

# The SCOTTISH Economy

## SHORT-TERM FORECASTS<sup>1</sup>

This section presents short-term forecasts for the quarterly growth rates of Scottish manufacturing (Division D of the 1992 SIC), output and annual growth rates are also included.

The present forecasting period extends to 2001q1. 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 driving the Scottish forecasts. Figure 1 depicts the actual growth rates for Scottish manufacturing output from 1986q1 to 1999q1 and the forecasts for 1999q2 to 2001q1. The Scottish Executive Index of Production has been re-based with 1995=100 and this change has been incorporated into our Short Term Model. The results are presented in Table 1 below.

The National Institute notes that UK manufacturing has declined since 1998q2 and is forecasting that UK manufacturing will continue this decline through to 1999q3. The forecast growth in UK manufacturing between 1999 and 2000 is only 0.6%. As in the Short Term Forecast of the *QEC*, 24, (3) we forecast no growth for 1999q1 and the Scottish Executive Index of Production figure for that quarter was zero. There has been little change to the Scottish forecast with 1999 growth forecast to be strongest in the second quarter and with the exception of 2000q1 reasonably strong growth is forecast for the rest of that year. The annual growth rate for Scottish manufacturing output for 1999 and the year 2000 is now forecast to be 0.9% and 2.4% respectively. The strength of sterling and the economic slowdown (in particular the effects on electronics) has contributed significantly to the slowdown in Scottish manufacturing but there are

<sup>1</sup> 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.

now strong signs of sustained economic recovery partly due to recovery in electronics growth and significant inward investment benefits.

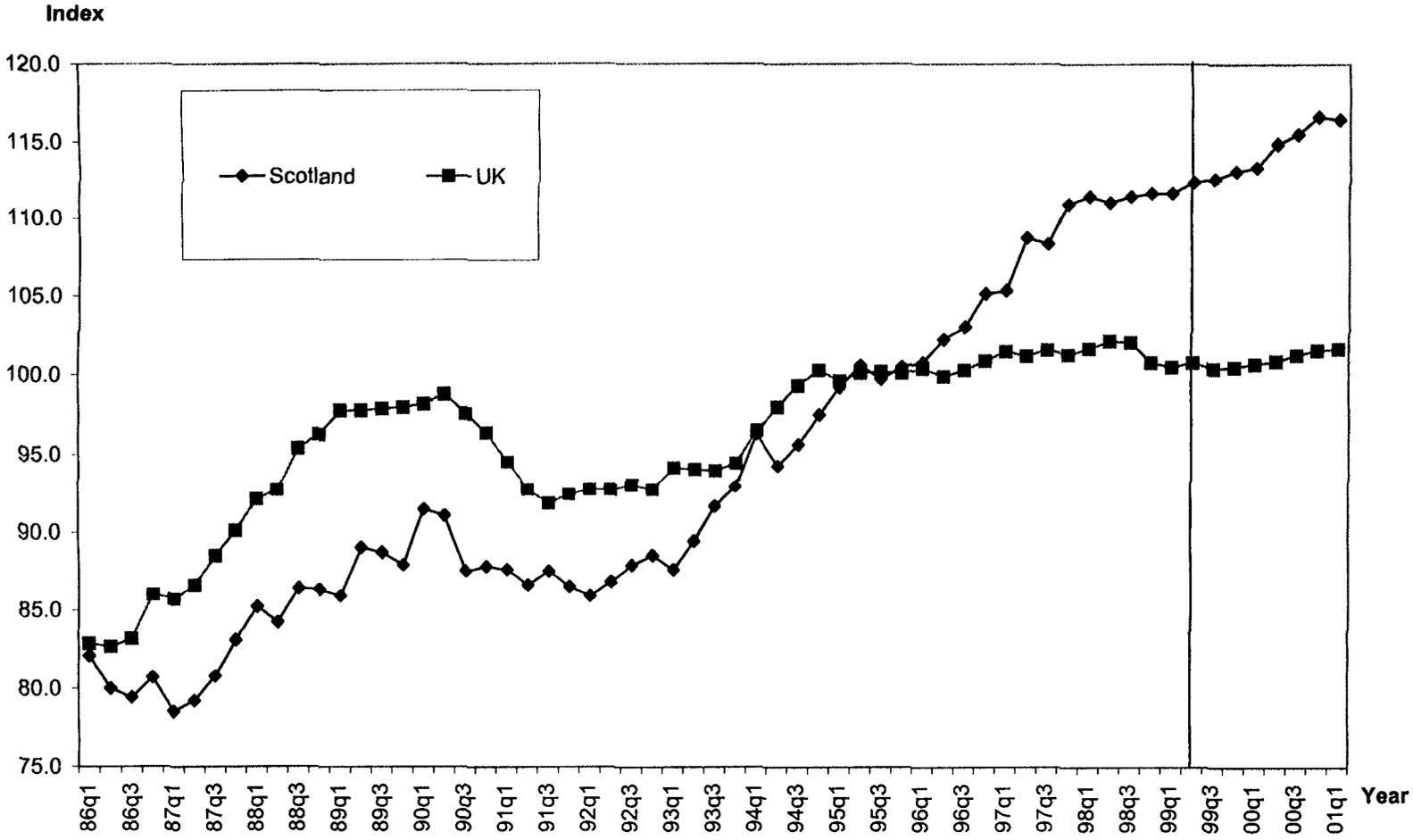
TABLE 1. QUARTERLY GROWTH OF SCOTTISH MANUFACTURING OUTPUT (%)

91/90	-2.7
92/91	0.2
93/92	3.6
94/93	5.6
95/94	4.7
96/95	3.1
97/96	4.8
98/97	2.1
95Q1/94Q4	1.7
95Q2/95Q1	2.0
95Q3/95Q2	-0.6
95Q4/95Q3	0.9
96Q1/95Q4	0.4
96Q2/96Q1	1.2
96Q3/96Q2	0.6
96Q4/96Q3	2.0
97Q1/96Q4	-0.8
97Q2/97Q1	3.5
97Q3/97Q2	0.5
97Q4/97Q3	2.4
98Q1/97Q4	-0.3
98Q2/98Q1	-0.4
98Q3/98Q2	-0.2
98Q4/98Q3	-0.4
99Q1/98Q4	0.0
FORECASTS	
99Q2/99Q1	0.6
99Q3/99Q2	0.2
99Q4/99Q3	0.4
00Q1/99Q4	0.2
00Q2/00Q1	1.3
00Q3/00Q2	0.5
00Q4/00Q3	0.9
01Q1/00Q4	-0.2
99/98	0.9
00/99	2.4

## THE DELOITTE & TOUCHE SCOTTISH CHAMBERS' BUSINESS SURVEY

The Deloitte & Touche Scottish Chambers' Business Survey, which is conducted by Strathclyde University's Fraser of Allander Institute together with the Scottish Chambers' of Commerce, is the largest and most comprehensive regular survey of business, employment and other issues affecting the Scottish business community.

**Output Index for Scottish and UK Manufacturing Industries  
(seasonally adjusted, 1995=100)**



In the present survey, which was conducted in June, 750 firms responded to the questionnaire.

## **MANUFACTURING**

### **Optimism**

The decline in business confidence eased from a net balance of -27% in the previous quarter to -10%. More than half of firms reported no change in confidence.

### **Orders and Sales**

For a further quarter these were slightly weaker than anticipated, the decline in total orders and sales continued though eased (net balances of -17% and -19% respectively). Respondents are confident of an easing in the rate of decline in the third quarter.

Concerns as to the levels of orders and sales eased slightly though remained the most pressing factor (61%), and concerns as to the level of competition remained high, being reported by 44% of firms. The importance attached to exchange rates increased.

### **Finance**

The declining trend in cash flow eased, and a net balance of firms are now expecting a rise in both turnover and profitability. Anticipations of price decreases ended.

### **Investment**

Changes to investment plans again affected less than 40% of respondents. Investment in the second quarter was again primarily authorised towards reducing labour [32%] and replacement of equipment [24%].

### **Employment**

Employment trends continued to fall, though the rate of decline eased from a net decline of 25% to 10%, and this net rate of decline is expected to continue. Recruitment activity improved slightly with 47% seeking to recruit staff in the second quarter. 31% reported increasing pay by an average of 3.76%, compared to an average of 3.57% in the previous quarter.

## **CONSTRUCTION**

### **Optimism**

The decline in business confidence resumed as the trends in orders were worse than anticipated.

## **Orders**

A net of firms had expected a rise in total orders but the outturn showed a net of 20% reporting a fall and a net of 23% of respondents expect a further decline. For all sectors the rate of decline in orders was greater than expected.

Private sector orders had been expected to rise for a net of 23% of firms however a net of 5% reported a fall. Orders from all sectors are expected to fall again in quarter three.

The percentage citing the low level of demand as the factor most likely to restrict activity in the next quarter fell marginally from 78% in quarter one to 77%.

## **Investment**

Changes to investment affected slightly more than a quarter of respondents, and the declines in plant/equipment and buildings investment continued. Of those investing in the second quarter 63% directed investment towards the replacement of equipment and 17% towards increasing efficiency.

## **Employment**

The rise in construction employment continued, though eased, at a net of 2%; this increase is expected to end in the third quarter. Fewer than a fifth increased pay by an average of 5.6%. Almost half sought to recruit staff in the second quarter with 63% of these firms reporting difficulties.

## **WHOLESALE DISTRIBUTION**

### **Optimism**

The decline in business optimism eased significantly to a net decline of 2%, as the fall in sales was less than anticipated.

### **Sales**

Respondents had forecast a further deterioration in sales for the second quarter, however, the net decline of 9% was less than had been anticipated. Nevertheless, once again, wholesale respondents continue to expect a further weakening of demand in the next quarter. Concerns as to competition were cited by 67% as the factor thought most likely to limit activity in the third quarter, whilst 22% cited exchange rates.

## Investment

Changes in investment plans were reported by almost 40% with 20% reporting both a rise and a fall.

## Finance

Cash flow trends improved significantly with 24% reporting rising cash flow and only 16% lower cash flow trends. A net of 7% expects turnover to rise over the next year though a net of 8% expects profitability to decline.

Expectations of price increases resumed with a net of 13% expecting to increase prices in the third quarter. Pressures to raise prices increased slightly, reflecting increased transport and raw material costs.

## Employment

Changes to employment levels were more widespread than in quarter one affecting almost 40%, though the decline was slightly greater than expected. Respondents continue to anticipate a decline in employment in the next quarter though the rate of decline is expected to slow. 30% reported increasing pay by an average of 3.19%.

## RETAIL DISTRIBUTION

### Optimism

Changes in business confidence affected half of respondents, and the decline in business confidence continued, easing considerably to a net of 7% reporting being less confident than at the end of the first quarter.

### Sales

The decline in sales was slightly less than had been anticipated, and less than had been reported in the first quarter; a further easing is forecast for the third quarter. Whilst 28% reported increased sales 46% reported a fall in sales, and 33% anticipate a decline in sales in the third quarter (compared to 40% who had anticipated a fall in sales in the first quarter survey).

### Investment

The downward trend in investment plans ended with a net of 2% revising investment intentions upwards.

## Finance

The deterioration in cash flow trends eased from -31% to -23% reporting a decrease. For the first time since the second quarter of 1998 both turnover and profitability are expected to increase over the next twelve months.

## Employment

The decline in employment was less than anticipated (a net decline of 8%), and a net of 1% expect a rise. 39% increased pay by an average of 3.7%, compared to an average increase of 4.09% in the previous quarter.

## FINANCIAL INSTITUTIONS

### Personal advances

Personal advances continued to rise during the three months to the end of June for a net balance of respondents and little change in the rate of increase is forecast for the third quarter.

### Corporate advances

The increase continued through the second quarter, and again corporate demand for credit was most evident for working capital. The demand for credit for plant/ equipment declined, whilst the demand for credit for buildings remained level for a net of respondents.

### Sectoral demand

Demand for credit increased from all sectors with the exception of manufacturing and this pattern is expected to continue through the third quarter.

## Employment

Changes to employment were limited, affecting around a quarter of respondents. 27% reported increasing pay by an average of 2.67%.

## TOURISM

### Optimism

Business confidence declined further as a net of -10%, compared to -9% in quarter one, of firms reported being less confident than three months earlier.

## Demand

The decline in demand was greater than anticipated and the decline is set to accelerate with more than half of firms anticipating a fall in total demand. Tourist trade continued to decline from all areas though a net balance of large hotels reported no change in business trade. Only business trade is expected to rise in quarter three.

Average capacity used was one percentage point higher than in the second quarter of 1998, but four percentage points lower than the second quarter of 1997.

## Investment

Investment continued to rise, although for 90% the main reasons for authorising investment were to replace/renew facilities or to improve facilities.

## Finance

Increased pressures on margins were again evident, although possibly less so than in the previous quarter. Turnover improved for a net balance of firms though costs again rose by more than had been anticipated. Turnover is expected to rise in quarter three for a net balance of 32% of firms.

## Employment

Only a third of firms reported and expect changes to overall employment levels. A net of tourism firms had expected employment to increase in the second quarter though the outturn showed a decline for a net balance of 4% of firms and a further fall is forecast.

## Recruitment

Recruitment activity was lower than during the same period of 1998, 82% compared to 95%. The average wage increase displayed a reduction as 46% reported increasing pay by an average of 4.8% (compared to 5.2% in the previous quarter).

## CONSTRUCTION

According to the Deloitte & Touche Scottish Chambers' Business Survey for the second quarter 40% reported changes in business confidence, overall only 17% reported increased confidence, a net balance of -6%. Falling optimism was evident for a net of firms employing less than 99.

A net of 4% of firms had expected a rise in total orders and a net of 23% in private orders though the outturn showed unexpected declines of -20%

and -5% respectively. Rising total orders continued to be reported by a net of firms employing more than 200. Public sector orders continued to decline and by more than firms had anticipated. During the third quarter orders from all areas are expected to decline. Rising private sector orders were a feature for a net of firms employing more than 200.

Overall 77% cited the low level of demand as the factor most likely to restrict activity in the third quarter, a slightly lower percentage than in previous quarters, and the percentage citing shortages of skilled labour declined to 14%. The downward trends in investment in plant/equipment were slightly worse than anticipated with a net balance of 3% reporting a fall. The downward trend is expected to rise through to the next quarter. Of those investing, 63% of respondents reported that the main reason for new investment was to replace existing equipment. Changes to employment levels affected a third of firms and the trends were as anticipated with a net balance of 2% reporting an increase. 18% reported increasing pay by an average of 5.6%. Once again around half of respondents sought to recruit.

Evidence from the Scottish Buildings Employers Federation construction trends survey covering the three months to the end of June showed that enquiries about new construction contracts weakened in Scotland. In Britain a majority of firms reported a rise in enquiries. Firms had anticipated a rise in work as a dividend of the new Scottish Parliament though this now seems unlikely in the short term.

According to the latest Halifax House Price Index prices continued to rise in August, albeit at a slower pace than in the preceding three months when prices increased at an average monthly rate of 2%. Despite this slowdown the annual rate of house price inflation accelerated from 8.2% in July to 9.4%. UK average house prices have risen by 8.6% since February following the fall in prices experienced last winter amidst widespread doom and gloom regarding the economy's prospects. The Halifax believe that the sharp turnaround in the housing market since the spring has been driven by the substantial reduction in mortgage rates and the marked improvement in the economic climate. Prices rose by 3.2% in Scotland in the quarter and by 2.5% over the year (one of the lowest in the UK).

In the company sector there is evidence of merger and acquisition activity with Miller Group planning large and small acquisitions in the property and housing sectors in the near future. Other activity included Tulloch homes, the Glasgow-based construction firm, buying MacRae homes, the

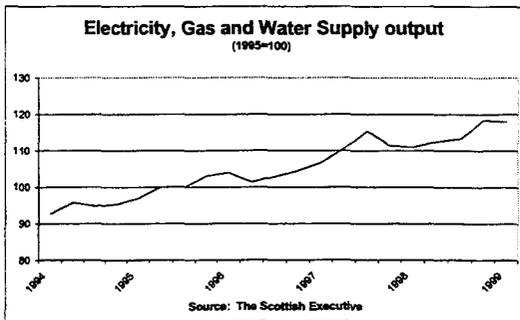
Inverness-based land holdings and timber framed manufacturing business in a deal valued between £3-£6 million.

**ENERGY**

**OIL AND GAS**

The data from the Royal Bank Oil & Gas Index for 1992q2 on q1 demonstrated a reduction in production of 15.6% although there was an increase of 6.2% on an annual basis. Oil production fell by 4.9% on a quarterly basis but over the year increased by 2.9%. Gas production fell by 29.8% for q2 on q1 but rose by 12.7% on an annual basis.

There was a 37.9% rise in the average oil price (\$ per barrel) for q2 on q1 and a 16.7% increase over 12 months. The Average Daily Oil Value rose by 33.6% and 23.5% for the respective periods. There was little change in the Provisional Total Average Daily Value over the latest quarter but over the year this increased by 18.2%.



This quarter has seen a complete reversal of the position in this sector 12 months ago. In April, UK oil revenues increased by 26.9% on the previous month and in May the average oil price was \$15. A year ago Brent crude was \$12 and falling and there were higher levels of taxation proposed. By June, UK oil revenues had increased by 34% over the year due to rising price and increased production. At the end of July to mid August the oil price moved through the \$19 mark. If the situation in Venezuela remains the same it is likely that the oil price will be pushed up further still. If the oil price remains close to \$20 then it is likely that the industry might revise its investment plans. The evidence from OPEC countries is that so far there has been strict adherence to the quotas set by OPEC. It is unlikely that the oil companies spending plans will change for 1999 but there could be an upturn in investment in the year 2000 if the industry remains in such an environment. Shell has publicly stated that the high oil price may not remain at its current level and thus activity may not

continue at its present level. The government has re-introduced rollover capital gains tax relief (the first time since 1987).

The latest Aberdeen Chamber of Commerce and Deloitte & Touche Oil & Gas Survey (July 1999) covering the oil & gas related sector demonstrated that optimism has increased slightly with only 25.6% reporting being less optimistic as opposed to 64.9% for 1999q1. The net balances for the respective periods were -12% and -58%. Almost 80% of respondents were less optimistic than one year ago although large firms were more confident than small firms were. The slowdown in exploration is clearly evident with 80% reporting reduced exploration levels with 54% expecting a reduction over the next six months. 77% of respondents also reported a decline in Scottish based activity though the decline is forecast to be less extensive over the next six months. The outlook appears to be relatively encouraging with no firms reporting any increase in activity for the first quarter but a small percentage think there will be an increase in activity in the second quarter and slightly more expect third quarter exploration activity to increase.

The declining trend continued with 57% reporting falling levels of production/service work. 45% of respondents expect production/service related work to decline in the third and fourth quarters and more than 60% expect a reduction in Scottish and UK based activity. 62.5% reported a decline in employment with 28% stating there was no change in employment. These trends are expected to continue.

BP-Amoco have announced they are to cut costs by £2.5 billion a year and sell off their lower margin fields so that the company can remain profitable with an oil price of \$11 per barrel. It will also invest £16.6 billion in oil & gas exploration in the Gulf of Mexico, Angola, the Caspian basin, Algeria and Trinidad. The overall aim is to cut the cost of oil production by \$2 per barrel and increase their return on capital by up to six percentage points by the year 2001. It is currently 9.3% after 13.7% last year. Scotland survived the global rationalisation exercise relatively well with Grangemouth securing £500 million of investment but there will still be 400 jobs lost at the plant. The company plans to spend up to £400 million each year over the next ten years to sustain its oil & gas production levels in line with costs across the company. The company hopes to recover £6.4 billion from disposals over the next three years. Nearly 14,500 jobs will have been lost due to the merger, mainly in America. Net profit for the second quarter was £856 million up from £717 million in 1998.

BP-Amoco is to build a 260-mile pipeline to transfer surplus gas from the Schiehallion and Foinaven fields to extend the Magnus field's life. Currently the 150mmcf/d of gas is flared or re-injected into the seabed. The gas injection scheme could extend the Magnus field life to beyond 2015. At the moment the field produces 70,000bpd and has a life of 10-12 years. All three fields would flare less gas and some gas would be used as a fuel at Sullum Voe.

Shell reported net income of £1 billion for the second quarter up 5% (on adjusted basis). In the first half of the year it achieved cost savings of £278 million compared to the target of £1.5 billion by the year 2001. Capital spending has been cut by 40% and there has been a 62% rise in exploration & production earnings.

French oil giants TotalFina and Elf Aquitaine have agreed to merge, creating the world's fourth-largest oil company and ending a bitter takeover battle that had dragged on for months. The deal values Elf Aquitaine at 52.6 billion Euros (\$54.3 billion, £33.7 billion).

## UTILITIES

The Scottish Executive Index of Production for Electricity, Water and Gas Supply fell by 0.4% for 1999q1 on 1998q4, outperforming the UK which suffered a 4.6% contraction over the same period. For the latest four quarters on the preceding four quarters growth was 3.0%, similar to the UK figure of 2.7%. Once again the quarterly figures reflect the exports of electricity over the winter and the reduction of demand in the first quarter due to total production cutbacks. All sectors of production over the last quarter demonstrate either negative or zero growth for both the UK and Scotland.

Utility regulators have declared proposals to cap utility prices (if directors salaries run ahead of performance) as 'unworkable.' It puts them in an impossible position of having to judge what is an equitable remuneration and what would be required to be achieved on a very large range of standards of financial, operating and service performance. The Electricity Association, Water UK and the CBI are fiercely opposed to the proposals and a source within the DTI admitted that there were a few practical problems in linking executive pay to regulatory regimes.

Wholesale electricity prices are set to fall by 13% resulting in a saving of £1.5 billion a year due to the more competitive trading arrangements to be introduced in October next year. Eileen Marshall, Deputy Director-General of the Office of Gas and Electricity Markets alleged that electricity prices in

the pool were 25% above the level required to justify new power station development. The cost of establishing the new market is estimated to be £130-150 million.

Scottish & Southern Electricity (SSE) has declared pre-tax profits of £463.2 million for the year up to the end of March 1999. However an exceptional charge of £169.9 million leaves only £293.3 million compared to £453 million in 1998. The £169.9 million includes £61.3 million for redundancies, £34.7 million in merger expenses and £24.3 million in decommissioning IT systems. £103 million of the merger costs are attributable to Scotland. Previously 200 jobs were to be lost in both Scotland and England but now the company admits that at least 10% of its 9,300 workforce will be lose their jobs. The areas where job losses will fall mainly are IT systems, HQ functions, the high voltage transmission and the low voltage distribution system. Many of these jobs will be lost at the Maidenhead site and the IT function will be relocated to the new £60 million Havant office. The group's move into gas supply has brought it 400,000 new customers for an acquisition cost of £35-50 each that should be recovered over 18 months. Gains of 100,000 customers outside SSE's area offset 100,000 customers lost to Centrica within their area. SSE also has £1.5 billion to spend on acquisitions but if no purchase is made £600-700 million will be returned to shareholders.

British Energy (BE) reaffirmed its commitment to become a vertically integrated energy supplier after its recent acquisition of Swalec. The electricity and gas distribution business in South Wales was a key element in the business strategy. BE also is to return £432 million to shareholders after failing to acquire London Electricity. It is widely suspected that if Yorkshire or Seaboard come onto the market later this year that BE would acquire one of them to further strengthen their distribution business.

Centrica, having purchased the AA for £1.4 billion, is expecting major cost savings from integrating the two businesses. Efficiency improvements could see the AA profits rise by £85 million by the year 2002 up to about £105 million. The cost of the savings is expected to be £95 million over 1999 and 2000. Access to the 9.5 million members for Centrica is an obvious benefit in target marketing.

Yorkshire Water has secured the £800 million contract to provide the new waste water treatment works for Aberdeen, Stonehaven, Peterhead and Fraserburgh. This is the group's first Scottish contract. The company will design, build and operate them for a 30 year period. ScottishPower (SP) has had some success in this area winning the

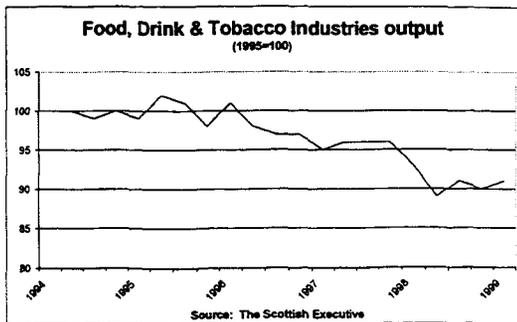
£35 million contract at Uddingston and a £50 million project at Levenmouth.

There will be a new pricing regime for water companies from 2002-05 with price cuts being imposed by the regulator of up to 15-20%. This has been set now at 15.3% up to the period 2004-05 or £38 per household. If this is followed then this will be an annual reduction of 2.9%. This is to take account of higher than expected savings by water companies. Water quality and environmental improvements are to cost £8.5 million between 2000-2005 and the prices to consumers may have to rise after that period. If maintenance is included then the total cost will be around £20 billion. Some firms face greater than average cuts and this includes SP at Southern Water where the cut is to be 15.6%, giving an annual average cut of 3.3%. Southern's average household bills will fall by £51 from £278 to £227 over the period. The Competition Act will force companies to allow usage of their pipelines by other companies by March 1999. Companies refusing to do so could face fines of up to 10% of UK turnover.

**MANUFACTURING**

**FOOD, DRINK AND TOBACCO**

The Scottish Executive Index of production for the Food, Drink and Tobacco (FDT) sector in Scotland stood at 91 in the first quarter of 1999 (1995=100), an increase from the final quarter of 1998 of 1.3%. However, much of this is due to a 5% increase in production in the Drinks sector, and the figure may be influenced by short-term changes in whisky. Indeed, the longer term change in drinks is actually negative, with production down by 7% over the year to the first quarter. The comparable figure for Food and tobacco is also negative, with output falling by 4.3% over the year to the first quarter, and so the Index does appear to show that FDT as a whole has had a difficult time over the most recent year for which data is available.



The more recent results from the Deloitte & Touche Scottish Chambers' Business Survey show

little to indicate that there will be any substantial change in the industry's performance in the near future. Confidence in FDT did rise during the survey period, but only by a small amount across the industry - 25.7% of respondents felt more confident than they did three months previously, but 22.9% felt less confident, a net figure of only 2.8. In addition, 51.4% reported no change in business confidence since the last survey. Confidence was also static in comparison to the position one year previously, with 30% reporting an increase and the same number reporting a decrease.

Similarly, the orders figures do not show any indication of substantial short-term changes in the industry's situation. One-third of respondents did report an increase in new orders, but this is almost exactly balanced by the number reporting a decrease. The picture for expected new orders is similar, although slightly more (31%) expect orders to increase than to decrease (26%). However, one notable point is that a substantial proportion, 57% expect turnover to increase over the next twelve months (the orders figures quoted above are for the next three months), and 41% expect profitability to increase over the same period.

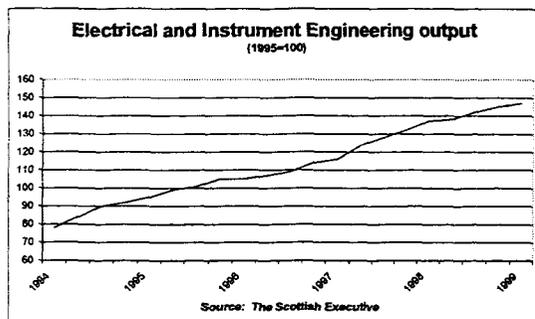
News from Scottish FDT companies includes the probable merger of the Edrington Group and Highland Distillers. The companies currently operate formal co-operation agreements, but Edrington seems likely to want to buy Highland shares in order to strengthen its distribution network in a deal with the French company Remy Cointreau.

Elsewhere, Scottish Enterprise announced the formation of a cluster-based strategy for the food industry which aims to create up to 6,000 jobs in Food and Drink in Scotland over the next ten years. The major element of the strategy is to encourage smaller Scottish based companies to develop innovations by instituting both formal and informal co-operation strategies.

**ELECTRICAL AND INSTRUMENT ENGINEERING**

The Scottish Executive Index of production for the Electrical and Instrument Engineering (EIE) sector in Scotland measured 147 in the first quarter of 1999 (1995=100), a quarterly rise of 1.3%. Over the year to the first quarter, EIE output rose by 8.3%, again far outstripping the 1.5% increase recorded across the whole of the manufacturing sector in Scotland. UK industry output increased by 6% over the year, although much of this will of course include the increase recorded in Scotland.

The more recent results from the Deloitte & Touche Scottish Chambers' Business Survey (DTSCBS), however, appear to show that some companies in EIE expect the industry's position to tighten at some point, a conclusion which is drawn from comparing the current and expected sales and new orders positions. With regard to sales, a net 23% of respondents to the DTSCBS survey reported a decrease in the current trend in total sales, while a net 21.4% expect sales to decrease in the next three months. 44.2% of respondents reported that new orders had decreased during the survey period while only 30.4% reported an increase in new orders. Similarly, 36.7% expect new orders to decrease in the near future compared to 23.4% who expected them to increase. Against this, however, is that a significant number, 37%, expect both turnover and profitability to increase over the next year and only 12% who expect a decrease. The prospect seems therefore to be that there may be a blip in output before growth is resumed.



News from the Company sector in Scotland includes the announcement by Amtel Corporation that it is to set up a plant in Lanarkshire to produce "smart" cards, following its acquisition of Motorola's card operation earlier this year. The facility will be a design-house and Amtel predict that the current 70 jobs will grow to nearer 2000 by 2002.

Elsewhere, Scottish Enterprise announced the formation of a cluster-based strategy for the electronics industry, which aims to double the number of people currently employed in electronics in Scotland. The major element of the strategy is to encourage Scottish-based companies to develop innovations by instituting both formal and informal co-operation strategies, and by focusing Scottish resources towards greater design and product development.

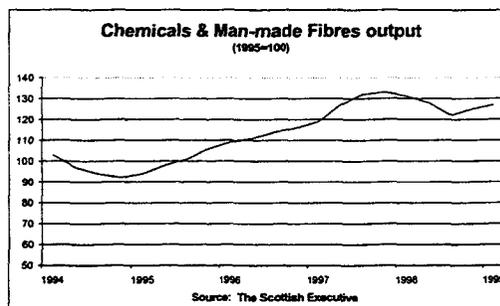
## CHEMICALS

The latest Index of Production for the Chemical & Man-made Fibres sector showed an increase of 0.9% for the first quarter of 1999. Over the year

however output in the sector fell by 2.8%. In contrast the UK as a whole showed a fall of 1.6% for the first quarter but an increase of 1.4% over the year.

Evidence from the latest Deloitte & Touche Scottish Chambers' Business Survey suggest that respondents are more confident about the general business situation for the first time since the first quarter of 1997. A net of 27% reported being more optimistic than in the previous quarter while a net of 20% were more confident than one year ago. The increase in confidence reflects an improvement in total orders with a net of 18% reporting increased orders. Although the decline in total sales continued the trend eased from a net of -57% to -9%. During the current quarter respondents expect the upward trend in orders to continue while the decline in sales eases to a flat trend. Orders/sales and competition continued to be cited as the main factors of concern although exchange rates and plant capacity were also considerations.

Cash flow trends improved significantly with almost half reporting improving and less than 20% worsening trends; a net of 36% expect both turnover and profitability to rise over the next year. Although most firms expect to make no changes to prices, the remainder expects prices to fall. Pressures to raise prices were less evident than three months ago.



Changes to investment plans were more widespread, being reported by more than half and the declining trend in investment in plant/equipment ended (a level trend). Investment authorised in quarter two was directed less towards the replacement of equipment [27%] and more towards reducing labour [45%].

The downward trend in total employment ended (a net balance of 0%) though a net of 18% expects a fall in employment during the current quarter. Approximately half the respondents attempted to recruit during the second quarter with recruitment activity widely directed.

An American pharmaceuticals company, Quintiles Transitional Corp, has confirmed plans to create 1,500 in Scotland, 500 more than had been anticipated. The company has already invested £100 million in employing 1000 people at plants at Bathgate, Livingston and Riccarton near Edinburgh. It plans to recruit new workers over the next six years. Most of the jobs will be in clinical trials management at the facility at Bathgate.

Scotia Holdings, the Stirling based drugs company, saw its shares jump almost 14% as it announced positive results in trials for its cancer drug Foscan. The company now plans to file a new drug application with US regulators by the end of September. Meanwhile Core Group, the Irvine based biotech firm, revealed that a take-over or merger could be announced before the end of the year following half-year losses of \$4 million. These were better than expected and reflected a £3.7 million investment in a new manufacturing base at Irvine.

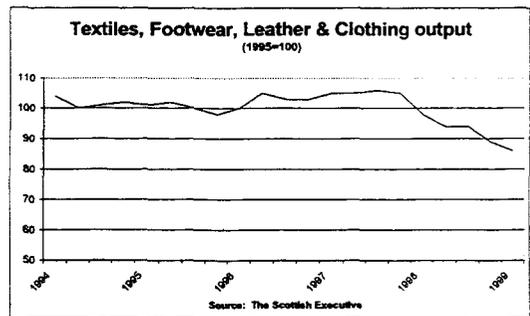
**TEXTILES, FOOTWEAR, LEATHER AND CLOTHING**

The Scottish Executive Index of Production for the Textiles, Footwear, Leather and Clothing (TFLC) sector in Scotland measured 86 (1995=100) in the first quarter of 1999, a 3% reduction from its position at the end of 1998. This is a bigger reduction than the 0.2% drop in total production in Scotland, and the Scottish sector's performance also compares unfavourably with that of the industry across the UK as a whole, where output rose by 0.3%. The industry's performance is also poor when examined over the year to the first quarter, with the figures showing that output fell by 12.2%. However, given that UK output in TFLC also fell over the year, by 8.7%, it appears that Scotland has probably been affected by world factors, which do appear to have hit the industry in Scotland harder.

The more recent results from the Deloitte & Touche Scottish Chambers' Business Survey (DTSCBS) indicate that the depressing picture shown by the Index of Production figures is unlikely to alter in the near future. Some 67% of respondents reported no change in short-term business confidence (which compares the current level of confidence with that of three months previously), and a net 7.2% actually reported a drop in short-term confidence. It is more worrying, however, to compare the current level of confidence with that seen one year previously. Over half (54.9%) of respondents reported a fall in confidence compared with one year previously, and the net reduction in confidence - the percentage

reporting a drop minus those reporting an increase - measured 34.7%.

Expected future movements in sales and orders provide little indication of impending improvements. Current orders were reported as falling for 42.4% of respondents, and the net figure (of those reporting rising orders minus those reporting a decline) was negative at 12.2 (in addition, 27.6% report no change in new orders, a figure which should be seen against the background of the drop in production outlined above). The expected trend in new orders is also down for a large chunk of the industry, with 32.7% expecting orders to fall in the next three months. The net figure is, not surprisingly, again negative at 12.5%. Over half (52.3%) report that capacity utilisation had fallen over the year, and a further 43.1% report no change. Investment intentions were also down for many firms, and 36% reported that their cash flow position had deteriorated.



The situation in the company sector echoes the depressing situation depicted above, and continues the run of bad news emanating from the industry recently. The major recent development was the decision by Coats Vyella to close the Paton & Baldwin plant in Alloa, which will result in the loss of 220 local jobs. The main factor cited by the company, another echo of the recent troubles plaguing the industry, is the current strength of sterling. While most recent attention in the industry has focused on the Borders, The Paton & Baldwin closure is the second closure in Alloa this year, Coats having earlier closed a ladies wear factory in the town.

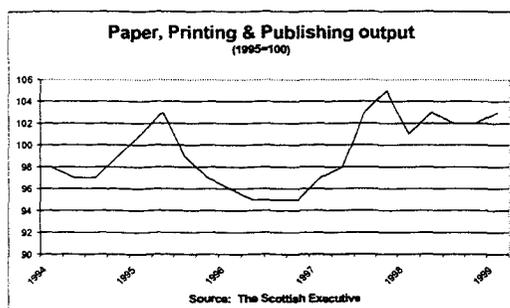
Another job-loss also recently announced was that by Alexandra, who specialises in uniforms and workwear, is transferring some production to Africa. The firm is currently seeking around 300 voluntary redundancies.

Finally, Dawson International's restructuring programme took a step forward when it sold JE Morgan, its American subsidiary which makes underwear. The sale may help Dawson find a buyer

for its Scottish operations, and its share price rose following the announcement.

### PAPER, PRINTING AND PUBLISHING

The most recent Index of Production and Construction for the Paper, Printing and Publishing sector in Scotland reveals an increase in output of 1.8% in the first quarter of 1999. Annualised growth for this sector in Scotland also remained positive with year on growth of 1.0 per cent. These figures compare favourably with those for the corresponding UK PPP sector which show that both quarterly and annualised output growth for this sector, to the first quarter of 1999, decreased by -0.9 and -1.2 per cent, respectively.



However, the results from the most recent Deloitte & Touche Scottish Chambers' Business Survey (DTSCBS) suggest that trading conditions remain difficult in this sector. The general business outlook by respondents for the second quarter of 1999 remains downbeat with nearly 30 per cent of respondents less optimistic about the general business outlook than three months previously. Although more than half of all respondents reported no change in business confidence, in comparison with the previous quarter, the downward trend in business confidence has continued and accelerated from -8% to -13%. In comparison with one year previously, the net balance of respondents that are less confident about the general business outlook has declined from a net 28 per cent to 12 per cent.

The trends in total orders and sales over the previous quarter reveal that demand in all markets fell in quarter two despite respondents anticipating increased orders across all markets. Thus, order and sales were down across all markets for a net 16 and 18 per cent of respondents. Markets most affected were Scottish and Export. The trends in both orders and sales, anticipated by respondents in the third quarter of 1999, suggest that demand will remain sluggish across most markets. Only rest of UK orders are expected to rise in the forthcoming quarter.

The average level of capacity utilisation for the Paper, Printing and Publishing sector remained at 76% in the second quarter of 1999. Investment intentions in this sector, over the past quarter, were revised downward again for both land and buildings and plant and equipment, as anticipated by respondents in the previous Commentary. This trend is again forecast to continue over the forthcoming quarter.

The latest DTSCBS also reveals that changes in total employment affected around one quarter of respondents, as the decline in employment eased (relative to the previous quarter) to affect a net 26% of respondents, over the past quarter. Respondents from the previous Survey anticipated this decline in total employment. Total employment is again expected to fall, however, its impact is anticipated to affect only a net balance of 3% of respondents in the forthcoming quarter. Over the same period, less than one third of all respondents increased wages and salaries by an average 3.0 per cent.

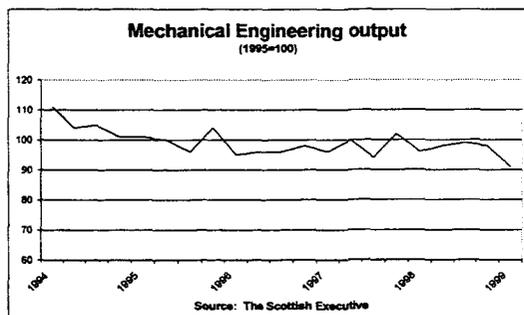
In summary trading conditions remain difficult within this sector although there are potential signs of improvement. Although demand was weaker than anticipated in the second quarter of 1999 and business confidence continued to decline, cashflow and profitability concerns eased within the sector. Moreover, turnover and profitability are forecast to rise over the forthcoming year. However, in general, growth will remain difficult for this sector over the forthcoming quarter unless demand across all markets increases.

In the company sector, Johnson Press (Edinburgh-based Regional Newspaper Group), which recently acquired Portsmouth and Sunderland Newspapers could be a potential buyer for the Herald and Evening Times if the Scottish Media Group (SMG) is taken over by Granada, who recently acquired an 18.6% stake in SMG. Interestingly, SMG have just acquired a stake in Heart of Midlothian football club in a deal worth around £8 million. However, given the recent investment in football clubs in England by the large TV groups, including Granada, this recent investment by SMG is likely to increase the overall attractiveness of the group for take-over.

Low & Bonar, the Dundee-based packaging and plastics group, is to sell its American packaging operations. The North American operation, with seven sites in Canada and one in Texas, has a turnover of around £90 million. The company is expected to receive around £80 million for this part of its group. The company will now focus on moulded plastics for markets including vehicle manufacture and the storage and shipping of agricultural and chemical products.

## MECHANICAL ENGINEERING

The Scottish Executive Index of production for the Mechanical Engineering sector in Scotland measured 91 in the first quarter of 1999 (1995=100), a quarterly drop in output from the final quarter of 1998 of 7.3%. This compares with an increase of 1.3% across all engineering (although this figure is if course dominated by the presence of Electrical and instrument Engineering) and to no change across all of manufacturing in Scotland. The Scottish sector's performance is also poor against the UK picture, where Mechanical Engineering output fell by a more modest 2.2%. Across the year to the first quarter, the sectoral output rose by a meagre 0.1%.



The more recent results from the Deloitte & Touche Scottish Chambers' Business Survey (DTSCBS) indicate little immediate prospect of improvement. Short-term changes in the level of business confidence turned negative for a net of respondents, with 28.6% reporting a fall in confidence compared to three months previously, compared to 16.3% reporting an increase. While hardly encouraging, however, this does represent an improvement on the yearly change, where 54% reporting a fall compared to the 19% who felt more confident - things do seem to have improved when comparing the three-month change with the annual change, even if the overall level of confidence remains negative. However, the sales position remains gloomy, with 62% reporting a decrease compared to only 11% who saw sales increase in the three months preceding the survey. The picture with regard to new orders is also less than encouraging, with a net 50% reporting a fall. The expected trend in new orders does, however, appear to be a little more encouraging. Here, a net of only 18.4% expect the trend in new orders to be negative in the coming three months.

The expected increase in turnover for next year is static, although a net 14.3% expect profitability to fall over the coming year.

In the company sector in Scotland, there is concern over Kvaerner's announcement that it is to lose

3000 jobs from its oil and gas workforce. It maintains two rig-building plants, one of which is in Fife. However, the Methil plant has a fuller order book than Kvaerner's Teesside facility, and it appears that of the two, Fife has a better chance of remaining open.

Elsewhere, the Weir Group has announced a reduction in pre-tax profits to £28.3 million (from £29.5 million in 1998), but expects profits to turn up next year with the purchase of an Australian company, Warman, and an expected up-turn in orders in 2000.

## SERVICES

### RETAIL & WHOLESALE DISTRIBUTION

According to the ONS, in July the seasonally adjusted estimate of retail sales volume is 115.1. This is 0.1 per cent above the June figure and 2.7 per cent higher than the July 1998 level. In May to July the volume of sales was 1.3 per cent higher than in the previous three months and 2.9 per cent higher than in the same period a year earlier. Based on non-seasonally adjusted data, the average weekly value of retail sales in July was £3,800 million, 3.3 per cent higher than in July 1998. In May to July the value of sales in current prices was 3.3 per cent higher than in the same period a year earlier.

The Scottish Retail Consortium/Royal Bank of Scotland Retail Sales Monitor for July shows the value of retail sales rose by a modest 1.1% in total. On a like-for-like basis, which covers retail space open for a full 12 months, the value of retail sales fell by 4.2%. This was a significantly weaker result than for the UK as a whole, where sales growth was 3.9% in total, and 0.8% on a like-for-like basis. The three-month like-for-like trend in sales growth in Scotland showed no improvement from last month's decline of 0.7%. This compared with a rise of 0.5% for the UK as a whole.

In previous months, The Retail Sales Monitor noted that there were sound reasons to expect that Scotland's economy would under-perform the rest of the UK in 1999. They are the persistent strength of sterling - which affects manufacturers and the tourism industry - and the weakness of the oil and gas sector as a result of low oil prices in 1998 and early 1999. It comes as no particular surprise, therefore, that July saw low growth in Scottish retail sales relative to the rest of the UK.

However, the poor July figures followed strong year-on-year growth in June. There are a number of reasons for this volatility. First, the weakness lies wholly in non-food sales, down almost 2% on the

year. Non-food turnover has been affected strongly by the timing of summer sales. Typically these had been held in July, but a number of larger retailers brought them forward to June this year. This had the effect of boosting turnover in June – hence the sharp rise in last month's Monitor – and depressing the July figures. Secondly, it is commonplace for data to exhibit a degree of volatility when the economy is at a turning point. For that reason, it is often better to consider trends over a period of months. Comparing the three months May to July with April to June, total sales were up by 4.5%, although like-for-like sales remained down by 0.7%. The three-month figures are more consistent with the wider UK picture and with emerging evidence that the Scottish economy may now be through its slowest period of growth in this cycle. The fragility of like-for-like sales shows that turnover growth is being won by new and expanded outlets. New sales space has come on the market out of cycle with sales volumes and there is heavy pressure on existing retailers from the growth of square footage in new stores.

The latest Deloitte & Touche Scottish Chambers' Business Survey shows that changes in retail business confidence affected half of firms and the decline in confidence continued though eased from -27% to -7%. Declining confidence was only a feature for the smallest retail firms. Changes in business confidence affected almost 50% of wholesalers and confidence continued to fall, albeit at a significantly slower rate as 30.7% reported being less confident (a net decline of -2% compared to -22% in quarter one).

Sales among retail respondents continued to decline though the rate of decline eased from -30% to -19%. Falling sales were reported by a net of firms in all size bands (except 20-99). Competition and business rates remained the two factors most likely to restrict retail activity with concerns over interest rates easing further.

A net of 16% of wholesale respondents from the first quarter survey had forecast a fall in sales though only a net of 9% reported a fall. Once again declining sales trends were a mainly a feature for a net of wholesale firms employing less than 100. Respondents expect a further deterioration in sales in the third quarter. Concerns as to competition remained the principal factor thought most likely to limit activity in the forthcoming quarter. Business rates declined as a concern whereas exchange rates became more of a concern. Concerns as to the levels of competition generally decreased with firm size.

The cash flow position of retail firms continued to deteriorate with a net balance of 23% reporting a

decrease. A net of retailers in all size bands reported declining cash flow trends. Both turnover and profitability are now expected to rise over the next twelve months though turnover is expected to rise at a faster rate than profitability. Both turnover and profitability are expected to fall for the smallest firms. Expectations as to increasing prices over the next three months continued, though eased.

Cash flow trends improved, with only 17% of wholesalers reporting lower cash flow and 24% rising cash flow trends. A net of firms in all size bands reported improved cash flow trends. A net balance of wholesale respondents now expects rising turnover over the next twelve months. Expectations of declining turnover were only reported by a net of smallest firms. The percentage expecting profitability to decline over the next year remained at a net of -8%. Profitability declined for a net balance of firms employing less than 20 and 200-499. Expectations of price increases in the third quarter rose with a net of 13% expecting to increase prices, compared to a net of 4% expecting to reduce prices in quarter one. Transport and other overheads remained the main pressures on prices.

Employment trends were less depressed than anticipated, although again changes affected only around a third of retailers. 39% increased pay by an average of 3.7% (compared to an average increase of 4.09% in quarter one). Changes to employment levels were reported by 36% of wholesale respondents, and the trends were slightly worse than expected – a net of 12% reporting a decline. The percentage seeking to recruit staff declined to 38% and 30% reported increasing pay by an average of 3.19% (compared to an average of 3.23% in quarter one).

The latest CBI Distributive Trades Survey, covering sales from 1 to 23 July shows retail sales volumes in the UK rose in the year to July at the fastest rate for nearly eighteen months, although not quite as rapidly as retailers had expected. Expectations are for growth in August to continue at a similar pace. Fifty per cent of retailers reported increased sales and 22 per cent said sales were falling, giving a positive balance of 28 per cent. This compares with positive balances of 11 per cent in May and 22 per cent in June.

Grocers, confectioners, off-licences, chemists and durable household goods reported the largest increases in sales when compared with a year ago. Retailers of clothing, furniture and carpets and footwear and leather goods also reported some increase on a year ago, while booksellers and stationers and hardware, china and DIY stores reported a fall in sales compared with last year.

Wholesalers' sales volumes rose only slightly in the year to July, and at a slower rate than had been previously expected. A slight drop in volumes is expected during August. Motor traders' sales volumes rose modestly in July, despite prior expectations of a fall. Sales are expected to fall sharply in the year to August, not surprising following the change in timing of the new car registration plate.

## TRANSPORT

The Scottish Executive has published *Tackling Congestion*, a consultation paper on solving the problems of Scottish transport. The main proposals include;

- Local authorities will be able to levy transport charges without a ceiling;
- The money does not have to be ring-fenced and could be made available to spend in other areas;
- Because of partnerships, money raised in one area could be spent in another local authority;
- Bus companies may be forced to tender for specific routes or bundles of routes including non-profitable but essential routes;
- Employers could face charges for providing workplace car parking;
- Significant additional powers are to be made available to police any new legislation brought forward.

The proposals have met widespread criticism with few groups or individuals giving them unqualified support. Even Prof. David Begg (John Prescott's transport adviser) could not fully support the measures given the absence of ring fencing. The basic problem is that traffic levels are forecast to grow by 50% over the next 30 years but even now many trunk routes cannot cope with the congestion. Urban motorists account for 18% of total vehicle miles but cause 86% of congestion and this is where the brunt of the charges will fall. People could be hit twice due to road usage charging and workplace parking if they travel and work in a controlled area. Even suburban developments that have high levels of congestion could face the levies.

The plans come at a time when the Deloitte & Touche Scottish Chambers' Business Survey for 1999q2 demonstrates that transport costs are a constraint to Scottish economic growth. Both the Scottish Chambers of Commerce and CBI (Scotland) have severely criticised the proposals. Small and medium businesses, tourism, manufacturing, retail and distribution are the most likely to suffer. The Freight Transport Association also expressed concern over the number of hauliers

smuggling diesel into the UK in hidden tanks. Diesel can be bought for 30p a litre and sold for 50p a litre in the UK. There is also concern over foreign hauliers who buy their diesel on the continent, drive to the UK to collect a load and transport it back to the continent without refuelling in the UK. This is having a small but significant effect on UK hauliers.

John Prescott has stated that improving the transport network will be 'a long haul.' He also admitted that congestion and workplace charging would not raise significant amounts of money for a significant time. Public spending on transport was £4.7 billion in 1998 and is to fall to £4.5 billion in 2000-01. For every £10 spent at the petrol pump £8.25 goes to the exchequer. Road taxation was below £20 billion in 1989-90 but was over £30 billion for 1997-98. Motoring has however never been cheaper with car travel only two thirds of the cost of either bus or rail transport in 1996. This paradox is at the heart of the difficulty in funding public transport.

## Air

BAA figures show that passenger levels at Edinburgh Airport increased by 16% in June this year compared with last year. The single biggest growth factor was the number of operators providing flights. Edinburgh with its new £54 million terminal now has 96 daily flights to London and a significant increase in direct links to major European cities. Total passenger numbers in Scotland grew to 1.5 million, up 6.4% on June 1998 levels. Edinburgh had 482,000 passengers compared to 702,000 at Glasgow (up 4.0%) but Aberdeen dropped to 228,000 (down 4.0%). BAA's UK airports had a 7% rise in passenger numbers, handling 113.8 million passengers.

BA operating profits for the first quarter fell by 45.6% to £94 million after widespread discounting in the industry. This compares to £225 million in 1998-99, which was a 61% decrease on the previous year. Analysts are forecasting a further downgrade in pre-tax profits. Increased fuel costs, over capacity on transatlantic flights, the strength of sterling and little improvement in demand in Asia are factors that have contributed to falling profitability. As a result BA is to cut capacity by 12% and concentrate on premium traffic. The lack of competition however will not allow economy passengers to move to another airline easily.

Both Easyjet and KLM are to severely reduce their services to Aberdeen and Edinburgh airports. The KLM move will result in 30 job losses. Stagecoach has stated that Prestwick Airport is not for sale despite rumours that an anonymous buyer has

offered more than double the acquisition price of £41 million. Prestwick recently won 'fifth freedom' rights and the airport's cargo could double to 120,000 tonnes in the next five years.

### Rail

ScotRail, who run 2,000 trains a day, is the most punctual rail company according to the Central Rail Users' Committee for 1998-99. ScotRail does face delays in delivery of new rolling stock from Adtranz (Derby) and Alstom (Birmingham) for the Glasgow-Edinburgh route and SPTE services respectively. Virgin Trains however have a poorer performance with one in five journeys behind schedule and cancellations up by 196%. The company has plans to replace 103 of its 131 trains over the next three years as part of a £4 billion network investment. They also claim that advance cheap fares represent the lowest real rail fares for 50 years. This year passenger numbers for the railways are up 12% with nearly 1,000 new services being added as well as investment of nearly £2 billion being spent by the train companies.

John Prescott has announced that rail companies and Railtrack face unlimited fines for poor performance under the new Railways Bill. The bill gives the Strategic Railway Authority wide ranging powers and plugs the gaps in the 1993 Railways Act particularly those relating to performance criteria. Recently Great Western Trains were fined £1.5 million over the Southall train crash that killed seven people and injured 150.

Railtrack is facing the prospect of a £40 million fine if it does not clear a backlog of work that results in delays to scheduled train services. The Rail Regulator has also set Railtrack a further target, to reduce delays by 7.5% this year as well as clearing the backlog - a total reduction of 12.7% by March 2000. If it cannot make the target then it faces a penalty of £1 million for each percentage point reduction it fails to meet. Recently freight traffic has increased by 40% and passenger traffic by 25% but this has seen a 21% rise in damaged track again leading to delays. Railtrack aim to address this problem with an investment of £40 million.

### Road

Stagecoach recorded a 39% increase in pre-tax profits up to £220 million keeping it in the FTSE 100 of which Porterbrook continued to provide over half of the operating profits. The UK bus operations added about £9 million to profits of £81.7 million for the core bus operations. The strength of sterling wiped about £10 million off

turnover. Arriva saw profits rise by 8% for the first half and these were aided by a £5 million gain from property sales. Turnover was increased to £833 million from £822 million while operating profit was £68 million. FirstGroup are also trading ahead of expectations and have placed an order with Alexanders of Falkirk for bodies for 100 double decker and 100 single-floor midibuses worth £12 million. Total investment in the 780 new buses is £80 million. Both FirstGroup and Stagecoach have expanded in the US market with a £602 million purchase of a school bus operator and a £773 take-over of Houston based Coach USA respectively. National Express has bought its third US school bus operator for £109 million for the Texas based group. The school market is worth an estimated £8.1 billion and National Express only has 1.3% of the 435,000 vehicles. Stagecoach may be considering a bid for Laidlaw, the biggest coach group in the US which also operates the Greyhound fleet. Laidlaw is twice the size of Coach USA with a market capitalisation of £1.6 billion.

### Sea

Forth Ports recorded pre-tax profits of £12.5 million for the six months to June, little change from the previous figures but saw turnover rise by 3.5% to £51.9 million. Second half growth is expected to be stronger. While business at British Pipe Coaters fell sharply there was increased business from pulp and paper. Clydeport returned a 13% increase in pre-tax profits to £5.4 million up to June while turnover increased by 10% up to £13.5 million. Clydeport are continuing with their development of Glasgow Harbour in conjunction with the Bank of Scotland and is expected to announce its partner in the operation of the roll-off ferry at Port Glasgow.

### TOURISM

According to the Scottish Tourism Index compiled by The Royal Bank of Scotland and The Scottish Tourist Board concerns abound over the outlook for the hotel sector in Scotland and survey data show the industry is pessimistic about its short-term prospects. The pound remains strong, the domestic economy is experiencing its weakest period of growth since the 1990-92 recession and economic performance across Europe undermines the market for overseas visitors.

However, the outlook is not all gloomy. The Royal Bank of Scotland are forecasting a pick up in UK economic growth in the second half of this year and stronger growth again in 2000 (taking the economy back to above trend growth). The pound is still expected to depreciate over the medium term and European growth prospects look set to improve.

The latest Fraser of Allander Institute/STB survey of hotels and other accommodation providers makes gloomy reading. Optimism about the business situation has deteriorated compared with three months ago and the same period last year. Demand is down, with the rest of the UK and overseas markets particularly weak. On top of this, there is clear evidence of rising costs, all of which suggests severe margin pressure for accommodation providers.

The Bank reports that it would be easy to conclude that the poor survey data and the difficult macro-economic environment justify pessimism about the hotel sector's longer-term prospects, especially given its experience in the early 1990s. However, it does not believe that this is justified. The experience of the sector during the 1990-92 recession is unlikely to be repeated because:

- the odds were always on a soft landing this time round;
- interest rates and gearing levels have been markedly lower in this cycle;
- supply growth in recent years has been limited; and
- underlying growth in the world tourism market remains strong.

Further, the hotel sector learnt a number of lessons from the last recession:

- there have been marked improvements in hotel management, cost control and operating efficiency; and
- there is a greater focus on yield and portfolio management, on-going product investment and on customer service.

Thus, whilst performance has been, and undoubtedly will be, affected by economic conditions, the sector is in much better shape to withstand the slowdown.

The Bank believes that these improvements in the sector are also partly responsible for the longer-term improvement in occupancy rates. Rates are high in historical terms and look to have peaked. Surprisingly, the average rate for 1998 showed little change on 1997 (0.25 percentage points higher). This was despite poorer performance in the second half of the year - driven by the conditions in the domestic economy - and appears to have been at the expense of room rates (estimated to have declined by 5%). Data for the first quarter of 1999, however, show an average occupancy rate of 60.4%, 1.5 percentage points lower than the rate achieved in the same period in 1998. Given economic conditions at home and overseas, we would therefore expect rates to be flat, at best, for

1999 as a whole, with the final outcome dependent upon room rates set by operators.

Visitor data confirm the slowdown in performance. In 1998, the total number of visits to Scotland by UK residents fell by 11.7%. This compares to a 5.3% increase in 1997 and is contrary to the trend evident over the last few years. Total expenditure by UK tourists also declined, by 12% in real terms. The picture was equally poor in the overseas visitor market, especially in key European markets. The expectation is that 1999 will be another difficult year - the domestic business and leisure markets will be limited by slower GDP and consumers' expenditure growth and the overseas market will still be affected by the strong pound, particularly if it stays 'stronger for longer' than expected. Nonetheless, the underlying trend in the visitor market remains upward.

Amid the slowdown, some hotels have fared well. The occupancy data show that hotels which are larger; situated in a city/town location; attract higher tariffs (implying better quality); and are part of a group continue to outperform the market. In 1998, average occupancy rates were up to 20% higher for hotels in these categories. On the other hand, smaller independent hotels in poorer locations and which have not invested in their premises are likely to have faced tougher trading conditions. Independent operators struggle to compete on a number of fronts with national and regional chains - branding, centralised marketing and booking, scale economies and access to finance. They also face difficulties in keeping pace with consumer expectations with regard to leisure and other facilities and advances in technology. Add to this, increased costs in the form of the National Minimum Wage, the Working Time Directive and Quality Assurance schemes and it is obvious that trading during the slowdown has not been easy for smaller operators. These pressures will continue. However, that is not to rule out a strong performance by smaller operators servicing niche markets, offering a quality product and value for money and which know and actively target their core markets.

The Index shows that despite the downturn in sector performance, investment in the hotel sector, particularly the mid-market and upmarket segments, remains strong. In addition to on-going investment by most operators in their premises and new facilities, the last few years have witnessed a number of large-scale refurbishments and new hotel developments. Activity has shown little sign of tailing off recently:

- development of the £8.5 million Carnoustie Golf Course Hotel and a £2.6 million upgrade

of the Cuillin Hills Hotel in Perthshire to become a 5 star establishment.

- on-going expansion by MacDonald Hotels including a £7.5 million 4 star development in the Borders and the £12.5 million Holyrood Hotel.
- in Glasgow, a new Holiday Inn Express; £10 million Travel Inn on George Street; £3.5 million refurbishment of the Copthorne; £10 million hotel development in Jamaica Street; development by Stakis on the Broomielaw; and a new City Inn hotel are all either completed or underway.
- in Edinburgh, refurbishment of the Posthouse; £12 million redevelopment of the Roxburgh Hotel; and extension of city centre Travel Inn are all earmarked or completed.

The Bank argues that this is indicative of the confidence in the longer-term prospects for the sector, particularly the chain/branded segment of the market. The outlook for the hotel sector over the next few years is one of continued real growth, albeit at slower rates than in recent years. Occupancy rates look to have peaked. Performance, including room rates, will be driven by economic conditions - which will pick up from the second half of 1999 - a depreciating pound, underlying growth in the tourism market, improvements in the key European markets and operational improvements across the sector. There remain tough times ahead for operators during the remainder of 1999, particularly for small independent hoteliers. However, the boost provided to the sector from Millennium celebrations, the expectation of a greater focus placed upon tourism by the new Scottish Parliament and new growth opportunities emanating from the Internet, specifically STB's Project Ossian, all bode well for the sector.