

24 December 2010

Caledonian Trust PLC

Results for the year ended 30 June 2010

Caledonian Trust PLC, the Edinburgh-based property investment holding and development company, announces its audited results for the year to 30 June 2010.

Chairman's statement

Introduction

The Group made a pre-tax loss of £294,000 in the year to 30 June 2010 compared with a profit of £1,346,000 last year. Excluding investment property revaluations the Group made a trading loss of £539,000 compared with a loss of £71,000 last year. The loss per share was 2.47p and the NAV per share was 165.4p compared with 167.8p last year.

Income from rent, service charges and dilapidations was £697,000 compared with £731,000 last year. Rental income was in line with last year but dilapidations were reduced by £32,000. Gains from the sales of properties were £71,000 compared with £560,000 last year. Other operating income was £81,000 compared with £254,000 last year which included the final settlement of £222,000 at St. Magnus House, Aberdeen.

Administrative expenses were £889,000 compared with £880,000 last year.

Net interest payable was £194,000, which was £263,000 less than last year due to lower interest rates. The weighted average base rate for the year was 0.5% compared with 2.49% last year.

Review of Activities

The Group has continued to concentrate on enhancing the value of its development properties by working toward or gaining valuable planning consents.

The Group's New Town investment portfolio continues to be realised when development opportunities are achieved or the investment value has been optimised. In Young Street, adjacent to Charlotte Square, the lease of number 17 determined in August 2008, and, after agreeing a dilapidations payment the property was sold to an owner occupier in July 2009 for £407,500, at the valuation, and the transaction completed in December 2009. In North Castle Street number 57 was vacated by the City of Edinburgh Council in March 2008 and a dilapidations claim was settled by Expert determination with costs against the tenants. Subsequently planning and listed building consents were granted to divide the property into two residential units, a ground and first floor townhouse and a basement flat. The town house was sold in September 2009 for £540,000, considerably above the June 2008 valuation and has since been converted to a townhouse by the purchasers for their own occupation. The

conversion of the basement into a two bedroom flat has just been very satisfactorily completed and will be marketed in the New Year.

The basement of 61 North Castle Street is contiguous with 57 North Castle Street and has benefited from the extensive works to the ground and first floor house above which we sold last year. Plans have been lodged for its re-conversion to the more valuable residential use.

The Group's other New Town property, 9 South Charlotte Street, between Charlotte Square and Princes Street, is let to La Tasca for a further sixteen years. The rent is due to be reviewed in 2011.

St Margaret's House, London Road, is our largest property in Edinburgh where we are pursuing differing short and long-term objectives. The building has been wholly let at very modest rents to charitable causes for several years. From 1 November 2010 it has been let to one charity, Art's Complex, who reconfigure and sub-let space to over 250 "artists" and "artisans" and "galleries". Almost all the parking spaces are let to our neighbours, the Registers of Scotland, on a short-term lease. Thus in the short term we hold the building with almost no outgoings and with gross rents which should rise to over £100,000 in a few years while the considerable development potential is realised.

We have made considerable but very slow progress towards our long-term objective for a large scale redevelopment. In June 2007 our Architects produced an "Urban Analysis Report" and in July 2007 Draft Development Proposals from which the City of Edinburgh Council suggested that a Development Brief be prepared covering St Margaret's, the adjacent 125,000ft² Meadowbank House, owned and occupied by the Registers of Scotland, and all the smaller varied properties lying between the A1 and "Smokey Brae". The preparation of the "Brief" involved considerable time and preparation including six community consultations over three months! The development brief was adopted by the City of Edinburgh Council in August 2009, so providing a "Master Plan" for the whole area. In July 2009 we lodged an application for Outline Planning Consent for a 231,000ft² mixed use development of residential and/or student accommodation, an hotel, and offices and other commercial space. This proposal was submitted to City of Edinburgh Council in July 2009 and was approved in November subject to a Section 75 agreement which we expect to sign shortly. The consented proposal allows for a street frontage to London Road (A1) and direct vehicular access from it together with an "at grade" pedestrian plaza, a transformation from the current bland appearance.

We have considered several proposals for our large development site at Waterloo, London SE1. Previously we had attempted to negotiate with Lambeth Council to purchase the contiguous garage owned by them or to enter into an agreement with them to our mutual benefit by realising the considerable marriage value. Agreement was not reached but the opportunity remains. Meanwhile we are negotiating a sale of our own site for residential use, unqualified as to planning, but with a delayed settlement subject to a small overage, if the adjacent site is developed.

The M74 extension to the Kingston Bridge over the Clyde in Glasgow is due to be completed in 2011 after considerable delays caused by the extensive planning process and a judicial review. We have two properties in Tradeston just east of the Kingston Bridge to which access will be greatly improved as a result of the road extension and which are benefiting from an extensive development programme, including the demolition or conversion of several Victorian industrial buildings and warehouses and the opening of the pedestrian bridge across the Clyde to the Broomielaw, Glasgow's modern financial district. All these changes will improve our small secondary shopping parade there at 1-7 Scotland Street. More importantly they will greatly improve the access to and attractiveness of our investment property at 100 West Street, a bespoke car showroom let to the Eastern Western Group until 2026 subject to a

fixed minimum rental uplift of 16% in May 2011. We have recently agreed to the tenant's proposal to extend the showroom space.

We have three development sites in or near Edinburgh on which we decided in 2007 to delay development because of the worsening economic conditions. In Belford Road, Edinburgh, a quiet cul-de-sac, less than 500m from Charlotte Square and the West End of Princes Street we have a long-standing office consent for 22,500ft² and fourteen cars which has been technically "commenced". We are currently promoting the site for an unusual type of office use for which an interest had been expressed. We also have a separate residential consent for 20,000ft² and twenty cars. This residential scheme is being redesigned to reduce construction costs by reducing the extent and type of excavation, by eliminating an expensive "weight transfer plinth" and by changing the proposed structural elements. In this revised scheme the parking will extend to two floors with the loss of the least valuable residential floor, but further space may be achievable on the upper floors. The existing residential planning consent has just been extended for a further five years.

In August 2006, five years after the original application, consent was granted for eight detached houses at a site in Wallyford, Musselburgh which is within 400 yards of the East Coast mainline station near the A1/A720 City Bypass junctions and contiguous to a recently completed development of 250 houses by two national house builders. In Wallyford we consider that the market for smaller houses has improved relative to larger houses and we have lodged an application to replace the two largest detached houses with a terrace of four providing ten houses altogether with a larger saleable area of 12,469ft². This change is acceptable to the planning department, subject to two minor conditions.

In East Edinburgh at Brunstane Farm, adjacent to Brunstane railway station, we hold a consent to reconstruct an existing cottage attached to the farm steading and to convert the steading into nine houses of various sizes totalling 14,000ft² altogether. Beyond the steading lies another detached stone building on which consent was granted in May 2009 for conversion to a detached house extending to 3,500ft² on open ground with views to the Forth estuary. We have also gained consent to install French windows in the existing five two-storey farm cottages to improve their southern aspect. Brunstane is in the Green Belt from which we made three separate unsuccessful applications for its abstraction. However, once the redevelopment is complete and the large area to the south recently abstracted from the Green Belt and included in the City of Edinburgh Local Plan for two hundred homes is developed, a reassessment of the existing Green Belt boundaries, including the two-and-a-half acres of scrubland which we own contiguous with Brunstane steading, is likely. Any abstractions from the Green Belt, particularly one within the City Boundary, would be very valuable.

The Company owns fifteen separate rural development opportunities, nine in Perthshire, three in Fife, two in Argyll & Bute and one in East Dunbartonshire, all set in areas of high amenity. Unsurprisingly, proposals for any change there meet local opposition, frequently vocal and often well co-ordinated. The new requirement to be outside the 1 in 200 year flood plan (i.e. less than 0.05% chance of flooding in any one year) can eliminate sites that pass all other tests. As small sites are less financially rewarding to local authorities and less important in achieving their housing targets, the support and priority given to them from planning authorities is often "patchy". The elected members of the planning committee now gain their seats on the council by proportional representation and are much more influenced by the concerns of individual constituents than they were previously. Thus the process of gaining planning consent for small well-located developments has become increasingly more tortuous and in some cases the scale of development has been restricted beyond what in many cases originally seemed appropriate and reasonable. Paradoxically, the more complex the process becomes, the more restricted the permissions are, the more the overall supply is reduced and the more valuable these restricted consents become.

In spite of all these difficulties I am pleased to report that considerable success continues to be achieved with our planning applications. I report first on some of our rural developments in Perthshire. At Tomperran, a smallholding in Comrie on the river Earn where we submitted an application for twelve houses over 19,047ft² in November 2007, we were required to change the proposed layout again, having previously adjusted it to accommodate a cycle path requested by the Council, and resubmitted an application in November 2007 which was approved in July 2009 for 19,206ft². The smallholding includes two acres zoned for industrial use and 34 acres adjacent to the settlement, a proportion of which is being promoted for a housing allocation in the emerging Local Plan. At Chance Inn steading, where we had previously applied for seventeen houses plus four affordable houses, in April 2009 we applied for a revised scheme containing ten private houses over 21,836ft² which was approved in September 2009. Separately, near Chance Inn farmhouse, an application for two detached houses totalling 3,366ft² was approved in June 2010. Recently approval has been gained to convert the integral garage at Chance Inn farmhouse into a semi self-contained "guest suite", and to upgrade the house, including adding an en-suite bathroom, and this work has started. The upgraded house and the two plots will be marketed next year. At Balnaguard, where we originally applied for nine houses over 15,719ft², we reapplied for a different configuration of 16,254ft² which was approved in July 2009. At Myreside Farm, in the Carse of Gowrie between Perth and Dundee, we lodged an application in September 2007 for eight houses totalling 12,410ft² on the steading adjacent to the attractive listed farmhouse, which was refused and lodged an appeal in October 2010. At Strathtay we had a proposal for four large detached houses and an alternative proposal for three large detached houses refused. A subsequent proposal for two houses 6,040ft² was subsequently approved in May 2010. Proposals for the remainder of the site in the village envelope are being formulated. At Camghouran, in northern Perthshire on Loch Rannoch next to the Allt Camghouran stream, we have lodged an application for three houses over 2,751ft². At Carnbo, where our proposal for four houses in the large garden of the former farmhouse was refused and the appeal was refused on the grounds that the housing allocation had already been met, we are now promoting the scheme through the emerging Local Plan. Carnbo farmhouse was sold for £320,000 on 1 March 2010 after some remedial work, the price reflecting the loss of part of the garden.

Planning work has started on two attractive rural sites near St Andrews in Fife. Larennie, Peat Inn, five miles from St Andrews an application previously made has been withdrawn and a new application was registered in June 2010 for nine houses, five conversions of stone buildings and four "new build". At Frithfield, six miles from St Andrews, an application is being prepared for twelve units.

The potential for planning gain differs between the specific sites already discussed and the large land holdings at Gartshore near Kirkintilloch and Ardpatrik on West Loch Tarbert, Argyll, and these in turn differ between each other, although both offer very considerable opportunities in the medium term.

Gartshore comprises the nucleus of the large estate owned until recently by the Whitelaw family and includes 120 acres of agricultural land, with parks surrounded by mature trees and 80 acres of policies, designed landscape and gardens including a magnificent Georgian stone pigeonnier and a huge walled garden. The ornate 15,000ft² Victorian stable block is indicative of the breadth of the original design. The exceptional quality of the design is complemented by a quite unexpectedly favourable location. Gartshore is only seven miles from central Glasgow, two miles from the M73/M80 junction, seven miles from the M8 (via the M73) and three miles from two Glasgow/Edinburgh mainline stations (Croy and Lenzie) and Cumbernauld commuter station. We are promoting Gartshore, a site at the very centre of Scotland, with excellent communications, as having enclosed landscaped parks with a designed landscape with mature trees suitable for high quality offices

and an hotel together with a destination leisure centre created from the restoration of paths, avenues, walled gardens, and built landscape features. Gartshore offers an immediately available site in a mature setting requiring no remediation and not suffering any of the sometimes difficult and long-delayed procedures associated with brownfield sites. These advantages will allow East Dunbartonshire which benefits from a highly skilled workforce to compete strongly with other areas for incoming investment.

Ardpatrick, like Gartshore, has very considerable medium-term development potential but for high quality residential property, compatible with the environment, a destination venue enhanced by restoration and appropriate leisure activities. Restoration provides a key to uncover the attractions of Ardpatrick mostly masked by neglect. Such restoration also provides a framework within which development can be created which is designed to attract a limited number of purchasers who appreciate Ardpatrick's natural beauty and are anxious to sustain and enhance it. Such purchasers will add to the quality, variety and vibrancy of the community. The ongoing restoration represents a huge commitment in money, time and skill and some particularly difficult tasks remain. Much of the residential property has now been restored including two houses within the house curtilage and four outlying cottages which have been sold. The restoration of the South Lodge is now almost complete and an access to allow restoration of the Keeper's Cottage has been laid. Consents have been granted to divide the house in four, to build one new house, to convert the stone garden shed to a house, to make the existing coach house and flat into two dwellings and to undertake certain residential extensions. Recently consent was also given to build a further house which complements and completes the existing design of houses within the curtilage.

Extensive restoration is also taking place in the built and designed landscape of the Estate whose original design and execution appear enlightened, the more so as it is revealed. Thus roads, ditches, walls, fences, gates and fields require attention to exhibit the created and proportionate order within a natural randomness.

Within Ardpatrick there were areas designated as "Rural Development Opportunities" in the Local Plan. The Reporter at the Local Plan Inquiry recommended that these areas should be professionally reviewed to determine the landscape "capacity". The survey covering Ardpatrick, the North and South Kintyre Landscape Capacity Study, was published in early 2010 and concludes that, although much of Ardpatrick landscape is of exceptional quality, most of the development opportunities relate to areas where intrusion is minimal and landscape considerations should not materially affect the high quality developments which we propose. Thus the attractions of staying at Ardpatrick will be made available to a wider public.

Economic Prospects

"Credit is a present remedy against poverty &, like the best medicines in Physick works strongly & has a poisonous quality". So Sir Isaac Newton, Master of the Mint, (1699-1727) succinctly observed. Almost certainly he would have adduced that the "poisonous quality" of credit is both long lasting and contagious. In the current economic crisis both such qualities are widely manifest.

In September 2009 the UK completed six quarters of economic contraction totalling 6.1%, including a swingeing fall of 2.4% in Q1 2009. The recession ended when growth restarted hesitantly, at 0.4% in Q4 last year and the economy has continued to grow since then including an anomalous 1.1% spurt in Q2 2010, but it has only just returned to the same level of output as at the end of 2008. Thus the recession, as formally defined, is now over although the economy remains "depressed", currently operating at 3.6% below its pre-recession peak in March 2008.

Forecasts of UK growth discussed later vary between 1.0% (Deloitte) and 2.4% (Bank of England central forecast) for 2011 and between 1.5% (Deloitte) and 2.8% (Bank of England) in 2012. If growth should average 1.8% each year, then GNP will regain the March 2008 peak in December 2012, nineteen quarters later, or just under five years, a period exceeding even the 1930-34 depression which lasted less than four years. While the current UK depression is likely to last longer than in the 1930s, it is less severe than in the 1930s when output fell by 7.5% recovered to 6% before falling again to 7.5%, six months later - a "double dip recession" - before making a rapid recovery. The current depression is likely to be longer than any in the last 80 years and has been deeper than any since the 1930s.

The crisis leading to the current "Second Great Contraction" was presaged on 9 August 2007 by a withdrawal of funding for collateralised mortgage securities - a black cloud in an otherwise clear blue sky. I Kings 18 recounts how the prophet Elijah sent his servant seven times to look at the seas. "It came to pass on the seventh time that he said 'Behold there ariseth a cloud out of the sea, as small as a man's hand'. So Elijah the prophet said to King Ahab 'make ready and get thee down that the rain stop thee not'. The heavens grew black and there was a great rain". Losses in the US predicted at \$20-30bn in September 2007 rose within two months to \$600-800bn. Surely a very great rain!

The Bank of England and its servants saw no such cloud on or before August 2007. Indeed, because of predicted higher inflation, interest rates had just been raised to 5.75% and growth was predicted at 2.5% to 3.0% per year. But the storm came, catching unprepared virtually all the authorities, who certainly had not made "ready and get thee down" after a long period of clear blue skies including 63 successive quarters of economic growth, a golden age of exceptional stability, the economy moving steadily in perfect Goldilocks fashion, neither too hot nor too cold, with inflation within the target range for more than fourteen years and an economic policy based almost solely on the monetary policy determined by independent MPC which had eliminated "boom and bust". HM the Queen disingenuously enquired of the Director of the London School of Economics, Professor Luis Garicano: "if these things were so large, how come everyone missed them?" Indeed part of the answer is that everyone who mattered was not looking for them. Specifically the MPC is constrained by its remit to target inflation at a low level on a specific narrow definition. Wider broader objectives favoured by some commentators and considered more likely by them to provide enhanced economic stability and growth are normally excluded from consideration. However, targeting CPI inflation like all single targets – money supply, the gold standard, the balance of payments, the £/\$ rate and the shadowing of the D-Mark – may be necessary but it is certainly not sufficient.

In the UK, recessions have occurred roughly every decade since WWI – apart from the recent period of golden stability and in the US fifteen times since 1926. The recessions lack common cause but normally follow one or more of wars, external shocks, particularly oil price rises and defaults, inflation and asset booms in finance and/or property. The current depression originates from an asset boom, or bubble.

Asset bubbles can usefully be differentiated between the delightfully termed "pure irrational exuberance bubble" and the "credit boom bubble". "Irrational" bubbles involve little credit and on bursting cause little collateral damage. The pricking of the irrational bubble in the high tech stocks in the late 1990s caused little collateral damage and, notably, did not materially affect bank balance sheets. Similarly, when the stock market boom of the late 1980s, which was not primarily sustained by credit, collapsed in 1987 the financial system was not stressed, so allowing the economy to recover quickly. Equity based "irrational" booms on collapse cause little collateral damage as the equity, the paper profits for instance of the dot.com companies, is the principal loss. Credit boom bubbles, or the "cycle of leveraging against higher asset values", as Professor Fredrick Martin, a former governor of the Fed, categorises them, are much more dangerous, causing the finance sector widespread damage on bursting.

Such a bubble was categorised by Hyman P Minsky in 1992 as a Financial Instability Hypothesis, or "Minsky" cycle which he describes thus: "capitalist economies exhibit inflations and debt difficulties which seem to have the potential to spin out of control the economic system's reaction to a movement of the economy amplifies the movement – inflation feeds on inflation and debt deflation feeds on deflation": a vicious spiral operates on both inflation and debt deflation, the stage now being experienced.

The advanced economies are experiencing a very severe Minsky cycle described by Carmen M and Vincent R Reinhart ("Reinhart") in the paper "After the Fall" as a synchronous global contraction, following the 2007 US sub-prime collapse, with virtually every country of the 182 recorded reporting significantly lower exports in 2008 and half of the 182 countries reporting outright declines in real GDP in 2009. Similar global contractions have occurred in the Great Contraction after the 1929 stock market crash and following the 1973 oil shock. He comments that the events of the past three years are not without precedent, but the precedents are distributed across countries and over time, and the current global contraction is notable both for the synchronous decline in output and for the "damage" to financial intermediaries which impaired financial markets and abruptly curtailed new lending.

Reinhart's study examines the three synchronous global contractions and the fifteen severe post WWII financial crises in both advanced and emerging economies to determine the behaviour of real GDP (both levels and growth rates) unemployment, inflation, bank credit and real estate prices in a twenty-one year window – i.e. ten years "before" the year, t , and ten years "after" – surrounding economic disruptions. The analysis of the current crisis "after" extends necessarily only to three years.

The effects of these adverse shocks persist long after their immediate and evident costs. In the decade following synchronous world-wide shocks and severe financial crises the median post crisis growth in GNP declined about 1 percentage point each year. Total output declines sharply in synchronous global contractions, particularly so in the Great Depression, but much less so in the 1973 oil shock. In half the advanced economies studied real GNP remained below the 1929 pre-crisis level until 1939 – an ominous precedent. In the current crisis median real per capita GDP is 2% lower than it was in 2007, comparable with the fall in GDP three years after the fifteen severe post WWII crises. Currently 82% of observations are at or below 2007 levels as opposed to 60% at a similar post-crisis interval. Thus individual countries' recessions are proving deeper, and more persistent and widespread.

Employment levels deteriorated considerably in the ten years following severe financial crises, particularly for the five advanced economies studied (Spain 1977, Norway 1987, Finland 1991, Sweden 1991 and Japan 1992) where the median unemployment rate at $t + 10$ is about 5% points higher. In ten countries (the five above plus the five emerging economies in the 1997 Asia crisis) out of the fifteen studied (10 plus four South American plus Turkey) unemployment has never fallen back to its pre-crisis level in the decade that followed or subsequently (30 years for Spain; 18 years for Japan!)

Real housing prices also proved to be significantly affected ten years after Severe Financial Crisis in the ten episodes for which housing data was available. Reinhart used a reference point as one year before ($t-1$) the financial crisis, as the crisis itself in year t affected real prices. In advanced economies' crises at $t + 10$ years (10 years plus 1 year) the median price level was 83.0% of the pre-crisis level, the lowest Finland, 58.9%, and the highest Spain, 123.2%. The inclusion of five emerging with the five advanced economies (i.e. 10 altogether) for which house price data was available (Columbia, Indonesia, Korea, Malaysia and the Philippines) produced similar results: the median price was 82.4%, the lowest Philippines 44.7% and the maximum Spain (as above) 123.2%. Reinhart notes that, while equivalent real estate data was not available in the Great Depression, the Annual Report of the League of

Nations of the 1930s, especially 1938-40, devoted several chapters to documenting the collapses in construction (and thus houses and house prices) as key determinants of the abysmal performance of output and employment then.

House prices are probably linked to employment levels and in the Reinharts' study both had long cycle times. In Professor Rogoff of Harvard's study (*This Time is Different: Eight Centuries of Financial Folly*) following banking crisis real house prices declined on average for six years with none less than three years and in Japan, the only country longer than seven years, an amazing eighteen years of decline (not yet recovered) but even excluding Japan the average decline was over five years. Unemployment downturn durations are similar to housing, but less severe. On average unemployment rises for almost five years, with an increase in unemployment rate of about 7 percentage points. In the Great Depression US unemployment rose 20 percentage points but emerging countries normally experienced less than a 7 percentage point rise possibly due to greater downward wage flexibility and less advantageous welfare provisions. In contrast Equity declines following banking crises are much shorter than housing averaging 3.4 years but much more severe averaging a 55.9% fall.

GDP declines following banking crises occur over a markedly shorter time than asset declines, equities and house prices, and employment and average only 1.9 years (for non banking crises typically less than a year). The average GDP fall of 9.3% is similar to the percentage point increase in unemployment but significantly less than the 35% and 55.9% falls in house prices and equity values respectively. Two factors contribute to the wide difference between the extent of GDP and asset falls. The actual GDP fall understates the gap between the potential GDP and the actual fall, the "output gap". For instance, with an inherent growth rate of, say, 2.5% potential output two years later would be 5.06% higher and a fall of 9.3% in actual (as above) gives a fall from potential output of 13.7%. The second factor is that GDP and, to a large extent, employment reflect the condition of the economy as a whole, but asset prices reflect an amalgam of the margin of the economy, the residual earnings capacity of enterprises and the marginal demand for assets. Credit availability, or rationing and credit price are major determinants of such asset demand.

Reinhart has shown that in the fifteen severe post WWII financial crises that during the ten years before the crises credit as a proportion of GDP rose significantly, the median being 38.4 percentage points. In Spain for example the minimum ratio before the 1977 crisis was 65.6% but at the time of the crisis it was 102.5% a rise of 36.8 percentage points. However, over that period the Spanish economy has expanded by 3.1% p.a or by 35.7%. Thus the earlier credit to GDP ratio, 65.6%, had grown to 102.5% of 135.7 or 139.1%. Over the ten years following the crisis the median deleveraging between the maximum credit ratio before the crisis and the maximum within ten years was 37.7 percentage points. The median figures encompass a wide range. Surges of 70 percentage points or more occurred in Japan (1992), the maximum in the advanced economies, in Chile (1981) and in Thailand (1997). This ratio often continued to increase after the crisis primarily because GDP decreased, notably in Japan where the ratio peaked in 1996, four years after the crisis. Reinhart concludes:- "The median duration (in years) of these credit booms, about ten years. The unwinding or deleveraging following a crisis is of comparable magnitude. Indeed, the median decline in credit/GDP is also about 38 percent. This unwinding also stretches over many years – often a full decade (and even longer). We cannot discriminate from this analysis whether the retrenchment in credit arises primarily from financial institutions' inability or unwillingness to lend after the crisis or from weak demand for loans associated with slower economic growth and greater resource slack. The surge in credit does appear to fuel growth in the pre-crisis decade, while its contraction following the crisis no doubt contributes to the sub-par performance in the macro-economic aggregates and in real estate prices in the decade that follows".

The accuracy of any analysis of the possible outcome of the 2007 crisis by reference to the fifteen post-WWII crises studied is prejudiced because, like the 1930s Great Depression and

the 1973 oil shock, it is a synchronous global contraction, and because only three years have yet elapsed. An analysis of changes in house prices and debt in the ten years to 2007 shows a similar pattern to that of the fifteen post-WWII severe financial crises. In the ten years to 2007 average real house prices rose by 68.0% (median 79.7%) and the domestic credit GDP ratio rose on average 54.4 percentage points (median 46.9%). The precedent of the outcome of the fifteen post war crises is most unfavourable: after ten years in the five advanced economies the median house prices had fallen 17% and in the ²¹⁰⁻¹⁸ worst case, in Finland, by 41.1%. De-leveraging expressed as bank credit as a proportion of GDP fell by about 38 percentage points, having risen by about the same figure and this de-leveraging took place over seven years on average. If the fifteen post-WWII crises are a reliable precedent, the re-adjustment as reported by Reinhart in August 2010 is still in its earlier stages. Real house prices have fallen only by an average of 8.0%, but in the five "worst" economies as defined by Reinhart, - US, Spain, UK, Ireland and Iceland - the fall is an un-weighted 24.2% in real terms. In the ten years before the 2007 crisis the median credit/GDP rise was about 59 percentage points, well above the 38 percentage points in the fifteen post-WWII crises but no general adjustment to the credit/GDP ratio has yet taken place except in the US and Iceland where the crisis unfolded earlier.

The extent of the likely further adjustment, how it is effected and how the damage to the economy is mitigated are greatly influenced by policy decisions. Reinhart opines that a "ubiquitous pattern in policy pitfalls has been to assume negative shocks are temporary when these were, in fact, subsequently revealed to be permanent or, at least, very persistent". Reinhart observes associations - he does not posit causation - on the long-term effects of severe economic dislocations. Growth falls and unemployment remains high; additionally real asset values fall and credit in relation to GDP falls; deflation follows except where the dislocation was caused by the exogenous inflationary spike as in the oil price crisis of 1973.

The causes of the associations are varied and complex. Policymakers could provide insufficient stimulus after a major crisis; credit supply may be reduced by the collapse of financial intermediaries or by changes in their criteria, preferences or statutory obligations; or slow recovery might reinforce slow recovery, a self-reinforcing feedback. Such reinforcement occurs if either perceived poor growth prospects resulted in below trend investment and hence lower productivity, or if unemployment, increased in the recession, remained high as a result of the increasing "unemployability" of the long-term unemployed.

Policy decisions taken in adverse economic circumstances may be self-reinforcing and reduce output further. Past inhibiting interventions have included trade, working practice, union and credit restrictions. Thus the output effect of crises may have the "remedy" as the cause. Alternatively perceived poor output after a crisis may represent reality, the higher level prior to the crises being unreal. Technical innovations, including financial innovations and liberalisation, provide increased prospective productivity in anticipation of which investment is increased. Such over-investment has taken place since the introduction of the diving-bell, the steam engine, the railways, the instalment credit industry, the deregulation of aspects of the finance industry and, latterly, aspects of the dot.com industry. Investment created on hope contracts steeply and then recovers to the appropriate level. Prior to the current crisis, from 1997, the period of "great moderation", several countries including the UK, Ireland, Iceland and Spain grew at rates significantly higher than in the previous 46 years. There is no evidence that the period of "great moderation" prior to the 2007 crisis is "normal". Indeed, it is possible that the earlier 46 years were "normal" and the subsequent uplift resulted from the influence of some "abnormal" factors. The prime suspect is the surplus capital or savings of export surplus countries such as China providing a one-off but long-lasting boom in the consuming economies of the West.

Whatever the cause or causes of the present crisis, the Second Great Contraction, the outcome is dependent on economic management. The Great Depression represents the economic downturn closest to the current crisis: it was a synchronous global contraction emanating from the heart of the western capitalist society. In the US the recession began in 1929 apparently a similar recession to that of December 1919-1921 economic growth flattened before a steep collapse coincided with the rapid failure of banks in 1931. A sustained recovery did not take place until March 1933 accompanied by the New Deal measures taken after the end of the "Banking Holiday". The index of Industrial Production fell from 114 in July 1929 to 54 in March 1933 when unemployment peaked at 24.9%. The cause and "cure" of the Great Depression may provide guidance for economic management now.

Many explanations have been put forward as the cause or causes of the Great Depression. Recessions were not an uncommon feature of the US economy, the early 1920s commencing with three recessions: December 1919 - July 1921, May 1923 - July 1924 and October 1926 - November 1927. The latter two were mild, lasting just over a year, but the earliest one was judged severe as real GNP fell 15% from a post-WWI peak in 1919. This post-war recession followed the high inflationary period of the War and during the course of the recession the Fed tightened monetary policy, described by Milton Friedman as "the first real trial of the new system on monetary control introduced by the Federal Reserve Act". The Fed's tightening occurred as the economy recovered and it was argued contributed to the economic recovery: Friedman notes "in retrospect we can see that this was a major step towards the assumption by government of explicit continuous responsibility for economic stability. During the 1920s the system took – and perhaps more correctly was given – credit for the generally stable conditions that prevailed, and high hopes were placed in the potency of monetary policy as then administered".²¹⁴⁻¹ Indeed the roaring twenties were a great economic success achieving a real growth rate of 4.6% per annum from 1920-1929. One cannot escape the hint of an ominous parallel with the esteem felt for the present regulatory and monetary system and the era of "great moderation".

The Fed tightened monetary policy in the 1919-1921 recession during a period of substantial deflation and the economy subsequently recovered: this association indicated that the economy could be deflated or liquidated without paying a severe penalty in terms of reduced output. However this misguided conclusion or premise was based on a misjudgement then of both the supply and the demand sides of the economy: the tragedy is that it was a premise that conditioned the initial response to the Great Depression. The supply position in early 1920s was the mirror image of the oil shock of 1973. There was a wide range of increases in supply following the Great War, particularly in the production of agricultural goods and in imported primary commodities which led to a drop in the wholesale price index of 46% between 1920 and 1921. Changes in domestic demand were offset by a huge growth in exports especially to the European countries devastated by war whose economies were not being constrained by monetary policy. If the earlier estimates of a 15% decline in output are adjusted for changes in real prices, the contraction is only 3%, an economic outcome in spite of, but not because of, the Fed's monetary policy.

The Fed's strategy, seemingly so successful over the 1920s, was carried into the beginning of the recession and was summarised by Hamilton Overview of the Great Depression-: "in short in terms of magnitudes consciously contributed by the Fed, it would be difficult to design a more contradictory policy.....". Milton Friedman in, *A Monetary History of the United States*, considers that the Fed made three major policy errors. First in order to protect the dollar and prevent the loss of gold reserves the Fed raised interest rates; second, although for a short time in 1932 the Fed eased monetary policy by making "open market" purchases of US debt - so releasing money into the system. This was reversed within six months as a result of Congressional pressure. Third, the Fed took no steps to ameliorate the liquidity problems faced by the banks of which 40% of those trading in 1929 had failed by 1932. The Fed was not alone in its view: Treasury Secretary Andrew Mellon said in 1929 "I see nothing in the

present situation that is either menacing or warrants pessimism". Friedman's explanation, the Monetary Hypothesis, of the great contraction when the supply of money fell 35% and prices dropped by 33% was that the relationship between the decline in aggregate output and the failure of the banks was causal. He contended that the failure of the banks caused the general economic contraction and not vice versa. Bank failures were transmitted to the economy by reducing the wealth of bank shareholders and presumably depositors, but much more importantly by leading to a rapid fall in the supply of money.

Bernanke in his thesis "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression" contended that the thesis proposed by Friedman was an incomplete explanation. He found that the monetary effects of the financial crisis were of themselves quantitatively insufficient to explain the subsequent falls in output; separately he argues that as money, according to monetarism, influences prices and not output, i.e. the "neutrality of money", the money supply restrictions do not explain the fall in output. He found instead that in such a deep recession the effectiveness of financial inter-mediation decreased, leading to reductions in credit supply and increases in its cost. He argued that as contracts between lenders and borrowers require detailed specific individual information on data that is subject to rapid and random change, sufficiently reliable information became increasingly difficult and expensive to obtain. Bernanke states "as the real cost of intermediations increased some borrowers especially householders, farmers and small firms (SMEs) found credit to be expensive and difficult to obtain. The effects of this credit squeeze on aggregate demand helped convert the severe but not unprecedented downturn of 1929-30 into a protracted depression".

Bernanke coined the acronym "CCI" "Cost of Credit Intermediation", a cost which bore particularly on "small idiosyncratic borrowers whose liabilities are too few to be publicly traded". He describes this cost as that of distinguishing between "good" and "bad" borrowers. Good borrowers desire loans to undertake individual specific investment projects which generate a random return from a wide range of possible outcomes whose mean always exceeds the total costs, including the CCI and opportunity (i.e. best other option) costs. Bad borrowers try to look like good borrowers but in fact they have no "project". They are assumed to squander any loan received in profligate consumption, then to default! Banks differentiate between these two classes of borrowers and in a competitive banking system the CCI is this cost of transmitting funds from savers to borrowers and includes all associated costs including losses by loss-making loans within the "good" category. The Banks' skill lies in evaluating potential borrowers, establishing long-term relationships and offering loan conditions that encourage potential borrowers to "self-select" in a favourable way. For instance it has been shown that borrowers with a high probability of default choose a contract with a higher interest rate and with lower collateral than borrowers with a low probability of default. Thus good borrowers offer both better collateral i.e. a lower loss on default and a lower risk of needing such collateral. The banking crisis altered the CCI. Liquidity preferences for the banks and the failure of others banks moved a proportion of borrowers to other credit channels with a higher CCI. Defaults also increased the CCI and the progressive erosion of borrowers' collateral relative to debt burdens increased the cost of and the probability of default. A normal response to a CCI increase would be to increase margins, but the more usual response is for banks just not to make loans to some people they might have lent to in better times. This pattern was reported in the 1930s, and precluded many borrowers, even with good projects, from getting funds while lenders rushed to compete for existing high grade assets. It was put at the time:- "We see money accumulating at the centers (sic) with difficulty in finding safe investment for it; interest rates dropping down lower than ever before; money available in great plenty for things that are obviously safe, but not available at all for things that are in fact safe, and which under normal circumstances would be entirely safe (and there are a great many such), but which are viewed with suspicion by lenders" (Frederiksen D.M 1931 p139).

Bernanke contends that money was available for a few safe borrowers but difficult for everyone else. A proxy for this shift is the margin for Baa corporate bonds over treasury bonds. Baa represents the “same” given risk over Treasury, the Baa rating being constant, currently classified as Moody’s lower medium and in turn being proxy for borrowers having limited access to capital markets. In 1930 the margin was 2.67 percentage points over Treasury but this widened to 7.93 percentage points in mid 1932. In contrast in the 1919-22 recession the differential never exceeded 3.5 percentage points.

The rise in the Baa-Treasury yield gap coincided with both the maximum rate of deposits loss in failed banks and in the sharpest reduction in loans granted as a proportion of personal income, a net reduction of 31%. It was reported at the time by the National Industrial Conference Board survey that “During 1930 the shrinkage of commercial loans no more than reflected business recession. During 1931 and 1932 it unquestionably represented pressure by banks on customers for repayment of loans and refusal by banks to grant new loans.” The classes of borrowers most affected were households, farmers, unincorporated business and small corporations. The Great Depression exacted a heavy price on normally creditworthy business as the choice of assets in banks’ portfolios was skewed in a non-perfect market where actions were determined according to different criteria.

A study of the Canadian economy in the Great Depression illustrates an economy with a similar debt crisis to the US but no banking crisis. Debt problems in Canadian agriculture and mortgage markets were as severe as the US, and major industries, notably pulp and paper, experienced many disruptions. In consequence, although these were no serious bank runs, bankers shifted from loans to safer assets. The following was reported in the *America Banker* (6 Dec 1932):- “The chief criticism of our present system appears to be that in good times credit is expanded to great extremes but, when the pinch of hard times is first being felt, credit is suddenly and drastically restricted by the banks. At the present time loans are only being made where the banks have a very wide margin of security and every effort is being made to collect outstanding loans. All our banks are reaching out in an endeavour to liquefy their assets”. Thus good borrowers find it more difficult to obtain credit when there is extensive insolvency: debt crisis should be added to the credit crisis as a source of disruption to the credit system.

The “credit view”, as Bernanke’s hypothesis has become known reinforced Friedman’s monetary view and provided a basis for explaining the depth of the Great Depression. It also offered an explanation for its persistence which in the US was for ten years or until 1939.

The second Great Contraction’s recovery cycle will be very much shorter than that of the Great Depression, although, as argued above, the period will be considerably longer than the non-banking recessions. However, there are several significant points of difference between the depressions and between the countries within the depression. The second Great Contraction is modest compared to the Great Depression, primarily because of the massive early and appropriate intervention of the authorities’ fiscal and monetary policies, the consequences of which are the source of some subsequent sovereign crises and give rise to policy options specific to the individual economies. The success of the interventions was noted earlier by *The Economist* as “Deft Policy saw off Calamity” Indeed! Importantly, the economies affected by the banking crisis, while they are predominantly also those affected by the Great Depression, now contribute a very much smaller percentage of the world aggregate demand, and are therefore more easily able to expand exports into the rest of the world, whose economy is estimated to grow 3.5% in 2010.

In July 2008 the FT surveyed the European economies and only one, Austria, was classified “sunny” i.e. “economic growth accelerating unemployment falling”, and none were classified as “serious lasting disruption”. By September 2010, (FT survey) 6 countries had become

"sunny", but three, Greece, Iceland and Ireland had been reclassified as "serious disruption". In Western Europe, i.e. leaving aside former CIS members, no non-Eurozone EU member was classified "as serious disruption" nor were any non EU members except Iceland, an exceptional and anomalous case. The focus of difficulties lies in four Eurozone countries the "PIGS" in all of which the uniform Eurozone monetary policies have facilitated a higher cost structure. Such uncompetitiveness can be remedied by one or more of: a step up in productivity, a lowering of real wages or a devaluation of the currency, but all these options present grave difficulties. Productivity increases have historically varied only within a narrow range, labour cost reductions are only achievable by maintaining wages below inflationary rises, an achievement accomplished by Germany in recent years, but one requiring unusual cultural norms, and such norms are not normally ascribed to the nations currently in need of them; the devaluation of the currency is precluded by membership of the Euro.

The "Anglo-Saxon" economies, principally the US and the UK, being not tied either to an external monetary system or to a fixed exchange system, are inherently more flexible in their economic policies. The US, has two unique advantages: the mandate for the Fed and its Chairman. The Fed has a dual mandate, to foster maximum employment and price stability a wider mandate than the MPC. The Chairman is Ben S Bernanke, the author of *Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression* (1983 American Economic Review), extensively discussed above, surely a serendipitous appointment.

The US economy, while at the epicentre of the storm, contracted only 5.4% in the Second Great Contraction, appreciably less than other high income countries, all much less than the historic average of 9.3% in the fifteen major banking crises studied by Rogoff and significantly below the catastrophe of the Great Depression. Qualitatively the US response has been "textbook": support for the financial system through "TARP" financial guarantees to "banking" institutions; fiscal stimulus; and action by the Fed to sustain the flow of credit. The TARP has been remarkably effective and likely to cost only ½% of GDP while financial guarantees sustained the financial institutions. True to his analysis of the Great Depression the Fed under Ben Bernanke has reduced interest rates to such an extent that this aspect of monetary policy is no longer effective, the so called "liquidity trap", where cash is preferred over bonds which are likely to fall in value as interest rates rise. Fiscal stimulus, outside the Fed's remit has been relatively limited, currently estimated at 6% of GDP representing under a fifth of the cumulative expected deficits of 2009, 2010 and 2011 and, although growth in the third quarter was 0.5%, it is less than the 1.2% in Q4 2009 and, due to a surge in productivity, unemployment has risen. Further fiscal measures would stimulate demand but until very recently seemed politically precluded. Martin Wolf polemizes such an attitude: an ambulance crew renders desperate resuscitation measures to a patient who has suffered a cardiac arrest; timely measures (the Economists "Deft Policy") save him and he makes a protracted and partial recovery in hospital; after two years but not fully recovered he sues his saviours alleging that, but for their interference, he would be as good as new; as for the arrest, it was a minor event and he would have been better off if left alone!

Fortunately the patient is not in sole charge of treatment, given the diagnosis is that the recovery from the cardiac arrest is only partial and the arrest had been induced by continuing external factors whose elimination is required to pre-empt a relapse. "Dr" Bernanke had prescribed further monetary expansion in the controversial form of the delightfully termed "Quantitative Easing" which, while not a panacea, should contribute to the treatment of several separate but inter-connected ailments. QE "treats" long-term interest rates, as opposed to the short-term rates modulated by the Fed "rate", but given the patient's many-faceted illnesses incorporates important therapies to treat two others: the threat of deflation and the growing overhang of external dollar balances.

Severe deflation constituted a major self-reinforcing factor in the Great Depression. Each time prices fell asset values fell, LTVs increased and some debtors became insolvent, so forcing further sales and then further asset writedowns. Such deflation increased the real value of debt and of interest costs. The Japanese experience in the 1990s is a contemporary example of a deflationary spiral when price changes fell from a "high" of plus 3% in 1990, to plus 1% in 1993 to 0% in the late 1990s and to minus 1.5% now. Between 2007 and 2010 the US price changes have fallen comparably from nearly plus 3% to plus 1%: the graphs are shockingly similar. Low inflation is undesirable and deflation potentially calamitous as the Japanese experience shows and as its pernicious reinforcing effect on the Great Depression confirms.

The Fed's motive for preventing deflation, or indeed for promoting "normal" inflation, may be reflected in recent remarks by William Dudley, President of the Reserve Bank of New York: "Very low interest rates can help smooth the adjustment process by supporting asset valuations, including making housing more affordable and by allowing some borrowers to reduce debt interest payments monetary policy 'can cut off the tail' of the distribution of potential economic outcomes it can help encourage the households and businesses with money to spend to do so". The US money supply is almost static and there is considerable excess capacity so any increase in supply, unless trapped in the financial system as excess reserves i.e. not lent, should increase output.

Rising US inflation diverts capital movements and modifies trade balances. Capital will move into more stable economies such as Switzerland or to economies offering higher returns such as emerging economies. In 2010 and 2011 as much as \$800bn was diverted according to the Washington based Institute for International Finance. The recipients of these inflows will experience exchange rate appreciation, although its appreciation may be offset by Capital controls, taxes or intervention by those recipients wishing to avoid such revaluation. The US has huge \$ creditor balances, an extra \$6,800bn being accrued since 2000, this massive inflow being a major source of the credit flood preceding and contributing to the "Second Great Contraction". This huge balance can be paid off in two ways: at one extreme the US economy deflates reducing \$ prices and causing a major slump or, at the other extreme, the US inflates reducing \$ prices by devaluing the \$ and increasing the value of external currencies (read China). The imposition of a deflation is exactly what the Eurozone creditor countries led by Germany are imposing on Greece and now Ireland. Fortunately the extent of the damage to their economies and to their banks can be contained by the "surplus" Eurozone creditor countries. If the \$ creditor nations, such as China, have mercantilist intentions to maintain trade surpluses and to resist their currency revaluation then the corollary is that the US deflates, an outcome that would cause a world slump. Such intentions could be interpreted as trying to impose a "German" solution on the US economy.

The Fed's actions indicate that the US prefers, with which the world should concur, the alternative policy. Unlike small Eurozone nations which have fixed exchange rates, no independent currency and no central banks, the US has a very wide discretion. To put it at its simplest form: there is no limit to the dollars the Federal Reserve can create. Earlier, on such a topic, President Nixon's Secretary to the Treasury John Connolly said the dollar "is our currency, but your problem". In a similar vein Martin Wolf said of the G20 negotiations over the dollar balances "if the G20 don't hang together, the Fed is about to hang them separately".

Bernanke (1983) demonstrated that amongst the major causes of the Great Depression were the cost of credit and its rationing, or non-availability on the current market credit terms, including credit withdrawal and its non-renewal. In corroboration Reinhart found that the median of private debt to GDP rises by 38 percentage points in the 10 years before a financial crisis and falls by an equal amount in the 10 years following the crisis. He concluded that deleveraging, repaying credit, is a powerful drag on recovery. The pattern of credit "freezing" described by Bernanke for the Great Depression is evident in the Second Great Contraction. As an illustration Alan Greenspan, formerly Chairman of the Fed, notes that "the instinctive

reaction of businessmen and householders (and bankers!) to uncertainty is to disengage from these activities that require confident predictions of how the future will unfold". This is evidenced by the rise in non-reinvested liquid resources by non-financial organisations to 21% the highest proportion since records began 58 years ago. These liquid assets have recently risen by \$1,800bn, the highest share of total assets for nearly 50 years. The banks hold a trillion dollars of "excess reserves" i.e. lendable reserves remaining parked in Federal Reserve banks yielding 25 basis points and as Greenspan notes "little evidence of banks seeking higher returns through increased lending". QE may alleviate credit shortages as well as counter deflation and unemployment but five years of extensive QE by Japan in the early 2000s affected no apparent changes, although the outcome without it is unknown. Its use in the US has been widely criticised in part because money is "created" to which Martin Wolf replies "the essence of the contemporary monetary system is the creation of money by private banks' often foolish lending. Why is such privatisation of a public function right and proper but action by the central bank to meet pressing public need inappropriate, especially when the broad money supply is barely growing and the banks will not lend?"

Bank lending in the US was 10% lower in Q3 2010 than a year earlier having dipped to 14% lower in Q1 2010 and in 2009 was about 10% lower than in 2008. The credit contraction does not indicate a strong recovery for the US where unemployment and spare capacity remain high and growth in 2010 is expected to be only 2.8% before slowing in 2011. Fortunately further fiscal loosening seems likely after a political deal between President Obama and the congressional Republicans to extend all the Bush era tax cuts together with a \$120bn payroll tax holiday. If enacted the US economy would grow in 2011 by 3.5% according to JP Morgan by an extra 0.7%, up to 4.1%, according to Deutsche Bank and by 4.0% according to the Economist. The proposal would raise the US fiscal deficit to 9-10% of GDP in 2011. The US would then be the only large industrial nation not to tighten fiscal policy in 2011.

The Economist says "America is injecting itself with another dose of stimulus steroids just when Europe is checking into rehab and enduring cold turkey". The lessons of the Great Depression seem to have been well learned across the pond. Reinhart author of "This Time is Different – Eight Centuries of Financial Folly" estimates that economies grow 1.5% points slower in the decade that follows a financial crisis: for the US, this time might indeed be "different". One hopes so.

For the UK the economic impact of external influences is favourable but domestic influences conflict. The continuing growth in World GDP estimated to be 22% over five years, including the resurgence of the US and the projected rapid expansion of developing countries. The significant devaluation of Sterling by 25% on a trade weighted basis since 2007 and by 16% and 19% against the \$ and the € respectively will provide a major stimulus to the economy. The availability of devaluation is a continuing reminder of one of the advantages of an independent currency.

The UK emerged from the recession with 0.4% growth in Q4 of 2009, later than other major economies, reflecting the disproportionate importance to the UK's over-extended financial sector, which was repeated in Q1 2010, before achieving strong rises of 1.1% and 0.7% respectively in the subsequent two quarters. In the current three months NIESR suggest a reduction in growth to 0.6%, a respectable 2.4%pa annualised. However the economy is still 4% below the pre-recession output in March 2008 and probably 10% below its potential capacity.

The UK economic downturn started in the spring of 2008 but as late as August 2008 when the Bank identified escalating inflation as the "key risk", economic output was projected to be "flat" and interest rates were still 5%. By November 2008, the Bank's greater concern was deflation and it then forecast a peak to trough decline in GDP of about 1.9% (actually 6.5%).

The Governor removed his previously stated opposition to a fiscal stimulus, saying the "transmission mechanism" of monetary policy had become impaired through the banking crisis. Subsequently interest rates were cut very rapidly to the still current 0.5% in March 2009. Patently further cuts are possible but little additional economic stimulus occurs due to the phenomenon quaintly described as the "liquidity trap". Monetary policy, as defined by interest rates, has been at its most accommodating practical level for over 21 months.

The Bank initiated a further monetary boost to the economy with its unprecedented programme of the delightfully styled "quantitative easing" and by February 2010 had purchased its self-imposed limit of £200bn of assets, providing liquidity to the vendors and reducing medium and long-term interest rates. Further asset purchases in 2011 are predicted by the EIU and the Bank reports that a survey by Reuters showed that 50% of respondents expected further asset purchases. Tellingly, the Bank, which in its November 2009 Inflation Report reported interest rate expectations of 3½% and of 4% at the end of 2011 and 2012 respectively now reports these at 0.75% and 1.25% respectively. Fortunately most forecasters agree that monetary policy will be expansionary for up to three years.

The expected continuing expansionary monetary policy contrasts with the fiscal contraction outlined in the CSR on 20 October 2010. The Chancellor, Mr Osborne, prefaced his proposals: "we are going to ensure, like every solvent household in the country: that what we buy we can afford; that the bills we incur, we have the income to meet; and that we do not saddle our children with the interest on the interest on the interest (sic!) of the debts we were not ourselves prepared to pay". Cynics aver that politicians rarely say what they mean and even less frequently mean what they say. Possibly this colourful couthy rhetoric was an enjoinder to the whole community to brace themselves for "cuts" and possibly the extreme nature of the proposals that followed was a "worst case" scenario from which he could jubilantly retreat or indeed it could allow "slippage" in its implementation so reducing the "cuts".

At face value the Government's proposals exhibit a strict pre-Keynesian ideology and, although the circumstances are far far removed from those of the Great Depression, there appears through the mists of time a shadowy spectre of the authorities' early reaction to that financial crisis. Then the US Fed mistakenly believed that the balancing of the budget was a correct response. The proposed costs are equivalent to a structural fiscal tightening of 1.6% per annum of GNP over the parliamentary term, the most sustained in living memory. The Chancellor's description of borrowing draws images of Thatcherism and the classic literary allusions of Micawber and Hamlet's Polonius. But economic management is not morality nor an abhorrence of fecklessness, but a balancing of returns and costs, where borrowing can be beneficial. In reality, as Samuel Brittan says, "the Deficit should be a policy variable rather than targeted to meet a dim accountant's idea of balance". Moreover it has been one used in the past: the current debt is 70% of national income but the average over the last 322 years is 112% with long periods above 100%.

The UK's fiscal stance is in marked contrast to that of the US although both countries have the same post bubble economic adjustments. The effects may not be exactly the same – the UK had a larger fall in output 6.4% compared to 4.0% but a smaller rise in unemployment 2.5% compared to 5.0% and higher "core" inflation 2.9% compared to 0.8%, due largely to the impact of the UK's devaluation, but the similarities outweigh the differences and they share precipitating factors. Most importantly they both must now choose between the immediate risks of fiscal retrenchment on recovery and the longer-term risks of fiscal deficits on credit worthiness and both rely on continuing expansionary monetary policies, the UK particularly so because of its choice of extreme fiscal tightening.

The IMF has recently shown that a 1% fiscal consolidation reduces real domestic demand by 1% and GDP by 4% over two years, provided at the same time monetary policy becomes

more accommodating, an option not realistically available in the UK. The IMF also concludes, helpfully for the UK, that a depreciating currency cushions the impact of a fiscal retrenchment and that spending cuts, 73% of the UK adjustment, are less damaging than tax increases. Finally reduced debt, i.e. following fiscal consolidation, is beneficial for itself but also because it lowers overall real interest rates, but with real interest rates close to 1% such an effect is currently muted. It is concluded that the proposed UK fiscal consolidation would contract GDP at a rate of 1% to 2% per year.

There are additional adverse factors affecting economic recovery. Further monetary stimulus is restricted to Quantitative Easing which affects the already low long-term interest rates and in any case as many long term borrowers are flush with cash low rates will not induce further investment. A further major hindrance to the expansion of the economy is the rationing of credit by the banks, as now confirmed by the Bank, where unwillingness to lend is independent of price. As Martin Wolf observes "the UK has launched a remarkable policy experiment. The contrast with the US should at least be instructive. We will never know whether disaster was indeed imminent, but the British are going to learn much and so will the rest of the world". Elsewhere he concludes: "The Chancellor and the Treasury are confident and persuasive. They can also point to the array of official organisations that support them. Having written on the UK economy for 23 years, I know it was ever thus. Yet, in retrospect the government was wrong perhaps half of the time. Economics is an art, not a science". Perhaps like the Fed in the Great Depression there will be changes – after all Mervyn King said "of all the ways of organising banking, the worst is the one we have today".

On present indications UK economic growth will fall below long-term trend historic levels and the 10% gap between actual and projected output will not easily close with a risk that capacity is being lost by the atrophy of the supply side. Growth is forecast at less than 2% pa until 2014 by Capital Economics and at 1.5% or lower by the EIU: these figures are more likely than higher figures produced by official sources. I conclude as I did last year, and I suspect I may do next year, quoting Alfred Marshall, the eminent Cambridge economist: "The commercial storm leaves a path strewn with ruin; when it is over there is calm, but a dull heavy calm".

Property Prospects

In the previous property investment cycle the CBRE All Property Yield Index peaked at 7.4% in November 2001 and fell steadily to a trough of 4.8% in May 2007 before rising in this cycle to a peak of 7.8% in February 2009, a yield surpassed only twice since 1970. A higher yield occurred over six quarters in 1974/75, the time of the secondary banking crisis, but then "Bank Rate" averaged about 11%, and in one quarter in 1991, just before Sterling left the ERM in 1992, when "Bank Rate" was again over 10%. In contrast in February 2009 Base Rate was 1.0%. Yields fell rapidly from the 7.8% peak in February 2009 and by February 2010 were 6.4% before falling only another 0.1% point in May 2010 to 6.3%, the present yield. The yield drop since last year is 0.9% points, equivalent to a rise in capital values of 14.3%.

The 7.8% peak yield in February 2009 was 4.6 percentage points higher than the ten year Gilt Yield, the highest "Yield Gap" since records began in 1972, and 1.4 percentage points higher than the previous record in February 1999. From the 1970s until the late 1990s, except for one year, the 1993/94 downturn, the position was reversed the - "Reverse Yield Gap"- and the Gilt yield exceeded the property yield. The "Yield Gap" of Property exceeding Gilts, was re-established in 1997 and has persisted since then until very briefly, at the recent 2007 property peak only. The current "Yield Gap" is 3.3 percentage points, much higher than the average over twenty years partly because of the current low gilt yields.

The All Property Rent Index which, apart from a brief fall in 2003, had risen consistently since 1994, fell 0.1% in the quarter to August 2008 and then fell substantially in each of the following four quarters, giving an annual rental loss of 12.3%. Since August 2009 the Index has risen slightly each quarter and at August 2010 was a small 0.9% higher. The growth in the rental index is due to a rise of 6.9% in office rents, with other sectors static or still falling. The most notable change was the rise in office rents in London where the City rents increased by 12.2%, Mid Town by 14.0% and the West End by 8.5%. In all rental categories there were widespread rental falls in most English northern Regions.

The recent returns to property investment, as measured by the IPD All Property Index, have been high, primarily because of the yield drop of 0.8% points between Q3 2009 and Q4 2009. In the year to 31 October 2010 the All Property return was 20.4%, compared with minus 14.0% in the year to 31 October 2009 and minus 22.5% in the year ended 31 December 2008 a month that produced a record fall of 5.3%. As the IPD total return figures include about (plus) 7 percentage points of return from income, the total figures disguise a larger capital loss. The Bank shows that Commercial Property prices are currently 35% below the mid 2007 peak having recovered from the maximum fall of about 44% in late 2008. The total returns to all property for the year to October 2010 were 20.6% slightly better than equities, 17.5%, but well in excess of bonds, 8.9%. Interestingly, property equities returned only 8.8%. Since October the investment market has continued to improve slightly and the Jones Lang LaSalle prime yield has dropped from 5.74% to 5.62% in December due to small changes in most sectors excluding retail.

Total property returns for 2010 are widely estimated at 13%-15% (Colliers 14.7%, Clutton 14.9%, IPF 13.6%). The return based on derivatives as at 13 December 2010 is 13.85%. These estimates are much higher than those made previously when, for example, on 1 March 2010 the return implied by the property derivatives for 2010 was 10.0%. The implied forecast then for 2011 was 6.5% which has now fallen to 4.1%. Other forecasts have also downgraded the 2011 forecasts during 2010. In February IPF forecast 2011 returns as 6.6% but in November the forecast was 5.2%, the reduction being due primarily to increases in investment yields. Colliers have reduced their 2011 un-weighted average from 12.0% in January 2010 to 7.6% in October 2010, primarily because of much lower figures for the retail sector. In 2012 the return implied by derivative pricing is currently only 3.5% but the IPF⁴ forecast 9.2%, Colliers 10.6% and Clutton 8.8%.

The projections for 2011 probably reflect the likely economic conditions resulting from the fiscal squeeze being implemented by the Government. Even in the year to October 2010 retail sales fell 0.1% and further falls seem likely next year. Projections of falls in retail rents and capital values are consistent with reduced growth, but other sectors may not be so adversely affected.

"Is this the end of the house price boom?" – so John Kay wrote in the FT as long ago as 12 October 2004. Among his conclusions were that booms are followed by slumps and that these who make "confident" predictions about the future of house prices are mistaken!" This time last year most commentators predicted a fall in prices in 2010 but a recovery thereafter. Deloitte forecast falls of 10.0% whilst Savills and Jones Lang LaSalle forecast setbacks, in 2010 of 7%. The Nationwide predicted a "period of moderation" in the months ahead. The price of derivatives based on the Halifax Property Index implied a 1% fall in 2010, a remarkably prescient indicator as the Halifax Index shows a 0.7% fall in the twelve months ended November 2010. Two years ago the derivatives based on the Index indicated a 21% drop in 2009 – the index rose 1% - and a drop of 15% in 2010. The Nationwide's prediction of a "period of moderation" is being vindicated by the rise of 1% in the annual rate in November 2010.

The results of two principal mortgage providers are remarkably consistent at present, but even this year the difference between these indices in the annual change in house prices has varied between them by up to 4 percentage points. Both indices are based on surveys for mortgage purposes based on "standardised houses" whose make-up is not disclosed but will comprise a set number of rooms including a bathroom. The Land Registry and LSL/Acadametrics indices are amongst those based on actual sales, i.e. including cash sales but the Land Registry compares current sales prices with the previous sale price of the same property i.e. it excludes new house sales and alone amongst the surveys takes a geometric mean thereby reducing the significance of outlying sales values.

The significance of the mensuration method can be illustrated by the "average" prices shown for June 2010: Halifax, Nationwide and Land Registry between £165,000 and £169,000; Communities and Local government £213,000; and LSL/Acadametrics £221,000. To November 2010 the Nationwide and the Halifax annual indices were within 1% of November 2009 the LSL and Communities and Local Government indices were 6% higher and the Land Registry index (using a geometric mean) 4% higher. Two other indices are based on surveys of or samples from selling agents. Hometrack collects data from 3,500 agents including estimates of price rises or falls. Rightmove has about 35% of all home sales particulars posted on its website and amongst other data it collates asking prices. These two surveys also report prices within 1% of last year's.

What has happened to prices over twelve months depends on which survey is used. The actual prices achieved eliminate considerable uncertainty and the wider the sample the better. Thus the LSL model has many advantages – unfortunately it excludes Scotland! In general terms the 2010 outturn is almost certain to be considerably better than the forecasts quoted last year. There appear fewer predictors than last year, some possibly heeding John Kay's advice about "confident predictions". Last years predictions for 2010 were in the broad range nil to -10% but this year's predictions for 2011 are almost wholly in the nil to 5% range. Capital Economics²⁰³ are the most gloomy at -5.1%, Deutsche Bank -5%, Savills -3%, Hometrack -2%, Cluttons -0.1% and the CML "flat or fall slightly".³⁰⁹

The housing market, like all markets, depends on the balance between supply and demand, but with an important distinction between the long and the short term. The supply of houses is relatively inelastic and slow to respond to changes in demand largely due to the long cycle time of acquiring, planning and then constructing. The supply is further constrained by the planning process which determines how many houses shall be built but then, because of the increasing complexities in the planning system, is frequently unable to deliver the programmed number of houses. Within established housing areas supply can be further curtailed by restrictions due to listing, conservation or by the requirements of flood protection. The long-term demand for houses, according to the currently used econometric models, is likely to continue to grow at a rate which is unlikely to be significantly altered, even by a depression as severe as is currently being experienced. Demand also grows with increasing affluence as time, convenience, amenity and quality of location all become of greater value. The fundamental imbalance between the supply and demand will result in higher prices in the long term.

In the short term the market is supplied by new houses and by recycling existing houses. The newly built stock houses have been largely liquidated following the overhang from the earlier boom and new construction is a small proportion of the previous output. Existing house supply is derived from owners exercising their discretion to move house –larger, smaller, smarter, relocation – who buy other houses so effectively completing a cycle, their demand matching the recycled supply. Another supply source, but a "non-discretionary" one is from estates, from household "breakups" and from repossessions. The volume from the first two should be relatively fixed, although the recession may have somewhat reduced "breakups",

but the supply from repossessions will vary considerably with interest rates and with economic activity.

Interest rates are likely to remain low, unlike recent depressions, but the effects of the proposed fiscal tightening on economic activity, particularly on unemployment is likely to be severe. Already unemployment has risen 35,000, employment levels are down and the jobless rate up to 7.9% from 7.8%. The OBR, which is forecasting 2.1% growth in 2011, higher than seems likely, expects unemployment to peak at 8.1% but more pessimistic forecasts are for 8.5% to 9.0%. The supply of houses from this source seems likely to rise, a view shared by the Council of Mortgage Lenders.

Short-term demand will be determined primarily by mortgage cost and availability. Fortunately Mortgage costs are likely to remain low but credit for house purchase seems very restricted. The rationing of credit highlighted in the Bank of England Q4 2010 Bulletin is almost certainly a major restricting factor in the future short-term demand for houses.

The housing market is a paradox: demand rationed by credit is the major influence on short-term prices and supply rationed by institutional factors is the major influence on long-term prices. In the short term credit rationing together with deteriorating economic conditions is likely to depress prices. Credit rationing is also a major contributory factor to the current slowdown and when it eases, probably coincident with stronger economic growth, supply will become limiting. The key determinant of the long-term housing market will continue to be the restrictions of supply by many overlapping and reinforcing controls and conventions producing significantly higher real prices.

Future Progress

We are not at present undertaking any development. During the year we succeeded in gaining planning permission for several of our sites which we have added to our existing portfolio of sites ready for development. However we will not commission development until market conditions improve further. We are completing minor refurbishments in the basement at 57 North Castle Street, and at Chance Inn Farmhouse. These houses will be marketed in the Spring. Foundations have been laid for two houses at Cockburnspath to protect the existing consents and other similar work elsewhere will be undertaken as necessary.

Refurbishment and restoration will continue at Ardpatrik on West Loch Tarbert, Argyll. Previously we have sold six separate properties, including four refurbished cottages, and at least two more properties will be marketed in 2011. The landscape review required by the Local Plan has confirmed a range of long-term development opportunities and may allow one or two further sites to be marketed shortly.

Planning work continues on many of our development sites. This comprises both submissions to the Local Authority for inclusion in future Local Plans and for developments under existing or evolving Local Plans. At Gartshore in East Dunbartonshire, but only seven miles from central Glasgow, discussions continue on the long-term prospects for the restoration of the estate coupled with a high quality "Green Business Park". At St Margaret's House, which now benefits from Outline Planning Permission for 231,000ft², we will undertake further planning work to enhance long-term value. At Baylis Road, Waterloo, there have been a number of proposals, one of which we expect to finalise shortly.

We continue to gain valuable consents on several of our fifteen rural development sites. Most of these sites were purchased unconditionally, i.e. without planning permission, for prices not far above their existing use value, and before the 2007 house price peak. The main component of the possible development value lies in the grant of planning permission and in its extent and is relatively independent of even large changes in house values. For development or

trading properties no change is made to the Company's balance sheet even when improved development values have been obtained. Naturally, however, the balance sheet will reflect such enhanced value when the properties are developed or sold.

I have commented on the investment property market in these statements over the last few years. The broad conclusion was that over the cycle real returns were at best poor. Consequently we decided to withdraw from that market and reinvest in specialist development opportunities. In the years immediately before the 2007 crash, I reported that investment yields were too low to be sustainable. Fortunately, during that period we declined several very highly-g geared investment proposals. We retained investment properties where we expected them to provide value above the then current investment value and some of these have achieved that goal.

Our conservative view of the investment market had been reflected in a conservative financing policy and our long-term relationships with our bankers. Our main funding is a low LTV loan maturing in 2011 which, in spite of the widespread falls in investment values, has always remained within covenant. We are at the advanced stage of negotiating a refinancing on a conservative basis at current market rates. Other facilities are with banks with whom we have had borrowings secured over the same properties since 1990 and 1994 respectively and these relationships are being continued or being offered for continuation.

The mid-market share price on 22 December 2010 was 95p a discount of 43.4% to the NAV of 167.8p. The Board does not recommend a final dividend but intends to restore dividends when profitability and consideration for other opportunities and obligations permits.

Conclusion

Three years ago I concluded: "The UK economy is expected to experience a major deflationary shock resulting from an unprecedented contraction of credit"; two years ago I concluded: "Fortunately the recession will pass, but will not leave its passage unmarked"; and last year I concluded: "This present alleviation (of the recession) comes at a terrible and continuing long-term cost: huge debts; high servicing costs; lower output....." and presages "a watershed in economic management, in political power and moral sway and in changing world order....." The scale of the cost in the UK is becoming evident, a continuing process, as the Euro crisis highlights, and the prospective pain of the remedial measures looms, encompassing lower employment, continuing business failure and a fall in the economy's output, now operating up to 10% below capacity. The depression resulting from a financial crisis is the worst since the Great Depression, but, fortunately, severe as it is, the worst consequences of that period appear to have been avoided, largely by improved economic management. However, there will be long-term changes following "The Second Great Contraction" which although discernible, are not yet evident.

The Group has improved the value of its development portfolio over the year and added slightly to the value of its investment portfolio. The short-term residential market is unattractive but the long-term market is becoming increasingly attractive. We expect to continue to realign the Group's assets to support a development programme at the appropriate time.

I D Lowe
Chairman

23 December 2010

Group income statement for the year ended 30 June 2010

	2010 £000	2009 £000
Gross rental income	648	650
Service charge income	24	24
Dilapidation income	25	57
Property charges	(305)	(265)
Net rental and related income	392	466
Proceeds from sale of trading properties	370	1,058
Carrying value of trading properties sold	(347)	(661)
Profit from disposal of trading properties	23	397
Administrative expenses	(889)	(880)
Other income	81	254
Other expenses	-	(14)
Net other income	81	240
Net operating (loss)/profit before investment property disposals and valuation movements	(393)	223
Profit on disposal of investment properties	48	163
Valuation gains on investment properties	450	1,932
Valuation losses on investment properties	(205)	(515)
Net valuation gains on investment properties	245	1,417
Operating (loss)/profit	(100)	1,803
Financial income	1	7
Financial expenses	(195)	(464)
Net financing costs	(194)	(457)
(Loss)/profit before taxation	(294)	1,346
Income tax	-	-
(Loss)/profit for the financial period attributable to equity holders of the company	(294)	1,346

(Loss)/earnings per share		
Basic (loss)/earnings per share (pence)	(2.47p)	11.33p
Diluted (loss)/earnings per share (pence)	(2.47p)	11.33p

Statement of comprehensive income for the year ended 30 June 2010

	2010	2009
	£000	£000
(Loss)/profit for the period attributable to the equity holders of the parent company	(294)	1,346
Change in fair value of equity securities available for sale	3	(9)
Total other comprehensive income/(loss)	3	(9)
Total comprehensive income for the period	(291)	1,337

Consolidated balance sheet as at 30 June 2010

	2010	2009
	£000	£000
Non current assets		
Investment property	16,410	17,045
Property, plant and equipment	22	25
Investments	5	2
Total non-current assets	16,437	17,072
Current assets		
Trading properties	10,891	11,032
Trade and other receivables	134	207
Cash and cash equivalents	250	906
Total current assets	11,275	12,145
Total assets	27,712	29,217
Current liabilities		
Trade and other payables	(485)	(612)
Interest bearing loans and borrowings	(5,673)	(1,985)
	(6,158)	(2,597)

Non current liabilities		
Interest bearing loans and borrowings	(1,900)	(6,675)
Total liabilities	(8,058)	(9,272)
Net assets	19,654	19,945
Equity		
Issued share capital	2,377	2,377
Capital redemption reserve	175	175
Share premium account	2,745	2,745
Retained earnings	14,357	14,648
Total equity attributable to equity holders of the parent company	19,654	19,945

The financial statements were approved by the board of directors on 23 December 2010 and signed on its behalf by:

ID Lowe
Director

Consolidated cash flow statement for the year ended 30 June 2010

	2010	2009
	£000	£000
Cash flows from operating activities		
(Loss)/profit for the period	(294)	1,346
Adjustments for :		
Profit on sale of investment property	(48)	(163)
Gains on fair value adjustment of investment property	(245)	(1,417)
Depreciation	12	10
Net finance expense	194	457
Operating cash flows before movements in working capital	(381)	233
Decrease in trading properties	121	351
Decrease in trade and other receivables	73	252
(Decrease)/increase in trade and other payables	(110)	129

			(297)	965
Interest paid			(210)	(468)
Interest received			1	7
Net cash flows from operating activities			(506)	504
Investing activities				
Proceeds from sale of investment property			947	1,450
Acquisition of property, plant and equipment			(10)	(13)
Cash flows from investing activities			937	1,437
Financing activities				
Repayments of long term borrowings	(1,087)	(1,077)		
Cash flows from financing activities			(1,087)	(1,077)
Net (decrease)/increase in cash and cash equivalents	(656)	864		
Cash and cash equivalents at beginning of year			906	42
Cash and cash equivalents at end of year			250	906

Notes to the audited results for the year ended 30 June 2010

- The financial information set out above does not constitute the company's statutory accounts for the years ended 30 June 2010 or 2009 but is derived from the 2010 accounts. Statutory accounts for 2009 have been delivered to the Registrar of Companies, and those for 2010 will be delivered in due course. The auditors have reported on those accounts; their reports were (i) unqualified and (ii) did not contain statements under Section 498(2) or (3) of the Companies Act 2006.
- All activities of the group are ongoing. The board does not recommend the payment of a final dividend in 2010 (2009: nil).
- (Loss)/Earnings per ordinary share

Basic (loss)/earnings per share is calculated by dividing the (loss)/earnings attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period as follows:

	2010	2009
	£000	£000
(Loss)/profit for financial period	(294)	1,346
	=====	=====
	No.	No.
Weighted average no. of shares: for basic earnings per share and for diluted earnings per share	11,882,923	11,882,923
	=====	=====
Basic (loss)/earnings per share	(2.47p)	11.33p
Diluted (loss)/earnings per share	(2.47p)	11.33p

The diluted figure per share is the same as the basic figure per share as there are no dilutive shares.

4. The Annual Report and Accounts will be posted to shareholders on or before 31 December 2010 and further copies will be available, free of charge, for a period of one month following posting to shareholders from the Company's head office, 61 North Castle Street, Edinburgh, EH2 3LJ.
5. The Annual General Meeting of the Company will be held at 61A North Castle Street, Edinburgh EH2 3LJ on Friday 28 January 2011 at 12:30pm.

For further information please contact:

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