increases in production were at Shell's Dunlin, Osprey and Brent; Amerada Hess's Scott and Elf Enterprise's Claymore. The major fall in gas production was at the British Gas Morecambe field falling from 1735mmcfd in April to zero in June. Other significant falls in Q2 include BP Amethyst; Conoco Jupiter and Victor, Shell Brent and Marathon East Brae. Terminal throughput at Sullum Voe declined by 90039bpd over Q2. Both Cruden Bay and Flotta showed small decreases. All gas terminals showed a decline over Q2 but Barrow and Bacton had considerably large falls in throughput.

The latest Deloitte & Touche Scottish Chambers Business Survey Oil & Gas survey indicates a significant rise in exploration work. This will be mainly Scottish based. Both production and service related work is higher than was expected at the end of 1995. It is thought this will level out in the second half of 1996 but no significant decline is forecast.

Total offshore capital building in the North Sea was £5bn last year and is expected to remain at £3.5bn until the end of the decade. Wood MacKenzie forecast that after that it will fall to £1bn in real terms. Fifty new fields could be developed at a cost of £7.2bn, significantly below the £10.5bn estimate of last year. Oil and gas production should increase in 1998 and 1999 due to new investment. These forecasts are strengthened by the sale of a considerable number of mature fields from the oil majors to companies who specialise in small recoveries. Oryx is to move its headquarters to Aberdeen following its deal with Cheveron. The Britannia field, ETAP and the West of Shetland continue to attract investment. The new technology of the Anasuria also increases the likelihood of many more marginal fields being developed thus lengthening the life of the North Sea.

Shell and BP are to keep Sullum Voe operating under a deal struck with the Council where the £7m rent will be halved and linked to actual, not forecast, throughput. A number of other income reductions have been conceded in order to secure a 25 year contract for the terminal which starts in the year 2005.

Coal

Scottish Power are to order an extra 1/4m tonnes of coal from Scottish suppliers this year above that ordered in March. Scotland will now supply Scottish Power with 3.3m tonnes of coal. RJB Mining announced a £95m share buy-back to increase earnings per share prior to renegotiating their contracts with the electricity generators in 1998.

UTILITIES

The Index of Production and Construction for electricity, gas and water supply in Scotland shows a -1.1% change for Q1 96 on Q4 95 and a 6.9% increase for the latest four quarters on the preceding four quarters. This compares with UK figures of 3.2% and 3.4% respectively. In Scotland the greater annual change is due to the exports of electricity while the negative quarterly change is due to seasonal decline.

Electricity

Scottish Power (SP) and Scottish Hydro Electric (SHE) have had an appeal to OFFER upheld to allow greater exports of electricity to England and Wales. This is worth £30m per year and will allow both companies to use the full capacity of the interconnector. Powergen attacked the decision stressing it's need for generating capacity in Scotland. Powergen's proposal for a gas fired power station at Gartcosh has been rejected by the local council and whilst further consideration will be given, the outcome will be determined by a public enquiry.

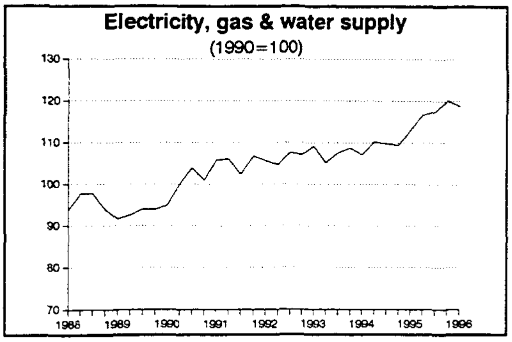
SP have taken over Southern Water with a £10.50 per share bid with plans to strip out £40-50m of costs from Southern Water and reduce water prices by 3%. The electricity and gas markets in the area are worth £1bn and £400m respectively. SP is the first multi-utility in the UK covering electricity, gas, water and telecoms.

SHE have announced plans to buy more power stations and make alliances with supermarkets who have large customer bases. Pre-tax profits rose by 15% to £195m for the year to 31 March. Profits in England and Wales increased by 25% whereas those in Scotland declined by 1%. SHE has forecast that 50% of its sales will be south of the border by the end of the decade.

The National Grid has to cut costs by 4-6% over four years from next April due to the price cap decision by OFFER which is expected to reduce revenues by £1.2bn and profits by £300m in 1997-98 (profits to 31st March were £617m).

Gas

Ofgas have presented British Gas, (BG), with extremely tough new regulatory measures. The original proposals have been relaxed but still require a 'one-off' cut in the gas transportation price of 20% as opposed to 28% which is to be followed by a 2.5% cut in the remaining years of the five year review. Ofgas have valued Transco's asset base at £11.7bn to avoid a retrospective clawback



of depreciation and the rate of return has been set at 7%. BG estimates the measures will mean a 15% cut in Transco revenues in the first year and 1% thereafter and could result in up to 8,000 jobs being lost. The Ofgas moves make it unlikely that BG will seek an MMC referral.

Water

Ofwat has expressed concern over executive pay in water companies, urging investors to curb pay and perks. Though institutional investors have largely ignored his requests, institutional investors at United Utilities have indicated displeasure over this year's executive pay proposals.

Nuclear

The £1.4bn sale of British Energy marks an end to electricity privatisation. Including £700m of debt the government will raise £2.1bn, some £500m short of previous estimates. The government has an unsold stake of 12.3% worth £160m. On the first day of trading shares fell from 105p to 94p incurring losses of £50m, the average investor lost £30. This reinforces statements previously made by analysts that there was no clear reason to buy shares in British Energy.

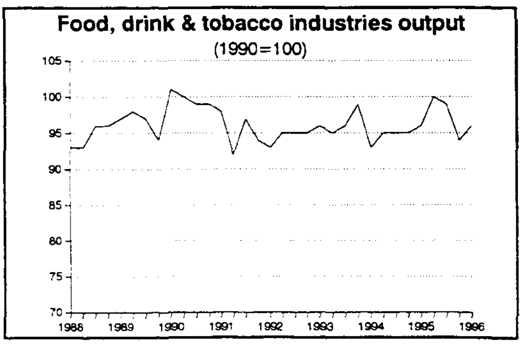
MANUFACTURING

FOOD, DRINK AND TOBACCO

The 6% fall in output recorded in Scotland in the third quarter of last year has been revised downward, but only slightly, from 5% to 6%. It therefore appears that there was some substance in the figures reported by the Index of Production. The figures also show that the reduction was due to reduced output in both food and tobacco and in drink but that drink bore the main burden with a fall in output measuring 7.3%. In the first quarter of this year, however, the industry has made some recovery with output increasing by 2%. Note that these figures are still too early to include the effects of the BSE scare. Indeed, the Index for the first quarter shows that food and tobacco output increased by 3.4% in the first quarter, while output in the drinks sector was unchanged. This strong performance of food and tobacco allowed the combined sector to outstrip the performance of the industry across the UK, where output increased by only 1%.

The July results from the Deloitte and Touche Scottish Chambers Business Survey, the first set of results which would include any effects of BSE, show surprisingly little impact (note, however, that the results for this sector are for Food, Drink and Tobacco as a whole, and that results are not available separately for the food industry, far less for beef alone). 59% of respondents to the July survey expressed no change in confidence from April, and for the remainder there was a net positive balance of optimism of 10%. Clearly, therefore, while the BSE scare has undoubtedly seriously affected some firms in Scotland, its has clearly had a more limited impact on the wider industry. In addition, industry optimism also shows an increase from the same period last year, with a net balance of 8% of respondents more confident. The July survey also reports that 43% of firms reported increased sales in the preceding three months and that almost 45% expect them to increase in the next three. Export sales appear to be holding with 36% reporting an increase and 36% expecting them to increase further, compared to only 21% who expect a decline.

Most company activity in this sector has concerned the drink industry. The main news at the UK level is the proposed deal between Bass and the Allied Domecq-Carlsberg joint-venture Carlsberg-Tetley. Bass has admitted that it is discussing the purchase of Allied Domecq's share of the company which, if successful would make it the UK's largest brewer with a market share slightly in excess of Scottish and Newcastle (which earlier this year became the UK's largest brewer when it purchased Courage). At the time of writing there are still some hurdles to be cleared, mainly concerning possible disposal of Bass's pubs. Another possible hurdle in the shape of a referral to the Monopolies Commission is not felt to be likely, given that the Scottish & Newcastle purchase of Courage was not referred. Of more concern to Scotland is that one factor behind the recent mergers in brewing is over-capacity, and press reports have already suggested



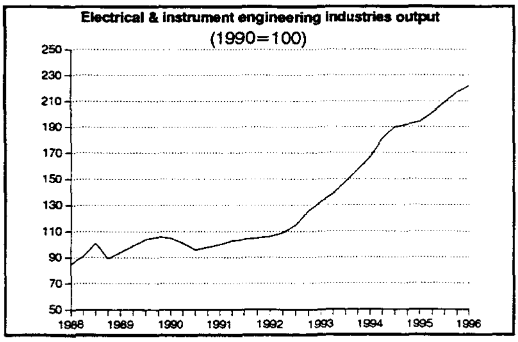
that the Carlsberg brewery at Alloa might be under threat. However, other reports suggest that the company currently has a lack of capacity, and it has explicitly denied that the deal presents any threat to the Alloa plant.

In the whisky industry, Highland Distillers has purchased Macallan-Glenlivet, the makers of The Macallan, one of the world's best-selling malt whiskies. Although Macallan-Glenlivet was initially hostile to the bid, it was quickly accepted as Highland already controlled 26% of the shares and pooled its resources with Suntory which owned a further 25%, giving the two effective control. Macallan-Glenlivet's concerns centred around its belief that the amount paid to the remaining 49% did not adequately reflect the brand's prospects, while Highland and Suntory appear to believe that the company was too small to fully exploit these.

ELECTRONICS

The Index of Production for the Electrical and Instrument Engineering sector in Scotland rose by 2% in the first quarter of 1996, to stand at 222 (1990=100). The last issue of this Commentary cited reports which raised concerns of an industry slowdown, and this is a modest increase by the recent standards of the electronics sector. However, it is fair to point out that the 2% increase reported in the previous quarter has now been revised upwards to 4%, and it would therefore seem wise to await any revisions to the first-quarter figures before commenting further. However, one factor may be that, given that many companies will experience an upsurge in orders in the period before Christmas, some slowdown in the rate of growth in the early part of the year is perhaps to be expected. The growth rate for the first quarter is still above that for all manufacturing in Scotland, where output increased by 0.2%, and greater than that seen in the electronics sector in the UK where output was unchanged. Electronics output in Scotland increased by 12% over the year to the first quarter compared to 3.4% across all Scottish manufacturing, and the sector's annual growth in Scotland in 1995 was double the UK level.

The more recent results from the Deloitte and Touche Scottish Chambers' Business Survey for July 1996 shows mixed news. More respondents felt optimistic than pessimistic over the general outlook in the three months prior to the survey, although the net difference is small at only 6.6%. However, the net balance of optimism over the year to July was greater at 12.8%, roughly similar to the figure in the April survey. New orders had also increased in the three months to July for a net 13% of respondents, with a net of 26% expecting these to increase in the coming three months. There is clearly therefore some expectation of an improvement. The greatest expected increase is in export markets where a net 32% of respondents see an increase in the coming three months.

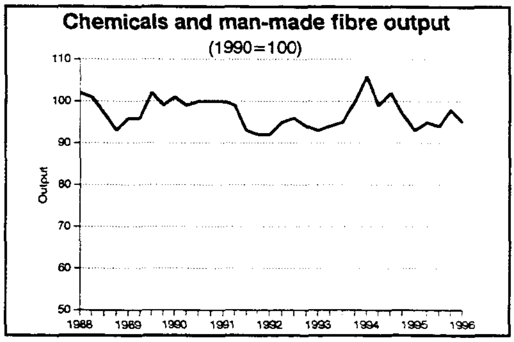


It is correct to point out that the electronics industry has experienced difficulties recently, and this seems to have been the source of the concerns mentioned above. The main worries have been over falling prices for micro-chips which, according to press reports, fell by up to 65% in the first half of this year. However, the source of this now seems to have been increased efficiency which allowed more chips to be produced from each silicon wafer. While increased efficiency will clearly affect the volume of chip production, lower costs should increase demand for the finished product, so that recent concerns over longer term prospects should diminish when the microchip situation is resolved. Chip prices now seem to be recovering somewhat, and the industry may now be beginning to revert to a more familiar growth pattern.

In Scotland, the picture is again dominated by developments in inward investment, particularly from the Far-East. Scotland attracted its first major Korean investment in May, with the decision by Shinho to invest £8 million in Fife to set up a computer assembly plant. This is expected to create around 300 jobs in early 1997. The Taiwanese company Liteon has also announced that it is also to build a monitor plant at Mossend to service the new Chungwa factory. Locate in Scotland had hoped that the Chungwa announcement would help develop a cluster of monitor companies, and there are hopes that the Liteon is the first of several companies which might be attracted to North Lanarkshire. One development outside the Far-Eastern companies is the announcement by IBM that it is to double the number of jobs at its help-desk facility which began operations in Greenock earlier this year.

CHEMICALS

Output in the Chemicals and Man Made Fibre sector fell by 4% during the first quarter of 1996 having witnessed growth of 5% during the previous quarter. Annualised growth fell by 2%. For the UK as a whole there was no change in the rate of growth.



Evidence from the latest Deloitte and Touche Scottish Chambers' Business Survey suggests that whilst a net of respondents reported being less confident than in the previous quarter the majority of firms indicated that they were either more or just as confident than in the same quarter of the previous year.

The rise in total orders continued although at reduced rates, a net of +6%. An easing in the rate of increase had been forecast yet firms remain confident of a strong rise in demand, bar Scottish demand. The rise in sales, a net of +22% was better than anticipated, although Scottish sales, like orders, were weaker than predicted. Both rest of UK and export sales are forecast to rise quite strongly in the current quarter.

Respondents reported an increase in average capacity utilisation [76%] although lack of demand remained the factor cited by the majority of respondents as most likely to limit output during the current quarter [cited by 67% of respondents].

Although changes to investment affected only a third of respondents the rising trend in investment in plant/equipment continued. Investment continued to be directed more towards replacement of existing machinery [46%] and generally less towards expansion [27%]. Respondents expect rising investment levels again with an increased emphasis towards replacement and less towards expansion.

The overall rise in total employment did not occur although some evidence in overtime working was evident.

A joint venture between British Petroleum and French owned Elf, Appryl, is likely to create approximately 200 permanent jobs in addition to temporary construction jobs. The increase in jobs will result from a £100 million investment in Grangemouth to build a propropylene plant which is due to be completed by 1999. Grangemouth was chosen after Locate in Scotland and Forth Valley Enterprises drew up a package of incentives thought to include help with site works and staff training.

Locate in Scotland was also responsible for attracting a US clinical research firm, Quintiles, which is to build a major facility at Inchwood near Bathgate. It will provide a clinical data management service and a packaging and distribution operation. The firm already employs 263 people at Riccarton near Edinburgh. The investment, valued at approximately £20 million was announced in May.

Plans were announced in July to build Britain's largest methanol processing plant in North Colliemore, Buchan by International Offshore Chemicals, an Aberdeen based company. The development will be the first downstream plant in the North sea since the discovery of North Sea Oil and is hoped to boost the Buchan economy with 100 permanent jobs and 600 construction jobs.

Meconic, the Edinburgh based manufacturer of fine chemicals and the worlds largest supplier of opiates, recently bought Phoenix Chemicals whose products include H16, an antidote to nerve gas and insecticides targeted at the tsetse fly. The purchase of Meconic for £6 million in shares and cash will allow Meconic to supply the increasingly complex products sought by the pharmaceuticals sector.

TEXTILES, LEATHER, CLOTHING & FOOTWEAR

The Index of Production for the Textiles, Leather, Clothing & Footwear sector in Scotland increased by 1% in the first quarter of 1996, following a 2% reduction in the final quarter of 1995. While hardly a very significant increase, the performance of the industry in Scotland did exceed that of the UK as a whole, where output was unchanged in the first quarter. Over the year to the first quarter, however, output in Scotland fell by 4%.

The results from the July Deloitte and Touche Scottish Chambers' Business Survey show some limited signs of encouragement. A net 6% of respondents felt more optimistic regarding future prospects, a small increase from the figure of 4% reported in the April survey. In addition, a net 2.5% were more optimistic than at the same time one year previously compared to 9% who felt less optimistic in April.

While the trend in sales was negative in the period up to July, 29.5% of respondents experienced a decline compared to only 20.6% who experienced an increase, the trend in new orders is more evenly balanced and 24.1% expect new orders to increase in the coming three months compared to 19.4% who foresee a decrease. Growth in orders is seen as most likely to arise in export markets.

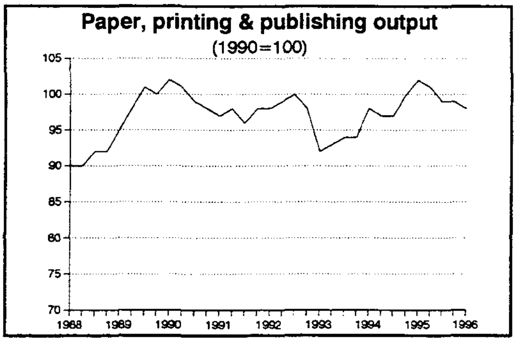
News in the company sector includes the announcement by Dawson International that it is to open a cashmere factory in China, intended to help guarantee raw material supplies in the face of concerns that the Chinese government may introduce restrictions on new foreign investment in cashmere. Lower labour costs do not therefore appear to have played a major part in the venture, which will cost Dawson £1 million. In this respect it is unlike another major textile company, Coats Vyella, which has increasingly sought to source from eastern Europe and Asia, where it is reported that labour costs are between 5-25% of those paid in either Europe or North America.

Finally, the Dundee-based industrial textile manufacturer Scott & Fyfe has acquired Fleming's Lace of Kilmarnock. Although Fleming continues to make traditional lace products, it has increasingly diversified into industrial areas including glass-fibres and this is the main reason behind the acquisition.

PAPER, PRINTING AND PUBLISHING

The Index of Production and Construction for the first quarter of 1996 shows a fall in output growth of -1% for both Scotland and the UK. Annualised growth in Scotland is unchanged with the corresponding UK figure indicating yearly growth of 1%. Output growth within this sector appears to have stabilised with no change on the past annualised growth figure.

In the previous two quarterly reports, declining business confidence had continued amongst respondent firms with more being less optimistic about the future business climate than previously recorded. However, the most recent Deloitte and Touche Scottish Chambers' Business Survey reveals that a net 10% of respondent firms are more optimistic about future business conditions as compared with the situation over the previous 3 months.



The trend in new orders, over the past 3 months, would seem to support the upturn in business confidence, as a net 8% of firms recorded a rise in new orders as compared with a net fall in the previous quarter (-9%). The increased volume in new orders has come through the UK market with a net increase in orders of 19% over the previous 3 months. The Scottish market share of orders has continued to decline with a net reduction of -11%. There was no net change in export orders. This net upturn in orders is forecast to continue over the next three months with a net 15% of respondent firms anticipating an increase in new orders, although export orders are expected to decline by a net -7%.

The trend in the volume of sales increased substantially over the past 3 months, with a net gain experienced by 55% of all respondents. This sector recorded a net downturn in sales in the previous quarter. The increased sales were particularly significant in the UK and Export markets with net increases of 33% and 18% respectively, noted by respondents. The upturn in sales is expected to continue over the next three months as a net 21% of respondents expect sales to increase above their present level.

The average capacity utilisation for the Paper, Printing and Publishing sector has again risen by over 3% points from the previous quarter, and now stands at 79.7%. Investment intentions for plant and equipment and land and building increased, with a net 14% and 3% of respondents indicating upward revisions. A net 10% of respondent expect this upward trend of investment in plant and equipment to continue over the next quarter and similarly, a net 3% of respondents anticipate increased investment in land and buildings. Of those respondents undertaking investment in the past quarter, 47% nominated increased efficiency as the main reason behind the investment decision.

The expected and continued fall in employment, anticipated in the last survey, was again realised with a net -3% of respondent firms experiencing a decline in total employment. This trend is forecast to continue with a net -3% of firms expecting further falls in total employment over the next 3 months.

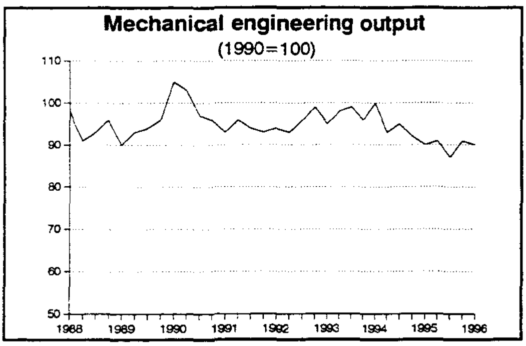
Among Scottish companies, there has been an increased amount of activity in this sector over the last quarter. In particular, the highly publicised take-over of Caledonian Publishing LTD by Scottish Television. Caledonian Publishing is the fifth largest newspaper group in Scotland with titles including The Herald and Evening Times. The acquisition by Scottish Television for £120 million adds Caledonian Publishing to an already growing and diversified Scottish media group which includes ownership rights in HTV (20%), GMTV(20%) and ITN(5%), amongst others. Scottish Television, in part, is owned by the Mirror Group Newspapers (19.9%) which controls two other prominent Scottish titles, the Daily Record and Sunday Mail.

Johnston Press, the Edinburgh based publishing group, has continued its acquisition of regional titles. Their purchase from EMAP (media and exhibitions group) of their regional newspaper business in a £211 million deal has increased their share of the UK regional papers to 6%, making the company the fifth largest publisher in this sector. The deal brings another 65 regional titles to the Publishing Group which now controls an empire of 146 papers with a turnover of £200 million.

Edinburgh based group Sidlaw (packaging and oil operator) reported a pre-tax loss of £4 million for the first six months ending March 1996. This follows a £1.16 million loss in the corresponding period in the previous financial year. This continued poor performance led to the removal of the Chief Executive (Digby Morrow) and there is now increased speculation about a possible take-over by a rival group. Reed Elsevier, the Anglo Dutch publishing and information group reported a 13% increase in first half profits to June 1996 which was attributed to strong performance in their scientific and professional journals. David S Smith (Holdings), the UK's largest processor of waste paper reported a 25% rise in annual pre-tax profits despite continued price volatility within this sector.

MECHANICAL ENGINEERING

Following the annual reduction in output of 5.5% in 1995, the Scottish mechanical engineering industry suffered a further setback in the first quarter of 1996, with output falling by 1% as recorded in the latest Scottish Office News Release (7 August 1996). This latest setback accentuates the gloomy and uncertain nature of the recovery by this industry.



In terms of business confidence, the previously-subdued optimism was turned into business pessimism in Q2 96, as shown in the latest Deloitte and Touche Scottish Chambers' Business Survey which records a net of 5.7% of corresponding firms expressing business pessimism. Moreover, compared with the same time a year ago, business confidence also deteriorated. The deterioration in business confidence arose mainly because the expected rise in the volume of new orders did not materialize in Q2 96, with a net 14.3% firms reporting a fall in total new orders, despite the continuing strength in export orders. However, the poor performance of total new orders is expected to be reversed and a stronger growth rate is expected in Q3 96.

The growth momentum of sales was maintained in Q2 except for Scottish sales, and is expected to do so in all markets in Q3. The process of de-stocking of finished goods and raw materials is still on-going and is expected to last into the next quarter. In keeping with the subdued business confidence, work in progress remained stagnant, as was the rate of capacity utilisation which remained virtually unchanged.

A glimmer of hope for this industry to get out of the present depressing state is that the rise in investment plans for plant/equipment and land/buildings strengthened further and is expected to sustain until Q3 96, albeit at a slower rate. The main reasons for authorising investment were: increasing efficiency, replacement and expanding capacity.

The rather sanguine employment performance maintained in Q2 96, particularly in full-time employment for both male and female employees. However, this good fortune is not forecast to last long as job-cuts are expected in every form of employment in Q3. Nevertheless, against this general background of job-cuts, 44.4% of the corresponding firms experienced problems in recruiting suitable employees in particular occupations. This probably reflects the underlying structural changes that are going on in this industry during the present phase of the recovery process, and little wonder that an increasing number of firms are increasing their training provisions.

SERVICES

DISTRIBUTION

Evidence from the second quarter Deloitte & Touche Scottish Chambers' Business Survey showed that confidence increased further in retailing, while in wholesaling optimism continues to decline. In retailing, a net balance of 14% of respondents were more optimistic about the general business situation than they were in the first quarter, which compares with the 10% balance who were more optimistic in the previous quarter. In wholesaling, a net balance of 6% were less optimistic than in the first quarter, much the same as the negative net balance of 5% in that quarter. Compared with a year ago, while wholesale respondents were again less optimistic, registering a negative net balance of 6%, in retailing, a net balance of 16% were more optimistic.

Sales growth in distribution differed appreciably between the two key sectors in the second quarter. A net balance of 24% of retailers reported that sales had risen, compared with the 15% balance reporting an increase in the first quarter. In wholesaling sales fell, a net balance of 3% of respondents reported a decrease, compared to the balance of 2% of respondents reporting an increase in the first quarter.

In both retailing and wholesaling, investment intentions remain significantly positive. Net balances of 15% and 18% of retail and wholesale respondents, respectively, reported an upward revision in investment intentions compared to the same period a year ago.

Actual retail sales rose at the highest rate in eight years with the volume of consumer spending in non food stores 2.4% higher between April and June than in the previous three months. The value of sales in June was 7.4% higher than the same period of the previous year. Food sales showed a moderate growth but there was a sharp increase in sales of household goods, clothing and other durable items.

John Menzies, the Edinburgh based retailer and newspaper distributor, made £35.9 million before tax during the 53 weeks to 4 May; this was down from £38.1 million in the previous 12 months.

Watson & Philip, the Dundee based convenience store operator and food distributor, reported a 15% increase in interim pre tax profits to £6.91 million. Growth was largely as a result of the addition of 30 new convenience stores and two food distributors.

Scottish Power began selling personal computers through 'Business Solutions' units located in the Group's Sound & Vision stores. They plan to target UK companies with between one and 20 customers who they feel, according to Ian Traynor "are not really being served at the moment." Through their retail, Scottish Telecom and Scotland-On-Line divisions they will provide a telephone based help desk for software support.

FINANCIAL SECTOR

It is perhaps fanciful to identify the Royal Bank's purchase of Warburg's share custody unit as one of the most significant events of the last quarter but there can be little doubt that the purchase is important not just in consolidating the Royal Banks position in one of its markets, but also in signposting the unbundling that is going on in portfolio management and the opportunities and threats such changes create.

The safe keeping of details of share ownership and certificates and other associated information, commonly known as global custody, is one of those tasks that is frequently ignored by investors as trivial and insignificant. In the past it was a service that was taken for granted and provided along with other portfolio management services. For the investment management companies, when numbers of shareholders were small and shareholdings were held, on average, for long periods of time, the problems of custody could be largely ignored. However, as turnover has risen with the more frequent purchase and sale of securities the physical problems of coping with custody have greatly increased. At the same time, the set of securities that fund managers purchase has broadened enormously with extensive investment overseas and all the attendant problems that this can cause, not least the problem that delivery of title in some markets can take weeks or months. Combine these factors with both increased competition amongst custody providers and a reluctance to pay for custody services and there are strong incentives for change in the way in which the industry is operated. Increased use of information technology is an obvious strategy to cope with the changes. The somewhat slow but inexorable move towards scrapping paper based share certificates emphasises the requirement of stockbrokers and markets for extensive electronic record keeping, but such facilities require heavy investment in software, software that once written can be easily duplicated and which can cope with 100 million records as easily as 1 million. The result has been a consolidation of custodian services. The purchase by the Royal Bank of Warburg's custody services makes the Royal Bank the UK's second largest custody operation and the sixth largest in the world.

Custody is, of course, only a tiny part of what investment managers provide for clients. Custody costs unit trusts about 0.05% of assets per year, a small sum compared to the management charges of 0.5 to 1% of assets that the typical unit trust now charges its customers. However there is no reason to believe that the forces operating in the global custody business are unique. Accounting and administration services may equally well be bought in from outside suppliers. Indeed, some trusts have traditionally farmed out their administration whilst a number of contracts have been announced in recent months where the back office activities of investment managers are out-sourced and carried out by other organisations. The concept is not new. The structure of many old established investment trusts where they are operated as individual companies, but have a contract for the supply of management and other services with an investment management house is essentially the same. What is different is that the individual suppliers of services have become much more specialised and the divorce between the investment advise and decision making, and all other aspects of the investment process such as marketing, administration, custody and accounting are becoming more transparent.

Should we care about such changes? For the consumer the changes are probably beneficial. Transparency allows for greater competition and a potential reduction in costs. The halving of global custody costs in recent years is a case in point. Of greater significance, perhaps, than the reduction in costs is the improvement in accountability that will occur as this process of specialisation continues. Although the source of poor investment performance is rarely in doubt, it is after all difficult for a manager to blame poor performance on administrative failings, it has been (and continues to be) difficult to hold managers to account. The unbundling of investment services will improve the ability of investors to hire and fire managers. The departure of one set of managers will not cause enormous dislocation in the administration or marketing of a trust. These functions need no longer be handled by the investment managers but by specialist organisations with well worked out systems and data requirements in place. The onus will be on the new fund managers to supply the appropriate data and conform to particular rules but besides this there will be little problem in changing fund managers. Changing a fund manager could be little different from changing the firm's auditors.

The impact of such changes may be most clearly imagined in the investment trust market where trusts have traditionally been tied to particular investment managers. No matter how poorly the fund has performed the trusts have stayed with the same firm of investment managers. Of course there have been some exceptions, the current battle over Kleinworts European Privatisation fund is a case in point, but the exceptions have been few and far between. The emergence of specialist service providers puts the possibility of a competitive market in fund management advise and decision making firmly on the agenda. Such a competitive market is long overdue. The evidence overwhelmingly suggests that investment managers cannot, on average, earn above average returns except by taking on higher risk. There may be a few exceptional fund managers with particular skills but identifying such managers is difficult if not impossible. In short, most investors do not benefit from the substantial fees paid to fund managers. A market in fund management would allow managers to compete for investment management contracts either by cutting costs or by offering exceptional management skills. At the very least, unbundling should allow investors to get a better idea of how their management charges are spent. The unbundling of investment activities so that specialist companies take on all the different routine operations involved in the running of investment portfolios suggests the possibility of changing fund managers easily and the emergence of a competitive market for retail investment advise and decision making. Such a market is long overdue. It already exists for pension fund investment but the structure of retail investment with investment management intertwined with the provision of other investment services has hindered its development.

It would be foolhardy to suggest that a competitive market in fund management will emerge quickly. Companies and individuals making substantial profits out of the current set up have little incentive to change. Up to the present, the beneficiaries of the specialisation taking place in investment operations have been the companies with marketing muscle who have entered the market, maintained charges and increased their profit margins. However, experience in other markets suggests that over time the availability of specialised service providers will encourage new firms to enter the industry and undercut existing providers. What is required is for these new firms to be Scottish based.

TRANSPORT

Air

BA announced its plan to cease flying to Scottish islands. According to this plan, starting from October BA flights from Glasgow and Aberdeen to the Western and northern isles will be operated by Loganair and Manx airlines, flying under the BA Express franchise banner. The routes affected include Glasgow to Stornoway and Benbecula, Aberdeen to Kirkwall and Sumburgh, Inverness to Stornoway, and Kirkwall to Sumburgh, which are estimated to carry about 250,000 passengers a year. It is expected that the new arrangement may result in job losses, a reduction in service or increased fares.

BA's decision came as a reaction to its rivals, EasyJet and Ryanair, which announced a decision to step up competition on lucrative Scotland-London routes by reducing fares or increasing the number of flights. While EasyJet has revealed a plan to almost double flights from Edinburgh, Glasgow and Aberdeen to Luton, Ryanair announced a fares cut by 15 per cent from £58 to £49 between Prestwick and London Stansted.

Road

A New System of Transport Projects Financing Scheme

Scottish city councils are competing against each other for Government cash under the "challenge funding scheme", a new transport project financing system being introduced in Scotland for the first time. The system of bidding for a specific project marked a departure from the traditional funding methods in which local authorities put in bids for a share of capital resources. In the past, however, the decision concerning the selection of projects and allocation of money among different projects was left to the local authorities.

For 1997-98, the Scottish Office has received about 12 applications involving expenditure of around £100m. Scottish Councils have made another 16 bids for 1998-99 during the last week of July (see Table 1).

A condition of the transport bids is that the planned projects must at least be partly funded through the Government private finance initiative (PFI). Thus the public financing contribution is believed to stimulate a PFI. The strategy of financing transport projects through competitive bidding was introduced in England five years ago as an initiative aimed at regenerating inner cities. More than 30 English cities including Liverpool, Wolverhampton, and Bradford bid for more than £1 billion of cash grants under the city challenge funding scheme. Considering the experiences of English cities, the British Road Federation referred to the challenge funding scheme as "a lottery". English Local Authorities had asked for £2.25 billion this year but had received approval for schemes worth only £800 million. This would be funded by £249m of grants from the central government and £551m from the local authorities. Birmingham, for instance, had bid for £53m, had £31m approved and received £13m while Liverpool city had bid for £13.6m, had £4m of projects approved but received no central grants.

Table 1 Competitive bids by Scottish city councils for challenge funding scheme

City Council	*Project*
Edinburgh (1997-98)	CERT - the Central Edinburgh Rapid Transport Scheme (£40m).
Edinburgh & Fife (joint proposal)	Improving transport links on each side of the Forth Bridge including the upgrading or repl. of the A90.
Glasgow	A new M8-M80 motorway link between the Provan area and Parkhead Forge as part of the regeneration of the east side of the city.
Aberdeen	A park and ride facility at Kingwells with a bus only corridor extending to the city centre (£7m).
Stirling	An arrival bus station with pedestrian links to the centre of the town and to Stirling Castle (£4.5m).

Source: The Scotsman, Monday 5 August 1996.

Mergers and acquisitions in the Bus Industry

There have been major consolidations taking place in the bus industry during the last quarter. In a £110m deal, FirstBus, which was created in June 1995 from the merger of Aberdeen's GRT and Weston super Mare-based Badgerline, have recently bought the Strathclyde Buses Holdings. With this and a previous takeover of the Greater Manchester Buses for £47m, FirstBus became the biggest bus operator in the UK with a 20 per cent market share. It is reported that the company will invest £21m over the next two years in 210 new buses for Strathclyde Buses. Profits were £32.5m for the year ending 31 March, £200,000 above that forecast and up from £24.8 million the year before. The total profit margin for the group's bus businesses rose to 13.6 per cent. With the Strathclyde acquisition already surpassing expectations, FirstBus is on course for a 15 per cent target by March next year.

In still another major drive for consolidation in the bus industry, Cowie took over British Bus in a £282.3m offer. The takeover of British Bus, which owns Clydeside Buses in Scotland with 300 buses and 565 staff, could increase Cowie's market share, from just 4.5 to 16.5 per cent. As a result Cowie has moved up from the sixth to the third largest company in the bus industry, just behind the Perth-based Stagecoach with 17 per cent.

Rail

InterCity East Coast became the first passenger train company operating in Scotland to be privatised, being taken over by Greater Northern Railways, a subsidiary of Sea Containers (the international transport and hotels group). A loss of jobs was felt as an immediate effect of this privatisation shake-up in Scotrail. Eight of the thirty top managers have lost their jobs and it is expected that there will be more redundancies. In the past InterCity East Coast has been paying Scotrail for the supply of drivers but is now planning to use its own drivers and this may have a knock-on effect on Scotrail.

In a price war with the airlines between central Scotland and London, the privatised company is now offering a £19 single ticket from Edinburgh, Glasgow, Dunbar and Motherwell to Kings Cross. This shows a 72.1 per cent fare cut compared with the previous £68 single ticket from Edinburgh to London. Since the main airline competition comes from the Glasgow and Edinburgh airports, however, there is no such fare cut from stations north of the central belt of Scotland. The new fare is planned to be promoted in a £250,000 marketing campaign. This price cut follows from the recent announcements by BA airlines, Ryanair and EasyJet to enhance competition for Scotland-London passenger transport.

The implementation of the Cairngorm funicular project, the £17m Scottish Highland railway development, will begin next spring. The aim of the project is to create one of the biggest tourist attractions in Scotland. However, due to its potential impacts on the natural environment of the area, the project was opposed by Scottish National Heritage and other environmental groups. It was the recent consensus reached between the SNH and the developer (the Cairngorm Chairlift Company) over the terms of a visitor management plan that made the planned implementation of the project possible.

The leading bus operators are not limited to the bus industry in their takeover bids and have also made ambitious expansions into rail services. Bus companies have acquired three of the first eight passenger rail franchises. National Express acquired two rail services - Gatwick Express and Midland Mainline - and Stagecoach took over South West Trains. Two further franchises have been awarded to consortiums in which bus companies have a stake. While there are a number of bus companies showing interest in the rail business, Stagecoach is planning to bid for all the remaining rail service franchises.

This shows a growing tendency for vertical integration - as operators seek to acquire rail rolling stock owners, or horizontally with bus companies expanding into rail services. This has caused a major concern that government policy which was intended to increase competition in the transport sector through bus and rail privatisation would end up creating a private-sector oligopoly. The two most controversial takeovers have already been referred to the Monopolies and Mergers Commission (MMC): the takeover of the Midland Mainline rail franchise by National Express and the acquisition of Porterbrook Leasing by Stagecoach. One of the things that made the latter case most controversial was the considerably high mark-up of £300m (the takeover bid was £825m) over the privatisation price.

Sea

The 66-mile network of the Caledonian Canal needs to be maintained as a matter of urgency, according to a report from the British Waterways, as ageing infrastructure has made the Caledonian canal one of the most dangerous in the UK. The major sources of worry are weak embankments and bridges near residential areas, power stations and railways.

Reduction of government funding by £92m over the last decade has been cited as one of the most important causes for poor maintenance of the UK canals. The Caledonian Canal serves about 100,000 people and its repair cost is estimated to be around £20m.