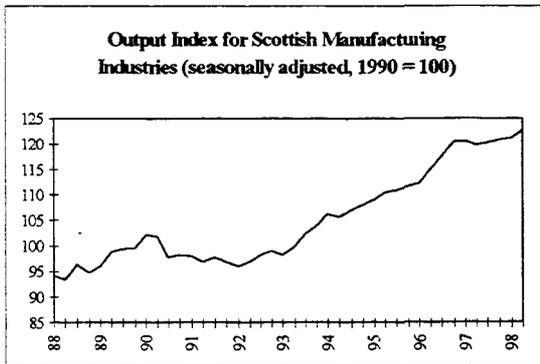


The SCOTTISH Economy

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 1998Q2. In making the Scottish forecasts, the past performance of the Scottish and UK manufacturing outputs are considered, and the National Institute's quarterly forecasts for UK manufacturing output are used for the Scottish forecasts. Figure 1 depicts the actual growth rates for Scottish manufacturing output from 1988Q1 to 1997Q1 and the forecasts for 1997Q2 to 1998Q2. The latest Scottish Office News Release (6 August 1997) made substantial revisions to the output index for the UK manufacturing output back to 1989. Moreover, given the recent rises in the

* 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.

interest rates, the National Institute's latest forecasts for the UK manufacturing output in the coming quarters have been reduced substantially. Accordingly the present forecast shows that the strong growth in Scottish manufacturing industries in 1996 is unlikely to maintain in 1997 and the annual growth rate for Scottish manufacturing output for 1997 is predicted to be around 3.5%. Further details of growth rates are presented in the following table.

92/91	0.3
93/92	3.6
94/93	5.6
95/94	3.5
96/95	5.3
95Q1/94Q4	0.7
95Q2/95Q1	1.4
95Q3/95Q2	0.5
95Q4/95Q3	0.7
96Q1/95Q4	0.5
96Q2/96Q1	2.6
96Q3/96Q2	2.2
96Q4/96Q3	2.5
97Q1/96Q4	0.2
FORECAST	
97Q2/97Q1	-0.7
97Q3/97Q2	0.3
97Q4/97Q3	0.5
98Q1/97Q4	0.4
98Q2/98Q1	1.2
97/96	3.5

THE DELOITTE & TOUCHE SCOTTISH CHAMBERS' BUSINESS SURVEY: SECOND QUARTER OF 1997

The Deloitte & 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 June, 783 firms responded to the questionnaire.

Business Confidence

In manufacturing, business confidence continued to rise, but at a reduced rate. A net balance of 7% of respondents reported that they were more optimistic in the second quarter of this year than three months previously, compared with a balance of 20% who were more optimistic in the first quarter. In the second quarter, manufacturing respondents continued to be more optimistic than a year ago, with a net balance of 18% of respondents reporting higher optimism.

In construction optimism has risen for three successive quarters. A net balance of 11% of respondents reported that they were more optimistic than in the first quarter. This compares with a 14% balance of respondents who were more optimistic in the first quarter over the fourth quarter 1996. A net balance of 18% of respondents reported that they were more optimistic than they were a year ago, compared with the situation in the first quarter where a net balance of 21% of respondents were more optimistic than in the same period a year earlier.

In distribution confidence increased both in retailing and in wholesaling, although at a slower rate in retail. In retailing, a net balance of 6% of respondents were more optimistic about the general business situation than they were in the first quarter, which compares with the 13% balance who were more optimistic in the previous quarter.

In wholesaling, a net balance of 13% were more optimistic compared with a positive balance of 3% in the first quarter. In comparison with a year ago, wholesale respondents were more optimistic, registering a positive net balance of 12%, while in retailing, a net balance of 7% were more optimistic.

Respondents in the tourism and leisure sector again reported an increase in confidence. In the second quarter, a net balance of 28% of respondents indicated that they were more optimistic about the general business situation than they were three months earlier, compared with a balance of 24% in the first quarter. A net of 28% of respondents were more optimistic in the second quarter than in the same quarter of 1996.

Orders and Sales

In manufacturing, orders and sales continue to rise, both at a slower rate than in the first quarter of 1997. For orders, a net balance of 12% of respondents reported an increase while, for sales, a balance of 18% of firms also experienced a rise. These figures compare with positive balances of 28% for orders and 28% for sales in the first quarter. Orders and sales growth continues to be positive from all main markets.

The growth of export sales, while remaining positive (+2%), has slowed down significantly from the first quarter (+16%) perhaps reflecting the continued strengthening of sterling which began last year.

In construction, new orders continued on a downward trend but again at a steeper rate than in the previous quarter. A net balance of 15% reported a decrease in orders compared with a net balance of 6% reporting a decrease in the first quarter. Orders from both Central Government and Other Public Sector remain severely depressed, and a net balance of 4% of respondents reported a decrease in private sector orders, compared with a positive balance of 18% in the first quarter.

Sales growth in distribution continues to differ appreciably between the two key sectors. A net balance of 12% of retailers reported that sales had risen, compared with the 27% balance reporting an increase in the first quarter. In wholesaling, sales fell back again. A net balance of 9% of respondents reported a decrease, compared to the balance of 1% of respondents reporting a decrease in the first quarter.

Tourism demand increased further in the second quarter and at a much faster rate than in the first quarter. A net balance of 27% of firms reported an increase compared with a balance of 5% reporting a rise in the three months to March. Demand in all markets increased.

Stock Adjustments

Stocks of finished goods and work in progress in manufacturing rose, while stocks of raw materials fell. A net balance of 1% reported a rise in stocks of finished goods, a balance of 8% reported a rise in work in progress, whilst for stocks of raw materials the negative net balance was 1%.

Finance and Investment

In the financial sector, the demand for personal loans continued to rise at virtually the rate as in the first quarter. A net balance of 62% of respondents reported an increase. The trend in advances to the corporate sector continued to strengthen, but at reduced rates. The demand for working capital remained strong, but at lower levels than in previous quarters. The rising demand for finance for investment in buildings and for investment in plant and equipment continued at lower levels than in the first quarter.

Manufacturing investment intentions in plant and machinery continued to increase in the present quarter, with a net balance of 16% reporting an increase and further upward revisions expected during the third quarter. Investment intentions in land and buildings remained positive, with a net balance of 7% of respondents reporting an increase, compared with a balance of 4% reporting an increase in the previous survey. Further expansion in land and buildings investment is anticipated during the third quarter. In construction investment intentions were unchanged. In retailing and wholesaling, investment intentions remain significantly positive. Net balances of 18% and 17% of retail and wholesale respondents, respectively, reported an upward revision in investment intentions compared to the same period a year ago.

Expectations

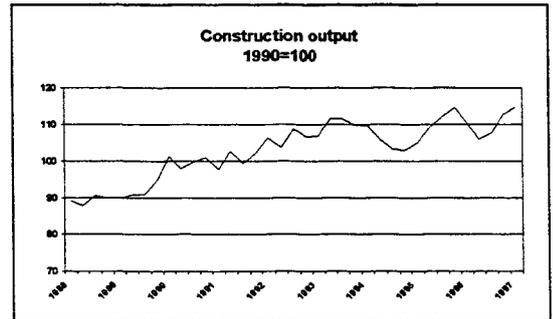
In all sectors the outturn in sales and orders in the second quarter was worse than expected by respondents in the first quarter. The rise in total orders and sales eased significantly in the second quarter. Demand conditions are expected to improve in the third quarter in all sectors.

CONSTRUCTION

The Index of Production and Construction showed a 1.9% rise in quarter one over quarter four but a 1.2% fall on the latest four quarters compared to the preceding four quarters.

Evidence from the latest Deloitte & Touche Scottish Chambers' business survey shows that once again, despite the negative trend in total orders, construction respondents appeared to be quite sanguine about the general business situation.

Compared to the previous quarter a net of 11% reported being more optimistic whilst a net of 18% reported being more confident than in the same quarter one year earlier.



In contrast to expectations the anticipated net increase in total orders did not materialise and a net of -15% was recorded. Orders from all sources fell, including private sector orders which had been expected to herald the increase in total orders. Despite the continued yet unexpected decline in orders, respondents remain optimistic about the current quarter forecasting a net increase of 8%. Once again the increase in total orders is forecast to result wholly from a net increase in private sector orders which will offset the continued decline in public sector orders. Not surprisingly lack of demand remained the most frequently cited factor thought responsible for limiting activity with the percentage citing this factor rising marginally to 83%. Once again concerns about shortages of skilled labour were voiced [15%] whilst the remaining respondents cited supply of land.

The anticipated net increase in total employment did not occur, the decline continuing instead at a net of -5%. Firms do however expect total employment to increase during the current quarter. On balance, firms reduced overtime and short time working and expect to continue doing so during the current quarter.

Recruitment activity continued to rise [55%] during the second quarter, however, the percentage of firms reporting increased recruitment difficulties fell to 9%. Recruitment activity was widely directed and though problems were reported they tended to be mentioned more frequently by those attempting to recruit professional/managerial, technical and skilled manual workers. Almost half had difficulty

Quarterly Economic Commentary

attempting to recruit suitable employees for particular occupations.

The Halifax House Price Index shows that house prices in the UK rose by 1.8% (seasonally adjusted) in the second quarter. Scotland, however, was the only region that experienced a fall in house prices (0.8%) and now has the lowest annual inflation rate in the UK with prices unchanged compared to a year ago. Despite expectations that Scotland will miss out on the boom in the housing market, George Wimpey, the UK's largest house builder plans to expand its Scottish interests.

The Government had decided to continue with plans to use the private finance initiative (PFI) to fund a £340 million programme to rebuild or improve some Scottish hospitals however the future of more than twenty other planned hospital projects is now in doubt.

ENERGY

OIL AND GAS

Oil and gas production continues to fall, as does the dollar price of oil per barrel and average daily revenues. Oil and gas revenues are at their lowest for almost two years and the seventh successive drop in oil production is due to both maintenance and delays in production from some new fields. The price of oil has fallen by 4% since last year and is currently \$17.70. Any further movement in oil and price is likely to be downward. The strength of the pound has reduced sterling revenues by 8.7% in June on a monthly basis and by 10% on an annual basis.

Oil output has declined by 12% for Q2 on Q1 1997 and by 5% on an annual basis. Gas output has fallen by 28.5% on a quarterly basis but has increased by 12% on an annual basis. Total output decreased by 19% on a quarterly basis with little change over the year. Combined oil and gas output now stands at 3.3 million boed, 31.6% down since the beginning of the year. From the beginning of 1997 oil production has declined by 19.9% while gas production has fallen by 46.2% over the same period.

The price of Brent crude has fallen continuously since January 1997 with the exception of a blip in May/June. The price has fallen by 14% for Q2 on Q1 1997 and by 6.5% on an annual basis. The drivers of the oil price are the strength of sterling, a falling

world spot price, rising stocks especially in the USA, growing supply and the ever increasing real possibility of the return of Iraqi oil to the world market.

The implications of falling output and price have had severe effects on average daily sterling revenues as these have been further reduced by the strength of sterling, which has appreciated by 20% since August 1996. Average daily revenues have reduced by 25% for Q2 on Q1 1997 and by 17% on an annual basis.

Due to the large numbers of maintenance there have been many fields seeing large falls in both oil and gas production. Many of these fields have resumed production albeit not at previous levels.

Recent studies have shown that the Atlantic frontier's economics compare favourably with those for the Gulf of Mexico and West Africa. Oil reserves in the area are estimated to be 900 million barrels. BP is the major player with 40% of the assets but some other companies are experiencing difficulties due to the high costs of deep water rigs and technical problems. The government has announced new measures to speed up licensing in the area. While tanker uplift is used at the moment a new study recommends a pipeline network to make the smaller fields viable.

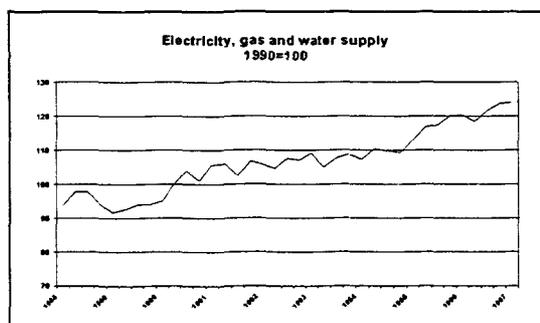
Changes in the budget to corporation tax could boost oil and gas companies assets by £1.2 billion. Cashflow should be increased by about 4% giving companies an extra £200 million each. The change will be particularly beneficial to Centrica who will gain £175 million annually. Government estimates show investment in the North Sea contributes 9.25% of total business investment this year and is forecast to be 6.25% in 1998. Development spending by the industry grew by 3.5% to £4.4 billion in 1996 (18% of industrial development spending). Treasury forecasts estimate that oil and gas revenues will contribute £4 billion to general government receipts in 1997/98. This is £500 million more than last year but £100 million less than the previous government's forecast.

The Brent field is to receive a £1.3 billion investment to modernise the platforms for maximum gas recovery. This will keep the field in operation until 2010. The Wood Group, AMEC and Brown & Root AOC have won a £650 million contract to keep all of Shell's North Sea oilfields in operation over the next seven years, which will secure 2,000 jobs.

UTILITIES

The Index of Production and Construction for Q1 1997 for electricity, gas and water supply in Scotland increased by 2.9% on an annual basis with little change on a quarterly basis. In the UK the annual change was 3.9% and for Q1 1997 on Q4 1996 a decrease of 3.1% was seen. The annual growth is explained by increased domestic demand for electricity while Scottish exports of electricity reduce the scope for increased UK generation following the winter. This also accounts for the absence of seasonal decline in Scotland.

Following the Chancellor's budget estimates for the windfall tax are now available. The electricity companies should raise £2.1 billion, the gas sector £0.7 billion, the water industry £1.65 billion and other privatised utilities £1.45 billion. Scottish Power (SP) is one of the hardest hit with a bill of £317 million but only £93 million applies to SP itself, while Scottish Hydro Electric (SHE) must find £45 million. British Gas (BG) and Centrica have levies of £440 million and £260 million respectively. The tax is to be spread over two years and share prices are not expected to suffer.



Margaret Beckett, the President of the Board of Trade, has announced a complete review of the regulation of all the utilities. The review will examine executive pay, shareholder return, investment and consumer benefits. The merger of OFFER and OFGAS is to be given serious consideration as multi-utility companies and arrangements are becoming more common.

ELECTRICITY

SHE saw annual pre-tax profits rise by 5.3% to £205.4 million. Profits in England & Wales increased by 16% to £54 million but only by 5.7% in

Scotland to £169 million. Business south of the border saw electricity volumes up 28% and turnover is now 30% of the group total. In Scotland domestic generation and supply profits fell by 10.5% but SHE retains a 30% market share. SHE has doubled its UK market share to 6% since 1990 and it is expected to treble by the end of the decade. SHE intends to spend £500 million doubling the capacity of two English plants if it secures long term deals with the Recs. A further £200 million will be spent at Boddam.

SP is to link with the Automobile Association to offer six million AA customer's domestic energy supplies across the UK. This will considerably strengthen the company's aim to be the most effective national multi-utility.

RJB Mining has called for a considerable reduction in electricity prices after the introduction of domestic competition in 1998. Coal prices have fallen 40% since 1989 yet electricity prices for the 23 million households' consumers decreased by only 12% in real terms. RJB proposes a further cut in coal prices of 11.5%, this would facilitate a fall in electricity prices of 7.5% to 10% over the next two years.

The introduction of domestic competition will mean real price cuts and has resulted in the regulator withdrawing its proposals for severe constraints on electricity prices. Competition in Scotland will come in selected urban centres in Lanarkshire, the Highlands and on the Isle of Skye.

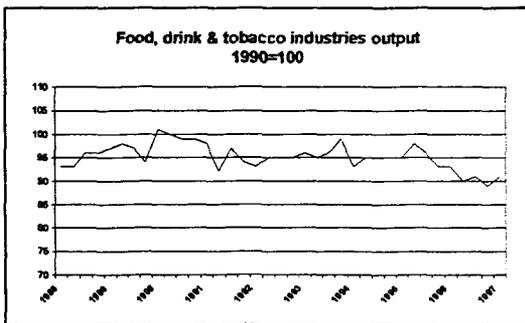
MANUFACTURING

FOOD, DRINK & TOBACCO

The Index of Production for the whole of the Food, Drink and Tobacco (FDT) sector in Scotland stood at 89 in the first quarter of 1997(1990=100). While this is a 2% rise on the final quarter of last year, the position within the sector shows differences in short-term performance, with the overall change resulting from a 2% drop in Food and Tobacco production in contrast to a 6% increase in Drink. The medium-term performance of both sectors is poorer, with an overall reduction across both sub-sectors of 5% since the first quarter of 1996, composed of a 2% reduction in Food and Tobacco output and an 8% fall in production in Drink. This fall in output in both sectors over the year contrasts with a 6.5% increase seen across Manufacturing in Scotland during the same time.

Quarterly Economic Commentary

The performance of the industry in Scotland is also poor compared to that observed across the UK as a whole. The Index of Production for the industry in the UK increased by 1% in the first quarter, due wholly to a 1% rise in Food and Tobacco production with Drink output falling by 1%. Over the year to the first quarter, however, for both sub-sectors the comparative performance of the industry in Scotland is also poor against a longer-term perspective. The indices for both areas are both set equal to 100 from 1990, and since then UK production has risen by 7% in real terms, which compares with an increase of 8% for UK manufacturing and 5.8% for Consumer Goods production. Production in Scotland has, however, fallen by 11% in total, composed of a 12% fall for Food & Tobacco and a 6% fall for Drink.



The results of the Deloitte & Touche Scottish Chambers' Business Survey (DTSCBS) for the second quarter of this year (available only for FDT as a whole) show, however, that recent performance has had relatively little effect on confidence within the industry. While the degree of optimism felt throughout the industry had not changed in the preceding three months for 61.1% of respondents, a total of 33.3% reporting an increase in optimism, there was a net balance of increased optimism of 27.7%. Indeed, 40% reported that they were also more optimistic than at the same point in 1996, and the net balance of those reporting an increase in confidence over those who reported a decrease over this time period equaled 28.6%. One reason for this appears to be that the trend in new orders is positive for many respondents, 33% reported an increase in new orders in the three months preceding the survey compared to 13.9% reporting a decrease. Furthermore, 44.1% expect the trend in new orders to be upward in the coming three months compared to only 5.9% who expect a fall. The expected trend in new orders is positive for all three markets (Scotland, other-UK and export) although the net

balance is strongest in Scotland. Capacity utilisation stood at 77.3%, and this was an increase from the same time in 1996 for a net 18% of respondents. However, there is little evidence that these results are likely to lead to any increase in employment in the short-term, given that the expected trend in employment was flat for 71.4% and there was a net balance of zero among the remainder.

A report prepared for the European Travel Research Foundation predicts that the whisky industry could lose up to £136 million in sales due to the abolition of duty free sales within the EU in 1999, claiming that this could result in the loss of 700 jobs in Scotland. The Scotch Whisky Association has used the report's findings to call for a delay in the legislation until a genuinely harmonised tax system for spirits is in place across Europe, arguing that the present regime discriminates strongly against spirits.

More positive news is that the drinks and leisure company Whitbread has announced plans to invest £22 million in Scotland over the next five years, expecting to create some 1,000 new jobs in new pubs and restaurants. The company is already Scotland's largest food operator outside the fast food chains, and operates the Brewer's Fayre, Pizza Hut and Beefeater outlets.

Scotland's largest brewer, Scottish and Newcastle, has begun to gather the benefits of last years merger with Courage, with pre-tax profits rising 21% to £834 million. This has been achieved partly by cost savings, with two breweries closed and the workforce reduced by 1,800. However, the group also believes that some part of the increase has been achieved investment in brands, pointing especially to increased sales of Fosters, Becks and Kronenberg.

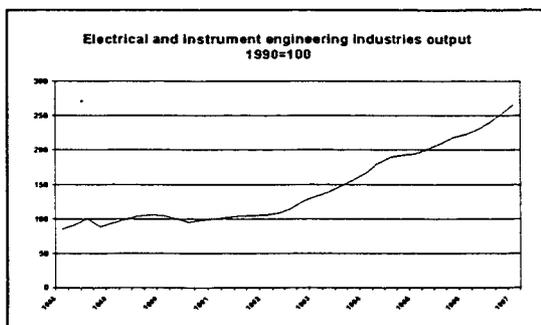
ELECTRONICS

In the previous Quarterly Commentary, the Index of Production and Construction for the Electrical and Electronic Engineering (EEE) sector in Scotland reported a 4% increase to the fourth quarter of 1996. This quarterly increase has been revised upward to 7% and the current Index reveals a further increase of 4% for the first quarter of 1997, to stand at 266 (1990=100) for the sector. Year on year growth to the first quarter of 1997 indicates a substantial rise of 17%. Output growth in Scotland again outstrips the EEE sector across the UK, where output increased by a modest 1% from the previous quarter and 2% over the year.

Quarterly Economic Commentary

The most recent Deloitte & Touche Scottish Chambers' Business Survey reveals a slight fall in the level of business optimism for the sector as compared with the previous Quarterly Commentary. However, overall the general level of business confidence remains positive. Over half of all respondents (51%) are more optimistic about the current business climate than the same time one-year previously.

The trend in the total volume of new orders, over the last quarter, reveals an increase in export orders for a small positive net balance of respondents. However, Scottish and UK orders fell over the same period. Export orders are forecast to fall over the forthcoming quarter with orders from Scottish and UK markets forecast to rise. The total volume of sales in the sector increased across Scottish, UK and export markets for a positive balance of respondents over the last quarter and this trend is forecast to continue over the forthcoming quarter.



Average capacity utilisation for respondents in this sector was reported at 81%, which represents an increase of 1% on the previous quarter. Investment intentions for plant and equipment and land and buildings were revised upward for a small net balance of respondent firms. Of those firms who undertook investment in the previous three months, 34% nominated expanding capacity as the main reason for the investment decision. Investment intentions for both plant and equipment and land and buildings are expected to be revised upward by a positive net balance of respondents over the forthcoming quarter.

Total employment over the previous quarter increased for a positive net balance of respondent firms (12%). The Deloitte & Touche Scottish Chambers' Business Survey also reveals that around half of all respondent firms attempted to recruit staff over the same period. Of those respondent firms

who attempted to recruit staff, 27% experienced increased recruitment difficulties, with technical and skilled labour noted as the main sources of labour most difficult to recruit. The trend in total employment is forecast to fall over the next three months for a net balance of respondents (20%). Over the past quarter, 29% of respondent firms increased wages and salaries by an average 4.5%.

In summary, output growth and the general business conditions in this sector remain strong. However, indications of a possible downward trend in export orders and employment may affect future growth rates for the sector.

In the company sector, Oki Electric is to base the manufacture of a new range of fax machines in its Scottish production plant at Cumbernauld. At present, the Oki factory in Cumbernauld generates output worth nearly £350 million a year and employs nearly 1000 workers. This plant is one of the biggest production sites in the UK for office equipment. The investment associated with the new production is estimated at £10m and is expected to add among 200 to 500 new jobs at the plant by the turn of the century. The new investment in Cumbernauld reflects not only the lower labour costs in Scotland, relative to Japan, but also the increasing quality of production at the Cumbernauld plant.

Filtronic Comtek, which designs and manufactures components for telecommunication systems, is to create 140 jobs in Scotland. The proposed investment is worth £3.3 million over three years. Electrocomponents, the electronic, electrical and mechanical parts supplier, reported a 13.3 per cent rise in pre-tax profits for the year ending 31 March 1997. However, the chairman warned that the continued strength of sterling was having an impact on export markets. Apple Computer, the struggling personal computer group, announced an alliance with Microsoft its previous rival. Microsoft has bought a \$150 million stake in Apple Computers. Finally, Alan Sugar is to dismantle the Armstrad trading company in a move that will generate £300 million.

CHEMICALS

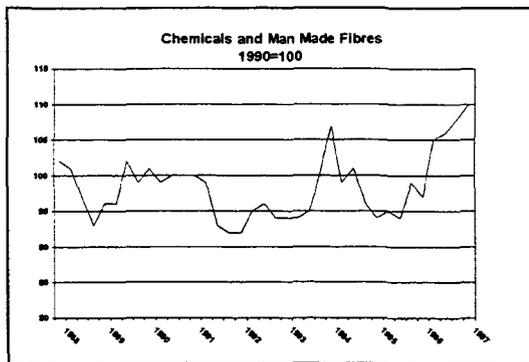
The latest Index for Production and Construction for Scotland reports an increase of 2% in output for the Chemicals and Man Made Fibres sector compared to the previous quarter while over the year output has grown by 11%. In contrast for the UK as a whole

Quarterly Economic Commentary

there was no change in output compared to the previous quarter although there was an increase of 2% over the year.

Evidence from the latest Deloitte & Touche Scottish Chambers' Business Survey showed a fall in business confidence during the second quarter, a consequence of lower than expected demand. A net of 17% reported being less confident than three months earlier while a net of 9% indicated that they were less optimistic than in the same period one year earlier.

Once again over optimistic expectations were not met and the rate of demand eased and firms are now cautious as to the rate of increase in orders and sales during the current quarter.



Scottish orders fell and only a level trend is forecast for the third quarter. While the trend in both UK orders and sales was better than predicted both are expected to fall in quarter three. The rising trend in export orders and sales was well below expectations and hence respondents are more modest in their expectations for the current quarter.

74% compared to 78% in quarter one cited the low level of demand as the factor most likely to restrict activity in the third quarter. Average capacity used rose a further three percentage points to 83% which was regarded by a net of 33% of firms as an increase compared to the same quarter of the previous year.

Changes to investment plans were reported by only a quarter of respondents and less than 5% of firms indicated reduced investment. Investment authorised in quarter two was directed towards the replacement of equipment [33%], expansion [22%] and increasing efficiency [22%].

For a further quarter respondents overestimated the increase in employment, a net of +4%, and a marginal strengthening in this rate of increase is forecast for the next quarter.

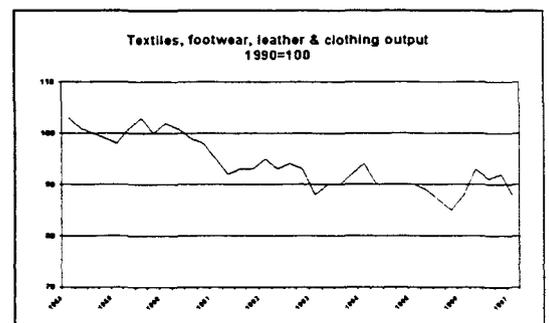
Only 17% of firms increased wages during the second quarter and the average wage increase was 3.1%.

Almost half attempted to recruit and only 9% indicated that recruitment difficulties had intensified during the second quarter. Activity focused predominately on technical and manual staff and to a lesser degree professional/managerial, clerical, part time and temporary staff.

In the company sector Glaxo Wellcome has sold its manufacturing plant in Annan, Scotland to Chirex. The US company has no plans to make any compulsory redundancies and expects to invest up to £30 million over the next five years. This follows news of a reduction in pre tax profits from £1.55 billion to £1.52 billion with turnover falling from £4.2 billion to £4.1 billion which revealed the damage caused by a strong pound and the decline in the ulcer treatment Zantac.

In an attempt to offset an expected sales gap after 2001 following the US patent expiry of its heart attack drug Zestril, Zenecca is to set to unveil more than 45 drugs and several other agro chemical products in December. This will necessitate new investment at many of its plants including the Scottish agro chemicals plant at Grangemouth.

TEXTILES, LEATHER, CLOTHING AND FOOTWEAR



The Index of Production for Textiles, Leather, Clothing and Footwear (TLCF) industry in Scotland stood at 88 in the first quarter of this year, a fall of 5% from the position in the final quarter of 1996.

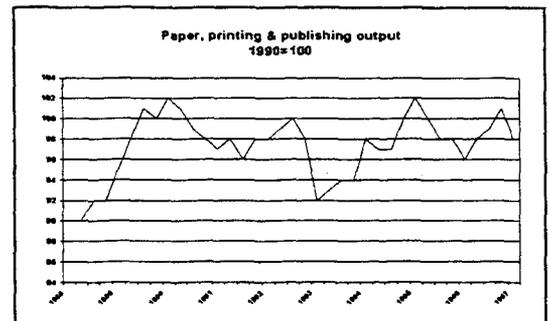
This fall is in line with, although larger than, the industry's achievement across the UK where output fell by 2% in the first quarter. However, the industry in Scotland has outperformed its UK counterpart over the year to the first quarter, with output increasing by 5% compared to no change across the UK. The most recent (second quarter 1997) edition of the Deloitte & Touche Scottish Chambers' Business Survey (DTSCBS), however, appears to show that the first quarter figures quoted above may indicate a general slowdown in the industry's forthcoming performance. The survey reports a net downturn in business optimism, with an overall balance of 9.4% of respondents feeling less optimistic than in the preceding survey (a net 12.4% also feel less optimistic than at the same time in 1996). This decrease in optimism seems to have been caused by a fall in new orders in the three months preceding the survey, with 45% of respondents reporting that these had actually fallen for a net 13.3% of companies. Respondents do, however, expect this situation to ease in the coming three months. 33.9% still expect new orders to fall and the net balance of those reporting an expected increase over those expecting a decrease actually becomes positive for the expected trend in new orders, although the positive balance is only 1.3%. The small size of this positive net balance largely appears to reflect expected difficulties in markets outwith Scotland - while there is a positive net balance of forthcoming new orders of 7% in the Scottish market, there are negative net balances of 7.9% and 27.7% for other-UK and export markets respectively. Capacity utilisation in the sector stood at 81.4%, and this is a decrease from one year previously for a net 9.7% of companies. Despite this, there are some indications that investment intentions have been revised upwards overall, mostly for replacement or to increase efficiency. Not surprisingly, most companies report a shortage of orders or sales as the factor most likely to limit output in the short-term. There seems little prospect of employment in the industry increasing in the short-term - the net balance of those expecting to increase employment over those expecting it to fall in the coming three months is negative, albeit by only 0.3%.

In the company sector, SEET, the protective clothing and schoolwear manufacturer is to make two acquisitions, the first an English-based schoolwear manufacturer and the second the purchase of BSP, which makes uniforms for the fire service, police and military markets. The company is financing the

acquisitions by a rights issue and by selling another subsidiary. Elsewhere, the Renfrewshire carpet company Stoddard Sekers has reported strong sales growth, fuelled, it believes, by the recent swell of building society windfalls.

PAPER, PRINTING AND PUBLISHING

The Index of Production and Construction for the Paper, Printing and Publishing sector in Scotland fell by 3% in the first quarter of 1997, to stand at 98 (1990=100). Annualised growth however in Scotland shows an increase of 1%. The corresponding UK figure reveals output growth fell by 1% over the same two periods. The latest fall in output is not in keeping with the generally improved business confidence reported in the two previous Quarterly Commentary's. However, the most recent Deloitte & Touche Scottish Chambers' Business Survey reveal that business confidence has fallen in this sector for a positive net balance of respondent firms. In comparison with the same period one year ago, the balance of respondents reports no change in the general business condition.



The trend in the total volume of new orders, over the last quarter, increased across Scottish and the rest of UK markets for a positive net balance of respondent firms. However, export orders fell over the same period. The trend in orders is forecast to increase over the next three months with the main source of new orders expected from Scottish markets. Over the previous three months, the actual volume of sales increased across all markets for a positive net balance of respondents. This trend is again forecast to continue over the forthcoming quarter.

The average level of capacity utilisation for the Paper, Printing and Publishing sector has increased by nearly 20% over the last quarter, and now stands at 102.09%. In comparison with same period one

Quarterly Economic Commentary

year ago, the current level of capacity utilisation is higher for 34% of respondents. There was very little change in investment intentions for both plant and equipment and land and buildings over the past quarter. Over the forthcoming quarter, investment intentions for both activities are forecast to be revised upward for a positive balance of respondent firms.

The latest Deloitte & Touche Scottish Chambers' Business Survey reveals that total employment fell over the past quarter for a net balance of respondent firms. However, over two thirds of all respondents attempted to recruit staff over the past quarter although 14% of respondents noted difficulty in recruiting suitable staff. The trend in total employment is forecast to be positive over the next 3 months. Over the past quarter, 40% of respondent firms increased wages and salaries by an average 3.9%.

In summary, the current fall in output growth, over the past quarter, coupled with the mixed results from the current Deloitte & Touche Scottish Chambers' Business Survey suggests an uncertain outlook for future growth in this sector.

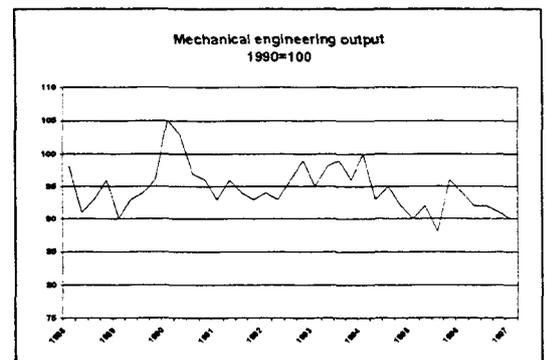
In the company sector, the Scottish Media Group has added Grampian Television to the multi media group that includes Scottish Television and the Herald newspaper. The Scottish Media Group holds a 90 per cent stake in Grampian Television after the successful £106 million takeover. Following this acquisition, the group has increased their holdings in Ulster Television to 15%.

David S Smith, the Packaging and Paper Group reported a 23% fall in pre-tax profits to £96 million in its financial year that ended on the 3 May 1997. The group suffered from the effects of cheaper imports caused by the appreciation of sterling that reduced domestic demand. Law and Bonar, the Dundee based Packaging and Plastic Group announced half-yearly pre-tax profits of £21.3 million, down from £26.2 million last time. The company blamed the strength of sterling and very competitive trading conditions for the fall in profits. Finally, Tullis Russell, the Glenrothes based employee-owned papermaking business posted record profits of £7 million in the year to the 31 March 1997. The group, which exports almost half its output, enjoyed a 34% rise in pre-tax profits

despite the continued strength of sterling and strong competition.

MECHANICAL ENGINEERING

The generally sluggish state of the Scottish (and UK) mechanical engineering industry is again reflected by the latest Scottish Office News Release (6 August 1997), which reported a slight reduction of 1.1% in Scottish mechanical engineering output in Q4 96 over Q3, rather than a 1% increase as reported previously. Moreover, the latest figures also showed a 1% fall in output in this industry in the first quarter this year.



These recent output reductions clearly dented business confidence in this sector, as is evident in the latest Deloitte & Touche Scottish Chambers' Business Surveys (DTSCBS). In contrast to the net of over 37% of firms being more optimistic in Q1 97 than Q4 96, by the end of quarter two 18% reported rising and declining confidence respectively, a net balance of 0%. The deterioration in business confidence was felt more so by medium-sized firms. In small firms confidence was level. Only the large firms reported a positive balance of optimism.

The rising trend in the volume of new orders and sales continued in quarter two, albeit at much reduced levels and well below expectations. The anticipated strong rise in export orders and sales did not occur, and domestic orders and sales, particularly rest of UK orders and sales, were much weaker than anticipated. Although firms expected new orders (mainly export orders) to pick up in Q3, the expectation of sales in Q3 remained depressing across the board.

There was further evidence in Q2 that the long-running process of de-stocking of finished goods and raw materials has stopped, with a net of 5% of firms

Quarterly Economic Commentary

building up stocks. Work in progress continued to increase in more firms, and the rate of capacity utilisation remained unchanged at 79%.

The rise in investment plans for plant and equipment maintained in Q2 97 and is expected to last until Q3 97. More firms were also investing in land and buildings. For those firms authorising investment in Q2 97, the main reasons were expanding capacity, increasing efficiency, replacement and introducing a new project.

On the job front, the overall situation of the job market in this industry remained encouraging. Although the majority of firms reported no change to the level of employment at all, on balance more firms recruited new staff in Q2 97. Notwithstanding the weak anticipation of demand, the situation in the job market is expected to be encouraging in the third quarter. Very few firms are expecting to make job cuts and many more firms expect to create new jobs. It is also expected that all forms of employment will benefit.

The generally sluggish state of this industry has helped keep wage claims modest. The problem of recruiting suitable employees in particular occupations, especially skilled manual workers, has eased somewhat (65% of firms had difficulties in this regard in Q2, compared with 79% in Q1).

To sum up, the second quarter performance in terms of new orders and sales in the Scottish mechanical engineering industry was much more modest than expected. The anticipated trends in demand remain modest in the third quarter. Combined with the harsher external trading conditions, this means a tough time ahead for the industry.

SERVICES

DISTRIBUTION

Evidence from the latest Deloitte & Touche Scottish Chambers' Business Survey shows retail respondents continue to indicate increased confidence although the rate of increase slowed somewhat. Wholesale respondents also reported increased optimism both compared to the previous quarter and the same period of 1996.

The increase in retail confidence was despite the trend in total sales falling short of expectations from

the previous survey however firms expect the trend to remain upwards during the current quarter. Compared to the same quarter one year earlier a net of 12% reported increased sales while a net of 26% expect a further increase in the three months to October. Firms were divided on the factor thought most likely to limit activity during the third quarter 40% cited credit facilities while 27% cited insufficient floor space. The increase in business confidence reported by wholesale respondents was in spite of a decrease in total sales based on the same period of the previous year, however, firms expect the trend to improve during the current quarter. Credit facilities were cited by 34% of firms as most likely to limit activity during the current quarter.

Compared to the same quarter of 1996, a net of 17% of wholesalers revised investment intentions in premises upwards. The corresponding balance for retail was +18%.

Although changes to employment affected only a third of retail respondents the trend remained nevertheless upwards and respondents expect the trend to remain so during the current quarter and at much the same rate of increase. Over 70% of wholesalers made no change to total employment during the second quarter and 83% expect to make no change during the current quarter. Nevertheless the trend in employment was upward and is forecast to remain so.

42% of retailers increased wages during the second quarter whilst 30% of wholesalers increased wages. In both cases the average wage increase was 3.9%.

Just over 50% of retailers attempted to recruit, activity was widely directed and recruitment problems were encountered in all categories. 45% of wholesalers attempted to recruit and again recruitment activity was fairly widespread, as were recruitment difficulties.

Windfall gains continued to fuel growth in high street sales at levels not seen since the 1980s. Although retail sales grew by just 0.3% in July compared to the previous month, annual growth jumped 6.5%, the highest level since July 1988. Windfalls were estimated to have added approximately £200 million to sales in June and £100 million to July sales.

After announcing its third profit warning this year, WEW, the Glasgow based discount retailer has

agreed to a takeover from its rival, Poundstretchers. Brown & Jackson, the parent company of Poundstretchers said it intended to hold onto the WEW name. The directors of WEW and its main shareholder Warburg Pincus have irrevocably accepted the offer. If shareholders do not accept the Brown & Jackson offer 4.5p a share, WEW said that the group would be unlikely to continue trading. The retailer was put up for sale after predicting that year end losses were expected to be at least £6.4 million, three times the level forecast earlier in May.

Asda has announced that it is to build five new stores this year, two of which will be in Scotland. The £100 million expansion is expected to create up to 5000 jobs nationally with 1000 in Scotland. The expansion follows news of a 16.1% rise in profits, higher than all of its competitors.

John Menzies is to appoint new management for its struggling division the Early Learning Centre that has been under attack by retailers such as Woolworths and Mothercare. The company expects pre tax profits to fall to £30.6 million from £35.9 million.

SCOTTISH FINANCIAL SECTOR

The advantages of Scotland as a centre for fund management and investment have often been ascribed to the traditional Scottish virtues of conservatism and economy; the detachment of fund management from London with a measured, slower, more thoughtful response to news and events; and to its lower costs particularly with regard to employment and office accommodation. Current upheavals in the fund management sector suggest that these virtues no longer count for much. Recent reports suggest that the value of equities managed in Scotland actually fell last year despite buoyant stock markets, a factor that normally would be expected to increase the value of funds under management. Scottish experience is in sharp contrast with that of both London and smaller European centres such as Dublin and Stockholm, all of which have shown substantial growth.

The attrition of the mutual life insurers is one cause of Scotland's problems. The much-publicised transfer of £15bn by Scottish Amicable from Glasgow to the Prudential in London will reduce funds under management in Scotland by around 8% although the impact will not be reflected in the figures until next year. A major problem last year

was the movement of the management of funds by General Accident to London, and the loss of business experienced by both Ivory & Sime, and Edinburgh Fund Managers. To some extent these changes might be dismissed as one-off events, unlikely to reoccur and balanced, to some degree at least, by the growth and success of other fund managers such as Aberdeen Asset Management which is seeing its assets quadruple to £11bn after a deal with Scottish Provident. However, even if the changes are merely the result of one-off extraordinary decisions, the impact on the sector may be severe. Loss of employment is one dimension, the loss of jobs in Glasgow as a result of the Prudential's decision to move investment management to London, is estimated at around 100 but other effects may be more significant and less obvious, not least the reduction in viability in Scotland of specialist financial services and the potential reduction in the pool of skilled personnel as individuals change jobs, move to other areas where fund management skills are in demand or simply retire early.

Some commentators see the changes as inevitable. The chairman of Prudential Portfolio Managers is quoted as saying that 'the only place to run UK equitiesis in London'. If true this would herald continuing losses of funds under management from Scotland. London offers economies of agglomeration. The concentration of financial activity in London means that specialised services are readily and almost instantly available. Experts are available on most aspects of the global economy and almost any type of investment strategy. Despite this it is difficult to believe that this is a significant day-to-day advantage to investment managers. Availability of data, information and dealing services might once have been a reason to prefer a London location but such services are now largely electronically based and as readily available in Scotland as in London, suggesting that the advantages do not lie in that direction. What London does offer however, is a pool of labour that is probably difficult to match in any other city of the world. Specialist fund managers abound with both geographic and other specific investment expertise such as the quantitative modelling of investment processes. Scotland offers little in these areas. Staff with highly specialised expertise can generally do better by migrating south at least in purely financial terms. They often find more job satisfaction pursuing their specialised interest with other like-minded individuals, than acting as a jack-of-all-trades in Scottish investment houses, or as the sole

representative in the firm of a particular area of investment expertise. Quality of life may be better in Edinburgh; although depending on one's interests this may not be the case, but the salaries and other aspects of working life are likely to be far better in London.

This is of course an over-simplified and pessimistic picture. Dublin suffers the same problems as Edinburgh relative to London. It too does not have the specialised labour and services instantly available or even Scotland's advantage as a long, well-established, internationally oriented fund management centre. It does, however, have relatively low taxes, a booming economy; a government committed to monetary union in Europe and offers an alternative political set-up to that at Westminster. Dublin offers an attractive alternative to London for companies wishing to diversify their risks against sudden, unexpected political and economic changes.

The importance of low taxes in the success of Dublin and its growth as a financial centre is particularly pertinent given the recent comments by Sir Bruce Patullo and other members of the Scottish Financial community on the possibility of the Scottish Assembly having tax raising powers. It is noteworthy that the discussion in Scotland has been conducted on the assumption that taxes would go up and not stay the same or fall, but taking this assumption as correct, it is readily apparent that a sector that is in decline relative to London, despite its lower cost base, can ill afford any possible increases in cost as a result of tax changes.

Such a bald statement as this needs some qualification. The problems we have identified so far centre on the relative decline of fund management in Scotland. The other two main areas of the Scottish Financial Sector, banking and life assurance do not show the same trends. The life assurance sector is experiencing changes in ownership and control, but the effects of these changes are not altogether apparent as yet. At some level the changes in ownership have been very good for the Scottish Financial sector. Scottish Equitable's contribution to its Dutch parent Aegon rose by 55% in the first six months of 1997 and the company saw, for example, personal pension business rise by 274%. Similarly, Scottish Mutual, now part of Abbey National, saw its income rise by 47% in the first half of 1997 and particularly large increases in sales of single life premium business.

Employment is reported as having risen by more than 300 people. However, as the transfer of Scottish Amicable's investment business to London reveals, the consequences of shifts in ownership are not always beneficial. There is a constant fear that employment will be concentrated in the lower paid clerical jobs and that changes in policy at Head Office (not in Scotland) will result in closure and dislocation.

The post war experience of the Scottish Financial Sector suggests that both of these fears are real. A proliferation of jobs in clerical and back office activities whilst desirable for providing mass employment is less attractive to the economy because of the relatively low income and training levels involved and, more importantly, because of its vulnerability. For example, a recent report compiled by the Centre for Research in Employment and Technology suggests that a considerable number of clerical and managerial 'back office' jobs will be lost as the financial industry grapples with the major changes currently sweeping through it. Whilst one might quarrel with the forecasts it makes it is difficult, on the basis of recent trends, to take exception to the sentiments. The 1990's have seen continuing job losses as manual procedures are automated and methods of sales distribution adjust to the possibilities opened up by low cost communications and computing. The purchase of a 9% stake in an Australian software house by The Royal Bank - it is paying £8m for a holding in Computershare a specialist in software for company share registrars, real time trading and clearing and settlement systems - emphasises the importance of computing to the financial community. In many areas of financial activity it is the ownership of proprietary computer software that is the basis for competitive advantage and market domination.

The banking sector is currently the bright spot in the Scottish financial scene. Both Royal Bank and Bank of Scotland have performed well along with other British banks. The Royal Bank is aiming to acquire the Midshires Building Society, doubling its mortgage lending and adding 115 branches to its network although it continues to look for other ways (and building societies) of strengthening its retail business. It has also strengthened its links with Scottish Widows by placing 33.4m shares with the Widows bringing the mutuals shareholding up to 4.7% of The Royal Bank's equity capital. At the same time Royal Bank has been pursuing its links with Tesco through a joint banking operation. The

aim of the Tesco link is to provide both telephone banking with a Glasgow call centre, and in-store banking, emulating the link between Sainsbury and Bank of Scotland. Whilst superficially attractive the fear must be however, that these links will, in the long term, reduce the role of the banks. Just as the building society-life assurance links of the mid to late 1980's have nearly all broken down and left the building societies (now banks) in a much stronger position in the life assurance market so too these supermarket-bank links may leave the supermarkets in a strong position in the retail banking market and erode the position of the banks. It is perhaps no accident that it is the Scottish banks that are involved in these activities with supermarkets predominantly in England. The links give the Scottish banks access to a wider market without having to invest in an extensive branch network. The arrangements are unlikely to be stable over the long term. The provision of retail banking services does not require extensive banking knowledge although it does require specialist software. We would expect the supermarkets to take total control over their banks once they have gained appropriate experience adding to the competitive pressures in the banking sector.

It is heartening to see the Scottish banking sector prosperous and in good shape, indeed so much so that some newspapers suggested that the Bank of Scotland might be a potential bidder for NatWest. In the circumstances the threats from possible tax increases associated with devolution seem overstated. Any increase in costs will not help the competitive position of the banks but is unlikely to be a major burden. For the life insurers the position is less clear. The demutualisation of Scottish life insurers that has taken place is recognition that their prospects as independents are not as good as their prospects as part of a larger organisation. Motives for demutualisation are many and varied but cost and sales pressures are undoubtedly contributory factors. Increases in the life insurers cost base through tax increases will not improve their competitiveness and could force more of the smaller companies to search for partners and to demutualise. The effects of a tax increase are unlikely to be dramatic but for an industry much of which is already struggling and in difficulties, the effects are unlikely to be beneficial! In fund management, increases in tax would reduce profitability but given the relatively few employees involved and the importance of confidence and performance on the future of the sector, the effects are unlikely to be dramatic. Other pressures,

particularly from changes in the life assurance sector, and the pool of skilled, trained and educated manpower in London are likely to be more significant. However, increased taxation would be a burden that the companies do not need at the moment. It could also be a deterrent to new entrants to the financial sector. Given uncertainty over future taxation in Scotland and the other problem parts of the sector currently faces it comes as no surprise that the Scottish Financial Sector has been losing out to Dublin and to other UK centres.

TRANSPORT

The government has announced a formal consultation period to achieve an integrated transport policy-making way for a transport paper next spring. By 2025 thirty-one million cars are forecast to be on the UK's roads leading John Prescott to warn of 'stark and difficult choices' in transport policy. Undoubtedly this will mean the introduction of road pricing, greater use of the Private Finance Initiative, increased fuel and driving related taxes and incentives to reduce car ownership in an effort to increase the use of public transport. While the Scottish parliament would have control over most areas of transport there is unlikely to be any significant change from UK policy.

Air

More than one hundred million passengers used BAA airports in the last twelve months for the first time. The seven UK airports, which all reported increased passenger numbers, gave BAA a 6% rise over the year. Figures for June show Glasgow with a 12.3% rise while Aberdeen and Edinburgh both recorded increases of 8.9%. BAA's first quarter profits were up 4.5% to £136 million and a provision of £102 million is to be made for the windfall tax although the expected liability is in the £70-100 million range.

By next spring Virgin could be flying from Aberdeen, Edinburgh and Glasgow further intensifying the fierce competition on the London routes. It will expand opportunities for Scots to connect directly with Virgin's low-cost international network. The £29 fare for Scotland to London has however deterred other operators from entering the market. The Virgin aim must be to capture the 'middle market' as it can undercut both BA and British Midland but it is unlikely to want to match EasyJet. All UK airlines (with international

operations) profits have suffered from a strong pound. BA has announced measures to cut costs by £1 billion and expect to achieve £200 million savings this year.

Rail

Great North Eastern Railway (GNER) has improved overall performance on the East Coast Main Line with revenues, journey times, punctuality and fares showing the best improvements. Revenues have risen by 8%, passenger numbers by 9% and Edinburgh passenger numbers by 20% on last year. Their trains operate at 59% capacity and they are forecast to operate at 65% in the next three years when they will effectively be full. GNER, who carry 30,000 passengers a day, want on this evidence to have their franchise extended to seven years to justify investment in tilting trains.

Railtrack could face a windfall tax of up to £500 million prompting fears that investment programmes could suffer. However pre-tax profits rose by 27% to £346 million in June attracting criticism of Railtrack's investment programme from both the Rail Regulator and the Government. Railtrack have responded with plans to invest £16 billion over the next ten years of which £8.3 billion would be spent on renewing existing infrastructure and £5.7 billion on daily maintenance. Railtrack faces further strong criticism from the Rail User's Consultative Committee for Scotland where Scotrail, GNER and Virgin pay more than £200 million to Railtrack. The Committee wants more detailed plans for Scotland and revenue and expenditure to be more transparent. Railtrack also received a further setback when legal opinion ruled it was liable for the costs of rebuilding bridges to take 40 tonne lorries by the year 1999 and not local authorities as previously thought. South Lanarkshire Council, which brought the action, could have faced a bill of £25 million.

Road

The government has announced an immediate review of road building in the UK. In Scotland the plans for a new Kincardine Bridge, the completion of the M8 between Glasgow and Edinburgh as well as developments on the A1, A68, M74, M77 and the M80 are also subject to review. The Scottish Office has a £200 million budget for roads but this is unlikely to survive the review with spending cuts on roads across the UK already evident.

Edinburgh is combating too many cars with their Greenways scheme, which gives priority to buses. Heavy parking restrictions and fines are also in use to curb illegal parking. Park and ride and the possibility of introducing schemes to discourage company cars in the city centre are all part of proposals to be put to Scottish Office minister Malcolm Chisholm in an attempt to influence UK transport policy. The government has released figures showing that in the last ten years traffic has increased by 36%. In 1996 traffic increased by 3% over 1995 levels. While motorways are only 1% of the UK's roads they carried 17% of traffic and 34% of goods vehicles in 1996. The number of articulated lorries rose by 60% in the same year.

FirstBus is to appeal against the decision to sell Midland Bluebird but are simultaneously in talks with the Cowie Bus Group over the sale of the subsidiary. FirstBus has acquired the Southampton based Citybus in an £11 million deal and has had annual pre-tax profits of £51 million in 1996, an increase of 132%. Stagecoach has seen profits to the year-end in April rise by 176% to £120.5 million. SouthWest Trains contributed £7.7 million to profits, an increase of 8%. The UK bus division saw profits of £67 million a rise of 14.9%.

Sea

The new Sea Containers ferry from Campbelltown to Ballycastle in Ireland will bring 40 jobs to the Argyll area with a further 200 jobs due to direct and induced effects. Passengers will contribute £7.7 million to the local economy of which £2.8 million should stay in the Argyll economy. This will bring unemployment in the area below 8.5%.