Caledonian Trust PLC

(The "Company" or the "Group")

Audited Results for the year ended 30 June 2014

Caledonian Trust PLC, the Edinburgh-based property investment holding and development company, announces its audited results for the year ended 30 June 2014.

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Chairman's Statement

Introduction

The Group made a pre-tax profit of £164,000 in the year to 30 June 2014 compared with a loss of £62,000 last year. The profit per share was 1.39p and the NAV per share was 147.2p compared with a loss of 0.52p and 145.8p respectively last year.

Income from rent and service charges was £344,000 compared with £334,000 last year. There were no sales of investment properties in the year. Profit on the sale of development properties was £33,000. Other operating income was £53,000 compared with £120,000 last year. Administrative expenses were £761,000 compared with £726,000 last year. Net interest payable was £104,000, an increase of £7,000 on last year, reflecting slightly higher borrowings. The weighted average base rate for the year was 0.5%.

Review of Activities

The Group's primary emphasis is now on development, including development to secure existing planning consents, and on the provision of infrastructure for development plots, and the marketing of house plots and houses.

We started realising our investment portfolio in 2005, two years before the investment property peak in 2007, and completed the sales of all the remaining large investments without development potential when specific opportunities arose or the property "matured". We retain two small, high-yielding retail investments.

St Margaret's House, London Road, a 92,000ft² 1970s multi-storey building on the A1 about one mile east of the Parliament and Princes Street, is our largest development property. Due to poor market conditions, it has been let since November 2010 at a nominal rent to a charity, The Edinburgh Palette, who have reconfigured and sub-let all the space to over 250 "artists" and "artisans" and "galleries". Tenant turnover is minimal and there is a lengthy "waiting list". One hundred and twenty of the 168 parking spaces are let to our immediate neighbours in Meadowbank House, the Registers of Scotland, on a short-term lease. We hold the building at no cost and are gaining small annual rent increases until we secure redevelopment.

In 2007, at the City of Edinburgh Council's suggestion, our architect produced a Development Brief for the triangle covering St Margaret's House, the adjacent 120,000ft² Meadowbank House, owned and occupied by the Registers of Scotland, and the various small properties lying between the A1 and "Smokey Brae", a modification of which was adopted by the Council in August 2009, as a Master Plan for that triangle. Based on this Master Plan, we lodged an application in July 2009 for Planning Permission in Principle (PPP) for a 231,000ft² mixed-use development of residential and/or student accommodation, an hotel, offices and other commercial space together with parking for 225 cars for all of which consent was issued in September 2011. The consented proposal would transform the local amenity as it allows for a street frontage to London Road and an "at grade" pedestrian plaza with a separate direct vehicle access, and would complement the recent great improvements to Meadowbank House.

The poor and constantly changing market conditions since 2011 have precluded the design of specific proposals. Accordingly, we applied for a renewal of the PPP in May 2014 and have already updated all the many technical reports as well as undertaken several new ones: all a lengthy and expensive process. A wide public consultation was held on 21 and 22 August 2014.

There are several development options for the site. If some of the existing building were retained initially, a series of smaller developments, each of 40,000ft² to 60,000ft², could be built as "pods". Part of the site is ideal for an hotel, occupying the higher westerly "tower" with views to the Castle, Arthur's Seat, the City and the Forth estuary. A part of the site has also been assessed for housing to rent at the "higher market rent level" – about 80% of open-market rents – with a medium-term option to sell at open-market prices. Student housing has also been considered, given the central location with excellent bus routes, the adjacent Meadowbank sports complex, easy access to the Park and daytime bus services from the door to Old College and the nearby George Square every twelve minutes and to Queen Margaret University and Heriot Watt every half-hour. Amongst many other possible office uses, the 231,000ft² consent would be eminently suitable for any centralisation of, or the transfer of, the various tax-raising powers to Holyrood, or for a large-scale relocation of "back offices" from London or the South East.

In 2007 we delayed the development of our three sites in or near Edinburgh because of worsening economic conditions. Last year I repeated my 2012 statement: "There is a tangible risk of a further fall in house prices. In these circumstances a large development of a block of flats or a number of houses requiring heavy infrastructure investment would result in an illiquid investment with very limited or nil profit margin: accordingly, we continue to delay any major investment ..." and only undertake "... small, low investment, low infrastructure projects". The 2012 statement proved prescient as the average house price in Edinburgh to the year ended 30 September 2013 fell 2.5% and there were larger falls in many areas including Perth and Kinross and East Lothian, important reference areas for many of our rural developments. Last year I said: "We will not commission any major development until market conditions improve further, until the possibility of a final glitch in the economy is insignificant and until after the referendum", a view that has proved to be prudent, if only because of the narrowness of the vote in favour of rejecting Independence, given that, as I argue below, a vote for Independence would have reduced property prices and property transactions very significantly, particularly in the three-to-five year period of negotiating the monetary and other settlements.

We have completed the extensive alterations to four listed Georgian stone-built, two-bedroom cottages at Brunstane Home Farm together with the infrastructure necessary for the next stages of the development. In addition to the four cottages we own a large listed steading and some two acres of land. The property is in the Green Belt in east Edinburgh, but is just off the A1 and lies immediately adjacent to Brunstane railway station with services to Edinburgh (seven minutes) and then north over the Forth Bridge to Fife. The route south is substantially constructed and the Borders Railway to Tweedbank/Galashiels is due to open in September 2015. The end terraced cottage sold this time last year for nearly £250,000, approximately £300/ft², a high price for the area. The mid-terraced house, with a lower valuation, sold recently for about 5% less. The two remaining cottages are currently being marketed. Fortunately the extensive demolition and masonry repairs on our adjoining property, which has prejudiced the amenity of the area, should shortly be completed and this will facilitate the sales which I expect in the spring.

We hold an implemented consent obtained in October 2012 to convert the listed stone-built Georgian Brunstane steading, to reconstruct a cottage attached to it and to form ten individually designed houses of various sizes over 14,648ft² altogether. These houses have recently been extensively redesigned, principally to provide contemporary-style large dining/living spaces, more en-suite bathrooms and better fenestration, together with lower construction costs. East of the main steading lies a detached stone building with consent for conversion and extension to a detached farmhouse extending to 3,226ft². The farmhouse site is on open ground with clear views to the Forth estuary to the north and to the Pentland Hills to the south.

Work started in December 2013 on the next phase of five houses, the "Horse Mill", which comprises the five stone-arched cart sheds, a single-storey cottage, the main barn and an hexagonal Horse Mill, a notable feature. The extensive and uncertain nature of the stone replacements and repairs required, some of it highly "tooled", resulted in quotes of over £250,000 for this work alone. In order to reduce this cost, we have employed contract staff directly and will effect all the necessary repairs – incidentally substantially greater than original estimates – for a fraction of the cost. The work will take over a year but, given the recent grave market uncertainties, together with the current market improvement, the delay will prove beneficial. Once the stonework is complete five new-build houses will be inserted in the reconstructed outer shell. The progress of the masonry work, which requires the use of traditional lime mortar unsuitable for use under plus 5^0C, is very weather dependent. We hurry slowly, but the quality is exceptional. Fortunately we will be able to execute the conventional building work in two stages, the first stage starting early next year. The masonry repairs of the Horse Mill phase will include the limited restoration of the west elevation of part of the next phase, the

Stackyard, a further five houses. Apart from this west elevation, all the Stackyard construction will be new, allowing a similar high-quality Product but at a much lower cost.

The five refurbished cottages lie west of the steading abutting the Horse Mill phase. South of these cottages and parallel to them we have recently secured permission to construct two new semi-detached houses which, together with a mature wood to the west, will create a traditional farm courtyard. These two new houses, each 1245ft^2, will be entirely of new construction with the courtyard elevations stone faced with natural stone. The work on these two houses and the conventional building, part of the adjacent first stage of the Horse Mill phase, will start early next year. The masonry work on stage two of the Horse Mill phase will take place simultaneously, allowing the conventional work to stage two to the Horse Mill phase to follow directly. The Stackyard phase of five new conventionally-constructed houses will follow, and then the new 3,226ft^2 farmhouse in its own private setting. Beyond the farmhouse we hold a further two-acre site, currently in the Green Belt, adjacent to a large area of ground recently abstracted from the Green Belt for housing and so designated in the Finalised Draft Edinburgh Local Plan.

The development totals 20,364ft^2 and I estimate the sales value to be over £5.0m. The cost of sales will be high due to the extensive repairs, part-traditional construction, and high infrastructural and professional costs, but, given the now satisfactory masonry repairs and the improving market, I expect a good outcome.

We have implemented a consent for eight detached houses at a site in Wallyford, Musselburgh, which is within 400m of the East Coast mainline station and near the A1/A720 City Bypass junctions. It is contiguous with a larger, recently-completed development of 250 houses by two national housebuilders, and Taylor Wimpey are building over 400 houses nearby, but on the other side of the mainline railway, which are selling rapidly at prices that have risen quickly to the current £208/ft^2 for large houses and £221/ft^2 and £242/ft^2 for smaller three and two bedroom houses. The market for smaller houses in the area has improved relative to larger houses, therefore we have obtained consent to replace the two largest detached houses with four semi-detached houses, providing ten houses with a larger saleable area of 12,496ft^2. The environment at Wallyford, formerly a mining village, but well located and on the fertile East Lothian coastal strip, continues to improve as a result of recent and current developments. We intend to start development next year.

The third of our delayed sites is in Edinburgh at Belford Road, a quiet cul-de-sac less than 500m from Charlotte Square and the west end of Princes Street, where we have a long-standing office consent for 22,500ft^2 and fourteen cars and where, by commencing construction, we have taken up that consent. We also hold a planning consent there for a residential development of twenty flats on over 21,000ft^2 together with indoor parking for twenty cars on which work commenced recently, securing the development potential.

The present residential design does not maximise the development value of the site, as it requires extensive excavation of the bedrock and consequent support for the neighbouring structures. The marginal cost of such work increases much more rapidly than the marginal revenue and once the easily-excavated areas are extended into the bedrock, the marginal costs quickly outweigh the marginal revenues. Moreover, this design cannot accommodate a variation of the floorplate to reduce excavation without a substantial reduction in marginal revenue substantially greater than the marginal reduction in cost. The scheme might be comprehensively redesigned and re-organised to eliminate this design disadvantage, but the resulting building may not fall within the current planning policy. We are undertaking preliminary site work to allow the marginal costs of different construction work to be more accurately assessed. This will allow modifications to the design and cost savings

within the current planning parameters. Fortunately, the value of these areas previously considered of least value, some 10% of the whole, have improved relative to average values and this may now allow them to be built below cost. In all circumstances I expect a satisfactory resolution.

The Company has three large development sites in the Edinburgh and Glasgow catchment areas. Two of these sites are at Cockburnspath, Scottish Borders, on the A1 just east of Dunbar on the East Lothian Border, where we have implemented the planning consent on both the 45 house plot northerly Dunglass site and on the 28 house plot southerly Hazeldean site. An additional area within the Dunlgass site, which is capable of holding twenty-four houses, is being evaluated further, as the ground conditions, which initially appeared to preclude development, are probably remediable, although expensive, and planning permission will be sought. At Hazeldean discussions are continuing on the possible sale of four house units to a Registered Social Landlord in order to meet the requirement for social housing.

These sites lie just on the Scottish Borders side of the boundary with East Lothian. In East Lothian prices rose in the last twelve months 5.0% but fell 2.6% in the Scottish Borders, and detached houses, the category almost exclusively in our sites, rose 9.9% in East Lothian but fell 5.7% in the Scottish Borders. Whenever the market appears suitable we will undertake a trial development of a self-contained group of four houses within the Dunglass site.

The third large development site is seven miles from central Glasgow at Gartshore, Kirkintilloch, (on the Union Canal), East Dunbartonshire, and comprises the nucleus of the large estate owned until recently by the Whitelaw family. It includes 120 acres of farmland, 80 acres of policies and tree-lined parks, a designed landscape with a magnificent Georgian *pigeonnier*, an ornate 15,000ft² Victorian stable block, three cottages and other buildings and a huge walled garden. Gartshore is near 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 and from Greenfaulds, a Glasgow commuter station. Gartshore's central location, its historic setting and its inherent amenity identify it as a natural site for development. To make the best use of these attributes, proposals have been prepared for a village of a few hundred mixed cottages and houses together with local amenities, all within the existing landscape setting. Such a development would complement our other proposals for a high-quality business park, including an hotel and a destination leisure centre all situated in an area entirely surrounded by mature trees. Discussions with and representations to East Dunbartonshire Council on the Local Plan currently being prepared on appropriate uses are continuing and we are seeking Council support for a joint promotion of the site.

The company owns fourteen separate rural development opportunities, nine in Perthshire, three in Fife and two in Argyll and Bute, all set in areas of high amenity. Such small developments are outwith major housing allocations and local authorities tend not to give them high priority. Being located in attractive areas, they are subject to objection to which Members, now elected by proportional representation, are increasingly sensitive, as their seats are less secure. Thus, gaining planning consent for such developments has become increasingly more difficult, requiring in some cases the scale of development to be restricted. Notwithstanding these difficulties, we continue to promote sites successfully through the planning process and to add new or improved consents to those we already hold.

In Perthshire, at Tomperran, a 30 acre smallholding in Comrie on the River Earn, we hold a consent for twelve detached houses over 19,206ft². The demolition work required for these houses to secure the planning consent has been completed. We have submitted an application for a revised layout for this site and a second planning

application for a further thirteen houses on our adjoining two-acre site previously zoned for industrial use. The total scheme of twenty-five new houses will occupy over 40,000ft². One benefit of these rearrangements is that the farmhouse, which was previously to be demolished, is retained in the revised scheme and results in twenty-five new houses in addition to the farmhouse.

At Chance Inn we hold a consent for ten houses over 21,836ft² in the farm steading. A separate consent was granted in October 2012 for alterations to the modern farmhouse there and to increase the combined size of the two consented detached house plots adjacent to the farmhouse from 3,366ft² to 4,118ft². The integral garage of the modern farmhouse was converted to a self-contained "guest suite" and the house was upgraded and was sold in November 2013. The house plots adjacent to the farmhouse will be marketed in the spring once the arrangements necessary to meet the strict phosphate reduction programme required for conservation of Loch Leven have been met. Negotiations to meet these criteria for the farm steading conversion are at an advanced stage and should complete shortly.

Nearby at Carnbo, on the A91 Kinross to Stirling road, the recently-published Local Plan included in the village settlement the paddock of the former Carnbo farmhouse which we had sold previously. Based on this inclusion we gained consent on 30 June 2013 for a development of four houses over 7,900ft². Our first planning application here was registered by the planning authority on 26 June 2008, more than six years ago! These plots will be marketed in the spring.

At Strathtay we gained consents in 2011 for two large detached houses totalling over 6,040ft² and for a mansion house and two ancillary dwellings over 10,811ft² in a secluded garden and paddock near the River Tay. We have completed initial building works and have taken up both the consent for the two detached houses and, separately, for the mansion house. Prices for detached houses in Perthshire rose 7% in the year ended 30 September 2014 and, provided the market continues to improve, these plots should be marketed in 2015.

At Myreside Farm, in the Carse of Gowrie between Perth and Dundee, we have had five planning attempts and appeals since our first application on this site was made in 2007. Using further guidance from the planning department we have at last gained approval for five new-build houses over 8,531ft², adjacent to the existing listed farmhouse.

At Camghouran on the south bank of Loch Rannoch we obtained consent for conversion of a small farm steading to three cottages over 2,742ft² in May 2009. Work necessary to secure the consent was carried out in May 2014.

In Fife we have attractive rural sites near St Andrews. At Larennie, adjacent to the Michelin-starred Peat Inn, five miles from St Andrews, a consent was gained in April 2011 to renovate and extend an existing stone-built cottage, to convert stone buildings to four houses and to build four new houses over 19,325ft², forming nine dwellings. Due to poor market conditions development has been delayed, but the existing permission has been extended for three years until April 2017. At Frithfield, six miles from St Andrews, a site with stunning views south to the Forth estuary, we have plans for twelve houses over 20,326ft² and are slowly meeting the many technical prerequisites for a successful application.

Ardpatrick is our largest rural development site, a peninsula of great natural beauty on West Loch Tarbert, but only two hours' drive from Glasgow and the Central Belt. The prospects for residential property are extremely good but their realisation requires considerable further inputs of money, time and skill. Extensive restoration is the key to the reinstatement of Ardpatrick's singular charm which continues to be masked by severe, prolonged neglect. Fortunately, due to the high quality and design of both the original Georgian and the later Victorian construction and design, much of the integrity of the estate remains intact, or recoverable, permitting repair and restoration wherever practicable. Progress has been appreciably slowed by essential repairs to Ardpatrick's buildings, farm sheds and landscape after two exceptional storms on 3 January 2012 and 24 March 2013 which caused over £150,000 of damage, the vast majority now recovered from insurances. Wet winters have highlighted the deterioration of much of the arterial and field drainage systems, the malfunctions causing damage to the roads, accesses, boundaries and environment and the field vegetation. The dry summer and autumn has permitted the reinstatement of ditches, the enlargement of culverts and the repair of drains and roads and culverts.

At Ardpatrick the development framework was changed by the 2009 North Kintyre Landscape Capacity Study. Prior to that study a consent was gained at South Lodge to double the size of the dwelling and to add a large garage. Following restoration South Lodge was marketed last year, went under offer in the summer and was sold recently for just under the £225,000 offer price. A delay in settlement is currently commonplace, but the referendum probably engendered so long a delay, the mortgage provider being a small English building society. Before 2009 we also gained consent to change the use of "Keepers", a bothy situated among the Achadh-Chaorann group of cottages, and to extend that building to form a three-bedroom house, conditional on providing a new access and drive. This work has been constructed and consent has recently been granted for an enhanced design. This property is on the market and will be relaunched in the spring of 2015. Several other consents were obtained in 2009 and fall to be renewed. The consent to sub-divide Ardpatrick House and to develop Oak Lodge, a two-storey 1,670ft² new build on the Shore Road, has been renewed. Applications are in process for the other renewals, including the conversion of the "Gas House" and the garage complex.

There are a number of practicable development opportunities within the areas designated in the Landscape Capacity Study. In 2011 we secured consent for two one-and-a-half storey houses each of 2,200ft² at the north end of the estate on the B8024 Kilberry Road. Nearby on the west side of the UC33 Ardpatrick Road we hold outline consent for a detached house in a woodland setting and have recently received outline consent for a further two houses on the Dunmore schoolhouse field on the east side of the UC33, bordering the Cuildrynoch Burn.

Unfortunately other potential new sites and many of the conversion sites are commercially difficult to realise. Current market conditions continue to be unhelpful as indicated by the mean price drop of 1.6% in detached houses in Argyll in the year to September 2014 and a drop of 3.8% in the quarter ended 30 September 2014, but major continuing constraints are the high cost of conversion and the cost of upgrading the inadequate infrastructure, partially due to the required enhancement of the public infrastructural services. Additionally there are now many competing sites. It is not difficult to envisage that second homes, holiday homes and relocation/retirement homes would be amongst the last to recover following a depression. However, in any sustained recovery Ardpatrick's place is assured.

Economic Prospects

In May 2014 the UK economy at last emerged from depression, passing the pre-recession GDP peak in January 2008 by 0.2 percentage points. This depression has lasted six-and-a-quarter years, far longer than any previous documented recession, of which the Great Depression was a comparatively brief four years from 1930 – 1934!

On 30 September 2014 the ONS issued revised Quarterly National Accounts showing the GDP in 2013, previously estimated at £1,612tn had been revised to £1,713.3tn, a significant increase of 6.2%. The revised figures showed that the economy emerged from depression in January 2014, about six months earlier than previously estimated, that the trough of the recession in Q2 2009 was 6.0%, rather than the previous estimate of 7.2%, and that by September 2014 the economy had grown from that trough by 9.3% rather than the 8.0% previously recorded. The revised figures show growth this year of 0.9% in Q2 and, using the revised methodology, 0.7% in Q3. The revised figures show that since the start of the recession in 2008 GDP is 2.4% higher than previous estimates – about the equivalent of a year of "normal" growth.

This "windfall" in the GDP has two sources. The basis of the computation of the statistics was altered to align more closely with the 2010 European System of Accounts and the 2008 Global System of National Accounts, a system being implemented by all "rich" countries. These revisions raised the estimate of the UK economy by including research and development and weapons manufacturing for the first time and by making revised increased estimates of charitable activities and by revising criteria to include, drug use and prostitution for the first time. Unfortunately, statistical adjustments, however arcane, and the inclusion of naughty and nefarious activities embellishing the figures, make absolutely no difference to the real output. Fortunately, now the real output is increasing rapidly, even more rapidly than expected, and it is forecast to continue to grow strongly. This time last year the Economist Poll of Forecasters, NIESR and HMIT forecast 2014 growth as 2.3%, 2.0% and 2.3% respectively, but now forecasts for 2014 are for 3.0%, 3.0% and 3.1% growth respectively and the current Bank of England forecast is 3.5% growth. For 2015 forecasts are slightly lower: 2.5%, 2.7% and 2.6% respectively but the Bank is again higher at 2.9%. Following the severe recession and the very long depression the current and prospective growth rates are a great relief rather than a cause for celebration. Certainly, they are similar to those of the years prior to the recession, but economies recovering from deeper recessions are usually followed by stronger recoveries. For example, following the previous recession in 1990, a recession of only 3.0%, subsequent annual rises in GDP were 3.2%, 4.8% and 2.9%. Following the trough of the Great Depression in the US in 1933, the US economy grew at 9% for several years. The "bounce" in the UK economy is not remarkable.

The recovery from the trough of the recession varies greatly among the advanced Western economies. The UK has grown 9.1% convincingly better than the Eurozone where individual countries are still flirting with recession and/or deflation and the Eurozone economy overall is only 3.4% above the level at the trough and still 2% below the pre-recession level in 2007, but the US economy has performed strikingly better and has risen 14.7% from the trough. Unsurprisingly, the Chancellor welcomed the emergence from depression as a "major milestone" and an endorsement/justification of the government's overriding objective of fiscal consolidation.

The underlying thesis of the Government policy appears to be that there is a causal link between low debt and high economic growth. Prior to the financial crisis, in the 2008 Budget, the then Chancellor, Alastair Darling, forecast that PSNB would be 2.9% of national income in 2008-09, falling to 1.3% of national income by 2012-13 and forecast that debt would then fall, as GDP grew, from a peak of 40% GDP in 2010-11. How quickly this changed: early in 2010-11 the Coalition reversed Labour's fiscal stimulus, introduced spending cuts and

increased indirect taxes, including VAT from 17.5% to 20.0% from January 2011, and placed increased austerity measures for subsequent years.

The fiscal tightening was estimated at £101bn or 6.5% of national income. Since then permanent downgrades to the outlook for the UK economy and public finances have led to further austerity measures, mostly scheduled to be implemented after the next General Election. The sum of the original austerity measures together with those announced subsequently are now expected to reduce public borrowing by £143bn or 9.1% of national income by 2017-18. Clearly, if the fiscal consolidation effected so far has a positive causal relationship with the UK economy's recent return to growth, there are further great opportunities.

A correlation between fiscal consolidation and economic growth may arise on quite spurious grounds, the result of a separate common factor. It was rumoured a don in a summer tutorial posited the correlation between the scantiness of undergraduettes' clothing and the consumption of bitter, ie the less they wore, the more the undergraduates drank! It might be contended that less clothing made the boys shyer or the girls less attractive so they drank more, but rather than a correlation, common factors suggested for both variables might be: the warm summer weather; the end of term exams; and the seasonal May balls. Or, perhaps he was correct: scantiness induces merriment and imbibition – or merriment induces scantiness and imbibition. Possibly casual relationships can be causal: and *vice versa*.

The Government's planned spending cuts relative to policies in place in 2008, 9.1% in the IFS figures quoted above, together with tax increases, will equate to more than 10% of GDP by 2018-19. In the 2014 Budget statement the Treasury argue that a lower debt ratio will allow a future government more flexibility to respond to any further crises and, more importantly, it would eliminate the negative effects of high levels of debt on the growth of the economy. Both arguments require assumptions at best unproven. The current debt is around 80% of GDP, high relative to recent years, but well below the UK's average of the past 250 years. Thus the UK's debt capacity is sufficient in most circumstances to allow its expansion and high debt, or certainly debt of 80% GDP or more, has permitted high growth in the past. The Treasury's statement implies that higher debt leads to lower growth. However, the experience of the recession and the depression, out of which the UK economy has just emerged, suggests that the lower the growth, as occurred during that time, the higher the increase in debt: thus the correlation is an inverse one. Or, rephrased, high UK debt did not cause the UK's recent poor growth: inversely, the collapse in the economy and the subsequent depression caused the increase in the debt.

During the long depression the economy operated below its peak 2007 output level. The general Government deficit was 11.3% of GDP in 2009, the largest ever recorded in peacetime, a rapid decline from the 5.0% deficit in 2007 when the economy expanded by 3.5%. The fiscal consolidation by the incoming coalition Government on 11 May 2010 was made in context of an estimated "permanent hole" (ie not cyclical) in the public finances of about 5.5% of national income which the then HMT March 2010 Budget estimated would be eliminated by the response under the then planned policies. Unfortunately by December 2013 this "permanent hole" was estimated by the OBR to have grown to about 8.25% of national income and the fiscal consolidation planned by the Government to eliminate it, together with a small safety margin, had expanded to 10% of national income from the earlier 5.5%.

In 2007, in spite of a growth rate of 3.5%, the expenditure exceeded Government revenue by 2.7 percentage points of GDP. Even during such a growth period, when it would be normal for the debt stock to fall overall,

debt continued to rise. Thus at the peak of the cycle, the Labour Government ran persistent deficits and so even with a notional average growth there was a considerable deficit: the economy was operated with a structural deficit rather than a cyclical deficit. The 2010 Budget had estimated the scale of the fiscal consolidation required to eliminate the structural deficit by 2015 – 16 and the further accumulation of cyclic deficits. However, due to the progressive increases in the sums required to effect the fiscal consolidation, caused primarily by higher estimates of the structural deficit, in turn partly increased by recent economic growth being considered to have resulted from cyclical take-up of spare capacity rather than increasing the underlying potential size of the economy, the deficit originally expected to be eliminated by 2015-16 is now £83.1bn, or £78.7bn after further budget trimmings by the Treasury. Consequently the reduction of the fiscal deficit is extended to 2018-19. In fact, of the planned fiscal tightening only 65% is now expected to be achieved by 2015-16: 35% has been deferred into the next parliament, commencing fiscal year 2016-17. Interestingly, of the total planned fiscal tightening, all the tax increases, and virtually all the investment cuts, would have been made by 2015-16, but all the further cuts are scheduled to fall on "current spending". By 31 March 2015, just 37 days before the 7 May 2015 election only 50% of the "current spending" cuts will have been implemented. Unsurprisingly, a great deal of planned pain and consequent opprobrium will fall on the post-election economy. "Funny that"!

The Chancellor's austerity programme Plan "A" may have been the only plan and calls for a Plan "B" were fiercely rebutted – but in practice, as shown above, the outcome has not been fulfilled or been in accordance with Plan "A": what was delivered was a modified version of the original plan, and one which was much less restrictive; actual fiscal policy has been more accommodating than the declared policy its advocates represent, although much more restrictive than recommended by some commentators and by advocates of Plan "B".

The recovery in the UK economy, which has grown 2.9% in the twelve months to September 2014, has been cited as proof of the efficacy of the austerity policy. If so, would not further austerity have been more efficacious? Alternatively, it is arguable that the amelioration of the fiscal tightening, particularly the delay in its completion target date and the protracted application of "current spending" cuts in favour of investment cuts and raised taxes, programmes already almost fully implemented, have prevented the worst effect of the fiscal tightening becoming evident. Indeed, Lawrence Summers, Professor of Economics at Harvard, argues that a proper interpretation of the recovery refutes arguments of those promoting austerity: in truth, the economy has recovered in spite of the austerity measures and not because of them, the rate of recovery being higher than otherwise expected because the austerity measures were not fully implemented, were delayed and were disproportionately applied to economic areas to which the economy was less sensitive. Additionally, other extraordinary Government policies have mitigated the damaging effect on the UK economy of the contractionary fiscal policy. Policies were introduced to boost the housing market, the "Help to Buy" programme and business via the FLS and the Bank of England promotion of export finance. Professor Summers cites circumstantial evidence for the contention that austerity and recovery are not positively correlated. Unlike the present position, recovery from deep recessions is normally followed by above average growth as illustrated earlier for the UK. The most extreme example of such a rebound was the 9% growth of the US economy after the trough of the 1933 Great Depression.

Tight fiscal policy has similarly impaired the economic recovery in the US, although in mid-2014 the US economy was 7.6% above the 2009 trough compared with the UK's 2.6% rise. Ben Bernanke, in his final speech as Chairman of the Fed, said: "To this list of reasons for the slow recovery - the effects of the financial crisis, problems in the housing and mortgage markets, weaker-than-expected productivity growth, and events in Europe and elsewhere - I would add one more significant factor – namely, fiscal policy. Federal fiscal policy was expansionary in 2009 and 2010. Since that time, however, federal fiscal policy has turned quite restrictive;" and "Although long-term fiscal sustainability is a critical objective, excessively tight, near-term

fiscal policies have likely been counterproductive. Most importantly, with fiscal and monetary policy working in opposite directions, the recovery is weaker than it otherwise would be. But the current policy mix is particularly problematic when interest rates are very low, as is the case today. Monetary policy has less room to manoeuvre when interest rates are close to zero, while expansionary fiscal policy is likely both more effective and less costly in terms of increased debt burden when interest rates are pinned at low levels."

A policy of fiscal contraction, or at least curtailing fiscal stimulus, in an economy with underutilised resources has had widespread support, economic judgements melding with moral and political prejudices, and has a long, but undistinguished, history. When the Great Depression hit the US economy in the early 1930s, there was no agreed intellectual theory on its cause and therefore no policy based on such a theory – one wonders how much different the position is now! The main theories advanced, all pre-Keynes, were based on supply, or more precisely over supply and infused the Liquidationists' case with moral overtones.

During the Great Depression two broad macro-economic theories were advanced to interpret it. Say's Law (Jean-Baptiste Say 1767-1832), later ambiguously interpreted Keynes "supply created its own demand", but also explained as "a glut can take place only when there are too many means of production applied to one kind of product and not enough to another". Thus a depression was a period of adjustment of the "too many means of production". The second broad macro-economic theory, the loosely-termed "Austrian school of thought", mimicked Say's law insofar as the Great Depression was interpreted as resulting from too much productive capacity from earlier over-investment. Both theories argued strongly against Government intervention as this would delay the necessary adjustments to supply. In essence, the conditions were caused by oversupply and not by under-demand.

These two theories formed an arguable intellectual basis for the "Liquidationists" in the Hoover administration and on the Federal Reserve Board, including Treasury Secretary Andrew Mellon, who advised Hoover to "liquidate Labour, liquidate Stocks, liquidate the Farms, liquidate Real Estate .... it will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people". In 1952, twenty years after his election defeat (8 November 1932), Herbert Hoover continued to maintain that, if Roosevelt and the "New Dealers" had stuck to his administration's policies, and, if they had had the resolve to "stay the course" and to "take our medicine", then a recovery would have been effected within eighteen months. Modern explanations of the Great Depression imply that it is almost impossible to imagine worse policy prescriptions in the 1929-1933 period.

Fortunately the "new deal" flooded the economy with liquidity, coming "off" the Gold Standard as part of this monetary easing, and engaged in a wide range of investments in infrastructure and financial support to the poor via the Social Security Act, so providing a major fiscal stimulus. Such a "New Deal" embracing both monetary and fiscal stimulus is not universally advocated or available. Advocates of restrictive policies continue to be highly influential, their power extending to implementation of policy. Jean-Claude Trichet, former President of the ECB, said on 8 July 2010: "It is an error to think that fiscal austerity is a threat to growth and job creation .... Economies embarking on austerity policies that lend credibility to their fiscal policy, strengthen confidence, growth and job creation" . The German Finance Minister, Wolfgang Schäuble, was quoted by the FT on 5 September 2001: ".... it is an indisputable fact that excessive state spending has led to the unsustainable levels of debt and deficits that now threaten our economic welfare". Similar views have been expressed by the highly-regarded economic institutions, the OECD and the BIS.

Fortunately, such conservative sentiments were not evident when the financial crisis struck in 2008. A key turning point occurred on 10 October 2008 when the G7 Finance Ministers, during a meeting of the IMF and World Bank, decided to "use all available tools to support systematically important financial institutions *and prevent their failure*." Crucially, this represented the turning point in the crisis, but their actions implied a quite unrelated *volte face*: the era of financial liberalisation was over: the Holy Grail of a robust self-regulating market, self-correcting integrated self-equilibrating system was shattered. Like the Holy Grail it had always previously been impossible to prove that such an idyll did not exist, at least until this revelation. The equivalent value of the undertakings given was unprecedented: 18% of Eurozone GDP, 73% of US GDP and 74% of UK GDP, and 25% of world GDP taken altogether. The support raised the fiscal deficit in 2007 in the US from 7% to 13% in 2009, in the UK from 3% to 11% and in Japan from 2% to 10%. These fiscal deficits were equivalent to those previously experienced only in wars. For the UK the rise in public debt relative to GDP was the fourth largest in history, exceeded only in the Napoleonic and the First and Second World Wars.

This prompt, massive and decisive action saved the day. Such crisis policies were endorsed by the leaders of the G20 countries in 2008 and in 2009, saying on 25 September 2009: "We pledge today to sustain our strong policy response until a durable recovery is secured. We will act to ensure that, when growth returns, jobs do too. We will *avoid any premature withdrawal of stimulus*". So the West was saved and a return to growth heralded, or so it appeared. Less than a year later, in June 2010, when all the G7 economies were still operating below the pre-crisis level, the UK and Eurozone being only at 94% of the pre-crisis level, the G7 announced after the Toronto summit: "Recent events highlight the importance of sustainable finances and the need for our countries to put in place credible, properly-phased and growth-friendly plans to deliver fiscal sustainability, differentiated for and tailored to national circumstances", and further: "Advanced countries have committed to fiscal plans that will at least halve deficits by 2013 and stabilise or reduce government debt-to-GDP ratios by 2016". Thus a reversal of previous policy from counter-cyclical action to austerity was announced, when aggregate demand was low and expansionary monetary policies were already approaching the limit of their effectiveness.

In practice, the 2010 G20 announcement articulated actions already being taken by most governments for reasons that varied among the participants. In May 2010 the UK incoming coalition government moved sharply to an austerity budget saying: "We are going to ensure, like every solvent household, that we buy what 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 (sic!) of the debts we were not ourselves prepared to pay". The Chancellor evokes echoes of Thatcherism and the classic allusions of Micawber and Polonius, but economic management is neither morality nor an abhorrence of fecklessness but an assessment of net balance. Colourfully put, Samuel Brittan observes: "the Deficit should be a policy variable rather than targeted to meet a dim accountant's idea of balance". This policy variable was well used in the past: currently debt is forecast to be 79.7% of GDP in 2015-16 but the average over the last 324 years is 112% with long periods over 100%.

The UK policy change had three distinct strands. The moral, ideological strand is characterised by the sentiments above. The political strand was the expectation, by adopting fiscal tightening, of being seen to differentiate that policy from their predecessors' "incorrect" policy, one that had led to the crisis, and therefore one for which they could be blamed; to pin all the pain on the Labour administration. The third strand had an economic element. Carmen Reinhart's timely analysis of financial crises "This Time is Different" supported the contention that when public debt exceeded 90% of GNP, growth was close to zero. However, later revisions of the data used by Reinhart indicate that between 1945 and 2009 advanced economies with above 90% debt to GDP still had growth rates of 2.2%, although 1.0 – 1.1 percentage points less than economies with debt between 60% and 90% of GDP. Thus slower growth may be associated with higher public debt, but such an association does not prove causation. Empirically it is difficult to envisage how higher public debt caused the UK's slow,

post-crisis growth, especially as net public debt was near its lowest ratio to GDP for nearly 300 years. Interestingly, the low public debt of Spain and Italy did not prevent the catastrophes that befell them and the rise in their debt is associated with the crash, which led to their poor growth.

Increased debt may burden the economy with higher interest rates. However, such cost only applies to new debt, and the refinancing of existing debt at maturity. Recently the UK's credit rating has been high and no measurable difference has occurred in interest rates as debt increased even when the extended period required for its reduction was announced. In practice the cost of new debt is probably at an all-time low as real short-term rates are practically zero and any change in the debt level would have to be very large to make any significant difference. For instance, if one assumes real interest rates of, say, 2% and debt at a high level of, say, 100% of GDP, then even an extreme position of halving the debt level to 50% of GDP gives a real saving only of 1% of GDP. Increases in debt ratios, given stable interest rates, are inexpensive and, as shown later, may prove good investments.

The fiscal multiplier is the ratio of the change in national income divided by the change in fiscal stimulus and for example an expansion of 50p for every £1 stimulus gives a multiple of 0.50. The multiplier varies with the state of the economy, exceeding 1.0 in some cases. In 2012 the IMF stated that, whereas it had previously used multipliers of about 0.5 "our reports indicate that multipliers have actually been in the 0.9 to 1.7 range since the Great Recession" research suggesting that in today's environment of economic slack, monetary policy constrained "by existing low interest rates and fiscal tightening in trading partners ..... multiples may be well above 1.0." The OBR used the earlier IMF assumptions in its forecasts and specifically in relation to their 2012 forecast Evaluation Report they have said: "In trying to explain the unexpected weakness of GDP growth over this period" (ie OBR forecasts were too high), "it is natural to ask whether it was caused in part by tightening – either because it turned out to be larger than we had originally assumed or because a given tightening did more to depress GDP than we had originally assumed." (ie the multiplier was larger than expected.) "In answering the question, we are concerned with the aggregate impact of different types of fiscal tightening on GDP (measured using so-called 'fiscal multipliers') and not simply the direct contribution that government investment and consumption of goods and services makes to the expenditure measure of GDP. This direct government contribution has been more positive for growth than we expected" .... but as growth was lower than forecast the fiscal multipliers must have been underestimated. The Guardian estimated that the "real" multiplier is 1.3, and OBR have underestimated the effects of the fiscal tightening on the economy by £76bn over five years and the fiscal contraction, originally estimated to have reduced economic growth by about 1% per year, has reduced it by nearly 2% per year.

Fiscal stimulus during a recession has distinguished support. Danny Blanchflower, formerly a member of the MPC, said: "In a way, the surprise is that it's taken everybody so long to work it out: Keynes knew it in the 1930s. This is the 'long, dragging conditions of semi-slump', and the multipliers are likely to be larger when you've got banks that aren't lending and you're coming out of the longest depression in 100 years."

The Government has consistently affirmed its support for "Expansionary Fiscal Contraction." The Chancellor even suggested an association, although he did not assert a causation, in his speech to the IMF after the UK's return to moderate growth in 2013: " ... despite warnings from some that our determined pursuit of our economic plan made that impossible. All of this demonstrates that fiscal consolidation and economic recovery go together, and undermines the pessimistic prognosis that only further fiscal stimulus can drive sustainable growth. Indeed that is precisely the wrong prescription for our economies ...". Earlier in 2013 the Prime Minister, in defence of the poor economic performance in 2012, said: "As the Independent Office for Budget

Responsibility has made clear, growth has been depressed by the financial crisis, by the problems in the Eurozone and by a 60% rise in oil prices between August 2010 and April 2011. They are absolutely clear, and they are absolutely independent. They are absolutely clear that the deficit reduction plan is not responsible; in fact, quite the opposite", so denying an inverse relationship between fiscal tightening and economic growth. The Chairman of the OBR wrote to the PM the very next day: "Every forecast published by the OBR since the June 2010 Budget has incorporated the widely-held assumptions that tax increases and spending cuts reduce economic growth ...". The multipliers used by the OBR, which were considerably smaller than those suggested by the IMF for an economy in the UK's condition, would, he said: "... have been sufficient to reduce GDP in 2011-12 by around 1.4%", and the weaker growth since the end of 2010 could in part be: "... because the fiscal consolidation measures have had a greater multiplier effect than we anticipated."

Amusingly, other critics of Expansionary Fiscal Contraction have supplemented academic argument with mischievous satire, possibly more telling than opaque academic tracts. Paul Krugman dismissed the proposition that fiscal austerity could "strengthen confidence, growth and creation" (Jean Claude Trichet 8.7.10) and have an "expectational" effect as a "confidence fairy". In a similar vein, he said the recent end to the depression allowed us to feel better because "we've stopped hitting ourselves over the head with a baseball bat. So we start to feel better." Tellingly, Keynes had foreshowed these polemics with his aphorism: "The Boom not the Slump is the right time for austerity".

There is continuing political institutional and academic support for "Expansionary Austerity". The political will is epitomised by the German Finance Minister, Wolfgang Schaüble's assertion "austerity is the only cure for the Eurozone". The institutional support includes the OECD and the BIS and the ECB, whose strong endorsement probably originates in the continuing fear of the hyper-inflation that engulfed the Central Powers after WWI. The academic support for the hypothesis derives from the recent work of Professor Alesina whose econometric work at Harvard in 2010 appears to provide statistical validity for the hypothesis, a disturbing endorsement of some perceptions current during the Great Depression. Professor Taylor, a Cambridge economist at the University of California, does not challenge the conclusions drawn by Alesina's processing of the data but refines the treatment of the same data in order to provide the increased randomisation in comparative trials in order to obviate the allocation bias in Alesina's analysis. Analysis based on these refinements do not support Alesina's conclusion. Professor Taylor prefaces his paper: "When is the time for austerity?" with a reference to the Spanish battlefields in 1809 during the Peninsular War. Alexander Hamilton, a Scottish surgeon, in his inaugural medical dissertation in 1814 entitled "Synocho Castrensi" (Typhus) described the treatment of 366 sick soldiers by him and two other surgeons: " ... this number was admitted, alternately, in such a manner that each of us had one third of the whole. The sick were indiscriminately received, and were attended as nearly as possible with the same care and accommodated with the same comforts. Neither Mr Anderson nor I ever once employed the lancet. He lost two, I four cases; whilst out of the other third [treated with bloodletting by the third surgeon] *thirty-five patients died*." A contemporary review states: "It is still noteworthy that Hamilton judged that his description of alternation and standard conditions would impress his examiners."

This is an early account of a randomised, controlled trial, eliminating a bias that pervaded certain medical trials even until the 1940s: bad habits die hard! Suppose Dr Hamilton considered on which grounds he should give the best standard treatment, the lancet, to all the soldiers he should restrict the trial to the 60 most ill. Suppose also he decided irrationally that only the weakest of that 60 should have the revolutionary, possibly life-saving, treatment of no lancet. Perhaps then there would have been fewer deaths in the stronger, lancet group – proof positive that the lancet was the better treatment.

In the backwards-looking "testing" of economic "procedures" the result of the application of "procedures" depends on the state of the health of the economy, this being one of many allocation variables, or biases, possible in macro-economics. Professor Taylor's contribution is to use a series of sophisticated statistical techniques that attempt to reduce any such inherent allocation biases. First, however, Taylor reworked Alesina's data which demonstrated, consistent with Alesina's results, that austerity is expansionary. In the second analysis of the same data, the data were stratified by the state of the cycle into two strata, boom and slump, and the first estimate was shown to be determined solely by the outcome in the "boom" stratum in which 1% fiscal tightening produces a statistically significant, positive increase in GNP in years one and two and a non-significant increase of 0.23% over the test period of four years. In the slump stratum there was a non-significant decrease of GNP of 0.55% over four years.

Taylor then finds two principal areas where the treatment, fiscal tightening, has not been allocated randomly, as would have happened if the soldiers selected for the lancet were admitted to the trial treatment later than the other soldiers. The timing of the fiscal tightening is a major source of misallocation and Taylor found that the treatment by fiscal tightening was made significantly more likely the higher the ratio of debt to GDP and concluded: "Governments pursue austerity when debt is elevated ..... when output is below potential treatment is more likely and being in treatment today is a good predictor of being in treatment tomorrow: austerity programmes persist". Taylor then used a two-stage technique designed to eliminate allocation biases to estimate the impact of (fiscal) treatment by the state of the economy. This analysis of the same data showed that austerity has a mostly negative effect, all years, both in the boom and in the slump strata of the data analysed. Summed over the four years studied the contraction in a boom economy was 1.13%, significant at a low level, and in a slump economy the contraction was 2.48%, significant at a high level. These results contrast with Alesina's findings and amplify the views of the IMF.

There is a possible reconciliation between Alesina's conclusions and those Taylor made after the adjustments applied to reduce misallocation. In practice, austerity measures are systematically applied in weak economic conditions, and, following a weak period, the economy, having spare resources, is inherently likely to grow faster, so recovering in spite of, not because of, the extreme fiscal treatment: a dead cat bounces whether it jumped or was pushed! In technical terms an economy in recession already has an endogenous bias to grow more rapidly. Thus the effects of an exogenous variable, the fiscal treatment, is not independent of the state of health of the economy, or for Dr Hamilton, the sickness of the soldier. Taylor summarises his findings: "By failing to allow for the endogeneity of treatment we could end up with a far too rosy view of the aftermath of fiscal treatment." Fiscal contraction prolongs the pain when the state of the economy is weak, much less so when the economy is strong. In his randomised trial blood-letting, as Dr Hamilton found, was the worst treatment, a treatment probably more damaging in ill patients.

The June 2010 OBR forecast for real GDP in 2013 was 5.2% higher than the out-turn. Taylor estimates that 3.0 percentage points of that shortfall were due to the fiscal austerity, but he concludes "our estimate of austerity's effects in the UK is probably conservative". Since Taylor's paper was published in July 2013, growth has continued, but not at the higher than trend rate expected after a severe recession and, on Taylor's analysis, is in spite of, not because of, fiscal tightening. Fortunately, the fiscal tightening has been far less stringent than was originally announced and many concessions, including tax giveaways, have been made which have mitigated the effect of the cuts – the actual austerity programme has been "Plan A minus". A little harm is less bad than a lot of harm!

The fiscal contraction has caused specific damage to the economy because of the nature of the cutbacks and because the cutbacks' ancillary effect on the productive capacity and the productivity of the economy. At the start of the 2014/15 tax year about 90% of the cuts to investment spending had been made but less than two-thirds of the cuts to benefit spending and less than one-third of the cuts to "other current expenditure". Thus, proportionately, the greatest cuts have been to public investment ie capital goods, not to so-called "investment" in public services that are actually current expenditure or usually public sector losses, where the IMF contend that, provided unemployment is high, the stimulus effect of investment is greater. Lawrence Summers, a former US Treasury Secretary, illustrates the benefit of such investment by assuming, according to convention, that such investment returns 6% in real terms and increases tax revenue by the marginal rate, say 25%, or 1.5% of the investment. As real interest costs are currently below 1.5%, the investment is self-funding. The return on investment is greater as it neglects the tax revenue, and welfare saving, of putting people back to work and the long-term benefit of combatting recession and of increasing the economy's capacity. Taking these and other factors into account, the IMF finds that a unit of such investment increases output by nearly three units. Unconsciously, perhaps, such investments were made in the US during the New Deal and in Germany before WWII. Summers says: "There really is a free lunch".

Fiscal contraction may have caused or contributed to irreparable damage to the economy. In past recessions output has recovered to a level consistent with the trend line of growth before the start of the recession, which was 2.8% in the UK from 1955 – 2007. This difference, the output gap, is currently estimated at between 11.5% and 15% of GDP as a result of the lowest growth rate of productivity in peacetime for over 150 years. In the US the trend growth rate was 3% and the output gap at the end of 2013 was 17%. If the US economy continued to grow at 3% and if the P.V. of the future GNP is also 3%, then the present value of the loss of GDP would always be 17%. After 100 years this permanent gap would cumulate to 17 times the current GDP, a cost greater than WWI, a hundred years ago. A failure to regain the previous trend line of economic growth is a large and growing loss, such is the wonder of exponential growth.

The cause or causes of damage to the structure of the economy which has occasioned such a failure are not clear. Indeed, it has been argued that the loss is overstated as the recent underlying growth rate may have been exaggerated or enhanced by the credit boom preceding 2007 and the accompanying atypical rise of the financial sector. However the growth in output in the credit boom preceding 2007 was not appreciably different from that previously. Moreover, when the crash came declines in employment did not vary among sectors, implying no one sector had been especially developed. Wage and price inflation did not increase prior to the crisis, and so it is unreasonable to assume that there was a general pre-2007 output boom.

The output gap, the difference between the level of output had the growth trend line been recovered and the actual output is estimated at between 11.5% and 15.0% of GDP. However, the existing gap is estimated to be only 2.5% for the UK (2013) and 3.0% for the US and it is argued that the output gap has been incorrectly estimated. However, as inflation has been steady, and has not given way to deflation, or at least not yet, it is unlikely that there are such vast unemployed resources available, as surplus capacity of that scale would have surely triggered falls in prices even with the traditional inviolability of wage levels and prevailing expectation of inflation. A probable explanation for the difference between the existing gap and the output gap is that the economic crisis and the long ensuing depression have damaged both potential output and its rate of growth. The imposition of the extra burden of "expansionary fiscal contraction", extending and deepening the depression, will have had more than an additive effect: many more economic activities can withstand the first round of stress than the second – the level of pain is exponential, not arithmetical.

The depressing effects of expansionary fiscal contraction are demonstrated in the elegant statistical analysis by Taylor. The effects of a prolonged depression can be induced by observation: skills atrophy; the long-term unemployed become unemployable; credit is abnormally restricted causing closures and inhibiting investment; businesses operating on written-off capital plant close and cannot compete at replacement cost; vital links in a production chain are lost and cannot be replaced; alternative overseas supplies are sourced; and, crucially, people simply give up; a six-year depression is a long time!

The Bank have held a contrary view since 2008, contending every quarter that, *inter alia*, economic performance will spontaneously improve or return to normal, and that low productivity is a temporary measure due to labour hoarding. Giles, the FT columnist, compared this attitude with that of the English football fans who, almost half-a-century after the 1966 World Cup triumph, exude continued hope for World Cup domination over experience, only to be beaten into the reality of mediocrity. But, like England, there is continuing failure to recover the past position and, indeed, as economic activity has increased unemployment has gone steadily down as more are employed while productivity, output per person, improves little. Lord King, adopting a theoretical view, together with some members of the MPC, maintain that there is an inherent, underlying rate of productivity increase which is unchanging: Adam Posen's populist explanation of this view was that a proportion of the workforce had not "woken up in the morning to find that their left arms had fallen off".

Unfortunately, productivity increases are not inherent – arms may no longer be required or may not be sufficiently dextrous, or more arms may be needed. Specifically, extra staff per unit of output are now required in North Sea oil and gas extraction because of diminishing returns, in the financial and auxiliary industries because of more onerous compliance procedures, and in transport where extra security measures are required. Ian McCafferty, an MPC member, concluded that these and other non-cyclical factors accounted for some 60% of the decline in productivity. Perhaps he also should have included the increased staffing of the public sector where productivity growth has been spectacularly low. Unfortunately, the improvements accompanying the manufacturing sector earlier last century, and the oil and finance sectors later, have now been largely exhausted and the levels of productivity growth then cannot be replicated at the present time.

Thus the fiscal contraction is being undertaken at a vast cost to the economy and to its productive potential with irrecoverable long-term costs. Fortunately, the original plan, Plan A, has not been rigidly adhered to and concessions from it and delays to it have occurred. The recent autumn statement in which the Chancellor announced yet another missed deficit-reduction target and allowed further relaxations including stamp duty reductions, costing about £800m, and useful, primarily middle-class, concessions on taxes, children's flights, savings and pensions all exemplify such derogations from Plan A. The Economist comments: "The real test – the additional pledges to slash public spending – is yet to come ...", but on the other side of the May 2015 election! That, no doubt, is too distant a prospect for the Chancellor as, based on the November Calculus poll, the current probability of a Conservative majority is less than 10%; while a Labour majority is about 40% probable: ...... a week is a long time in politics .... !

The Chancellor, with the necessary nod to political expediency, has identified the UK's overriding economic problem as fiscal to which he seeks to apply an overriding solution: "Our first benchmark is to cut the deficit [241] quickly to safeguard Britain's credit rating." A fiscal deficit may have many causes, as a headache may be caused by a transient hangover or a serious meningitis, the significance of the symptom depends on the circumstances, and, according to the circumstances, the appropriate treatment varies. In Dr Hamilton's experiment the use of the scalpel cured 88 soldiers but 34 died. Bloodletting as a medical cure persisted right into the 19th century "to clear out" infected or weakened blood and "to cause haemorrhages to cease" [342] for

which it is difficult to contemplate a less suitable treatment! Interestingly, Harvey, the discoverer of the circulation of the blood in the early 17th century, rejected it as a medical treatment but its practice persisted long after its efficacy had been disproved. Similarly, clinical medical trials continued to be conducted until as late as the 1940s whose results were invalid because they neglected the simple statistical sampling requirements followed by Dr Hamilton in 1809.

In economics as in medicine, the treatments don't always fit the disease, the sample is incorrectly drawn, or the diagnosis is wrong: moreover, outwith the abstract nature of a controlled experiment, the salient points are easily obscured. At present, the use of fiscal austerity expansion is not the optimal way to cure the fiscal deficit, if that is the overriding objective. Similarly, as Dr Hamilton might have surmised, the optimal way to ensure the health of the soldiers in his care was not to cure them of Typhus but to eliminate the conditions that led to their disease. The UK's underlying economic problem is not fiscal, but financial, as the economy is not operating at full capacity and the rate of change in productivity is low, resulting in reduced rates of increase in the output of the economy and the increased tax derivable from that higher output. The Chancellor is currently using an inappropriate remedy to treat a condition that is primarily a symptom of a greater hindrance to economic growth.

Krugman's criticism of one specific economic policy blunder: "Most modern economists – to the extent that they think about it at all – regard the Great Depression (in the 1930s) as a gratuitous, unnecessary tragedy ... ... a nightmarish slump thanks to the stupidity (or at least ignorance) of policymakers" is far too strong for the current circumstances, but illustrates the scope for policy errors.

In contrast two very good other political choices have mitigated the potential damage to the UK economy. The decision not to join the Eurozone has been wholly vindicated, as the current UK growth rate is 2.2 percentage points higher than the Euro area and its growth prospects are considerably better. The Euro periphery is locked in a fiscal contraction and has separate economies requiring separate policies with no means of effecting these. A less obvious but more dangerous risk is that of political instability resulting from perceptions of inequality, inadequate representation, frustration and inequity. Underlying and reinforcing instability are tensions caused by prolonged unemployment, especially amongst the young, and the distillation, fuelled by envy, of frustration into racialism or, worse, radicalism. At present, as the FT comments, the Eurozone occupies the no-man's land between systemic cohesion and political disintegration.

The European project had backing amongst inside bureaucrats, political elites, and "liberals" and professional and business groups with few dissenting views. Emphasis has always nominally been on economic argument, which as many American economists observed, was largely fallacious, but diffused the political ambitions of its proponents. The UK was fortunate to have had Gordon Brown as Chancellor at the crucial time of the recent decision on the Euro. His reputation was greatly sullied by the events leading to the financial crash, but his achievements include an immediate, effective and correct reaction to the crash, the deflection of the pro-Euro lobby and, most recently, a pivotal intervention in the Scottish Referendum debate, which may have had a crucial influence in leading to the rejection of independence.

The economic cost of independence would have been great. The specifics of the likely settlement with the rUK and the EU cannot easily be judged but whatever they would have been the economic cost to Scotland would have been considerable, the extent varying with the settlement and the oil output and its price. Without any doubt Scotland would have faced higher interest costs on debt incurred, higher central and administrative costs

due to its wide geographic spread and layout, high social costs due to unfavourable demographics and higher long-term unemployment. There is no evidence to support Scottish latent higher productivity, entrepreneurship or special skills, leading to higher economic output, and no good argument to show how these beneficial traits could have been nurtured in an independent Scotland; assertion is not argument. Indeed, the SNP administration is committed to the centralisation of policies within the Government, to a more redistributive society, to higher and more progressive taxation and to increased emphasis of the rights of the state and state officialdom over individual rights. This is not a textbook prescription for higher growth.

Whatever the long-term effects of independence, the short-term effects, while the transition was being effected, would have been most unfavourable. Inevitably there would have been a large scale move to rUK in the banking and financial sectors and in certain technical sections relying on UK-recognised technical standards. Investment decisions where the balance Scotland and rUK was close would mostly have been made in favour of rUK as the downside risk to investment in a Scotland with uncertain currency and trading relationships would be very large. In the months prior to the vote and, as the outcome became less and less clear, property transaction numbers slowed appreciably and some were conditional on a "No" outcome. Relocation, diversion of investment and delay would have continued through the period of the settlement and would have caused a recession in Scotland. Post the settlement Scotland would have grown at a slower pace than rUK from a lower base following the Scotland recession.

"It's Scotland's oil" has been the evocative rallying cry of the SNP since the North Sea field was established, and the oil revenues accruing to Scotland provided an important and substantial backing for the SNP's economic case in which it made quite unrealistically large estimates of oil revenue accruing to Scotland based on oil prices of around $113 and unsupported levels of extractible oil. However, the debate and the subsequent referendum all took place before the recent dramatic fall in the price of oil from $115 in June to $65 in early December. SNP estimates of extractible oil seem equally exaggerated. North Sea oil production fell 8.6% in 2013 and had declined until then without interruption by 62.3% over ten years. The tax revenue was almost £14bn in 2011 and was forecast then to be £11bn in 2016, a forecast that has been progressively downgraded in each Budget statement to £4.0bn in the 2014. The Budget projections, like those by the SNP, were made before the recent fall in oil price. Due to the very high rate of tax on oil and gas extraction, very approximately 62%, falls in price have a disproportionate effect. If the marginal cost of production is $50 then the tax take at a price of $110 is $37.2 per barrel, but at $65 the tax take is $9.3 tax per barrel. Clearly, at current prices the tax revenue would fall substantially, the estimated tax of £4bn for 2016 reducing to £1.0bn tax. The tax revenue is calculated before any allowance for loss of tax in the ancillary industries and in their employees and "second round" effects on their suppliers.

The discussion on the economics of independence, the price of oil, Scotland's currency and the economic potential of an independent Scotland is not determinative for many Scottish voters. John Kay says: "If your opinions are not based on facts, changing facts will not necessarily change attitudes". So it is with many "Yes" voters, many of whom were fervent, determined, organised enthusiasts and, as Philip Stephen said in the Financial Times on 19 September 2014, some with an "air of menace" and "an undercurrent of intimidation". To the believers, theirs is the true religion and with such a faith one can never find fault. Subsequent to the referendum, support for the SNP has apparently increased, reinforced by clear politicking by Alex Salmond, who is the most articulate of all UK politicians, that only promises and "vows" produced a rejection of independence: these are not being kept: hence a further referendum is required! These failings are encapsulated in the view of one Glaswegian mourning his loss "Glasgae said aye". The true believers will accept everything offered, but it will never be enough.

The cost to Scotland of an independent state would be significant; this is a club with a high entry fee, unknown benefits and high long-term costs. For the Nationalists the satisfaction and pleasure deriving from such a club, the realisation of the dream of a political Utopia and the lifting of the yoke far outweigh the cost. Indeed, for the many in the protected public sector, the cost will be small. It is entirely proper that Scotland has been given such a choice, but it is inequitable for the questions to be put again and again awaiting a random "yes", which, according to Professor Summers, would be an "irreversible mistake that Scotland avoided".

The third exogenous benefit to the UK economy is the fall in oil prices and ironically the UK gain is Scotland's bane as, although the fall in price will reduce the UK's oil tax revenue and have a "horrible effect" according to Sir Ian Wood on North Sea prospects, there are more than compensating advantages to the UK, a net-importer of oil.

Oil prices are particularly volatile and the longevity of the present fall will determine the economic outcome. A large fall occurred between1985 and 1986, partly in response to the significant production increases in non-OPEC countries following the "oil shocks" of the 1970s but prices recovered quickly. The current fall results largely from another non-OPEC surge in output- the US fracking revolution. In the near future the oil price will be determined by marginal changes in production by high-cost producers, a wide-ranging group including, tar sands, marginal fracking sites, oil-strippers Arctic oil, west Shetland fields, small fields (with high overheads) and reworked larger fields, the inverse of the previous position when it was the marginal changes in the lowest cost producer – Saudi Arabia – that determined the price. If and when the pendulum of production change crosses to the OPEC cartel the determinants of pricing will change.

The financial and political cost to the majority of OPEC producers is extremely high but Saudi, the traditional swing producer, maintains output; but at some point the power struggle within OPEC will probably result in sufficient co-operation to regain control, but at what price is that likely to be? This time last year the six year future price of Brent crude was *c*$88 and now, in early December 2014, the five year price of Brent crude is *c* $88. Implicit in the forward pricing are assumptions about OPEC and, more tangibly, about the financial viability of high-cost US production when prices are lower. US tight oil producers have recently managed spectacular reductions in costs and, given the technological expertise in the US, I suspect that in future marginal costs will be much lower than generally expected. If so, the $88 price could be too high. Certainly the IEA predict that, primarily due to US production, non-OPEC oil supply will continue to rise from 58% of global output to 60%.

A price drop of $40, say to $70, would transfer 2% of world output from oil producers to consumers, who, having a higher propensity to spend than producers, would give a much-needed boost to demand. Lower oil prices yield significantly lower inflation, as already is occurring in the UK, directly in fuel prices, but also in lower production and distribution costs in the economy. Lower energy prices will encourage manufacturing, particularly high energy intensity manufacturing, giving import substitution, a feature of the upturn in and the reshaping of the US economy, which enjoys exceptionally cheap gas supplies. The UK economy will expand reaping increased taxes. The likely political changes will have minimal effect on the UK economy. In contrast current prices severely imperil the economies of some countries, particularly Iran, Russia and Venezuela, and the adventurism followed by some of them. The oil price collapse in the 1980s was held to be partly responsible for the fall of the Berlin Wall in 1989 and changes in the USSR, but different political pressures now obtain and the Russian culture seems inured to hardship: and wounded animals are more dangerous!

I said last year: "Interestingly, Saudi is reported to have said that it no longer intends to increase its oil capacity beyond its current level of 12,500 mb/d before 2040 because of the growth of supplies elsewhere. The increasing supply from fracking coupled with other higher cost sources such as oil sands and Arctic oil and the increasing competition from gas, where supply is likely to benefit even more from fracking, seem likely to outweigh the continuing but differing supply interruptions as exemplified by the "Arab Spring". Prices will fall from the present $100, but, on present technology, a limit of $60 to $80 seems likely as that is currently the cost below which most oil from most unconventional sources, including fracking, becomes uneconomic". This has proved prophetic.

Economic growth, delayed and suppressed by the fiscal contraction policy of the UK government, will continue, assisted by lower energy costs. UK growth would be further assisted if the budgetary conditions proposed by the Coalition are not enforced, as I do not expect them to be either because they will be allowed to "slip" by a Conservative administration or will not be undertaken by an alternative government. Scotland's "No" vote has protected the Scottish economy from a severe short-term shock and a damaging effect on the UK economy. The oil price fall is a great boon for the UK, which will have unfortunate ramifications in some regions, and, while economic growth will continue in the UK, the higher growth levels normally following a severe recession will not be achieved, and the on-going Eurozone crisis will exert a depressing influence.

Property Prospects

In the previous property investment cycle the CBRE All Property Yield Index peaked at 7.4% in November 2001, then 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, on brief occasions when the Bank Rate was over 10%. The yield fell rapidly from that 7.8% peak to a low of 6.1% in 2011, before rising by 0.2 percentage points in 2012 and falling back again in 2013. This year it has fallen decisively to 5.7%, representing a rise in capital value of 22.8%.

The yields have fallen in all components of the Index, as occurred last year except for the two Retail Indices which were unchanged. This year the Retail Warehouse Index has fallen from 6.1% to 5.2%, a significant rise in value of 17.3%, and the Shop Index has fallen from 5.8% to 5.4%. Yields fell most rapidly in the Industrial sector, from 7.2% to 6.4%, and least rapidly in the Office Index, from 5.9% to 5.6%.

I noted last year that within each component of the All Property Index the largest fall in yields took place in the London area and this year that pattern was repeated. London Industrials fell from 6.1% to 5.2%, or a capital increase of 17.3% and in the South-east and the South-west capital values rose 14.0%. However, outlying areas also rose appreciably in value, Wales having the smallest rise of 7.5% and northern areas generally rising 10%. The differential rise of London over the other areas is much less marked than I recorded last year but by a much smaller margin: colloquially described as "rippling out", the amplitude of the waves falling with the spread. In the All Shop sector, a similar but more circumscribed "rippling out" is evident. The Yield in Central London shops has fallen to an unprecedented 3.3% from 3.7% last year, giving a 12.1% increase in value Yields in other southern areas have also fallen about 0.4 percentage points. A big rise in London values accompanies small rises elsewhere, but the disparity is less marked than it was last year. In the Office sector the yield reduction in the Central London area has been 0.1 to 0.2 percentage points. In sharp contrast office yields in the South East and Eastern area have fallen from 7.6% and 8.0% to 6.6% and 7.0% respectively, an increase in value of 15.2%

and 14.3%. Yields in all other areas have fallen significantly albeit less dramatically and tapering off toward the north with Scotland's yields now 7.1% compared with 7.5% last year.

The peak yield of 7.8% in February 2009 was 4.6 percentage points higher than the 10 year Gilt Yield, then the highest "yield gap" since the series began in 1972 and 1.4 percentage points higher than the previous record in February 1999. The 2012 yield of 6.3% was a record 4.8 percentage points higher than the previous exceptionally low 1.5% gilt yield. The yield gap in 2013 reduced to 3.7% as the 10 year gilt yield rose to 2.4%, or 0.9 percentage points, and outweighed the 0.2% fall in the All Property Index to 6.1%. This year gilt yields are unchanged but the fall in the All Property Yield of 0.4 percentage points to 5.7% has reduced the yield gap to 3.3%.

The All Property Rent Index, which apart from the brief fall in 2003, had risen consistently since 1994, fell 0.1% in the quarter to August 2008 and then fell by 12.3% in the year to August 2009. Since 2009 there have been small increases of only 0.9%, 0.1% and 0.6% in the year to August 2012, but in 2013 rental growth improved slightly to 2.6%, and there has been another small improvement this year to 2.9%, but the Index, currently at 178, is 6.3% below the June 2008 peak of 190. Interestingly, the Rent Index peaked about a year later than did capital values, because of anticipated rental increases. Office rents rose 7.6% this year, the principal cause of the 2.9% rise in the All Property Index, as the Shops and Industrials indices rose by 1.1% and as Retail Warehouses fell by 1.2%. The overriding influence on Office Rents was a continuing rise in London, particularly in Southbank, (17.8%), Mid Town (13.2%) and City (11.1%), contrasting with nominal rises only in most other areas except South East (5.2%) and Eastern (5.4%) and, exceptionally, the North East (5.9%), but the Scottish Office Rental Index rose only 1.3%. Industrial rent levels in most regions were largely unchanged, except for a rise of 7.4% in west Midlands and a fall of 3.5% in Scotland. A small rise in Shop rents masked a further rise in Central London shops of 10.9%, following last year's rise of 13.6%, as rents were virtually unchanged in all other areas. Since the depression started six years ago in 2008, the All Property Rent Index has fallen about 1% per year, the Office Index has recovered to just above the earlier level, Industrials have fallen by 0.5% per year, but Shops have fallen 2% per year and Retail Warehouse 3½% per year. Since the market peak of 1990/1991 the CBRE rent indices, as adjusted by RPI for inflation, have fallen: All Property 32%; All Office 37%; All Shops 27%; All Industrial 40%: and All Retail Warehouses 21%.

Property Investment, as measured by the IPD All Property Index, returned 20.1% in the year to 31 October 2014of which the income return was 7.0% and the capital return, 13.1%. Office and Industrial property returned 25% and 15%. This time last year the All Property Index return was 7.4% of which the income return was 7.0% and the net capital return 0.4%. Previous returns in the years to 31 October were 3.1% (2012) 8.7% (2011), 20.4% (2010) and minus 14.0% (2009), and minus 22.5% in the calendar year 2008 when in December alone the index fell a record 5.3%. In the year to 31 October 2014 the All Property Index return of 20.1% and the Property Equities return of 18.6% was significantly more than the 5.4% return from Bonds and the poor return of 0.6% from Equities.

Property Investment returns for 2014 are forecast at about 19%, significantly better than the 10.7% IPD Index return to December 2013 which included an income return of 5.7% and an increase in capital values of 5.0%. Last year's forecasts for 2014 were for a return of around only 8.0%, as almost all forecasters then expected capital values to stabilise and rent increases to be small. All forecasters expect total returns for 2015 to moderate from the high levels unexpectedly achieved in 2014. Cluttons expect yields to fall and rents to rise in all sectors apart from retail in small towns and supermarkets, with Industrials in the south east having above average returns. Colliers forecast an All Property Total return of 8.4% with the Office sector returning 12.3%,

due to continuing capital growth, and the Retail sector 5.6% due to negligible capital growth. Rental growth in the Retail sector is expected to be very small for several years except in London and the South East. The IPF[314] survey forecasts total returns of 10.8% in 2015, the highest return being offices at 12.6% and the lowest being Standard Retail at 9.9%. They forecast growth in capital values of about 5.0% for all sectors except offices where 7.7% is forecast. Interestingly, in 2016 a very reduced return of 6.6% is forecast.

In 2012 I said: "I see no recovery in the investment property market until there is a prospect of normal economic growth" and in 2013 I said: "Fortunately the UK economy is at that stage ..... the prospects for the investment market are better than at any time since 2007". And so it has proved, as the IPD All property return in the year ended October 2014 was 20.1%, compared with 7.4% last year of which all but 0.4% was a return of income, and with 3.1% the previous year of which the 6.8% income return was offset by a fall in capital values of about 3.6%.

The underlying factors that brought about this year's great improvement seem likely to continue, with one notable exception. Demand for investment has many components but a major one is a synthesis of perception, analysis, future expectation, momentum, confidence and "gut" feeling: possibly a variant of Keynes's "animal spirits" all contributing to "group think". During the deteriorating phase of the cycle the "group think" view that predominates is that the market will continue flat or deteriorate further, so reducing demand. When the "group think" changes – and there will always be rare exceptions successfully anticipating the change like George Soros on the 1992 ERM withdrawal and the £, and Bill Gross, Pimco, on yield drop in the bond market - the transformation in demand is dramatic. The value change that accompanies these reversals of "animal spirits" is very large; and such a reversal took place in the general property investment market last year.

The underlying factors responsible for this reversal continue to operate and will support the investment market. The return to economic growth, lower employment with net earnings now rising above inflation, and favourable tax treatment on lower incomes and subsidised credit for house purchase, all contribute to increased aggregate demand, leading to a rise in demand for occupational property, and higher rents and investment values. However, specific types of investment property will be influenced by secular changes in demand. Substantial changes are taking place in the retail sector where continuing increases in online shopping reduces retail property requirements and where changes in consumer habits and consumers' economic perceptions are reducing demand for large or, probably more correctly, very large supermarkets and changing consumer tastes and prejudices also reduce the demand for "traditional" supermarkets in favour of discounters. The prospect of little or no rental growth in large supermarket rents together with lower alternative use values will make such investment unattractive and values will fall.

However, in general the improved occupational market increases rents, and prospective rental growth, reduces voids, improves lease terms and decreases rent arrears, defaults and unrecovered service and dilapidations costs, all of which lead the increased demand for investment property. The increased demand has been supported by the supply and price of credit, its availability in turn reinforcing demand. Anomalously, the longer this continues, the more likely it is to continue in the short term, as the momentum of the rise improves the analysis of the investment and the credit worthiness of the investor.

The increasing supply of credit increases the demand for investment property. Cushman and Wakefield report that the number of outside lenders continues to increase, that new lending increased considerably in 2013, that increases are continuing in 2014 and that 60% of an increased number of respondents are saying they expect to

increase lending compared with 40% of respondents in 2013. Some banks are now also supporting speculative development. Loan margins are generally 150bps to 225bps, compared with 190bps – 250bps in 2013 and 250bps -300bps in 2012 and LTV's are 60-70%, a rise from 60% - 65% last year and 50-60% previously. Unsurprisingly, the value of investment transactions to October 2014 was £40bn, 12% above those in 2013 which represented a 60% increase over 2012. The current rate of investment is almost equivalent to the three peak years of 2005-07. The current credit terms represent a considerable improvement over recent years, but they are still much "tighter" than the halcyon (and subsequently disastrous) times pre–2008 when LTVs were 80-85%, margins *c*1.0% and repayment terms, fees and covenants much more benign! Because of decreasing supply of suitably-priced investment property in London, lenders are increasingly prepared to fund investments in the regions where investment has risen to 59% of the UK total, the highest percentage since 2006. Regional office yields have recently declined more quickly than prime and in Edinburgh, for instance, have declined from 6.50% to 5.75%. With increased debt support and as prime investments become more limited, demand has increased for second tier and secondary markets and average yields have declined over 1.00 percentage points. Thus there is a recovered confidence in the investment market which is set fair.

This time last year forecasters for house prices in 2014 were optimistic. HMT's "Average of forecasts" showed a rise of 6.7% in 2014 and the OBR forecast above 5% in 2014 (and 7% in 2015). The 2014 out-turn is likely to be strikingly higher and is estimated by the HMT survey to be 9.3%. Increases in house prices in the year to the end of October 2014 are reported as 8.8% Halifax, 8.5% Nationwide; and 10.5% Accadata. The average annual figures mask a wide discrepancy in performance between regions. If Greater London is excluded from the Accadata[5] survey, house price inflation falls to 7.4% and, if the South East is also excluded, it falls to 5.0%. Elsewhere among regions it is only at 3.2% in Yorks and Humber, North, and Wales and at 3.8% in the North West with the other regions East Anglia, East Midlands, South West and West Midlands between 5.5% and 6.9%. The lowest percentage rises in price occurred in the four areas with the lowest average price, c£160,000 per property, compared with the England and Wales average of £275,000. The highest percentage price rise occurred amongst the most expensive houses. In England and Wales houses in the first quartile, up to £150,000, rose 3.6%, in the second quartile, up to £182,000 4.2%, and in the third quartile up to £245,000 6.6% and above £244,000, 10.1%. In the four regions with the poorest annual growth, the September 2014 price was below the peak price in 2007/8, in Wales by as much as 9.%.

Interestingly, in London the relative performance of higher and lower-priced localities is reversed. There has been a recent large reduction in the rate of price growth at the top of the market with prices falling recently in six of the top seven boroughs ranked by price. The top one-third of boroughs ranked by price recently increased by 0.5% per month, compared with a 1.5% increase in prices per month in the bottom third of London Boroughs ranked by price. It seems that the huge rise in the more expensive London areas in London has at least paused.

The differences noted among the regions in England and Wales is also pronounced in Scotland. The annual change in price is 5.1% in September, a small fall from the 5.8% recorded in August as "the monthly house price growth has ebbed away as doubt raged over the future of Scotland within the United Kingdom .. ..". The top quartile of Local Authority areas ranked by price experienced annual growth of 8.7% while in the fourth quartile growth was only 1.4%.

Forecasters expect UK house price inflation to continue at a more moderate rate than experienced in 2014 to date. HMT's forecasters expect growth of 5.8% in 2015 followed by a 5.7% rise in 2016 and 4.7% and 4.0% rises in the subsequent two years or 21.7% over four years. The OBT forecast for 2015 made in March 2014 is for a 7.1% rise and in December 2014 is for a 6.0% rise. Unusually, Surveyors are slightly less optimistic than

the HMT's forecasters. Savills expect that, if the Mansion Tax is introduced, Prime markets will fall in 2015 by 2% for £1m-£2m houses but by 8% to 10% for houses valued over £5m, although they expect this initial over-reaction to have been attenuated by 2019, with price rises of 16% in Prime London and 20% in Prime Regional. In the "Mainstream", UK market prices rises of only 2.0% are expected in 2015 with no increase in London but a 3.5% increase in Scotland. By 2019 they forecast a 19.3% rise in the UK, 10.4% in London and 17.6% in Scotland. Jones Lang Lasalle are slightly more optimistic than Savills, as in 2015 they forecast 4.0% growth in the UK and 3.5% in Scotland, together with a five year growth of 22.8% in the UK and 19.3% for Scotland. Rettie, a leading Scottish Surveyor, is more optimistic about the Scottish Market, forecasting 5.0% to 6.0% growth in each of the years 2015 to 2018, a cumulative growth of 24.3%, compared to Savills forecast for Scotland of 14.7% in the same period.

The prospective continuing rise in housing prices will narrow the gap between the real value of houses and the price which is still below the peak prices before the recession. [301] The Halifax index peaked at the £199,600 recorded in August 2007. The equivalent inflation-adjusted price in October 2014 would have been 18.55% higher, or £236,625, but the current October 2014 Halifax index is £186,135 – a long way to go! If house prices rise at just over 4.0% and inflation is 2.0%, then over ten more years will elapse before the August 2007 peak is regained in real terms. House prices are difficult to predict and historically errors are large, especially around the timing of market reversals or shocks. Last year I said there would be an imminent such turning point in the housing market: " ... the key determinant of the long-term housing market will be a shortage of supply, resulting in high prices. For most UK markets that position has now been reached."

House prices are determined by the balance between supply and demand, a constantly changing iterative process. The current oil market provides a dramatic example of the effect of change of supply and demand on price where supply is no longer controlled by OPEC. Confusingly, that drama currently being enacted in the oil market is the inverse of that playing in the housing market. In the oil market the demand for oil is inelastic, especially in the short term and especially in the process, transport and manufacturing industries. Previously, the supply of oil was controlled or limited within narrow parameters dictated by the effective exercise of oligopoly power by the OPEC cartel who determined the price by appropriate rapid adjustment to supply.

The housing market is also subject to rapid but less extreme adjustments, but for the inverse reason. The supply of houses is relatively inelastic with the notable exception of the supply of second-hand homes which, when there are large price falls, such as occurred recently, leaves an "over-supply". This elastic "over-supply" is produced to the market when an increase in demand occurs and accounts for a rapid rise in sales without any notable price change until the market clears. The long-term supply is inherently inelastic and responds slowly to changes in demand due to the long production cycle time which includes negotiating land purchases, securing planning consents, so often delayed for years, and then construction. In contrast short-term demand is very elastic being greatly influenced by mortgage cost and availability. Over the past year mortgage costs have continued to fall and the supply of credit has increased, although the April implementation of the Mortgage Market Review is moderating this increase. Additionally, the Government "Help-to-Buy" schemes are providing an increasing supply of credit or shared equity at favourable prices, adding to demand. Perversely, the stamp duty alterations will also add to demand. The mean house price in Scotland is £170,000 on which, until recently, the stamp duty was 1% or £1,700 but on the new UK system will be £900. Thus the new stamp duty cash cost is £800 less, an important reduction on a £170,000 purchase bought on 5% equity or £8,500 cash. Effectively the purchaser has now sufficient cash for just over a £185,000 purchase. As house demand is "credit constrained" stamp duty changes will increase demand for lower-cost houses .... and their prices!

Current demand will be reinforced by an increase in the long-term requirement for houses, which, according to the currently-used econometric models, will cause a cumulative supply shortage of 1.4m houses in England and of 400,000 in Scotland by 2022, according to Savills. Increased incomes will also increase demand as time, convenience, amenity and quality of location all become more valued. There will be an imbalance between the demand and supply leading to higher long-term prices. The prospects for the housing market are extremely good.

Future Progress

The Group has positioned itself to take advantage of a housing market which is improving and which I expect to continue to improve over the next few years. We have completed major investments in long planning processes and although larger schemes are still being promoted, most of the required investment has been made. Our emphasis is on the completion and realisation of development opportunities which can be marketed shortly, and within our development portfolio there are sufficient opportunities to allow several years of such sales. As these sales take place other development opportunities will then be brought forward to provide replacements for these realisations.

Last year in my statement I said: "We will not commission any major development until market conditions improve further, until the possibility of a final glitch in the economy is insignificant and until after the referendum". Market conditions have since improved, the UK economy is likely to continue to expand, although prospects in Scotland are less favourable, given the likely turndown in the oil sector, the threat of a recession in Scotland following a "Yes" vote has now passed. We will seek to develop our major sites as soon as those immediately available are completed. In a liquid and improving market we plan to secure all practicable developments, as there is ample opportunity to reinvest elsewhere as opportunities continue to be presented for the use of our strong development expertise to create high returns.

We do not depend on a further recovery in prices for the successful development of our sites as 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. A major component of the Group land development value lies in the grant of planning permission, and in its extent, and it is relatively independent of changes in house values. For development or trading properties no change is made to the Group'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.

The policy of the Group will continue to be considered and conservative, but responsive to market conditions and opportunistic. The mid-market share price on 22 December 2014 was 124.5p, a discount to the NAV of 147.2 as at 30 June 2014. The Board does not recommend a final dividend, but intends to restore dividends when profitability and consideration for other opportunities and obligations permit.

Conclusion

The UK has emerged from the longest depression since 1873-96. Policy interventions by Governments have alleviated the worst possible outcomes, especially for unemployment and social conditions as the measures in the New Deal did for the US in the 1930s. In the UK the restrictive fiscal policies delayed a return to the pre-recession level and the long depression has damaged the long-term supply capability and reduced the output level significantly below the pre-recession trend. The alleviation of fiscal policy, "Plan A plus", together with the stimulative housing measures and overdue changes at the Bank have at last established "normal" growth in the economy, although a "rebound" from recession is absent.

The "Help-to-Buy" housing programmes have provided a major boost to the house market and to the economy. The flow of credit to companies continues to be a major restriction on growth but prospective recoveries in Banks' equity bases together with the extended FLS for SMEs should produce some alleviation. The restoration of a competitive market in banking and credit to replace the long-established oligopoly market, while highly desirable, is equally unlikely, although the establishment of a new range of banks and the emergence of crowd funding and of retail bonds are favourable trends. Perhaps it is for these and many other reasons that Mervyn King, the previous Governor, said: "Of all the banking systems, ours is the worst"!

The economic advantages the UK enjoys from controlling its monetary system and from an independent currency are being palpably demonstrated by the continuing unresolved underlying crisis in the Eurozone where political ambition battles economic reality. The Eurozone may yet pay a big price for these political ambitions. The European ideal, particularly the creation of the Eurozone, was a triumph of hope and ideology over economic reality: a fervour, a cause and an establishment appeal that denied, finessed and overrode critical analysis. So it was with the Scottish referendum, but in Scotland the cause, so cunningly presented, was not gained, but the victory was narrow and is insecure. The changes this maelstrom will engender will be manifold and not universally harmful; but they will touch all of the UK.

The UK economy and the cause of those rejecting Independence have received a gift, not from heaven above but from the earth below. The large reduction in oil price represents a huge boon to the UK economy, giving a much-needed boost to consumers. Low energy prices will suffuse the economy with activity. Wrapped with this gift is the discovery of huge "tight oil" and gas shale deposits providing a primarily UK alternative to the inexorable decline in the North Sea and its supporting services. The benefits ascribed to the North Sea were hugely exaggerated by the "Yes" voters, but the expected benefits of the remaining oil are now much lower than any considered previous estimate. If it was Scotland's oil, it has now largely evaporated, burning out like a political will o' the wisp.

Unlike many other property companies, the Group has successfully negotiated the worst economic crisis for over a century. The prospects, contrary to the last seven years, are very good.

I D Lowe

Chairman

23 December 2014

Consolidated income statement for the year ended 30 June 2014

	Note	**2014**	2013
		£000	£000
Revenue from development property sales		**513**	-
Gross rental income		**332**	312
Service charge income		**12**	22
Property charges		**(181)**	(203)
Net rental and related income		**676**	131
Cost of development property sales		**(480)**	-
Administrative expenses		**(761)**	(726)
Other income		**53**	120
Net operating loss before investment property disposals and valuation movements	5	**(512)**	(475)
Valuation gains on investment properties		**975**	620
Valuation losses on investment properties		**(195)**	(110)
Net valuation gains on investment properties		**780**	510
Operating profit		**268**	35
Financial income	7	**1**	1
Financial expenses	7	**(105)**	(98)
Net financing costs		**(104)**	(97)
Profit/(loss) before taxation		**164**	(62)

	Note		
Income tax	8	**-**	-
Profit/(loss)for the financial period attributable to equity holders of the company		**164**	(62)
Profit/(loss) per share			
Basic and diluted profit/(loss) per share (pence)	9	**1.39p**	(0.52p)

The notes on pages 32 – 50 form part of these financial statements.

Consolidated statement of comprehensive income for the year ended 30 June 2014

	2014	2013
	£000	£000
Profit/(loss) for the year attributable to the equity holders of the parent company	**164**	(62)

.Consolidated balance sheet as at 30 June 2014

	Note	**2014**	2013
		£000	£000
Non current assets			
Investment property	10	**9,415**	**8,635**
Property, plant and equipment	11	**35**	**24**
Investments	12	**1**	**-**
Total non-current assets		**9,451**	8,659
Current assets			
Trading properties	13	**11,498**	**11,771**
Trade and other receivables	14	**67**	**176**
Cash and cash equivalents	15	**34**	**6**
Total current assets		**11,599**	11,953
Total assets		**21,050**	20,612
Current liabilities			
Trade and other payables	16	**(525)**	**(431)**
Interest bearing loans and borrowings	17	**(3,180)**	**(3,000)**
Total current liabilities		**(3,705)**	(3,431)
Net assets		**17,345**	17,181
Equity			
Issued share capital	21	**2,357**	2,357
Capital redemption reserve	22	**175**	175

	Note		
Share premium account	22	**2,745**	2,745
Retained earnings	22	**12,068**	11,904
Total equity attributable to equity holders of the parent company		**17,345**	17,181

NET ASSET VALUE PER SHARE **147.19p** **145.80p**

The financial statements were approved by the board of directors on 23 December 2014 and signed on its behalf by:

ID Lowe

Director

The notes on pages 32-50 form part of these financial statements.

Consolidated statement of changes in equity as at 30 June 2014

	Share capital	Capital redemption reserve	Share premium account	Retained earnings	Total
	£000	£000	£000	£000	£000

At 1 July 2013	2,357	175	2,745	11,904	**17,181**
Profit for the year	-	-	-	164	**164**
At 30 June 2014	**2,357**	**175**	**2,745**	**12,068**	**17,345**
	======	======	======	======	======
At 1 July 2012	2,377	175	2,745	12,007	17,304
Share buyback	(20)	-	-	(41)	(61)
Loss for the year	-	-	-	(62)	(62)
At 30 June 2013	2,357	175	2,745	11,904	17,181
	======	======	======	======	======

During the year, the company did not buy back any shares.

(*2013:100,000 shares for a consideration of £61,000*)

Consolidated cash flow statement for the year ended 30 June 2014

	2014	2013
	£000	£000
Cash flows from operating activities		
Profit/(loss) for the year	**164**	(62)
Adjustments for :		
Gains on fair value adjustment of investment property	**(780)**	(510)
Depreciation	**13**	13
Net finance expense	**104**	97
Operating cash flows before movements in working capital	**(499)**	(462)
Decrease/(increase) in trading properties	**273**	(406)
Decrease/(increase) in trade and other receivables	**108**	(36)
(Decrease)/increase in trade and other payables	**(10)**	9
Cash absorbed by the operations	**(128)**	(895)
Interest paid	**-**	(14)
Interest received	**1**	1
Net cash outflow from operating activities	**(127)**	(908)
Investing activities		

Investment in the year	**(1)**	-
Acquisition of property, plant and equipment	**(24)**	(9)
Cash flows from investing activities	**(25)**	(9)
Financing activities		
Share buyback	**-**	(43)
Increase in borrowings	**180**	275
Cash flows from financing activities	**180**	232
Net (decrease)/increase in cash and cash equivalents	**28**	(685)
Cash and cash equivalents at beginning of year	**6**	691
Cash and cash equivalents at end of year	**34**	6

Notes to the consolidated financial statements as at 30 June 2014

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1 Reporting entity

Caledonian Trust PLC is a company domiciled in the United Kingdom. The consolidated financial statements of the company for the year ended 30 June 2014 comprise the company and its subsidiaries as listed in note 5 in the parent company's financial statements (together referred to as "the Group"). The Group's principal activities are the holding of property for both investment and development purposes.

2 Statement of Compliance

The group financial statements have been prepared and approved by the directors in accordance with International Financial Reporting Standards and its interpretation as adopted by the EU ("Adopted IFRSs"). The Company has elected to prepare its parent company financial statements in accordance with UK GAAP; these are presented on pages 51 to 59.

3 Basis of preparation

The financial statements are prepared on the historical cost basis except for available for sale financial assets and investment properties which are measured at their fair value.

The preparation of the financial statements in conformity with Adopted IFRSs requires the directors to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

These financial statements have been presented in pounds sterling which is the functional currency of all companies within the Group. All financial information has been rounded to the nearest pounds thousand.

Going concern

The group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Chairman's Statement on pages 2 to 20. The financial position of the group, its cash flows, liquidity position and borrowing facilities are described in Note 18.

In addition, note 18 to the financial statements includes the group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

The group and company finance their day to day working capital requirements through a related party loan (see note 17).

The Directors have prepared projected cash flow information for the period ending twelve months from the date of their approval of these financial statements. These forecasts assume the group will make property sales in the normal course of business.

Should these sales not complete as planned, the directors are confident that they would be able to sell sufficient other properties within a short timescale to generate the income necessary to meet the group's liabilities as they fall due.

For these reasons they continue to adopt the going concern basis in preparing the financial statements.

Areas of estimation uncertainty and critical judgements

Information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amount recognised in the financial statements is contained in the following notes:

- *Valuation of investment properties (note 10)*

  The valuation of properties is subjective and based on similar transactions in the market, rental yields and development potential. The company's directors are experienced in dealing with such properties. Director's valuations at the balance sheet date are based on independent external valuations as at 30 June 2013. The Executive Directors have respectively over 40 years and 30 years experience in commercial property. RJ Pearson is a Fellow of the Royal Institution of

Chartered Surveyors and has practised as a surveyor in Scotland for 37 years during which time he has specialised in commercial property.

- *Valuation of trading properties (note 13)*

  Trading properties are carried at the lower of cost and net realisable value. The net realisable value of such properties is based on the amount the company is likely to achieve in a sale to a third party. This is then dependent on availability of planning consent and demand for sites which is influenced by the housing and property markets.

4 Accounting policies

The accounting policies below have been applied consistently to all periods presented in these consolidated financial statements.

Basis of consolidation

The financial statements incorporate the financial statements of the company and all its subsidiaries. Subsidiaries are entities controlled by the group. Control exists when the group has the power to determine the financial and operating policies of an entity so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date it ceases.

Revenue

Rental income from properties leased out under operating leases is recognised in the income statement on a straight line basis over the term of the lease. Costs of obtaining a lease and lease incentives granted are recognised as an integral part of total rental income and spread over the period from commencement of the lease to the earliest termination date on a straight line basis.

Revenue from the sale of trading properties is recognised in the income statement on the date at which the significant risks and rewards of ownership are transferred to the buyer with proceeds and costs shown on a gross basis.

Other income

Other income comprises income from agricultural land and other miscellaneous income.

Finance income and expenses

Finance income and expenses comprise interest payable on bank loans and other borrowings. All borrowing costs are recognised in the income statement using the effective interest rate method. Interest income represents income on bank deposits using the effective interest rate method.

Taxation

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case the charge / credit is recognised in equity. Current tax is the expected tax payable on taxable income for the current year, using tax rates enacted or substantively enacted at the reporting date, adjusted for prior years under and over provisions.

Deferred tax is provided using the balance sheet liability method in respect of all temporary differences between the values at which assets and liabilities are recorded in the financial statements and their cost base for taxation purposes. Deferred tax includes current tax losses which can be offset against future capital gains. As the carrying value of the group's investment properties is expected to be recovered through eventual sale rather than rentals, the tax base is calculated as the cost of the asset plus indexation. Indexation is taken into account to reduce any liability but does not create a deferred tax asset. A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised.

Investment properties

Investment properties are properties owned by the group which are held either for long term rental growth or for capital appreciation or both. Properties transferred from trading properties to investment properties are revalued to fair value at the date on which the properties are transferred. When the Group begins to redevelop an existing investment property for continued future use as investment property, the property remains an investment property, which is measured based on the fair value model, and is not reclassified as property, plant and equipment during the redevelopment.

The cost of investment property includes the initial purchase price plus associated professional fees. Borrowing costs directly attributable to the acquisition or construction of qualifying assets are capitalised during the period of construction. Subsequent expenditure on investment properties is only capitalised to the extent that future economic benefits will be realised.

Investment property is measured at fair value at each balance sheet date. External independent professional valuations are prepared at least once every three years. The fair values are based on market values, being the estimated amount for which a property could be exchanged on the date of valuation between a willing buyer and a willing seller in an arms-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

Any gain or loss arising from a change in fair value is recognised in the income statement.

Purchases and sales of investment properties

Purchases and sales of investment properties are recognised in the financial statements at completion which is the date at which the significant risks and rewards of ownership are transferred to the buyer.

Property, plant and equipment

Property, plant and equipment are stated at cost, less accumulated depreciation and any provision for impairment. Depreciation is provided on all property, plant and equipment at varying rates calculated to write off cost to the expected current residual value by equal annual instalments over their estimated useful economic lives. The principal rates employed are:

Plant and equipment	-	20.0 per cent

Fixtures and fittings	-	33.3 per cent
Motor vehicles	-	33.3 per cent

Trading properties

Trading properties held for short term sale or with a view to subsequent disposal in the near future are stated at the lower of cost or net realisable value. Cost is calculated by reference to invoice price plus directly attributable professional fees. Net realisable value is based on estimated selling price less estimated cost of disposal.

Financial assets

Trade and other receivables

Trade and other receivables are initially recognised at fair value and then stated at amortised cost.

Financial instruments

Available for sale financial assets

The group's investments in equity securities were sold during the year.

Cash and cash equivalents

Cash includes cash in hand, deposits held at call (or with a maturity of less than 3 months) with banks, and bank overdrafts. Bank overdrafts that are repayable on demand and which form an integral part of the Group's cash management are shown within current liabilities on the balance sheet and included with cash and cash equivalents for the purpose of the statement of cash flows.

Financial liabilities

Trade payables

Trade payables are non-interest-bearing and are initially measured at fair value and thereafter at amortised cost.

Interest bearing loans and borrowings

Interest-bearing loans and bank overdrafts are initially carried at fair value less allowable transactions costs and then at amortised cost.

New Standards and interpretations not yet adopted

The International Accounting Standards Board (IASB) and International Financial Reporting Interpretations Committee has recently issued the following new standards and amendments which are effective for annual periods beginning on or after 1 January 2014, unless stated otherwise, and have not been applied in preparing these consolidated financial statements.

- *IFRS 9 Financial Instruments: Classification and Measurement* which is the first phase of a wider project to replace IAS 39.

  Financial Instruments: Recognition and Measurement, replaces the current models for classification measurement of financial instruments. Financial assets are to be classified into two measurement categories: fair value and amortised cost. Classification will depend on an entity's business model and the characteristics of contractual cash flow of the financial instrument. The standard is effective for annual periods beginning on or after 1 January 2015.

  As at the time of publication of these financial statements, the IASB is re-deliberating the requirements for classification and measurement in IFRS 9 while the requirements of latter phases of IFRS 9 are in development and therefore remain uncertain.

Operating segments

The Group determines and presents operating segments based on the information that is internally provided to the Board of Directors ("The Board"), which is the Group's chief operating decision maker. The directors review information in relation to the Group's entire property portfolio, regardless of its type or location, and as such are of the opinion that there is only one reportable segment which is represented by the consolidated position presented in the primary statements.

5	**Operating profit/(loss)**	**2014**	2013
		£000	£000
	The operating profit/(loss) is stated after charging :		
	Depreciation	**13**	13
	Amounts received by auditors and their associates in respect of:		
	- Audit of these financial statements (Group and Company)	**9**	13
	- Audit of financial statements of subsidiaries pursuant to legislation	**6**	7
	- Tax advisory services	**-**	24
		======	======

6	**Employees and employee benefits**	**2014**	2013
		£000	£000
	Employee remuneration		
	Wages and salaries	**371**	385

Social security costs	**41**	45
Other pension costs	**32**	52
	———	———
	444	482
	======	=======

Other pension costs represent contributions to defined contribution plans.

The average number of employees during the year was as follows:

	No.	No.
Management	**2**	2
Administration	**2**	2
Other	**2**	4
	———	———
	6	8
	======	=======

	2014	2013
Remuneration of directors	**£000**	£000
Directors’ emoluments	**250**	250
Company contributions to money purchase pension schemes	**25**	45
	======	======

	Salary and		Pension	**2014**	2013
Director	Fees	Benefits	Contributions	**Total**	Total
	£000	£000	£000	**£000**	£000
ID Lowe	110	5	-	**115**	135
MJ Baynham	125	2	25	**152**	152
RJ Pearson	8	-	-	**8**	8
	———	———	———	———	———

243	**7**	**25**	**275**	295
======	======	======	======	======

7 Finance income and finance expenses

	2014	2013
	£000	£000
Finance income		
Interest receivable:		
- on bank balances	**1**	1
	=====	=====
Finance expenses		
Interest payable:		
- Bank loans and overdrafts	**10**	3
- Loan stock repayable within five years	**95**	95
	105	98
	======	======

8 Income tax

There was no tax charge/(credit) in the current or preceding year.

	2014	2013
	£000	£000
Profit/(loss) before tax	**164**	(62)
	======	======
Current tax at 22.5% *(2013 : 23.75%)*	**37**	(14)

Effects of:

Expenses not deductible for tax purposes	**8**	15
Losses carried forward	**131**	87
Other deferred tax charges related to properties	**-**	(104)
Effect of rate change	**-**	16
Revaluation of property not taxable	**(176)**	-
Total tax charge	**-**	-
	======	======

In the case of deferred tax in relation to investment property revaluation surpluses, the base cost used is historical book cost and includes allowances or deductions which may be available to reduce the actual tax liability which would crystallise in the event of a disposal of the asset.

Reductions in the UK corporation tax rate from 26% to 24% (effective from 1 April 2012) and to 23% (effective 1 April 2013) were substantially enacted on 26 March 2012 and 3 July 2012 respectively. Further reductions to 21% (effective from 1 April 2014) and 20% (effective from 1 April 2015) were substantively enacted on 2 July 2013. This will reduce the group's future tax charge accordingly.

9 Profit/(loss) per share

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

	2014	2013
	£000	£000
Profit/(loss) for financial period	**164**	(62)
	========	========
	No.	No.
Weighted average no. of shares:		
for basic earnings per share and for diluted		
earnings per share	**11,783,577**	11,814,045
	========	========
Basic profit/(loss) per share	**1.39 p**	(0.52p)
Diluted profit/(loss) per share	**1.39p**	(0.52p)

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

10 Investment properties

	2014	2013
	£000	£000
Valuation		
At 30 June 2013	**8,635**	8,125
Revaluation in year	**780**	510
Valuation at 30 June 2014	**9,415**	8,635

The carrying amount of investment property is the fair value at the balance sheet date as calculated by the directors, based on external independent valuations at open market value made by Montagu Evans and Rettie & Co, independent property consultants, at 30 June 2013. The properties have been valued individually in accordance with the definition of market value and good practice guidelines set out in the 6th Edition of the Royal Institution of Chartered Surveyors valuation and appraisal manual. In this regard, market value is defined as "the estimated amount for which a property should exchange between a willing buyer and willing seller in an arm's length transaction after proper marketing wherein the parties had acted knowledgeably, prudently and without compulsion". The values have taken into account rental values and development potential.

Investment properties comprise a number of commercial properties, some of which are leased to third parties with an initial rental period. Subsequent renewals are negotiated with the tenant.

The cumulative amount of interest capitalised in respect of the group's investment properties is £476,000 *(2013: £476,000)*.

11 Property, plant and equipment

	Motor Vehicles	**Fixtures and fittings**	**Other equipment**	**Total**
	£000	**£000**	**£000**	**£000**
Cost				
At 30 June 2012	25	54	66	145
Additions in year	-	9	-	9
At 30 June 2013	25	63	66	154
Additions in year	8	-	16	24
Disposals in year	(15)	(49)	(20)	(84)

At 30 June 2014	**18**	**14**	**62**	**94**
Depreciation				
At 30 June 2012	20	53	44	117
Charge for year	3	2	8	13
At 30 June 2013	23	55	52	130
Charge for year	3	3	7	13
Disposals in year	(15)	(49)	(20)	(84)
At 30 June 2014	**11**	**9**	**39**	**59**
Net book value				
At 30 June 2014	**7**	**5**	**23**	**35**
At 30 June 2013	2	8	14	24

12 Investments

	2014	2013
	£000	£000
Available for sale investments		
At the start of the year	**-**	4
Purchased in year	**1**	-
Sold in year	**-**	(4)
Available for sale financial assets	**1**	-
	======	======

13 Trading properties

	2014	2013
	£000	£000
At start of year	**11,771**	11,365
Additions	**207**	406
Sold in year	**(480)**	-
At end of year	**11,498**	11,771

14 Trade and other receivables

	2014	2013
	£000	£000
Amounts falling due within one year		
Other debtors	**25**	21
Prepayments and accrued income	**42**	155
	67	176

The company's exposure to credit risks and impairment losses relating to trade receivables is given in note 18.

15 Cash and cash equivalents

	2014	2013
	£000	£000
Cash	**34**	6

Cash and cash equivalents comprise cash at bank and in hand. Cash deposits are held with UK banks. The carrying amount of cash equivalents approximates to their fair values. The company's exposure to credit risk on cash and cash equivalents is regularly monitored (note 18).

16 Trade and other payables

	2014	2013
	£000	£000
Accruals and other creditors	**525**	431
	======	======

The Group's exposure to currency and liquidity risk relating to trade payables is disclosed in note 18.

17 Other interest bearing loans and borrowings

The Group's interest bearing loans and borrowings are measured at amortised cost. More information about the Group's exposure to interest rate risk and liquidity risk is given in note 18.

Current liabilities

	2014	2013
	£000	£000
Floating rate unsecured Loan Notes	**2,725**	2,725
Unsecured loan	**455**	275
	3,180	3,000
	=======	=======

Terms and debt repayment schedule

Terms and conditions of outstanding loans and loan stock were as follows:

	Currency	Nominal interest rate	**2014** Fair value	**2014** Carrying amount	2013 Fair value	2013 Carrying amount
			£000	**£000**	£000	£000
Unsecured loan	GBP	Base +3%	**455**	**455**	275	275
Floating rate unsecured loan stock	GBP	Base + 3%	**2,725**	**2,725**	2,725	2,725
			3,180	**3,180**	3,000	3,000

18 Financial instruments

Fair values

Fair values versus carrying amounts

The fair values of financial assets and liabilities, together with the carrying amounts shown in the balance sheet, are as follows:

	2014		2013	
	Fair value	**Carrying amount**	Fair value	Carrying amount
	£000	**£000**	£000	£000
Trade and other receivables	**67**	**67**	176	176
Cash and cash equivalents	**34**	**34**	6	6
	101	**101**	182	182

Loans from related parties	**3,180**	**3,180**	(3,000)	(3,000)
Trade and other payables	**525**	**525**	(431)	(431)
	3,705	**3,705**	(3,431)	(3,431)

Estimation of fair values

The following methods and assumptions were used to estimate the fair values shown above:

***Available for sale financial assets* –** as such assets are listed, the fair value is determined at the market price.

***Trade and other receivables/payables* –** the fair value of receivables and payables with a remaining life of less than one year is deemed to be the same as the book value.

***Cash and cash equivalents* –** the fair value is deemed to be the same as the carrying amount due to the short maturity of these instruments.

***Other loans* –** the fair value is calculated by discounting the expected future cashflows at prevailing interest rates.

Overview of risks from its use of financial instruments

The Group has exposure to the following risks from its use of financial instruments:

- credit risk
- liquidity risk
- market risk

The Board of Directors has overall responsibility for the establishment and oversight of the company's risk management framework and oversees compliance with the Group's risk management policies and procedures and reviews the adequacy of the risk management framework in relation to the risks faced by the Group.

The Board's policy is to maintain a strong capital base so as to cover all liabilities and to maintain the business and to sustain its development.

The Board of Directors also monitors the level of dividends to ordinary shareholders.

There were no changes in the Group's approach to capital management during the year.

Neither the company nor any of its subsidiaries are subject to externally imposed capital requirements.

The group's principal financial instruments comprise cash and short term deposits. The main purpose of

these financial instruments is to finance the group's operations.

As the group operates wholly within the United Kingdom, there is currently no exposure to currency risk.

The main risks arising from the group's financial instruments are interest rate risks and liquidity risks. The board reviews and agrees policies for managing each of these risks, which are summarised below

Credit risk

Credit risk is the risk of financial loss to the Group if a customer or counterparty to a financial instrument fails to meet its contractual obligations and arises principally from the Group's receivables from customers, cash held at banks and its available for sale financial assets.

Trade receivables

The Group's exposure to credit risk is influenced mainly by the individual characteristics of each tenant. The majority of rental payments are received quarterly in advance which reduces the group's exposure to credit risk on trade receivables.

Other receivables

Other receivables consist of amounts due from a company in which the group holds a minority investment.

Available for sale financial assets

The Group does not actively trade in available for sale financial assets.

Bank facilities

At the year end the company had no loan facilities available *(2013: Nil).*

Exposure to credit risk

The carrying amount of financial assets represents the maximum credit exposure. The maximum exposure to credit risk at the reporting date was:

	Carrying value	
	2014	2013
	£000	£000
Available for sale investments	**1**	-
Other receivables	**25**	21
Cash and cash equivalents	**34**	6
	60	27

======= =======

The company does not have an allowance for impairment on trade receivables as, based on historical experience, management does not consider that such an impairment is required.

Credit risk for trade receivables at the reporting date was all in relation to property tenants in United Kingdom.

The company's exposure is spread across a number of customers.

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due without incurring unacceptable losses or risking damage to the Company's reputation. Whilst the directors cannot envisage all possible circumstances, the directors believe that, taking account of reasonably foreseeable adverse movements in rental income, interest or property values, the group has sufficient resources available to enable it to do so.

The group's exposure to liquidity risk is given below

30 June 2014 £'000	**Carrying amount**	**Contractual cash flows**	**6 months or less**	**6-12 months**
Floating rate unsecured loan stock	2,725	2,774	48	2,726
Unsecured loan	455	463	8	455
Trade and other payables	525	525	525	-

30 June 2013 £'000	**Carrying amount**	**Contractual cash flows**	**6 months or less**	**6-12 months**
Floating rate unsecured loan stock	2,725	2,774	48	2,726
Unsecured loan	275	280	5	275

Trade and other payables	431	431	431	-

Market risk

Market risk is the risk that changes in market prices, such as interest rates, will affect the company's income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return.

Interest rate risk

The Group borrowings are at floating rates of interest based on LIBOR or Base Rate.

The interest rate profile of the Group's borrowings as at the year end was as follows:

	2014	2013
	£000	£000
Unsecured loan	**455**	275
Floating rate instruments – financial liabilities	**2,725**	2,725
	=======	=======

The weighted average interest rate of the floating rate borrowings was 3.5% *(2013: 3.5%)*.

A 1% movement in interest rates would be expected to change the Group's annual net interest charge by £32,000 *(2013: £30,000)*.

19 Operating leases

Leases as lessors

The group leases out its investment properties under operating leases. The future minimum receipts under non-cancellable operating leases are as follows:

	2014	2013
	£000	£000
Less than one year	**125**	176
Between one and five years	**360**	503
Greater than five years	**311**	362
	_____	_____

	796	1,041
	=====	=====

The amounts recognised in income and costs for operating leases are shown on the face of the income statement.

20 Income tax and deferred tax

At 30 June 2014, the group has a potential deferred tax asset of £1,162,000 (*2013: £1,199,000*) of which £321,000 (*2013: £412,000*) relates to differences between the carrying value of investment properties and the tax base. In addition the group has tax losses which would result in a deferred tax asset of £841,000 (*2013: £787,000*). This has not been recognised due to the uncertainty over the availability of future taxable profits.

Movement in unrecognised deferred tax asset

	Balance 1 July 12 at 26%	Additions/ reductions	Balance 30 June 13 at 23%	Additions/ reductions	**Balance 30 Jun 14 at 20%**
	£000	£000	£000	£000	**£000**
Investment properties	516	(104)	412	(91)	**321**
Tax losses	700	87	787	54	**841**
Total	1,216	(17)	1,199	(37)	**1,162**

21 Issued share capital

	30 June 2014		30 June 2013	
	No	**£000**	No.	£000
Issued and				

fully paid				
Ordinary shares of 20p each	**11,783,577**	**2,357**	11,783,577	2,357
	========	**=======**	========	=======

Holders of ordinary shares are entitled to dividends declared from time to time, to one vote per ordinary share and a share of any distribution of the company's assets.

22 Capital and reserves

The capital redemption reserve arose in prior years on redemption of share capital. The reserve is not distributable.

The share premium account is used to record the issue of share capital above par value. This reserve is not distributable.

23 Related parties

Transactions with key management personnel

Transactions with key management personnel consist of compensation for services provided to the company. Details of this are given in note 6.

Other related party transactions

The parent company has a related party relationship with its subsidiaries. The group and company has unsecured floating rate loan stock due to Leafrealm Limited, a company of which ID Lowe is the controlling shareholder. This is on normal commercial terms. Leafrealm received £95,000 *(2013: £95,000)* of interest in respect of its holding of Floating Rate Unsecured Loan Stock. The balance due to this party at the year-end was £3,180,000 (*2013: £3,000,000*). Transactions with subsidiary undertakings have not been disclosed as the company has taken advantage of the exemption contained within FRS 8.

Annual Report and Accounts

The Annual Report and Accounts will be posted to shareholders together with a Notice of Annual General Meeting on or before 31 December 2014 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, 61A North Castle Street, Edinburgh, EH2 3LJ.

AGM

The Annual General Meeting of the Company will be held at 61A North Castle Street, Edinburgh EH2 3LJ on Friday 30 January 2015 at 12:30pm.

A copy of this announcement and the Company's Annual Report and Accounts for 2014 will be made

available on the Company's website http://www.caledoniantrust.com shortly.