

THE SCOTTISH ECONOMY

SHORT-TERM FORECASTS*

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

The present forecasting period extends to 1997Q3, and the National Institute's quarterly forecasts for UK manufacturing output are used in driving the Scottish forecasts. Figure 1 depicts the actual growth rates for Scottish manufacturing output from 1988Q1 to 1996Q2 and the forecasts for 1996Q3 to 1997Q3. The forecasts show that the overall growth trend of Scottish manufacturing output will maintain throughout the forecasting period. However, the growth momentum will subdue towards the second half of 1996, then start to pick up in the first quarter of 1997, and finally tend to weaken again thereafter. For 1996 as a whole, the output of Scottish manufacturing industries is predicted to rise by around 2.7% over 1995. Further details of growth rates for Scottish manufacturing outputs are presented in the following table.

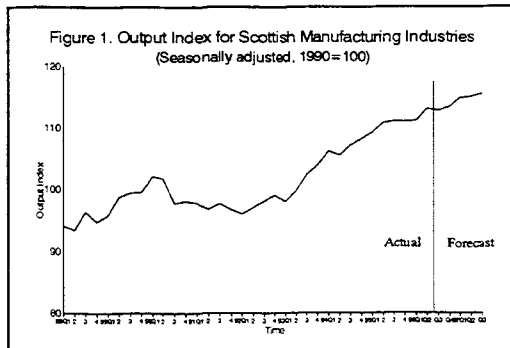


TABLE 1. QUARTERLY GROWTH OF SCOTTISH MANUFACTURING OUTPUT (%)

92/91	0.4
93/92	4.1
94/93	5.0
95/94	3.5
93Q4/92Q4	4.8
94Q4/93Q4	4.1
95Q4/95Q4	2.6
94Q4/94Q3	1.0
95Q1/94Q4	0.9
95Q2/95Q1	1.5
95Q3/95Q2	0.3
95Q4/95Q3	0.0
96Q1/95Q4	0.2
96Q2/96Q1	1.7
FORECAST	
96Q3/96Q2	0.0
96Q4/96Q3	0.6
97Q1/96Q4	1.3
97Q2/97Q1	0.2
97Q3/97Q2	0.4
96/95	2.7

* 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.

THE DELOITTE AND TOUCHE SCOTTISH CHAMBERS' BUSINESS SURVEY CONSTRUCTION

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. In the present survey which was conducted in September, 801 firms responded to the questionnaire of which 797 were useable.

Business Confidence

In manufacturing, business confidence continues to rise. A net balance of 10% of respondents reported that they were more optimistic than three months previously, compared with a balance of 3% who were more optimistic than in the second quarter. In the third quarter, manufacturing respondents continued to be more optimistic than they were a year ago, with a net balance of 9% of respondents reporting higher optimism.

In construction, optimism continues to fall but at a slower rate than in the second quarter. A net balance of 6% of respondents reported that they were less optimistic than in the second quarter. This compares with a 14% balance of respondents who were less optimistic in the second quarter over the first quarter of 1995. A net balance of 1% of respondents reported that they were less optimistic than they were a year ago, compared with the situation in the second quarter where a net balance of 14% of respondents were less optimistic than in the same period a year earlier.

In distribution confidence rose further in retailing, while in wholesaling the decline in optimism has almost ceased. In the third quarter in retailing, a net balance of 20% of respondents were more optimistic about the general business situation than they were in the second quarter, which compares with the 14% balance who were more optimistic than in the first quarter. In wholesaling, a net balance of 1% were less optimistic than in the second quarter, a reduction on the negative net balance of 6% in that quarter. Compared with a year ago, wholesale respondents were again less optimistic, registering a negative net balance of 11%, while in retailing, a net balance of 25% were more optimistic.

Respondents in the tourism and leisure sector reported another considerable increase in confidence. In the third quarter, a net balance of 43% of respondents indicated that they were more optimistic about the general business situation than they were three months earlier, much the same balance as in the second quarter. A net balance of 52% of respondents were more optimistic in the third quarter than in the third three months of 1995.

Orders and Sales

In manufacturing, orders and sales continue to rise in the third quarter, at a faster rate for orders and at the same rate for sales. For orders, a net balance of 7% of respondents reported an increase while, for sales, a balance of 9% of firms experienced a rise. These figures compare with positive balances of 1% for orders and 9% for sales in the second quarter. Orders and sales from the domestic Scottish market are now rising again, while orders from the rest of UK fell slightly as sales rose. Export orders and sales continued to grow quite strongly, at a slower rate for orders but at a faster rate for sales.

In construction, new orders continued on a downward trend and at a faster rate than in the second quarter. A net balance of 31% reported a decrease in orders compared with a net balance of 5% reporting a decrease in the second quarter. Orders from both central government and other public sector continue to be severely depressed, while orders from the private sector remained static after rising in the second quarter.

Sales growth in distribution continued to differ appreciably between the two key sectors in the third quarter. A net balance of 37% of retailers reported that sales had risen, compared with the 24% balance reporting an increase in the second quarter. In wholesaling sales fell again. A net balance of 14% of respondents reported a decrease, compared to the balance of 3% of respondents reporting a fall in the second quarter.

Tourism demand increased further in the third quarter again at a faster rate than in the previous quarter. A net balance of 67% of firms reported an increase compared with a balance of 56% reporting a rise in the three months to June. 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 rose. A net balance of 2% reported a fall in stocks of raw materials while for finished goods the negative net balance was also 2%.

Finance and Investment

In the financial sector, the demand for personal loans continued to rise at much the same rate as in the second quarter. A net balance of 40% of respondents reported a rise, compared with the balance of 42% reporting an increase in the second quarter. Advances to the corporate sector are also rising strongly, while the demand for working capital continues on a strong upward trend. In addition, the demand for finance for investment in buildings and for investment in plant and equipment is continuing to rise.

Manufacturing investment intentions in plant and machinery were again revised upwards in the third quarter, with a net balance of 4% reporting an increase and respondents expect to revise these intentions up further again in the fourth quarter of 1996. The deterioration in manufacturers' investment intentions in land and buildings continues although at a slightly slower rate. A net balance of 2% of respondents reported a decrease, compared with a balance of 3% reporting a decrease in the previous survey. Respondents also expect a slight further decrease in buildings investment in the fourth quarter of this year. In construction, investment intentions continue to decline, while in retailing and wholesaling, investment intentions remain significantly positive. Net balances of 14% and 15% of retail and wholesale respondents, respectively, reported an upward revision in investment intentions compared to the same period a year ago.

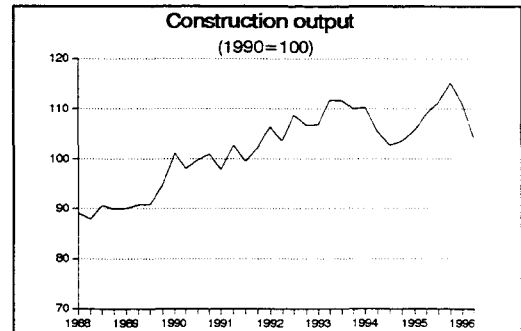
Expectations

With the exception of retailing and tourism, the outturn in the third quarter was *worse* than expected by respondents in the second quarter. In manufacturing, while the outturn was generally worse than expected in the second quarter this did not fully apply to export performance, where orders were only slightly down on expectations and sales slightly bettered expectations.

Demand conditions are expected to improve in the fourth quarter in all sectors except construction and wholesaling. Manufacturing is expecting a strong increase in orders and sales, with the biggest anticipated improvement coming from the Scottish

and rest of UK markets. In retailing strong growth is expected but at a somewhat lower rate than the outturn in the current quarter.

CONSTRUCTION



The latest available Index of Construction shows that in the second quarter of 1996, output in the Scottish construction industry stood at 104.3, a fall of 6% from the previous quarter. This represented an increasing decline over the 4.2% fall in the first quarter. The year on year figure, however, still recorded an increase of 5%.

Signs of ongoing stagnation are still evident in the UK as a whole, whose second quarter figure of 89.6 is barely changing (a mere 0.1% up on the previous quarter). However, despite this, the year on year figure shows a fall of 1.2% reflecting the industry's recent decline.

While the Scottish construction index shows definite signs of continuing decline, the UK as a whole is bumping along the bottom, with no indication of an upturn.

In the third quarter of 1996, the Deloitte & Touche Scottish Chambers' Business Survey states that overall business optimism has fallen for a net 6% of respondents, which is less than in the previous quarter. Only a net 1% of respondents are less optimistic than they were a year ago compared with a net 14% in the previous quarter.

That this gives a sign of encouragement is countered by the trend in total orders which is downwards for a net 31% of respondents, a considerably larger balance than the net 5% who were experiencing a declining trend in the previous quarter.

As in previous quarters the trends in public sector orders have been strongly negative for both central

government and other public sector orders, with reported balances of -61% and -55% respectively.

Of slight encouragement is the fact that respondents report that only a balance of 6% foresee the trend in total new orders continuing to decline. However, orders from central government are expected to continue to fall for a net 33% of respondents and other public sector orders are expected to continue to decline for a net 26% of respondents.

For some considerable time now private sector orders have helped to counter declining public sector orders. In the third quarter orders from the private sector are flat with a slight improvement (a balance of 2%) forecast for the fourth quarter.

The actual trend in employment continued downwards for a net 12% of respondents, with a balance of 28% shedding the self employed. The trend of using flexible labour ie part-time, temporary, sub-contracted and the self employed, to act as a buffer against fluctuations in demand is evident in the construction sector as in the rest of the economy, and is forecast to continue.

Capacity utilisation at 81% is 1% up on the previous quarter. Of those firms who reported increasing wages and salaries the average increase was 3.33% which is slightly lower than the 3.8% reported in the previous quarter. And 46% of respondents attempted to recruit with a balance of 8% experiencing increased difficulties.

The latest NHBC figures for housing starts in the third quarter 1996 show Scotland with 4,400, an increase of some 700 over the previous quarter. This gives Scotland 10.8% of UK housing starts compared with 9.8% in the quarter before.

Looking at the last two twelve month periods and comparing them shows that in the UK as a whole there was a 9% fall but in Scotland the fall in housing starts was 11%.

Whilst the NHBC figures provide a mixed message the most up-to-date information on the construction industry is a bit more buoyant. Recent performances have been mixed and there has been a lot of acquisition and merger activity.

Hewden Stuart has taken over the Agent Plant Group from Kvaerner Construction for £9.35million. Tarmac has turned in very poor half year results. Barratt has increased turnover by more than £54.3million to £634.3million. Redland,

the building materials group, has been severely affected by the collapse of the market in Germany as has its rival the RMC Group. Beazer Homes saw pre tax profits slipping by almost £10million to £46million.

Overall the industry is affected by the poor take up of the Private Finance Initiative and by the length of time planning applications take to process approval. When the foregoing is coupled with the Environment Agency's singling out of the construction industry as the country's second worst water polluter (after sewerage companies) it is little wonder that the sector is not overly confident about the future.

ENERGY

Oil & Gas

The latest quarter, Q3 96, has seen oil and gas revenues grow by 24.6% over the same period last year despite oil production being at its lowest level in August since June 1995. Oil revenues have reached their highest levels since October 1990. Average daily oil production has decreased by 3.4% on an annual basis with no significant change over the quarter. Average daily gas production has fallen by 26.3% for Q3 on Q2 96 but is only down 3.4% on an annual basis. The oil price remains high averaging \$20.86 in Q3 96, a rise of 28.8% over last year. While this price level is not sustainable over a longer time period, the severe winter forecast for the US, low stocks and Iraqi uncertainty suggest that the price will not fall significantly in the short term.

The Royal Bank of Scotland's combined oil & gas index fell by 8.6% for Q3 96 on Q2 96 but rose by 2% on an annual basis. The quarterly change is due mainly to a 26.3% fall in gas production. The annual change reflects increased gas production to levels above that seen in 1995 which masks the decrease in oil production over the year.

The oil price for Brent crude has reached its highest level since the Gulf War peaking at \$25.18 in October 1996. The oil price has risen 9.7% on a monthly basis and 34.8% on an annual basis (month to month). With sterling appreciating against the dollar, Brent crude averaged £14.42 per barrel, a 9% increase on a monthly basis. Other factors underpinning the oil price include a higher level of demand and non OPEC supply failing to match expected output. The increased use of just-in-time supply means prices are more likely to move

suddenly and this uncertainty over the winter will maintain the high price level.

The main net changes in oil production in Q3 96 were increases of approximately 30,000bpd at Shell Tern, Shell Dunlin and BP Andrew. Amerada Hess and Mobil brought on stream the new fields Fergus and Nevis. The largest falls in production are Chevron Alba and BP Miller. Gas production increased significantly at BHP Ravenspurn and the Conoco V fields whilst BP's Cleeton and Bruce recorded large decreases in gas production.

Terminal throughput fell in Q3 96 at Cruden Bay by 33,218bpd. Both Flotta and the Forties system saw substantial increases. Gas throughput fell at Easington, (150mmcf/d), but rose at St. Fergus and Theddlethorpe. Tanker uplift grew in line with oil production.

The Aberdeen Chamber of Commerce Oil & Gas Survey for Q396 indicates that a third of respondents expect an increase in exploration work. The rise in Scottish based activity was weaker than expected and it is expected that UK exploration work will decline over the next year. Average capacity used has fallen to 76.6% in Q3 96 from 86.3% in Q2 96. Oil & Gas related employment was increased by 44% of respondents but more temporary, sub-contract and self-employed workers were used than expected.

Oil output from the North Sea is forecast to fall in 1996 according to Wood McKenzie. Delays in several projects has meant production is down 2% on 1995 for the first half of 1996 and the estimate for production for 1996 is now 2.6million bpd, this will mean deferred revenue of £500million. Decommissioning costs in the North Sea could come to £8.7billion of which Shell, Esso and BP account for 40% of these costs. Abandonment is thought to reach a peak in 2007 to 2018. Companies are increasingly forging alliances to cut exploration and production costs in efforts to prolong activity in the North Sea.

The government has approved Shell/Esso's £300million plan to develop the Curlew field. It involves a floating production system producing 45,000 bpd in 18 months time. 100mmcf/d of natural gas will be piped to St. Fergus. With reserves of only 71million barrels of oil and 244bn cubic feet of gas the estimated life of the field is 8 years. Shell have also gained approval for the £220million satellite Kingfisher field where reserves are estimated to be 56million barrels of oil and

368bn cubic feet of gas giving a life expectancy of 9 years.

The DTI have supported Elf/Shell's plans to land Shearwater gas at Bacton not Teeside. Chemical producers on Teeside have condemned the decision as 'a wasted opportunity'. Elf wishes to export gas to Belgium via Bacton and Shell wants to supply the lucrative South East markets. The UK and Norway have reopened talks on Norwegian gas exports which will only add to the present over supply.

Coal

Waverly Mining Finance has reported a pre-tax loss of £4.5million due to production problems at Monktonhall colliery. Mining (Scotland) made profits of £7.6million in the 15 months to March 31st 1996. Demand for Scottish coal is set to increase in the next few years despite the current substitution of gas for coal in electricity generation.

RJB is to spend £300million developing a deep mine in Nottinghamshire, the first for fifteen years. It will take 15 years to develop, produce 3million tonnes coal per annum and employ 300 people. The government is to spend £400million on the former British Coal sites in regeneration and decontamination programmes. The sites are mainly in the Midlands and the North. The initiative is hoped to create 55,000 jobs.

UTILITIES

The Index of Production and Construction for electricity, gas and water in Scotland shows a decrease of 1.8% for Q2 96 on Q1 96 and a 5.4% increase for the latest four quarters on the preceding four quarters. This compares with UK increases of 1.0% and 4.4% respectively. The negative change in Scotland on a quarterly basis reflects decreased domestic demand. In E&W gas consumption has increased by 15%. Higher demand in E&W has meant net imports from Scotland and elsewhere have risen considerably, and Coal consumption has decreased by 7%.

The Labour Party propose a windfall tax on utilities if elected. The tax is designed to combat:

- underpricing of companies when privatised;
- the opportunistic behaviour of companies due to ineffective regulation;
- the exploitation of monopoly market power over consumers.

It has been suggested that rather than raise £2.5 billion, much more, possibly £5-7 billion could be collected. While in principle the idea may seem equitable and straight forward, the whole issue is becoming increasingly complex. The tax must not be discriminatory, i.e. it must be applied to all utilities, (even BAA), and should not distort competition if it is to be legally sound. If it is to be borne in the main by shareholders then it can only be a one off exercise, otherwise they will demand a higher return which in the long run will lead to higher prices. There are also no guarantees that it will not be passed onto employees in terms of job losses or that consumers will suffer as investment is cut back. The regulators have previously signalled that prices should not rise to pay for the tax but the Director General of Ofwat has reservations about this. Prices must be set at a level that allows the utilities to make a profit and continue to invest in the business. Finally the tax may not apply to those who made early large gains and then have sold out and moved on leaving institutional investors and consumers to weather the storm.

Electricity

Scottish Hydro-Electric, (SHE), have failed to buy British Gas's, (BG), domestic gas supply business in Scotland and the North of England. The £250 million deal would have given SHE access to 2.5 million gas consumers as well as the opportunity to sell electricity to them in 1998. SHE still have plans to expand into the supply business and are currently considering £1bn of projects.

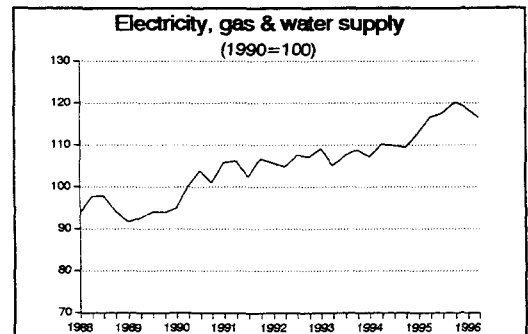
The Scottish Secretary has rejected some of the inquiry inspector's recommendations on the Interconnector project to Northern Ireland. He has asked for one quarter of the 60km powerline to be laid underground, however, Scottish Power have stated this will more than double the £20 million cost of this part of the project which may make it unviable. This type of intervention could set a precedent for future powerline inquiries with political issues becoming more important. The inquiry for a gas fired power station at Gartcosh may only consider planning issues and not the wider economic effects on the mining and generation industries. These terms of reference would tilt the balance in favour of Powergen. Its opponents fear that up to 1,000 jobs could be lost for only a direct gain of 35 jobs to local residents.

East Midlands Electricity has been bought by Dominion Resources of the US for £1.3bn. It is

one of the best managed Recs with pre-tax profits of £214 million from its core businesses. Cal Energy have made a hostile bid of £766 million for Northern Electric. If this were to go ahead then of the 12 Recs at privatisation, six will be American owned and only three will remain independent. United Utilities or SHE would be acceptable buyers for Northern's supply business.

Gas

British Gas have referred the Director General's decision on Transco to the MMC. The main arguments they state are Transco will lose £400 million in revenue, up to 10,000 jobs out of 20,000 could be lost and that international expansion plans would have to be dropped. The regulator has refused to be hounded emphasising that the present arrangements are against the public interest. The MMC inquiry could take a wider remit than price control alone. If the findings are in favour of BG then it calls into question the unaccountability of independent regulators but if Ofwat's views are upheld then this will seriously shake up a monopoly that is still largely unresponsive to the changing environment it finds itself in.



Water

Southern Water, now owned by Scottish Power is to make cost savings of £45 million. Job losses are estimated to be 4,000 although there will be no compulsory redundancies. A major strategic change is to concentrate on its core businesses with no further overseas commitments. Ian Lang has ruled against Severn Trent and Wessex's bids for South West Water. The company intends to buy back 10% of its shares and increase capital spending. The Labour Party have proposals to force water companies to increase spending. The water companies are to face a price control review in 1999, five years earlier than expected. This is due

to the substantial recent improvements in performance which the Director General wants passed on to consumers.

Nuclear

British Energy, (BE), is to shed 1,500 jobs of which 260 will be in Scotland. These will be spread evenly between Hunterston, (95), Torness, (80) and East Kilbride, (85). This is to achieve savings of £50million, however, BE still requires further savings and a merger between Nuclear Electric and Scottish Nuclear has not been denied.

The UKAEA has revealed ten previously unreported incidents at the Dounreay plant in the past twenty two years. The implications are the site suffered unreported damage or that incidents were dealt with but not made public. The integrity of the UKAEA has been called into question with opposition parties calling for an inquiry.

MANUFACTURING

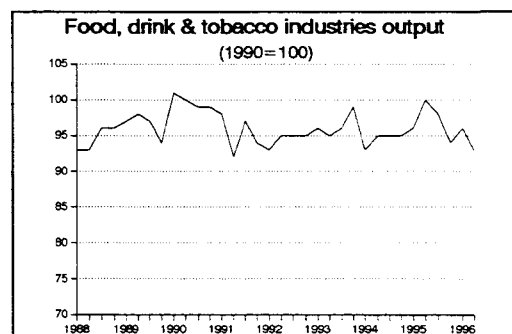
FOOD, DRINK AND TOBACCO

The Index of Production for the Food, Drink and Tobacco (FDT) sector in Scotland fell by 3% in the second quarter of this year to stand at 93 (1990 =100). Production fell in both parts of the industry, although more so in Food and Tobacco (4%) than in Drink, where output fell by only 1%. Industry performance in Scotland was below that of the rest of the UK, where both parts of the industry saw no change in output. As before therefore, we expect FDT to continue to bump along an essentially unchanged level of output, a situation which has persisted since 1990 (see graph).

The third quarter results from the Deloitte & Touche Scottish Chambers' Business Survey do, however, show a positive balance of optimism with regard to the sector's immediate prospects, with 31% of respondents more optimistic than in the previous survey, compared to 15.4% who felt less optimistic (although the proportion who felt more optimistic compared with one year previously was 42%). The trend in new orders in the sector was flat, with 74% reporting a level trend, and 74% expect this to persist over the next three months. In export markets, particularly important to the drink sector, however, there was a strongly positive balance of companies who expected exports to increase in the coming three months, 54% of respondents expect export orders to increase

compared to only 10% who expect a fall. The industry was currently working at 72% capacity utilisation, no change from the previous quarter, and 63% of respondents cited a lack of orders or sales as the factor most likely to limit output in the next quarter.

News in the company sector includes the announcement that Scottish Pride is proposing to sell off its cheese and butter operations to Scottish Milk, its major supplier of milk. Scottish pride is currently the subject of a proposed takeover bid by Robert Wiseman dairies which, if successful, would leave Wiseman with around 75-80% of the Scottish milk market (the deal is currently with the Monopolies and Mergers Commission). While Wiseman is not thought to be interested in Scottish Pride's non-milk business, Scottish Pride has stated that it wishes to resist any takeover, it is believed that selling the butter and cheese operations could help to strengthen its balance sheet.

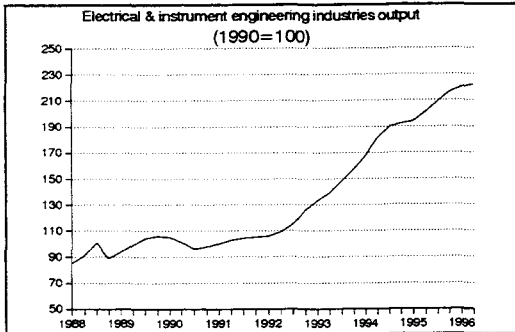


Hopes that the Scottish Secretary might be able to introduce some limited relief from the BSE ban for Scottish farmers have not materialised. The argument that some BSE-free certified herds in both Scotland and Northern Ireland might be excluded from the ban fell through, after the EC announced that there was no possibility of "regionalising" the ban until after the UK has carried out the slaughter of the 147,000 cattle agreed at the Florence summit.

In the whisky industry, Highland Distillers has announced that the takeover of Macallan-Glenlivet cost it around £3million in re-organisation costs, adding to a poor financial performance last year. Total profits fell from £43million to £37million, with shares falling 9p as the results were below expectations.

ELECTRONICS

The Index of Production for the Electrical and Instrument Engineering sector in Scotland rose by only 1% in the second quarter of this year to stand at 222 (1990=100), the second quarter in succession during which output has increased only modestly. Unusually, growth in electronics is also below the average for all manufacturing, where output increased by 1.8%. Output growth was also low across the UK, where output also increased by only 1%. While reports of the industry's demise are almost certainly premature, it does begin to appear that electronics growth has modified somewhat from the rates which we have come to expect of the sector, and earlier issues of this Commentary (eg May 1996) have noted reports which suggested that world growth in electronics may have slowed. It is as yet too early to assess the duration of this slowdown, and recent press reports (see, for example, the *Financial Times*, 10 October, 1996) have suggested that the industry is beginning to pull out, with chip prices increasing from last year. However, should the next issue of the Index of Production show that growth has been low for three successive quarters, then questions will begin to be raised about how much the industry can contribute to the local economy.



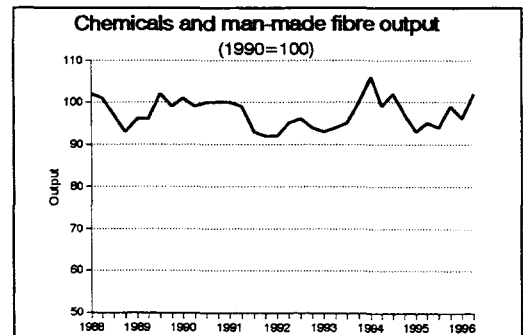
The third quarter results from the Deloitte & Touche Scottish Chambers' Business Survey are also less than encouraging. The balance of optimism amongst respondents in the electronics sector was negative, with 27% of respondents feeling less optimistic than at the time of the previous survey and only 15% feeling more optimistic. The trend in new orders was negative for 34% of respondents compared to only 26% who reported an increase. However, some bright news is that the expected trend in the next three months is expected to become positive, with 36% reporting that they expect an increase compared to 20% who foresee a decrease. There is expected to be a positive shift in

the important export markets, where 34% see orders increasing compared to 22% who anticipate decreases. However, 91.6% of respondents see a lack of orders or sales as the factor most likely to curb output in the next quarter.

In the company sector, the main news is the attraction of another large Far-Eastern investment, with the announcement that the South Korean company Hyundai Electronics is to build a £1 billion semiconductor plant at Dunfermline. The plant will open in 1999, and is expected to create around 700 new jobs. Hyundai have followed several other Far-Eastern companies into Scotland, the most recent being the Chungwa factory at Mossend.

CHEMICALS

The Index of Production and Construction for Scotland showed a 6% increase compared to the first quarter whilst year on year production had increased by 1%. The corresponding UK figures showed an increase of 1% in the quarter and 3% in the year.



Evidence from the latest Deloitte & Touche Scottish Chambers' Business Survey indicates that respondents are more confident about the general business situation than in the previous quarter and the same quarter of 1995.

The increase in confidence reflects the continued increase in both total orders and sales, even though the trend in total orders weakened due to less than anticipated increases in rest of UK and export orders. Firms remain confident that total orders and sales will continue to increase during the current quarter. Despite the forecast increase in orders/sales the majority of firms continued to cite lack of demand as the factor most likely to limit activity during the current quarter whilst 24% cited plant capacity.

Respondents built up stocks of finished goods, no change was reported in stocks of raw materials or the amount of work in progress. Although, on balance, firms expect to run down stocks of finished goods and raw materials during the current quarter and a net of respondents expect work in progress to decline, the majority expect no change.

On average firms were utilising 82% of available capacity which was regarded as an increase compared to the same quarter of the previous year for a net of respondents.

Although the majority of respondents made no revision to investment plans in land and buildings 12% revised intentions downwards, investment intentions in plant equipment were flat [0%]. Investment authorised was for the following purposes: capacity expansion [36%], replacement [27%] and increasing efficiency [27%].

There was no net change in total employment, though there was increased female employment in full time, part time, temporary and sub contracting positions, this was at the expense of self employed staff. Despite the flat trend in total employment 76% of firms attempted to recruit. Although none reported any increase in recruitment difficulties, problems were experienced by those seeking to recruit technical, professional and managerial and skilled manual staff and to a lesser degree other manual, part time and temporary staff.

Oxford BioMedica, the gene therapy company, published its pathfinder prospectus in early November for its planned flotation. The proceeds will be used to provide working capital, fund ongoing research and development and recruit up to 30 staff in the first year. Further clinical developments are to be funded through corporate alliances.

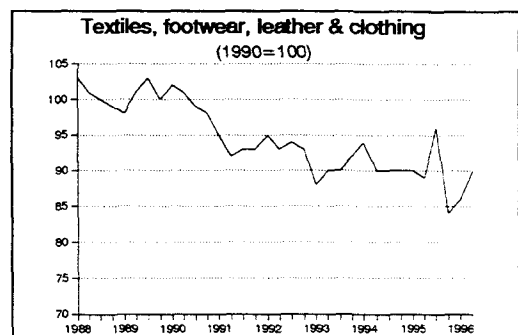
Scotia, the Scottish based biotechnology company, revealed that progress had been made towards approval of its new diabetes and cancer drugs. Regulatory go ahead for Tarabetic, which treats nerve damage suffered by diabetics, depends only on the UK Department of Health now that all questions raised by the regulators have been answered. Scotia's cancer drug, which protects blood against the effects of radiation therapy, has been accepted for consideration by the London based European Medicines Evaluation Agency. If the EMEA makes a recommendation this leads to simultaneous approval in the 15 member states of the European Union.

BP Chemicals announced a £500 million expansion in Grangemouth which will take place over the next five years. The expansion will provide approximately 1,500 jobs during construction and up to 250 operational jobs. The company is to expand ethylene production by over 40% and invest in new polyethylene capacity. The announcement followed the decision by Ian Lang which will ensure that Grangemouth will continue to have access to plentiful supplies of chemical feedstock from North Sea oil and gas well into the next century.

Following the announcement of positive European test results for Lexipafant, British Biotech reported that it expects to have a major new product on sale in 1998. The new drug which is to be given the name Zacutex treats acute pancreatitis, an illness that can cause failure of liver and kidneys and which affects up to 100,00 cases in Europe each year and up to 200,000 cases in the US. Trials in the US are not expected to be completed until the middle of 1997 and the group expects to make a formal application to the US Food and Drink Administration in the first quarter of 1998.

TEXTILES, LEATHER, CLOTHING AND FOOTWEAR

The Index of Production in the Textiles, Leather, Clothing and Footwear (TLCF) sector in Scotland rose by 5% in the second quarter of this year, in excess of the 1% increase seen in the industry across the UK, and the second quarter increase in TLFC output also outstripped the 1.8% rise seen in the whole of manufacturing sector in Scotland. Although the figures are only for one quarter, this is encouraging news given the sector's performance in recent years (see the attached graph), and follows a 1% rise in output in the final quarter of last year. Despite this, however, output in the year to the first quarter fell by 4%.



The Deloitte & Touche Scottish Chambers' Business Survey also show some limited signs of encouragement. The balance of optimism in the sector was positive, with 30% feeling more optimistic than during the previous survey compared to only 15% who felt less optimistic, although 54% of respondents reported no change. The trend in new orders was also positive, with 42% reporting an increase in the previous three months compared to 18% reporting a decrease. In addition, most respondents, 90% in total, expect the trend in new orders to either grow or to continue at the increased level in the coming three months. There was a positive balance in the trend in new orders in both UK and export markets and both, but particularly export orders, are expected to increase strongly in the coming three months. Capacity utilisation is high at 72%. However, while these figures are encouraging, there is an indication that the improvement may be somewhat fragile, in that 63% of respondents cited a lack of orders or sales as the factor which they felt was most likely to limit output in the coming three months.

In the company sector, the main news in recent months has been the announcement by Claremont Garments that it intends to close its Glasgow factory with the loss of up to 700 jobs. The company is a major supplier to Marks and Spencers, and the closure follows a restructuring which will see the Glasgow work transferred to England.

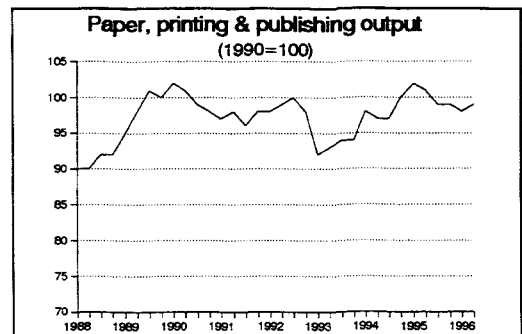
The well known Scottish mini-conglomerate Grampian Holdings has purchased the Langotholm-based woollen retailer Edinburgh Woollen Mills (EWM) for £65million, and Grampian is also to buy EWM's main supplier, Scottish Woollens Group, for a further £5million. Grampian already owned 255 of EWM's shares, and the purchase now gives it control of the company's 230 shops.

Dawson International has purchased an American company, Forte Cashmere, for \$1million plus possible further performance payments. The deal is intended to strengthen Dawson's distribution interests in the USA, and follows its recent opening of a cashmere factory in China.

Finally, the Dundee-based fabric company Halley Stevenson has been purchased by its management for £6.4million. The company specialises in making special finishes, such as the waterproofing for Barbour waxed jackets.

PAPER, PRINTING AND PUBLISHING

The Index of Production and Construction for the Paper, Printing and Publishing sector in Scotland increased by 1% in the second quarter of 1996. The corresponding UK figure reveals a fall in output growth of -1% over the same period. Annualised growth for both Scotland and the UK indicates a similar fall in output growth of -1%. Since 1994, quarterly changes in output growth within this sector, for both Scotland and the UK, appear to have stabilised with less pronounced upward or downward trends.



Following on from the previous quarterly report, the most recent Deloitte & Touche Scottish Chambers' Business Survey reveals that business confidence has continued to improve within this sector. In the previous quarterly report, a net 10% of respondent firms reported more favourable business conditions, as opposed to the previous quarter. Business confidence has continued to rise in the current quarter with a net 23% of respondent firms, within this sector, more optimistic about the general business situation than in the previous quarter. A further net 10% of respondent firms reported greater optimism about the present general business conditions, as compared with the same period one year ago.

The trend in new orders over the previous two quarters would seem to support the increased business confidence reported by respondent firms in this sector. A net balance of respondents firms indicated increased new orders in Scottish, rest of UK and export markets although the total volume of orders, over the previous three months, remained unchanged for the overall net balance of respondent firms. Over the next three months an upturn in the volume of orders is predicted by a net 33% of

respondent firms. The increased orders are anticipated, by respondent firms, across Scottish, UK and export markets.

Examining the trends in the volume of sales over the past three months indicates that a net 3% of respondents firms reported an increase in their volume of sales. Despite such a small net overall increase, of respondent firms, a positive net balance of 12, 8 and 29 percent reported increased sales in Scottish, UK and export markets over the previous three months. This trend in sales is forecast to continue, into the next quarter, with a net 25% of respondent firms forecasting an increase in the volume of sales.

The average capacity utilisation for the Paper, Printing and Publishing sector has fallen by just over 1%, from the previous quarter, and now stands at 78.62%. The stocks of finished goods and raw materials also fell over the previous three months for a net 3 and 13 percent of respondents. This downward trend is forecast to continue into the next quarter with a net 20 and 11 percent of respondent firms anticipating further reductions in the stocks of finished goods and raw materials.

Investment intentions for plant and equipment and land and buildings, over the past quarter, had mixed fortunes. The former were revised upward by a net 3% of respondent firms while investment intentions for land and building activities were revised downward, over the same period, by a net 12% of respondents. Over the forthcoming quarter, investment intentions for both activities are forecast to be revised downward by a net 3 and 9 percent respectively, of respondent firms. Of those respondents who undertook investment in the previous three months, 43% nominated increased efficiency as the main reason behind the investment decision. A further 30 and 21 percent respectively, cited expanding capacity and plant replacement as the underlying reasons behind their investment.

The expected and continued falls in employment, noted in the previous two quarterly reports and anticipated to continue in this quarter were not realised. The latest Deloitte & Touche Scottish Chambers' Business Survey reveals employment in this sector increased for a net 27% of respondent firms. The increased employment appears to consist of an increase in temporary and full time posts with both male and female employment increasing by the same net proportion of respondent firms. The expected employment trends, over the next 3 months, are forecast to remain stable with the net

balance of respondent firms reporting no expected change.

Sidlaw, the Edinburgh-based group which have been troubled with continued poor performance, are set to dispose of their oil services division (ASCo) as part of a restructuring package aimed at reducing current debts. The oil services division, with operations in Aberdeen and Peterhead, generated around 30% of Sidlaw's total turnover in the last financial year. The disposal of ASCo to a management buy-in team (Secretside MBI), for £56 million cash, will eliminate the group's current £52 million debt. Following the withdrawal from its textiles operations last year, the Edinburgh-based group is now set to focus on its flexible food packaging division, with a more conservative approach to future debt gearing anticipated.

Low & Bonnar, the Dundee based Packaging and Plastics group, have marked down profits from £57 to £53 million for the year ending February 1997. The fall in anticipated profits are due to poor trading conditions in their silage wrap sector, which has been caused by adverse weather conditions. The current marked down profits still represent a slight increase on last years profit of £52.5m.

Watmoughs, the Bradford-based printer, reported a fall in half yearly pre-tax profits from £10.1 million to £9.62 million. In accordance, City analysts have revised down full-year forecasts from around £28 million to £25 million.

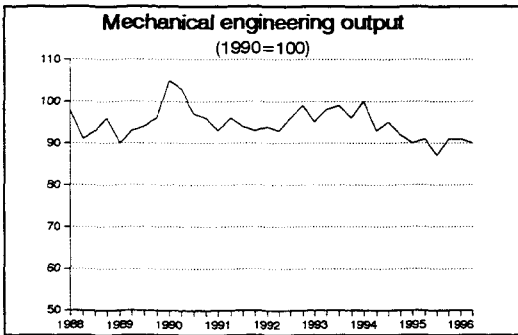
Reed Elsevier, the Anglo-Dutch publishing and information group, paid £100 million in the acquisition of Tolley, the UK tax and legal publisher. The acquisition followed the announcement of an increase in half yearly profits of 12%, to £416 million. The United News and Media group, was successful in the takeover battle with Reed Elsevier and Dutch publisher VNU, for the international exhibitions company Blenheim, with a £592.5 million offer. However, Reed Elsevier are expected to expand further with additional acquisitions anticipated in the near future.

The paper manufacturing and distribution industry, troubled by a cyclical downturn in prices and sales since the middle of last year, has recorded falling profits across the sector and in both European and US markets. Arjo Wiggins Appleton, the Anglo-French paper group announced a fall in pre-tax profits, from £135.3m to £32.3m. Jefferson Smurfit, the Irish paper group also announced a fall in pre-

tax profits from £200.6 million punts to £126.2 million, representing a fall of 37%. Similarly, US paper companies Georgia-Pacific, Champion International and International Paper, the world's largest paper company, all reported substantial downturns in profits which are attributed to the recent falls in paper and pulp prices, coupled with weak demand.

MECHANICAL ENGINEERING

The latest Scottish Office News Release (6 November 1996) recorded yet another fall of 2% in Scottish mechanical engineering output in the second quarter. Although output in Scottish manufacturing as a whole had recovered its historical peak level by Q3 93, and has been on a steady growth path ever since, the Scottish mechanical engineering output is still a long way below its historical peak level (by 15%). This poor performance by the Scottish mechanical engineering industry reflects the generally depressed state of the UK mechanical engineering industry as a whole, which also suffered a 1% fall in output in the second quarter and stood 15% below its peak level of output.



However, the most recent Deloitte & Touche Scottish Chambers' Business Survey shows some encouraging signs for the Scottish mechanical engineering industry. Following the setback in the second quarter, business confidence recovered in the third quarter, with a net of 13.5% of firms expressing increased business optimism. Moreover, compared with the same time a year ago, business confidence also improved. The improvement in business confidence was backed up by an across-the-board rise in the volume of new orders from all sources and sales to all markets (both domestic and overseas) in the third quarter. A net of 9.6% of firms reported a rise in the volume of new orders, and it is expected that growth in the volume of new orders in the final quarter will be even stronger.

Again, it is export orders that are forecast to dominate. The situation with total sales shows a very similar picture, with general growth in all markets, particularly in the overseas market.

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 renewed business confidence, work in progress started to pick up again, as did the rate of capacity utilisation which stood at 79.8%, slightly higher than that in the first quarter.

More revealing evidence of the improved business confidence is that the rise in investment plans for plant/equipment and land/buildings strengthened further in the third quarter and is expected to sustain until Q4 96. The main reasons for authorising investment in the third quarter were: expanding capacity, replacement, increasing efficiency and introducing new technology.

In the job front, the feared all round job-cuts did not occur in the third quarter, rather, the job market for this industry remained stable in Q3 96, (particularly in full-time employment for male employees). The generally depressed state of this industry has helped keep the wage claims modest, and overall no firm has experienced any difficulty in retaining employees. Nevertheless, against this general stagnant background of the job market, 60.7% of the corresponding firms experienced problems in recruiting suitable employees in particular occupations, especially skilled manual workers.

To sum up, the Scottish mechanical engineering industry remains depressed at the moment. However, there are signs of a recovery in terms of improved business confidence, rising trends in the volume of new orders and sales, and firms' intentions to invest for the future. This is a period in which the firms are undergoing substantial restructuring and re-organisation. One cause for concern is the increasingly acute problem of firms' being unable to recruit suitable employees, particularly skilled manual workers. Therefore, it is imperative that firms increase their training provisions. Fortunately, this seems to be happening in an increasing number of firms.

An example of the revival in the Scottish mechanical engineering industry is shown by Clyde Blowers, a soot-blowing equipment making company. In September, Clyde Blowers bought Bergemann, a German rival for £17.1m. With the

acquisition of Bergemann, Clyde Blowers has become one of the two world leaders in this industry, and its share of the market will jump from 11% to 40%.

SERVICES

DISTRIBUTION

Evidence from the Deloitte & Touche Scottish Chambers' Business Survey shows that wholesalers remained less optimistic about the general business situation although over 50% reported no change to the level of confidence compared to the second quarter. Confidence about the general business situation in the retail sector remained buoyant during the third quarter and a third of firms reported being more confident than in the second quarter whilst only 13% reported being less confident.

Contrary to expectations the decline in total wholesale sales, compared to the same quarter of the previous year, did not ease and a net of -14% was recorded however once again respondents expect a slight easing in the trend during the fourth quarter. Confidence in the retail sector reflects a rising trend in total sales, compared to the third quarter of 1995, which exceeded expectations. Over 50% of firms noted an increase in retail sales and 42% expect a further increase during the current quarter whilst only 18% reported falling sales in the three months to September and 14% expect sales to fall.

Stock shortages remained the most frequently cited factor thought most likely to limit activity in the wholesale sector during the current quarter [36%] followed by credit facilities [33%]. Insufficient floor space became the most frequently mentioned factor thought likely to limit retail activity during the current quarter [34%] whilst 28% cited credit facilities and 23% cited stock shortages.

Compared to the same quarter of 1995 a net of +15% of wholesalers revised investment intentions in premises upwards and a net of +14% of retailers revised investment intentions in premises upwards which compares to +25% in the previous survey.

House of Fraser could close between five and ten of its British stores as they face a £50 million bill to cover shop closures, stock write-downs and a major cost cutting exercise. There are, at present, seven Scottish stores employing more than 1,000 people

and an accounting office in Glasgow employing sixty people. It is not known which of the stores are most at risk but analysts expect that small provincial town shops are more likely to close. John Coleman, the chief executive expects to finish the review some time in 1997.

The retail group, Sears, sold its half of the St Enoch shopping centre in Glasgow for £159.8 million to the German open-ended fund, Despa.

FINANCIAL SECTOR

The arguments over the merits of demutualisation continue to rage. The Scottish financial sector with its strength in mutual life assurance companies is particularly vulnerable to changes in the form of corporate governance since such changes may herald not just a change in ownership but also a change in headquarters location. The problem is not, of course, solely a difficulty for Scotland but as the aftermath of the Morgan Grenfell-Deutsche Bank debacle indicates, where Peter Young, a Morgan Grenfell fund manager, invested heavily in obscure Scandinavian companies, it may also become a problem for London too. In this case Deutsche Bank is proposing to move control of portfolio investment out of London to Frankfurt.

The ending of The Royal Bank's link with Scottish Equitable following the buy-out by the Royal Bank of the minority 20% stake held by Scottish Equitable in Royal Scottish Assurance, and the sale of a stake in the same company to Scottish Widows has raised questions over the possibility of a merger or take-over of Scottish Widows. The move by the Royal Bank to sever its connections with Scottish Equitable reflects the changes at Scottish Equitable following its demutualisation and acquisition by the Dutch insurer Aegon, and in particular its refocussing on pension products. The Royal Bank's involvement with Scottish Widows involves not just a commitment to joint ownership of the Royal Scottish Assurance company but also involvement in Direct Line Life and the possibility of other joint financial ventures. Prophecies of mergers are certainly premature. Competition between the life assurance mutuals and other financial institutions, particularly building societies and banks, has caused the commercial relationships between insurers and deposit takers to be generally short lived and uncertain, but the life assurance companies continue to look vulnerable in the medium term given their lack of a retail distribution network.

An interesting proposition thrown up by the

continued war of words between the mutual and joint stock companies relates to the compensation that might be paid to policyholders in mutual life companies which are being demutualised. Recent practice in the building society industry has been to compensate investors who have held accounts for some minimum period of time using a sliding scale so that the larger depositors receive the greatest amount of compensation from demutualisation. Alliance and Leicester Building Society, however, in their recent announcement indicated a preference for a flat rate compensation scheme where all investors who qualify receive the same amount. The scheme has the advantage of simplicity and since all investors only have one vote is in some senses fair, but it does not reward those investors who have provided the Society with the greatest amount of capital or who have been depositors or borrowers with the Society longest. A number of analysts have argued that the largest rewards should be paid to long standing depositors (and presumably mortgagees); they after all have provided the Society with funds (and loans) on which profitable interest differentials have been earned for the longest period.

The compensation to demutualised life assurers has typically involved additional payments into the life fund of the company for the benefit of policyholders with the largest benefits flowing to those with the largest and longest term policies. An alternative response is the issue of shares to policyholders but again with entitlement to shares based on the size and term of the policy. Recently, however, executives at Standard Life, staunch proponents (for the moment) of the benefits of mutuals, have suggested that compensation according to the past contributions of a policy to the company is inappropriate. The largest compensation, they suggest, should be paid to new policyholders and the smallest to long established policyholders. The reasoning behind this argument lies in the benefits of mutuality. Long term policyholders, they argue, have benefited from having policies with a mutual company since, in general, a mutual company offers higher returns than a joint stock company. In contrast, recent policyholders are deprived of these benefits if demutualisation takes place and hence deserve compensation for their loss of rights.

The argument is appealing although far from convincing. The growth of the mutual companies and hence their substantial current embedded values has not come about through the efforts of recent policyholders. Quite the reverse. New

policyholders involve the company in considerable expense in the early years of a policy. The costs associated with acquiring new business almost certainly represent a drain on the company's funds for a period of years after the issue of a new policy since commission payments are often staged through time. Such arguments suggest that compensation to new policyholders should be small; their contribution to the life fund will to date have been very small. Leading aside such practicalities however, the Standard Life argument is interesting because it reflects the use of the net present value (NPV) criterion in choosing between financial investments. The NPV of an investment represents the difference between the costs of an investment and the benefits from the same investment where both the costs and the benefits are discounted to reflect the time value of money, the fact that a pound today is worth more than the same pound received in a years time. The NPV of an investment can be given an intuitive interpretation. It represents the immediate increase in value attributable to an investment that comes from investing in it. The NPV can be thought of as the amount of dividend that can be paid immediately as a result of investing in the project.

What Standard Life is arguing is that investment in a life policy with a mutual company represents a positive NPV investment. By taking on a life policy with a mutual company the investor immediately becomes better off. Putting the argument in this way reveals the flaw in the argument. No one would realistically accept the argument that purchasing a life policy immediately makes the purchaser better off given the high level of expenses and charges involved in purchasing a life policy. Early surrenders are particularly (financially) painful experiences for policyholders. The argument can only hold if the comparison is with a policy taken out with a joint stock company since mutuals have typically paid out more to policyholders than have joint stock life companies. Compared to investment in other assets, particularly direct investment in shares and bonds where the level and magnitude of expenses is low, the argument is less satisfactory. Most financial investment offers a zero NPV (or in the case of investments with high management charges a negative NPV). It is difficult to believe that investment in a mutual is significantly better than many other forms of investment. In short, Standard Life's argument is ingenious and interesting but only correct in a very limited comparison between mutual life companies and joint stock assurers. Its implementation would be unfair and unpopular. It

might, if implemented, act as a deterrent to further demutualisations. More likely, however, it would result in a call for greater independence and powers for mutual life assurance directors from the managers who run the mutual life insurers. This would be no bad thing!

TRANSPORT

Air

The Caledonian Airways owner and tour operator, Inspirations, have issued a profit warning for the end of September. As a result its shares lost a third of their value, diving 47p to about 87p by the first week of October. The major source of the group's problems was a series of delays in maintenance which delayed flights of Caledonian Airways during the August and September holiday periods. Caledonian was bought in March 1995 from BA which has continued to be responsible for maintenance. The financial crisis mainly resulted from the direct costs in passenger compensation, provision of accommodation arising from the delays and the negative effects of publicity.

In the continuing price war between the airlines, Ryanair launched the cheapest ever return flight fare between Scotland and London at just £39. Even though this offer was initially introduced on a short-term basis, starting from the first week of November to the second week of December, it is possible that it may be extended indefinitely. Attractive fares between Scotland and London could result in a considerable growth in passenger numbers. In the six months to the end of September, the number of passengers at Edinburgh Airport rose by 16.2 per cent to 2.1 million. The only BAA outlet that exceeded Edinburgh was Stansted, with passenger growth of 23 per cent to 2.8 million. In addition to the lower fares, the advance of Edinburgh could be explained by the strong tourist season. Over the same period, meanwhile, Glasgow registered a 2.4 per cent drop to 3.2 million passengers. The October figures showed a 20.7 per cent rise to more than 360,000 and a 10.5 per cent rise to 220,000 for Edinburgh and Aberdeen respectively and a 2.7 per cent fall to 502,000 for Glasgow.

Road

The state of competition in the bus market in central Scotland has become the subject of considerable concern for the last six months. The

major source of concern related to conditions surrounding the acquisition of Strathclyde Buses. On the grounds that it was against public interest, the Monopoly and Mergers Commission (MMC) ordered Stagecoach to divest its 20 per cent shareholding in Strathclyde buses in August. This was followed by the acquisition of the Glasgow city bus operator by FirstBus with a £110million bid. However, the latter deal could not resolve the problem of monopoly in the bus market. Since FirstBus was already a dominant bus service operator in the region, the case of its takeover of Strathclyde Buses was referred to the MMC in September. Following the announcement of the inquiry by the department of transport, FirstBus shares fell by 8p to 160.5p. As a result FirstBus has already expressed its willingness to dispose of some of the routes run by its Falkirk-based Blue-Bird subsidiary in order to win regulatory clearance. The Commission is expected to report the result of its inquiry within three months of the referral.

Rail

The Virgin Group was selected as the preferred bidder for the Birmingham division of British Rail, which runs Britain's longest distance train between Dundee and Penzance. A unique feature of this arrangement was the duration of the franchise, which runs for 15 years, to give Virgin the opportunity to invest in trains and services. The success of Virgin in winning the bid was hailed by rail users in Scotland. Even though the current service is limited to Aberdeen-Plymouth, Edinburgh-Brighton and Glasgow-Bournemouth CrossCountry routes, it is expected that the group will expand its operation to the rest of Scotland. The major source of such optimism arises from the fact that the new operators will apply the marketing skills that have boosted the London-Paris business since their takeover of Euro-Star(UK).

The franchise of CrossCountry is expected to be followed by that of Scotrail. While privatisation of the InterCity West Coast line will take place early next year, twelve preliminary bidders, including the Virgin Group, have already made presentation to the franchising director. However, the franchise of Scotrail is going to be one of the most controversial cases of rail privatisation and, as a result, industry sources express it as "a political hot potato". An area of considerable concern was the possibility of bus operators horizontal expansion into the rail services in Scotland. In order to preclude this probability the Office of Fair Trading has begun a formal consultation into the chance of Stagecoach

being shortlisted. Also, recognising that its referral to the MMC was imminent if it continued its bid for takeover, FirstBus has ruled itself out of the race for Scotrail franchise.

Sea

Pre-tax profit of Forth ports rose by 45 per cent to £10.2 million. Turnover for the six months to June more than doubled from £18.2 million to £41 million. This resulted mainly from its acquisition last year of the ports of Tilbury and Dundee. Without this takeover, the turnover of the Leith-based port operator would be just 4 per cent. Also, as a result of the acquisition, earnings per share rose by 25 per cent to 18p and the dividend increased by 11 per cent. Dry cargo tonnages increased 38 per cent at Dundee, and 33 per cent at Leith.