Caledonian Trust PLC

(The "Company" or the "Group")

Audited Results for the year ended 30 June 2012

Caledonian Trust PLC, the Edinburgh-based property investment holding and development company, announces its audited results for the year ended 30 June 2012.

Chairman's Statement

Introduction

The Group made a pre-tax loss of £1,424,000 in the year to 30 June 2012 compared with a loss of £925,000 last year. The loss per share was 11.98p and the NAV per share was 145.6p compared with 7.78p and 157.6p respectively last year.

Income from rent and service charges was £371,000 compared with £704,000 last year. Rental income was reduced due to the sale of certain investment properties. Losses on sales of properties were £362,000 compared with a loss of £273,000 last year. Other operating income was £85,000 compared with £43,000 last year. Administrative expenses were £821,000 compared with £896,000 last year. Net interest payable was £162,000, a decrease of £98,000 on last year, reflecting lower borrowings. The weighted average base rate for the year was 0.5%.

Review of Activities

The Group has continued to invest in enhancing the value of its development properties by working towards or gaining valuable planning consents and by improving, or expanding existing consents and by maintaining existing consents. In the autumn we started the extensive alterations to three Georgian cottages at Brunstane Home Farm for sale in the spring together with infrastructure necessary for the next three stages of the development. We realised our development/investment property at Baylis Road, Waterloo, in the spring and the proceeds paid off our two remaining bank loans.

We started realising our investment portfolio in 2005, two years before the investment property peak in June 2007.

For several years we have been realising the Group's New Town investment portfolio when development opportunities were achieved or when the investment value had been optimised. Two sales in the spring of 2011 completed this programme. Apart from the basement at 61 North Castle Street which is our only remaining New Town investment, acquired, as indeed was that whole portfolio, in the late 1980s, just before the office rents in Edinburgh more than doubled! Planning and listed building consents have been granted for its re-conversion to the more valuable residential use. With the benefit of hindsight these recent disposals seem as well-timed as those of 2005 as yields in Scotland have increased by about 0.5% in the last year for prime property on a drop of about 70% in value.

St Margaret's House, London Road, a 92,000ft^2 office building on the A1 about one mile east of the Parliament and Princes Street, is our largest individual property. Since November 2010 it has been let at a very modest rent to a charity, Art's Complex, who have reconfigured and sub-let all the space to over 250 "artists" and "artisans" and "galleries". Very encouragingly tenant turnover is minimal, and there is a lengthy "waiting list". Almost all the parking spaces are let to our neighbours, the Registers of Scotland, on a short-term lease. Thus we hold the building with minimal outgoings and are gaining small annual rent increases while we await redevelopment opportunities. As long ago as July 2007 our architects produced Draft Development Proposals from which the City of Edinburgh Council suggested that a Development Brief be prepared for the triangle covering St Margaret's House, the adjacent 120,000ft^{2}Meadowbank House, owned and occupied by the Registers of Scotland, and all the smaller varied properties lying between the A1 and "Smokey Brae". The Brief required detailed preparation and months of consultations and long-lasting negotiations before it was eventually adopted by the City of Edinburgh Council in August 2009, so providing a Master Plan for the whole area within the triangle. In July 2009 we lodged an application for Planning Consent in Principle for a 231,000ft^2 mixed-use developmentof residential and/or student accommodation, an hotel, and offices and other commercial space together with parking for 225 cars. This proposal was approved in November 2010, and the consent was issued in September 2011.

The consented proposal allows for a street frontage to London Road (A1) and direct vehicular access from it and an "at grade" pedestrian plaza which will transform the area. An indication of the possible improvement to the urban realm and the street frontage has been given by the recently-completed improvements to the neighbouring Meadowbank House where a modern multi-storey glass extension has been added to the front, replacing the previous drawbridge walkway which led to a small recessed entrance hall, and so linking Meadowbank directly to the street and providing a positive edge to the street. The existing consent, 231,000ft^2, is very large by normal Edinburgh standards, unless possibly there was a centralisation of Government offices or a very large-scale "back office" relocation from London, and a series of smaller developments each of 50,000ft^2 to 100,000ft^2, keeping the existing building at least initially would meet local demands. We have commissioned our architects to draw up draft proposals for an hotel at the West End of the site looking towards Princes Street and we are assessing the suitability of a small part of the site for social housing to be occupied at the higher market rent level – about 80% of open-market rents, as rental prices are currently rising in Edinburgh. The demand for student accommodation is also increasing, but as the supply will increase soon due to current and proposed development, this market is less attractive at present.

We have considered several proposals in the last few years for our development site at Waterloo, London SE1 and we had unsuccessfully attempted to negotiate with Lambeth Council to purchase the contiguous garage site owned by them or to enter an agreement with them to realise the marriage value. Because of the high holding costs we agreed a sale of our own site for £3.0 million less retention for contingent engineering costs relating to the nearby London Underground line and the sale completed in May 2012.

In 2007 we delayed the development of our three sites in or near Edinburgh because of worsening economic conditions. As will be shown later while economic conditions are likely to continue at the present depressed level for some time, 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 but to start, or prepare to start, on small low investment, low infrastructural projects.

Our development project at Belford Road, Edinburgh, a quiet cul-de-sac less than 500m from Charlotte Square and the west end of Princes Street would require a very significant investment and so remains on hold: we have a long-standing office consent for 22,500ft^2 and fourteen cars where, by completing necessary road works, the consent has been taken up. We also hold a planning consent for a residential development of 20 flats, with car parking over 21,000ft^2. The development appraisal has a most unusual characteristic. The marginal cost of each ft^2 gained in the under-building whether for car parking, office or residential use rises very rapidly when the easily excavated areas are extended into the bedrock and as it gets nearer the public road. We seek one of the economists' holy grails: where does marginal cost equal marginal return, when marginal return includes an appropriate margin? In contrast the marginal revenue from each extra ft^2 of floor space in the upper floors vastly exceeds the marginal cost and at an increasing rate! It should also be possible to gain more of this very valuable space.

We have implemented a consent for eight detached houses in Wallyford, Mussselburgh, at a site which is within 400m of the East Coast mainline station, near the A1/A720 City Bypass junctions. The site is contiguous with a larger recently completed development of 250 houses by two national house builders and Taylor Wimpey has just started marketing a development of 200-400 houses on the other side of the mainline railway. As we consider that the market for smaller houses there has improved relative to larger houses, we have obtained consent to replace the two largest detached houses with a terrace of four, providing ten houses with a larger saleable area of 12,496ft^2. The environment at Wallyford, formerly a mining village, but located on the fertile East Lothian coastal strip, continues to improve as a result of recent and current development.

We have commenced work at Brunstane Home Farm, adjacent to a suburban railway station in east Edinburgh, where we hold a consent to convert the listed stone-faced Georgian steading, and to reconstruct a cottage attached to it, to form ten houses of various sizes over 14,648ft^2 altogether. These

houses have recently been extensively redesigned principally to provide larger dining/living spaces, more en-suite bathrooms and better fenestration and to lower construction costs and consent was given for this work in October 2012.

East of the steading lies a detached stone building on which consent has been granted for conversion to a detached farmhouse extending to 3,226ft^2. This house sits on open ground with views to the Forth estuary. The steading together with five stone Georgian cottages is served by a private road from the west which passed behind the terraced cottages, three of which have been vacant for many years. We let an external works contract for the first phase of the services infrastructure and for works including car parking, hard-standing and redesign of the gardens prior to the improvement of the cottages. A separate building contract for the extensive alterations to the three vacant cottages was let in June 2012. The interiors have been largely reconstructed with new services, a bathroom, an additional toilet, fitted kitchen with Bosch appliances and French doors installed leading onto a patio and the garden. An original Georgian cottage facingsouthwith French doors near a railway station and within the city, but with a country atmosphere, will be a desirable property. The cottages will be marketed in February 2012 in time for the spring sales. At that time we expect to let the contract for the next phase of five houses of the redevelopment, the "Horse Mill" which comprises the five stone-arched cart-shed a single storey cottage, the main barn and an hexagonal Horse Mill, a notable feature. A further five houses are proposed in the balance of the farmyard and the "Stackyard". The farmhouse sits in a private garden beyond these houses. Next to the farmhouse we hold a further two acre site, currently in the Green Belt but anomalously lying between the farmhouse and a large area of ground recently abstracted from the Green Belt for housing.

The Company owns fifteen separate rural development opportunities, nine in Perthshire, three in Fife, two in Argyll & Bute and one in East Dunbartonshire, all set in areas of high amenity. Such small developments outwith major housing allocations are of a lesser importance to local authorities and they tend not to give them high priority. Because they are located in attractive areas they often are subject, in varying degrees, to local objections to which elected members are increasingly sensitive in part because under proportional representation council seats are much less secure. Thus gaining planning consent for small, well-located developments has became increasingly more difficult and in some cases, in order to obtain consent, the scale of development has had to be unreasonably restricted. Paradoxically, the greater the restrictions, the more supply is reduced, the more valuable the achieved consent becomes.

In spite of these difficulties we continue to promote sites through the planning process and to gain new or improved consents. In Perthshire at Tomperran, a smallholding in Comrie on the River Earn, we hold a consent for twelve detached houses over 19,206ft^2 issued in July 2009. Approximately one acre of Tomperran adjacent to the settlement zoned for industrial use is being promoted for a housing allocation in the emerging Local Plan. A further larger area is being promoted for housing, but the Finalised Local Plan is expected to allocate an infill area in south Comrie instead.

At Chance Inn we hold a consent for ten houses over 21,836ft^2 in the farm steading and an improved consent has just been granted to increase the size of the consented detached houses adjacent to the modern farmhouse from 3,366ft^2 to 4,118ft^2. In July 2010 approval was gained to convert the integral garage of the farmhouse into a semi-self-contained "guest suite" and to upgrade the house, including adding an en-suite bathroom. The upgraded house and the two separate house plots will be marketed in the spring. Nearby at Carnbo we expect the emerging Local Plan to retain the paddock of the former farmhouse in the village settlement and to gain a presumption for a small development of four detached houses. At Strathtay we gained consents for two large detached houses over 6,040ft^2 in the summer of 2011 and a further consent in the autumn for a mansion house, two ancillary dwellings and a service block over about 10,811ft^2 in a secluded garden and paddock near the River Tay. This mansion-house site and the two individual houses will be marketed in the spring as plots or as completed bespoke houses.

At Myreside Farm, in the Carse of Gowrie between Perth and Dundee, we have made two unsuccessful applications. Using further guidance from the planning department we submitted newproposals for one new "farmhouse" and four houses on the site of the existing buildings which should be determined shortly.

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 19,325ft^2 for the nine dwellings. At Frithfield, six miles from St Andrews, a site with stunning views, we are applying for consent for twelve houses over 20,326ft^2.

Our two largest rural development properties have significant long-term prospects but the realisation of these prospects depends in Gartshore on the recognition of the planning potential and in Ardpatrick, on an improvement in the market conditions, sufficient at least to warrant further investment in infrastructure.

Gartshore 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 stone *pigeonnier*, an ornate 15,000ft^2 Victorian stable block, cottages and other buildings and a huge walled garden. Surprisingly, Gartshore is only seven miles from central Glasgow, two miles from the M73/M80 junction, seven miles from the M8 (via the M73) and three miles from two Glasgow/Edinburgh mainline stations and from Cumbernauld commuter station. Gartshore's central location, its historic setting and its inherent amenity identify it as a natural site for development of a high-quality landscaped business park, including an hotel, and a destination leisure centre. Discussions with and representations to East Dunbartonshire Council on appropriate uses continue and we are seeking support from the Council for a joint promotion of the site.

At Ardpatrick the prospects for residential property are extremely good, but their realisation requires very considerable further inputs of money, time and skill. Restoration is the key to the reinstatement of the full attraction of Ardpatrick which, in spite of efforts so far, is in part masked by the neglect of the past. Fortunately the high quality of much of the earlier 19th and early 20th century construction and design remains intact or recoverable, so facilitating restoration and repair.

The development framework was changed by the 2009 North Kintyre Landscape Capacity Study. Before that in 2006 a consent was gained at South Lodge to double the size of the dwelling and to add a large garage. It has been fully restored and is being marketed for sale. In late 2006 we gained consent to change the use of "Keepers" a bothy situated among the Achadh-Chaorann group of cottages and to extend the building to form a three-bedroom house, conditional on putting in a new access road which was completed last year.

There are a number of practicable development opportunities within the areas designated in the Landscape Capacity Study. In September 2011 we secured consent for a 1,670ft^2 house and double garage on the Shore Road south west of South Lodge and in April 2011 consent for two one-and-a-half storey houses of 2,200ft^2 each at the north end of the estate on the B8024 Kilberry Road. Nearby on the UC33 Ardpatrick Road there are attractive secluded elevated sites within the areas designated by the Capacity Study for which we are applying for consent. Unlike most other areas the infrastructural requirements of these developments are moderate. All the consented plots will be marketed in 2013.

Unfortunately other potential new sites and many of the conversion sites are commercially difficult to realise. Current market conditions are unhelpful, but major continuing constraints are the high cost of conversion and the overall cost of upgrading the inadequate infrastructure, partially due to the required enhancement of the public services. Considerable effort has been expended on minimising the costs of reinstatement and development by operational efficiencies, but the current burdens and restrictions will curtail earlier plans, unless some relaxations become available or other development opportunities emerge.

Economic Prospects

In 1932, eighty years ago, the western world was in the midst of the Great Depression, the circumstances, causes, consequences and cure of which are relevant to the "second Great Contraction" as termed by Reinhart and Rogoff in "This Time is Different". Three years earlier, on 29 October 1929, in the Wall Street Crash stocks had lost approximately 10% of their value, an event marking the onset of the Depression. In 1930, the first bank panic occurred resulting in a wave of bankruptcies and a major contraction in the money supply, and GNP fell 9.4% and unemployment rose from 3.2% to 8.7%. In 1931 the second major banking crisis occurred and GNP fell another 8.5% and unemployment rose to 15.9%. In 1932 there was a record fall of 13.4% in GNP accompanied by a rise in unemployment to 23.6%, a fall of industrial stocks to 20% of their 1929 values, and a failure of 40% of the banks existing in 1929. Since 1929 GNP and the money supply had both fallen 31%, and industrial production 45%.Worse was to come. In December 1932 the third, and largest, wave of banking panics occurred, and economic activity declined even further, reaching its minimum in March 1933. The "new era" of the "Roaring Twenties" had appropriately enough gone out with a bang!

During the Great Depression two broad macro-economic theories were advanced to interpret it. Say's Law (Jean-Baptiste Say 1767-1832), ambiguously interpreted by 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 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 capacityfrom earlier overinvestment. The theories argued strongly against Government intervention as this would delay the necessary adjustments to supply. In essence the conditions were caused by oversupply not underdemand.

Such 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 Farmers, 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 his memoirs published 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 the policies his administration had put in place, the economy would have made a full recovery: if they had had the resolve to "stay the course" and "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.

Subsequent theories of the causes of the "Great Depression" differ from those of the Liquidationists. Some contended that specific events were the principal or, at least, a principal cause: the 1929 Stock Market Crash, both the immediate wealth effect andas a predictor of future economic activity; the collapse of consumer durable spending; the collapse of the housing market structure; and the Smoot-Hawley Tariff of 1930, which imposed a 40% tax on over 20,000 imports. These and similar theories, collectively termed non-monetary/non-financial, may account for the trigger for the first year of the Great Depression, but they do not provide a good explanation for its length, depth and durability. The US economy had previously suffered many recessions, most recently in 1919/1921, but output then had only fallen 3% before recovering quickly, but the Great Depression was different.

"This Time is Different" is the title of Reinhart and Rogoff's analysis which distinguishes the greatest five depressions within which the Great Depression is further categorised as the "First Great Contraction" and the current depression as the "Second Great Contraction". Before the onset of these depressions all five shared the "confidence" of "This Time is Different", which had unusually high debt levels, and inflated asset prices and all five subsequently suffered prolonged financial and banking crises.

An advertisement placed on 14 September 1929 graphically illustrates. "This Time is Different":

FAMOUS WRONG GUESSES IN HISTORY

when all Europe guessed wrongly

The date – October 3rd, 1719.The scene – *Hotel de Nevers, Paris*.A wild mob – fighting to be heard."Fifty Shares!" "I'll take two hundred!" "Five hundred!""A thousand here!""Ten thousand".Speculators all – exchanging their gold and jewels or a lifetime's meagre savings for magic shares in John Law's Mississippi Company.

TODAY YOU NEED NOT GUESS

History sometimes repeats itself – but not invariably. In 1719 there was practically no way of finding out the *facts* about the Mississippi venture. How different the position of the investor in 1929!

Today, it is inexcusable to buy a "bubble"- inexcusable because unnecessary. For now every investor has at his disposal facilities for obtaining the *facts.* Facts which - as far as humanly possible, eliminate the hazards of speculation … … "

STANDARD STATISTICS INC, 200 VARICK STREET, NEW YORK NY

An advertisement placed in the late 2000s before the Second Great Contraction might well have read:

> FAMOUS WRONG SPECULATIONS IN HISTORY: *The Great Depression or when the Western World bankrupted.*
>
> History rarely repeats itself. In 1929 investment was not regulated and lacked today's sophisticated computer controls and risk sharing across the world. How different the investor of today.
>
> Today you need not speculate. In 1929 there was limited technology, no insurance, little regulation, no control of inflation, rigid exchange rates and no sophisticated computer modelling.
>
> Today you do not buy a bubble, there is no inflation, boom and bust is banished, globalisation and advanced technology guarantee exponential growth and the downside is protected by regulation and profound understanding of monetary policy and the risk spread by securitisation
>
> CONDUIT INVESTMENTS – 13 STRUCTURED STREET, LONDON WW1

Both advertisements imply changed times, new understandings and technology and new certainty, symptomised by Reinhart and Rogoff's title "This Time is Different". Unfortunately the consequences have broad similarities including the depression's depth, its protracted length, its widespread propagation and the concentration on the financial sector. A third of the US banks closed in the First Great Contraction in the US; over a third of the UK banks would have closed in the Second Great Contraction, including the RBS, had not the UK government intervened about twenty-four hours before it ran out of cash.

The most persuasive explanation of the First Great Contraction is provided by the "Monetary Hypothesis" of Friedman and Schwartz and is based on the inter-relationship among money stocks, prices and output. Friedman observed that money stock, output and prices went down together from

1929 to 1933 and then up again in subsequent years. The money supply dropped 35%, prices 33% and GNP 43%. Unfortunately, such simultaneous changes do not prove causality: what was causing what? Are changes in the money stock causing changes in prices and output, or is the money stock passively reflecting changes in the economy or, indeed, is there an unmeasured other factor that is affecting all these variables? In order to determine causality Friedman identified four periods where changes in the money stock or in monetary policy had occurred for reasons unrelated to contemporary changes of output and prices. A sudden outside, or exogenous, monetary change and a later response in the economy might reasonably be interpreted as cause and effect, provided a similar pattern could be seen over and over again.

Friedman's tests indicated a direct causality between money supply and output and he asserted the Federal Reserve Board's policies had been the major cause of the progression of the recession into the Great Depression. The money supply was affected very severely by the failure of about half the nation's banks and the loss of the deposits, an effect "geared" up by the bank multiplier and which he claimed the Fed failed to offset by expanding the money supply. Separately he indicted the Fed for not lending aggressively to solvent but illiquid banks. For instance Friedman said "At all times throughout the 1929-1933 contraction, alternative policies were available to the System by which it could have kept the stock of money from falling, and indeed could have increased it at almost any desired rate". These policies did not involve radical innovations. They involved measures of a kind the System had taken in earlier years, or of a kind explicitly contemplated by the founders of the System to meet precisely the kind of banking crisis that developed … … …"

Ben Bernanke, the present chairman of the Fed paid a gracious tribute to Friedman in a speech given in honour of his 90th birthday:- "I would like to say to Milton and Anna: regarding the Great Depression, you're right, we did it. We're very sorry. But thanks to you, we won't do it again."

Notwithstanding this fulsome praise, Bernanke has been a leading critic of the Monetary Hypothesis which he contends bothqualitatively "and quantitatively" is not comprehensive, although he supports the main findings. One shortcoming of the Monetary Hypothesis is that economic theory holds that change in the stock of money changes nominal variables such as prices, wages and exchange rates, but not real variables such as output, real GDP and real consumption i.e. money is neutral, whereas by implication Friedman maintains that it is "non-neutral" over a protracted period. Quantitatively Bernanke contends that the reductions in the money supply were insufficient to account fully for the falls in output.

To counter these deficiencies Bernanke proposes further explanations for the extent and length of the Great Depression, including particularly the increased cost of credit intermediation (CCI) and the cost and availability of credit. Bernanke's CCI covered a wide range of additional costs in obtaining credit and he notes banks' preferences for more liquid investments even when higher credit risk clients, or more likely, clients whose credit risk was difficult to determine, because of lack of information or uncertainty, were likely to produce higher returns. If £χ is a "big" number the certainty of £1.0χ is more "valued" than say a 55% chance of £2χ, even if the expected value of the latter is £1.1χ.

Bernanke measured the extra cost of CCI as the increased cost of BAA corporate bonds, the best proxy he could find for borrowers whose liabilities are not traded, over US Government bonds. In the twelve months before October 1930 the average premium was 3.06 percentage points, but in the next twenty-four months it was 4.76 percentage points, or 1.70 percentage points higher, and reached 8.00 percentage points in mid-1932. In contrast, in the 1920-22 recession the differential never exceeded 3.5 percentage points. The effect of the shrinkage of credit due to "risk aversion" was also very significant. For the twelve months to October 1930 loans outstanding represented 80% to 86% of banks' demand and time deposits, but during the twenty-four months from October 1930 loans shrank almost steadily to 64% falling later to less than 60%. In the same two periods net loan extensions divided by net monthly income fell from -1% to 12.8%with a record fall to 31% in October 1931, the worst month for bank failures.

Bernanke reinforces his theoretical analysis of the role of credit in The Great Depression with contemporary empirical evidence, citing a 1932 National Industrial Conference Board survey: "During

1930, the shrinkage of commercial loans no more than reflected business recession. During 1931 and the first half of 1932, it unquestionably represented pressure by banks on customers for repayment of loans and refusal by banks to grant new loans". "Refusal" implies the operation of a policy, not a risk-assessed non-acceptance practice of determining loans by rationing. Bernanke cites D M Fredrickson, writing in the October 1931 Harvard Business Review who illustrates the position:- "We see money accumulating at the centers, with difficulty of finding safe investment for it; interest rates dropping down lower than ever before; money available in great plenty for things that are obviously safe, but not available at all for things that are in fact safe, and which under normal conditions would be entirely safe (and there are a great many such), but which are now viewed with suspicion by lenders". Fredrickson suggested that low interest rates *per se* do not indicate "easy money"; money may be easy for a very few safe borrowers, but difficult for everyone else.

It appears a stark anomaly that a low price can persist with a high demand! In different circumstances it occurred in 1932 when the Fed suspended its brief open-market purchasing operation because it considered that the then low interest rate indicated more than adequate supplies of money. Unfortunately, the withdrawal of open-market purchases, and the policy signal so implied, was followed by a further dramatic relapse in the economy. Low interest rates do not imply adequate money or sufficient credit, a confusion that persists.

Bernanke provided an explanation for this paradox as an addition to Friedman's Monetary Policy through an elaboration of Irving Foster's 1933 "credit" hypothesis of The Great Depression. Foster emphasised the effect of deflation in reallocating wealth from debtor to creditor, and causing asset prices to fall below the security value in banks' accounts. A huge fall in asset value without deflation creates the same result. Such falls impair banks' solvency, and, as solvency is more important, if only in regulatory terms, than profitability, assets are reallocated from loans to safer, probably government, securities and loans become "unavailable". Policy before the New Deal did not include shoring up, rescuing or recapitalising banks, so exacerbating the role of credit as one of the causes of the depth, the extent and the spread of propagation of the Great Depression. The policies that contributed to the recovery from the Great Depression are, *prima facie*, likely to be effective now as indeed is the reversal of any policies that contributed to it.

The most striking policy measures contributing to the recovery were those associated with Franklin D Roosevelt's "New Deal" following his inauguration in 1933. Famously he closed all the banks for an extended "holiday" and in one day, 9 March 1933,during that closure the Emergency Banking Act was passed and signed into law. This Act provided for deposit insurance and federal loans to those banks assessed as solvent. Confidence in the banks was regained, deposits surged and the banking system was stabilised, bank failures falling from more than 500/yr prior to the depression (4004 closed in 1933) to less than ten/year. Within a month billions of dollars in hoarded currency and gold flowed back, thus stabilising the banking system and expanding the money supply.

Greater expansion of the money supply resulted from two other policy decisions taken later in March and in April 1933. The US abandoned the gold standard and allowed the dollar to float on the foreign exchange markets with a nominal gold price which the administration set progressively higher until it reached $35 per ounce ($20.67 before) at which point the dollar had depreciated 41%. The exchange rate against the German Reichsmark fell from 4.21 to 2.48 with similar falls against other fixed exchange rate currencies. The devaluation of the dollar, the rise in the dollar value of gold "created" extra dollars which were used to purchase securities (QE) so increasing the money supply and reducing interest rates and the devaluation increased domestic demand.Those policies were very expansionary.

The New Deal fiscal policy was originally contractionary, but this policy became subordinated to other conflicting policies. In order to balance the "regular" (non-emergency) Federal budget the Economy Act of 14 March 1933 was introduced which, *inter alia*, cut civil servants' pensions, and veterans' pensions by 15%. However, the non-federal budget savings were soon vastly exceeded by the spending on the various public and social "aid" programmes introduced such as the Works Programme that employed 3.8m men on public infrastructure, the Tennessee Valley Scheme, the Reconstruction Finance Corporation that loaned money to various beneficiaries, including indebted firms or firms

seeking investment funds and the Agricultural Adjustment Act, a subsidy scheme for farmers. Thus there was a substantial, if notionally unintended, fiscal expansion.

A portion of this fiscal expansion was directed to the housing sector. The Home Owners' Loan Corporation refinanced mortgages on longer terms of up to fifteen years, the Federal Home Loan Bank Board guaranteed the savers' deposits in Savings and Loans ("thrifts") and the Federal Housing Administration provided insurance for mortgage lenders for up to 80% LTV twenty year low interest loans. These measures boosted the rapidly-sinking housing market. Also at the same time 15% of the Public Works Administration budget was spent on low-cost housing and slum clearance.

In 1934 growth returned to the US economy – a notable 8.9% - and, also of great importance, prices rose 3.1%. The return of inflation in 1934 followed a deflation of 24.0% since 1929 which had dealt a crushing blow to the economy by increasing the real value of debt by 31.6%, and by reducing the value of debtors' security and the assets and reserves of the banks.

The "involuntary" Fiscal expansion was probably a political reaction to the growing social unrest in the Great Depression but it was a key element in the recovery from it. Thus the US was following a Keynesian approach to taxation and spending, which served it well. Truly, by accident of design, the New Deal mobilised a formidable armoury of policies that facilitated the recovery from the Great Depression. Unfortunately, such was the depth of the Great Depression, that <u>real</u> output did not reach the pre-recession level (of 1929) until 1940, over ten years later.

The Second Great Contraction was undiscriminating in its extent and in its severity in the developed world and all major western economies declined 3% to 5% or more in 2009.In 2010 most economies recovered by 2% or more but performed much less well subsequently. The US economy is likely to be the best performing in 2012 growing 2.1% following 1.7% in 2011 and a forecast continued growth in 2013 of 2.1% and of 2.8% in 2014.The Eurozone is likely to contract by 0.3% in 2012 and have nil growth in 2013 followed by only 1.1% in 2014. Within the Eurozone there are very wide variations among the constituent countries. The two best performing economies, Germany and France, have average forecast growth rates over the three years to 2014 of 1.1% and 0.6% respectively, according to the OECD, but the next two largest economies, Italy and Spain, are forecast to have contracted by 0.87% and 0.73% respectively by 2013, although meagre growth of 0.6% and 0.5% respectively returns in 2014. Greece continues to be the worst-performing economy of the Eurozone and is forecast to have an average contraction of 4.0% pa until 2014 by which time the economy will have contracted 23.6% since growth ceased in 2007. The UK economy is likely to contract 0.1% in 2012 but grow 0.9% in 2013 and 1.6% in 2014, but growth then to fall to about 1.1% in both of the subsequent years.

The US economy appears to be recovering well. US housing prices have risen for six consecutive months and the S& P/Case-Shiller house price index by a seasonally adjusted 0.3% in September and is now up 3% over the last year. Even in some of the cities hit hardest by the housing crash, such as Las Vegas, Phoenix and Detroit, housing prices have risen about 1% and house building statistics have risen 15% to their highest level since Lehman Brothers failed. The turnaround in the housing market has several important direct and indirect consequences. The construction industry, normally 4% of GDP, is currently 2% and indicates the extent of a possible recovery. Increased prices increase consumers' wealth which, historically, after a lag, results in a 4% increase in consumer expenditure per $1 extra wealth. Current housing wealth is about $19tr and a modest 5% growth would add an extra $40bn in consumption or say 0.3 percentage points to GDP.

Rising house prices have coincided with a continuing fall in consumer debt from 100% of GNP to 87% which is already close to the long-term trend and, with a rise in consumer confidence, as evidenced by a rise of 30% in the Michigan index of consumer sentiment since last year, consumers become both more able and more inclined to borrow. The rising housing market will increase consumers' equity in their houses putting some out of negative equity and allowing others, with 20% or more of equity, to refinance an existing mortgage or take out another one on a new house at lower interest rates, also boosting consumption.

The change in the labour market indicates the improving economy and in turn supports that improvement. At present the ratio of open jobs to total employment is 2.7%, the pre-recession level, compared with less than 2.0% in 2009. Thus there is the possibility of a virtuous cycle: rising employment creates demand for houses boosting the housing sector which in turn creates more jobs. Fortunately such a virtuous cycle can be facilitated by bank lending which has been rising steadily since mid-2011 as the US banks, as opposed to most European banks, have largely been properly recapitalised. The major potential threat to the US economy is the January 2013 "fiscal cliff", the expiration of fiscal loosening initiated by President George W Bush, amounting to almost 4% of GNP. The extent of the renewal of the fiscal stimulus will be a major determinant of US economic growth. The resolution will be a "cliff hanger".

The prognosis is that the US will have had a "good" recession, a Second Great Contraction that fortunately has been merely a side show compared with the Great Depression. If this prognosis proves correct, it will be largely because many of the factors responsible for the Great Depression are no longer operating, either by circumstance or by policy decisions.

The US economy entered the Second Great Contraction with a floating exchange rate. The $/€ rate in mid 2007 was 0.7451 and by mid 2011 it had fallen to 0.6952 and is down 6.4% on a trade-weighted basis from its high this yearso providing a stimulus to the economy as evidenced by the almost doubled exports over five years.The current floating exchange rate, as opposed to a fixed rate or the gold standard, did not preclude the beneficial effect on demand of a devaluation.

The Fed reacted to the onset of the crisis very quickly and has pursued a very expansionary monetary policy ever since. In December 2007 the Fed rate was 4.25% but by December 2008 it had been reduced to 0.00%-0.25% where it has been maintained since. In December 2008 the Fed announced the first of what were to be three large-scale programmes of purchasing Bank and mortgage-backed securities. The first of these, QE1, in December 2008, purchased mortgage-backed securities and was expanded in May 2009 to include $300bn Treasury Bonds. By October 2009 the QE1 programme had purchased $1.25tr MBS as well as the $300bn bonds. In November 2010 QE2 was announced with the aim of buying $600bn of Treasuries by July 2011, a target completed timeously.

In September 2011 the Fed announced "Operation Twist", the purchase of $400bn of six to thirty year bonds and the sale of $400bn of three year bonds thereby lengthening the maturity of the Fed's portfolio and reducing longer-term interest rates. Operation Twist was extended by a further $267bn in June 2012 and later the Fed announced its commitment to keeping rates low until late 2014.The latest announcement in September is the most far reaching as the Fed announced QE3, orQE infinity as it is being termed, a programme to keep buying unlimited bonds, including mortgage-backed securities, "for a considerable time after the economic recovery strengthens" and it has promised to keep rates at virtually zero until 2015. QE1 and QE2 were announced soon after the US inflation expectations, as derived from the bond market, indicated that deflation possibly threatened, which would result in an increase in the real value of debt and so imperil any recovery. QE infinity has been announced when inflation expectations are a "safe" 2% and there is no obvious deflation threat. Unsurprisingly the derived inflation level has risen to almost 2.5%. The Fed is able to conduct monetary policy without being tied to an inflation target, unlike the Bank of England, as it has a dual mandate both to limit inflation and to safeguard full employment. At times more employment is more important than less inflation. This powerful stimulus has unsurprisingly boosted asset prices: thirty year mortgage-backed Fannie Mae bonds yield 2.2%, the S&P index has recovered from a low of 600 to over 1400; and all high-yielding bonds, stocks, corporate debt loans and structured assetshave risen sharply. The high yields available on buy-to-let houses have attracted investors who accounted for 20% of all house sales in October. Blackstone has invested $1bn in 6,500 houses in 2012. It would be most surprising if this benign monetary policy did not continue to have a beneficial effect on the economy. Mr Bernanke suggests that QE has already increased output by 3% and employment by more than 2m, but with interest rates already so low QE3 is likely to be less effective than previous stimuli.

The current huge monetary stimulus stands in direct contrast to the initial response to the "Great Depression", but compared with spectacular recovery then the recovery rate now appears slow. However, the success of the current stimulus should be measured by the comparative shallowness of

the contraction resulting from early action. The extent of the possible recovery is indicated by the 14% gap between current output and output at the trend level. This gap indicates a demand shortage and limits the extent of any resulting inflation – the stimulus is more likely to achieve too little demand than excessive demand leading to inflation.

In the New Deal the fiscal stimulus was an indirect result of social and public expenditure programmes. The fiscal cliff, the programmed elimination of $500bn tax cuts and the introduction of $1,000bn government spending cuts, is a Damoclean sword hanging over the economy sufficient to result in a 3.8% contraction in GNP if there was a sudden withdrawal of these fiscal stimuli. The extent of the extension of these stimuli is uncertain. However, having followed the precedent of the New Deal, a relapse to liquidationist policy that characterised the Hoover policies at the beginning of the Great Depression would counter all the very successful policy initiatives that have enabled the US economy successfully to temper the damage of the Second Great Contraction.

The Eurozone's economic analysis lacks cohesion as comparisons between the Eurozone and the US or the UK usually vary much less than the variation among its individual constituent countries. The Eurozone and most of the constituent economies, including notably Greece, had growth rates usually at or above those of the US and the UK before entering the Second Great Contraction. In the recession in 2009 all western economic areas contracted significantly, the US by 3.5% and the UK and the Eurozone by about 4.4%but inthe three years since then the US has recovered more than the Eurozone and the UK, both of which are expected to contract in 2012 and over the next three years the Eurozone has the lowest expected growth. Within the Eurozone several economies, including Italy and Spain, the third and fourth largest, are contracting in 2012 and face continuing contractions in 2013.

In the Eurozone only limited aspects of economic policy are common to all the Eurozone countries, primarily the use of the Euro and the monetary and other controls of the ECB. The Euro is not part of a fixed exchange rate system, unlike the US tie to the Gold Standard before the New Deal, and since the start of 2007 the trade-weighted index has declined by over 10% providing a stimulus to demand.

The ECB is a central bank, without full powers, but with a wide responsibility, primarily for price stability, but also "supporting economic growth and preserving financial stability, provided price stability is achieved". In response to the current crisis the US Fed reduced interest rates very quickly and supplied a huge and continuing monetary boost to the economy. In contrast the ECB started cutting rates from a peak of 4.25% in July 2008, reducing them slowly to 1.25% in April 2011, before increasing them briefly to 1.50% in July 2011, and then resuming a reduction to 0.75%, the current level, in July 2012. The ECB's mandate is that its official policy stance reflects the changing economic conditions of the Euro area as a whole, and therefore does not reflect the diversity among the national economies. One size has to fit all.

The ECB is hampered by more serious constraints. It has no power or overt political mandate to undertake a vast expansion of the money supply or to operate as a lender of last resort. These constraints are reinforced by the German Bundesbank tradition, in whose image it was formed, of rigid inflation targeting as per its mandate and on independence from government, both of which developed as a result of Germany's experience of the hyperinflation of the 1920s. Rescues of delinquent debtors by means involving the creation of money with the inherent risk of inflation were therefore contrary to its inflation mandate, its political restrictions and its cultural inheritance. In such a context, Jens Weidmann, President of the Bundesbank, quotes a warning from Goethe's Mephistopheles: "Such paper in the place of gold is practical: we know just what we hold … … But wise men will, when they have studied it, place infinite trust in what is infinite".

The contrast between the ECB position and that of the US Fed in the New Deal and in the midst of the Second Great Contraction could hardly be greater. The turning point of the Great Depression was arguably the recognition that, instead of letting more banks fail, as about 10,000 had in total by the time of the New Deal, the Fed would guarantee them and issue the necessary recovery funds. Similarly, in the 2008 US financial crisis the signal event that marked the turning point may have been the recognition that the Fed was wholly committed to increasing the money supply to meet all the requirements of essential financial institutions. This may have occurred in a television interview with

Ben Bernanke, in which he declared that the Fed was the world's lender of last resort. When asked if he had been "printing money" he replied "Well, effectively … … ... and we need to do so, because our economy is very weak and inflation is very low".

Things change, even for the ECB. The ECB appears to have moved from implacable opposition to limited acceptance of the need to support the Eurozone financial system, as evidenced by the multitude of various ad hoc measures undertaken, including a declaration by the Chairman of "unlimited" support.[242]Unfortunately, in spite of such declarations, market opinion and political reality are at variance with the Chairman's aspirations. Even a few weeks after the declaration the probability, based on bets lodged, of a country leaving the Euro before 2014 was still over 55%. A distressing feature of the ECB's various supportive schemes is that the "half life" appears to shorten progressively. For instance the most recent proposals have been subject to different interpretations by different nations and so render the proposal at best uncertain, but certainly not "unlimited". It appears that whenever the ECB advances the political process slows down, a continuing pattern that is the true tragedy of the Eurozone's crisis management, one wholly inherent to its structure. The restatement of the policy returns the Eurozone to the position before the Chairman's announcement - the existing policies are still inconsistent with the survival of the integrity of the Eurozone. Without doubt the Eurozone appears to be moving towards a position where the financial crisis might be controlled by means other than greater fiscal austerity, with its echoes of the pre-New Deal "Liquidationists", but the question is whether the political will and democratic endorsements of that will achieve the necessary solution and consent timeously and so avoid the crisis before the crisis arrives. A patent oversimplification but a coruscating insight to the political reality of this "enigma" machine is given in my Spanish phrase book: "*Esta Sonora (Merkel) pagaraportodo ... ...* "

Just as the Eurozone's structure precludes certain New Deal policies for the whole, it precludes other polices for the constituent members as is singularly relevant and demonstrated in the Greek economy. Like that of the Eurozone, the Greek economy grew strongly in the years before the recession, but contracted 3.3% in 2009, similar to the Eurozone's contraction of 4.3%.But since then Greece's economy has continued to contract by 3.5% in 2010 and by over 6.0% p.a. in the two following years. Further contractions of 4.5% and 2.5% are forecast for 2013 and 2014 respectively by which time the economy will have contracted each year for six years, longer than the period of contraction in the US during the Great Depression. Tragically the Greek economy demonstratesthat certain features of the Eurozone were the major contributing factors to the dramatic contraction in output and that other features of the Eurozone are the major contributing factors to the difficulty in recovering from that contraction.

For several years before the recession Greece benefited from growth rates of up to 6.0%, but incurred substantial Government deficits from which it accumulated debt equivalent to 120% GDP. This was facilitated by the then implied "guarantee" that all sovereign debt was "Eurodebt" and the availability of such funds to finance deficits at Euro-interest rates, rates whose level was related to repo rate set by the ECB's to whom by treaty monetary policy is wholly ceded and which sets interest rates and whose Executive Board "gives the necessary instructions to the National Central Banks." Central monetary control, but no fiscal control, allowed fiscal latitude, at least in the short term. Such central control constricts the monetary policies available to independent nations and because the Euro is a common currency Greece cannot devalue as a means of stimulating demand, unlike the US when it left the Gold Standard.

The New Deal introduced many Government aid and investment agencies, which caused federal deficits and supplied demand to the failing US economy. The Greek economy is characterised by persistent current Government deficits which were 6% of GNP even in pre-recessionary 2006 but rose to a peak deficit of 16% in 2009,and the total debt has now spiralled to its present level of 170% of GNP. The fiscal stimulus appears already to be very large! *Prima facie* it appears none of the New Deal options is available to Greece. Worse, the Greek economy is a debt trap. If both Government debt and GNP are 100 (ratio 1:1) and if growth is less than the interest rate, then the ratio gets progressively worse: for instance if growth is 3% and the average coupon rate on the debt is 4% then, unless repayments are made, after one year the debt has grown to 104 but GNP only to 103 and the ratio becomes 1:01. The current Greek ratio is 1.6, and, if growth as forecast is -7%, and the coupon is say

5%, then after a year its ratio becomes 1.8. The Greek budget published on 31 October 2012 forecast debt to rise to 1.9 times GNP. Needless to say as the ratio – and of course other economic indicators – deteriorate, the higher the coupon becomes on new debt raised either to meet the deficit or to replace debt being rolled over: a bad situation gets worse.

Sovereign debts are either repaid, monetised – redeemed in devalued money – or defaulted, probably for Greece in some combination as a default has already occurred. The prospects of full repayment are remote. If the integrity of the Euro is to be maintained there can be no devaluation or rampant inflation, so default is inevitable if Greece is to remain within the Eurozone. However, maintaining the integrity of the Euro
does not cure the underlying problem that resulted in Greece threatening its integrity or the inherent uncompetitiveness of the Greek economy.

Competetiveness might be restored if "strong" Euro countries like Germany inflate, increasing costs, or Greece deflates, reducing costs**.** The former seems unlikely given German culture and the latter will cause considerable further contraction of the economy, giving more serious unemployment and possibly severe social and political unrest. The non-economic difficulties could be alleviated by continuing fiscal transfers to Greece, subsidising the economy but not curing it. Greece would become to the Euro area as the Highlands and Islands are to the UK (or may become to the rest of Scotland!). Such transfers will require both fiscal and cultural changes in the rest of the Euro area which at present seem unattainable, unless there is a *NeuenVertrag*. The bitter irony of the tussle between creditor and debtor countries is that it resembles the inverse of the tussle that arose after the treaty of Versailles in 1919 when the French adopted a positive and moralistic stance against the Germans, but it may be functional to consider the possible social, political and economic repercussions of such a fine moral stance.

HM the Queen, touring the LSE at the beginning of the Second Great Contraction, remarked to the Director of the London School of Economics, Professor Luis Garciano: "If these things were so large, how come everyone missed them?" If the same question is asked of the ECB in relation to the inherent instability of the Eurozone then the statement made by Herman Van Rompuy, now President of the European Council, in 2010 provides some insight. "The Euro … … was like some kind of sleeping pill, some kind of drug. We weren't aware of the underlying conditions."

The ECB diagnosed the disease but misidentified the victim – their Emperor had (healthy) clothes as their reports in August 2009 indicated. Commenting on global imbalances in current account surpluses and deficits, the ECB said: "The issue is important as a potentially disorderly unwinding could pose a risk for the global economy and the stability of the international financial system". The article focused on the rise of the US current account deficit "to unprecedented levels" and the surpluses of China, Russia, Saudi Arabia and Japan, contrasting these imbalances with the current account of the whole EMU countries which were "broadly balanced". Unfortunately within the Eurozone lay the largest imbalances as Greece, Portugal and Spain had deficits of 11%, 10% and 9% respectively while Germany and the Netherlands had surpluses of 6.5% and 9%. These were all larger than the then US current account deficit of 6%!

The long-term survival of the Eurozone requires a different New Deal, a political New Deal that will transform the structure of the organisation. When the reunification of Germany took place the writer, Thomas Mann, termed it "Not a German Europe but a European Germany" but what may emerge is a European Germany in German Europe.[251] However, rather than by a Gestaltic jump, the process may proceed slowly and erratically prodded by the fear of collapse, restrained by the power of inertia and, as envisaged originally by Jean Monnet, a founding father of European integration, crystallised by the process of step-by-step technical integration, and coalesced through crises – "crises are a great unifier" he said. But they may also prove a great fragmenter.

The UK is not shackled by the economic inflexibility of the Eurozone or by the greater restrictions faced by individual Eurozone members. The UK controls both monetary and fiscal policy and sterling floats. The UK debt is rated AAA and on current policies the public sector net debt is estimated by the

OBR to peak at 80% of GNP in 2015-16. Inflation, while at 2.4% in Q3 2012, is forecast to reach the target 2% within Q4 2014 and having fallen over 2 percentage points in a year.

Notwithstanding the flexibility of policy measures and the comparatively stable conditions of the UK economy, growth has been low. The recovery from the last recession took place in 1991 (Lord Lamont's "Green Shoots" – unfortunately the earliest ones were rather frosted!) and lasted more than sixteen years; - sixty-six successive quarters – before falling in five consecutive quarters in 2008-2009 by 6.3% and recording the largest annual fall since the Second World War. Growth resumed in 2010 but fell to 0.8% in 2011 and during 2012 returned to recession when it is expected to have contracted slightly. The current depression has already lasted fifty-seven months, longer than any of the five major recessions since 1920, as even the Great Depression lasted forty-nine months, and at this stage of the cycle output was already above the pre-recession level, while in the current depression it remains at 4% below the pre-recession level. If output continued to grow at the pre-recession level of, say, 2.5%, then it would have been 17.3% higher than the current level.

Forecasts for the UK economy are conditional on developments worldwide, but in particular the Euro area. The Bank puts it elegantly: "A key source of risk is if policy makers in the Euro area are unable to ensure that the required adjustments to the levels of both debt and competitiveness in some countries take place in an orderly manner. The degree of requisite rebalancing and adjustment is so pronounced that there remains a risk of serious dislocation ... … there is no way to calibrate the size and likelihood of such outcomes". The Bank's "central" projection is that growth in 2013 will be 1.25% to 1.75%, but it noted that the average of independent forecasters showed a 44% chance of 2013 growth being less than 1%. In 2014 the "central" forecast is for 1.75% - 2.25% growth.

Other forecasts, normally conditioned by the Euro crisis, are similar for 2013 and 2014: the OBR expects 1.2% and 2%; NIESR 1.1% and 1.7%; and HMT (Independent Forecasts) 1.1% and 1.7%. Forecasts of only 0.5% for 2013 are given by EIU and Capital Economics. The prospective growth is low compared with pre-recessionary growth and much lower than that expected from an economy recovering from a recession.

The US authorities engaged a wide range of resources under the New Deal which led to the recovery from the Great Depression. The UK authorities are less comprehensive and more tentative than the admittedly very aggressive – maybe "gung-ho"- measures taken in the mid-1930s. The conditions now bear little relation to the very dire conditions obtaining in the Great Depression, but the policies used then can be considered in the contemporary context.

An over-riding part of the New Deal was that the measures were extreme and far-reaching. Possibly a view was formed that something "so big" was bound to be effective, the "bazooka" effect so sought by the ECB – and so badly misfired – that confidence increased, giving an immediate boost to the economy.

The width and the aggregate effect of UK measures fall far short of those of the New Deal although in one very important area no policy change was or is required as, unlike the US tie to the Gold Standard, Sterling's value floats freely as it has done since the withdrawal from the Exchange Rate Mechanism on 16 September 1992. The floating £ permits the UK economy to benefit from the increased demand resulting from lower exchange rates, which depreciated from the real effective exchange rate of 97.7 at the beginning of the recession to 77.4 in early 2009 since when it has risen as the Euro crisis intensified in mid-2011 to about 91.0 The overall devaluation is about 8% and 12% against the Euro, giving only a modest boost to demand.

The New Deal provided a significant monetary boost, and in the current crisis the Fed has used a wide variety of policies and massive resources to ease monetary policy. The Bank has also undertaken extensive monetary easing and expansion, but it has been more circumspect. The Bank, having surprisingly raised Bank Rate in 2007 to 5.75% just before the storm struck, has, unlike the Fed, cut the rate slowly to an all-time low of 0.5% in March 2009 where it remains. Bank Rate (implied by formal market interest rates) is not expected to rise above 0.5% until Q1 2015, six years after it was reduced to the current all-time low. Interestingly, market rates imply a further fall in Bank Rates next

year. The Bank has also completed a massive £375bn asset purchase programme which last year the Bank estimated had raised GNP by 1½% to 2%. The Bank considers that the transmission mechanism occurs as sellers of gilts buy other assets, reducing yields on corporate debt and equity and so encouraging investment, and the boost in asset prices may encourage consumer spending. Finally, lower yields may lower the exchange rate and boost net trade. The implication is that these are desirable ends and if so, there seems considerable merit in the Fed's policy of bypassing gilt purchase and purchasing other classes directly, especially, as in the US, mortgage-backed securities.

QE is an indirect policy and critics such as the EIU remain "sceptical about the benefits of QE for the real economy" and suggest it "does not improve credit flows to smaller companies". The New Deal provided a measure of direct support for smaller companies, in an economy where the "Great Contraction" was very real. The Fed's restrictive monetary policy before the New Deal caused around 10,000 bank failures whose greater effect was not the loss to depositors or shareholders but the effect on the money supply and the volume of credit the overall effect of which, between 1929 and 1933, was that while the public, through liquidation of assets and savings, increased their cash holdings by $1.2bn, the cost of the extra liquidity was a decline in bank deposits of £15.6bn and a decline in loans of $19.6bn, equivalent to 19% of GDP in 1929. The conditions before the New Deal are in many significant ways totally different from those applying now, but the commercial banks operate on the fractional system which, with a much-reduced reserve , say 5%, of total deposits can multiply the money supply twenty times. Unfortunately, the reverse applies equally, and as the commercial banks as a whole are responsible for the vast majority of money creation, when the banks' criteria change, for whatever reason, they determine the change in credit and liquidity available to a greater extent than the central bank.

The effect of credit, or rather the lack of it, on the economy is widely recognised. The Bank acknowledges that QE does not directly improve credit flows to small companies while the OBR state "growth is not forecast to return to firmly above trend rates until 2015 as credit conditions *begin to normalise*". The Bank's November Inflation Report states "Bank loans to private non-financial corporations continued to declinein Q3" as indeed they have done since 2009 by 19.1% as indicated by the resolution in broad money. Surveyson credit for SMEs consistently report that credit is not available for credit-worthy schemes and such views are supported by anecdotal evidence. David Miles, a member of the MPC, quoted D M Frederiksen (see above):- "we see money accumulating … … … but not available at all for things that are in fact safe .. … .. " David Miles said "he (Frederiksen) might have been describing how things looked at the end of 2008".

The unavailability, the rationing of credit, for schemes within the normal range of credit risk, and the importance of such credit has been acknowledged by the introduction of Project Merlin, which failed dismally to meet its objectives, and recently by the Funding for Lending Scheme ("FLS"). The Bank's Inflation report says: "Tight bank credit conditions may also have constrained some companies' investment .. .. ..in particular SMEs .. .. .. as they tend to rely more heavily on bank credit .. .. .. to the extent that FLS improves corporate credit conditions, that should support investment."

Both Project Merlin and the FLS rely on banks' participation, incentivised by lower lending and moral persuasion, which in Merlin's case clearly were insufficient, probably because reducing lending was a greater priority than the marginally-enhanced profit potential. The incentives on FLS are greater but as the Bank says the extent of "pass-through is uncertain. For example some banks .. .. .. will take the opportunity to boost profits and capital .. .. .. " The FLS's introduction may be based on a long overdue official recognition of the deterioration in credit conditions. The Inflation Report in August says "UK bank lending was more likely to decline than increase over the coming eighteen months, in part reflecting the fact that some banks had announced plans to shrink new lending over the next few years". One wonders why the Governor has taken so long to invite Mr Hester to tea .. .. .. The November report continues: "Lending is likely to remain weak given the need for some banks to contract their balance sheets". The Governor put the position more starkly: "I am not sure the advanced economies in general will find it easy to get out of the current predicament without creditors acknowledging further likely losses .. .. .. a significant writing down of asset values and recapitalisation [of the financial systems]". Some banks' necessity to contract their balance sheets is reflected in their valuation. Andrew Haldane, executive director of the Bank of England, writing in the

FT, observes that, while prior to 2007 each £1 of bank equity was valued at £2 to £3, now "most global banks are valued at a discount – many at a small fraction of their equity book value".

The FLS may mitigate the difficulty in supplying credit but will not solve it. The banks have not been lending because their losses, prospective losses and impairments have eroded and will continue to erode their equity. Equity will also be eroded by the restitutions required for

PPI mis-selling of £4.6bn to £10bn, according to the Bank, money laundering, Libor fines and other scandals. In addition, higher capital ratios and risk weighting of assets will require more capital, to maintain existing loan volumes without contemplation of expansion. Alternatively a partial solution is available by shrinking the loan book, a strategy currently restricting credit and previously precluding the successful implementation of Project Merlin. Delay is a vital strategy as it assists debtors, and asset values may rise rather than fall, and the passage of time allows access to the huge stable underlying profits available to the oligarchy of the UK retail banks – a high-energy drip feed.

The domestic profitability compares starkly with the UK Banks' international operation which was responsible for three-quarters of UK Banks' losses in the early years of the crisis. The MPC observed that these losses overseas resulted in a domestic requirement to stock their balance sheets: some of the UK's credit shrinkage was imported.

The huge balances allowed the banks to gear up their equity and, while it lasted, their profits. In the 1880s total bank assets were 5% of GNP but by 2007 this had risen to 500% of the very much larger GNP and the three largest banks' assets had grown from 7% of GNP to 20%. The equity leverage changed from three to four times to thirty times but the return on these huge assets was only 0.5%, the same as over 100 years earlier. Only a very slight fall in value of profitability in a vast portfolio was required to bring down the whole edifice. In the US, they have a saying: "Gathering dimes in front of a steamroller".

Amusingly, the near failure of some banks has been interpreted as a triumph for Karl Marx, for communism at the heart of capitalism. In the near failure the capital holders got nothing, they were raped by the staff who paid themselves extravagant sums out of illusory profits. The shareholders had been destroyed by the workers, having duped them into paying vast wages to retain "talent". These workers had enjoyed what Professor John Kay describes as a call option; bonuses and remuneration plans based on shareholders' 5% equity holding, effectively another call option. For some this provided too great a temptation to gear up wildly, especially if the downside was a comfortable retirement marred only by lectures on moral hazard – possibly too difficult a concept for practical men!

Some commentators are more direct. Martin Wolf says: the UK's banking system remains too feeble, not least because of the damage of further write-downs … ..brutal reassessment is necessary to recognise losses, restructure and recapitalise. Without the necessary recapitalisation UK economic growth will continue to be hampered, and although this requirement is at least recognised no proposals are evident. This handicap does not apply in the US where, with measures supported by the Fed, the US banks were properly recapitalised. The US recapitalisation is consistent with economic theory and with the view of the Fed. However, what is strikingis that recapitalisation was one of the important earliest policies in the New Deal, significantly part of the extended "Bank Holiday".

In contrast to the UK, the New Deal was also characterised by fiscal expansion, although I have shown earlier that this was largely inadvertent. The US is currently following such an expansionary policy, albeit one that may be attributed to the so-called "fiscal cliff" of tax rises and spending cuts. Fortunately market sentiment indicates that a "deal" shortly will substantially reduce the cliff.

The UK policy has been to jump off a "cliff" by embracing tax rises and spending cuts. In 2010 the incoming Coalition government moved sharply to an austerity budget: "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". So far the Chancellor is achieving precisely what he sought to avoid. 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[OBR-6] but the average over the last 324 years is 112% with long periods over 100%.

A policy of sharp fiscal consolidation, the current policy, is likely to be counter-productive. Herbert Hoover, writing at the time of the New Deal, advocated "stay the course" and "take our medicine". Parker in his overview of the Great Depression comments: "In hindsight, it challenges the imagination to think up worse policy prescriptions for the events of 1929-33". The cumulative output loss so far exceeds that of the 1930s and is at least 10% below what would have been forecast from previous trendsas fiscal contraction leads to economic contraction. Lawrence Summers, a former US Treasury Secretary, puts it succinctly "the [UK]doctrine of expansionary fiscal contraction is an oxymoron in the current context". Instead he recommends increasing demand in the short run as a means of jump starting economic growth and setting of a virtuous circle in which income, growth, job creation and financial strengthening are mutually reinforcing.

A recent study by the NIESR concludes that austerity at the current level has a pernicious effect and is self-defeating and considers that UK GDP could be 4.3% and 5.0% lower in 2012 and 2013 than it would be without the government's fiscal consolidation programmes. Moreover, had the growth occurred, the debt-GNP ratio would also have been lower.

The IMF has attempted to quantify the relationship between the marginal effect of a £1 reduction in government spending and the change in the output of the economy, considered by the OBR to be 50p, or 0.5 of the marginal change. However, the IMF considers that 0.5 is too low by 0.4 to 1.7, especially in an environment where interest rates are already low and trading partners also experience low growth. Their estimate for the periphery of the Eurozone is nearer the high end of the adjustment and, if it were 1.5 for the UK, then a fiscal adjustment of 3% would imply a GDP drop of 4.5%. Particularly worrying is the possibility that losses in output are permanent, the hysteresis effect occurring when factors of production are permanently lost – scrapped, retired etc – and cannot be recovered.

I conclude that immediate prospects for the UK economy are not good. Even excluding the possibility of major external upsets, the economy will at best grow slowly, continuing to be hindered by severe economic discord in the Eurozone. The UK's prospects would be greatly improved by major changes in monetary policy, by reform in banking, including regulation and increased competition, by bank recapitalisation, and by the subsequent increased provision of credit, and by a less restrictive fiscal stance. Many economic difficulties, including those experienced in the Eurozone, have been caused by insufficient understanding of the consequences of particular actions, by over-riding political concerns or by indifference to the likely outcomes. The current monetary policy is focused on inflation targeting and is implemented narrowly and restrictively and those factors limit the contribution that monetary policy makes to economic recovery. A change in policy would be beneficial: perhaps the appointment of a new Governor will facilitate it.

Property Prospects

In the previous property investment cycle the CBRE All Property Yield Index peaked at 7.4% in November 2001 and fell steadily to a trough of 4.8% in May 2007 before rising in this cycle to a peak of 7.8% in February 2009,[201] a yield surpassed only twice since 1970,[201] on briefoccasions when Bank Rate was over 10%. Yields fell rapidly from the 7.8% peak to a low of 6.1% in 2011 from which they have risen by 0.27 percentage points to 6.3% over the last year. The yields of components of the Index, Retail, Office and Industrial all increased similarly except shopping centres which remained steady at 5.9%. However yields fell 0.1 percentage points in Central London shops, Out of Town Shopping Centres and London Docklands and Fringe office areas.

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 correct yield of 6.3% is however 4.8 percentage points higher

than the exceptionally low 10 year Gilt Yield of 1.5% creating a new record. The present record "yield gap" occurs primarily because of the low gilt yield, while the 2009 "gap" occurred primarily because of high property yields.

From the 1970s until the late 1990s, except for one year, the 1993/94 downturn, the position was reversed – "the Reverse Yield Gap" - and the Gilt yield exceeded the property yield, the current "Yield Gap" was re-established in 1997 and has persisted since then, except very briefly at the 2007 property peak when property yields fell to 4.8%. The "Yield Gap" of 4.8 percentage points is much higher than the average over twenty years partly because 10 year Gilts yielded only 1.5% at the comparison date.

The All Property Rent Index, which, apart from a brief fall in 2003, had risen consistently since 1994, fell 0.1% in the quarter to August 2008 and then fell substantially for four consecutive quarters by 12.3% altogether. From August 2009 rents rose for four consecutive quarters, due wholly to a rise of 6.9% in office rents, and the index rose by 0.9% in the year to August 2010 and by 0.5% in each of the years to August 2011 and 2012.

Office rents have continued to rise over the last two years, by 2.8% in August 2011 and a further 0.7% to August 2012, mostly due to increases in London. Other sectors are little changed except out-of-town retail where rents have fallen by 2% to 3% altogether over the two years to August 2012.

Property Investment, as measured by the IPD All Property Index, returned 3.1% in the year to 31 October 2012, of which the income return of 6.8% was offset by a fall in capital values of about 3.6%. In the year to 31 October 2011 the return was 8.7% of which 6.9% was income and 1.7% capital. In the year to 31 October 2010 the return was 20.4% compared with minus 14.0% in the year to 31 October 2009 and minus 22.5% in the year ended 31 December 2008, a month that produced a record fall of 5.3%. As the 2008 IPD total return figures include about (plus) 7 percentage points of return from Income, the negative total return figures disguise an even greater capital loss than indicated by the return. The Bank notes that

Commercial Property prices had fallen about 44% by late 2008 but had recovered by 2010 to be about 35% below the 2007 peak, and with the small capital growth of 1.7% recorded last year more than offset by this years fall of 3.6% will now be about 36% below the peak. The total return of 3.1% as measured by the IPD index for the year to 30 September 2012 was far lower than the return to equities of 9.8%, to bonds of 7.6%, and to property equities of 15.5%.

Total Property returns in 2012 are forecast to be about 2.3% and the mean return based on derivatives 1.6%. This time last year returns in 2012 were forecast between 4.5% (IPF) and 8.2% (Colliers), but the return implied by derivatives of 1.2% appears almost certain to be least inaccurate. The forecasts made in 2010 for 2012 of between 8.6% and 12% were unsurprisingly even more inaccurate, but the derivatives at that time indicated only 4.0%. Future returns implied by derivatives are poor, rising from only 1.75% in 2013, to 3.0% in 2014 and 3.25% in 2015 and 2016. Surveyors forecast total returns at around 5.0% in 2013 rising to 8.0% in 2014 and the IPF forecasts are similar. Poor prospective returns occur because in 2013 almost all forecasters expect capital values to continue to fall and rental increases, if any, to be small. Subsequent years are forecast to have small increases in capital values and in rents. All these forecasts were made before the OBR December report and the Chancellor's autumn statement, both of which downgraded previous forecasts of economic growth. Low economic growth, which may relapse back into a third recession, will reduce demand for occupational property and so reduce rents and increase vacancies, both of which will reduce investment values.

Present and prospective economic conditions have already reduced the quality of tenants' covenants which has had a dramatic effect on tertiary property values. Since the peak the difference in yield between primary and tertiary property has widened from lows in 2007 of between 1.8 percentage points and 2.8 percentage points, depending on the category of property, to between 3.5 percentage points and 7.5 percentage points. For retail property the difference was increased from 2.1 percentage

points to 5 percentage points. The difference between prime and secondary has also increased, as prime yields, have risen 0.17% points during 2012, but secondary yields have risen 1.67 percentage points. These differentials are expected to continue to widen.

Retail has been particularly badly affected in the depression. Between 2007 and 2012 thirty seven large retailing companies averaging over one hundred stores each have gone into administration each year and this year so far another fifty-two companies have failed affecting 3907 stores. Vast numbers of other retailers have also gone out of business giving vacancy levels of up to 30% in some high streets, and much lower rents and greatly reduced investment values. All categories of retail investment property are affected to some degree except prime London shops and prime retail centres.

I see no recovery in the investment property market until there is a prospect of "normal" economic growth. However the overall investment property market will continue a secular erosion caused by technical obsolescence, loss of locational primacy and competition from new formats, particularly for retailing. Last year I reported the sale of a New town office for £650,000 that we sold for £970,000 in 1989. In real terms this represents a fall in value of about 65%.

Investment values are also being depressed by the significant change in the credit market which seems likely to continue to depress demand even after economic conditions improve. Credit is severely restricted by rationing and, even when available, the conditions are now much more onerous. Typically, compared with pre-2007, margins moved from *c*1% to *c*3.5%, LTVs from 80-85% to 50-60% and repayment terms, fees and covenants are much more onerous. At the present time the strategy of the traditional non-specialist investment company has been undermined. Unfortunately rising yields, increased vacancies and tighter credit conditions have caused many property-based loans to be delinquent or non-refinanceable, estimated at *c*£100bn. Many loans are being "managed" by the lenders, but if conditions require these properties to be refinanced at short notice, a large supply of mostly secondary property will erode investment values further. For specialist investors such sales will present many opportunities and this niche together with certain other niche markets will be amongst the few rewarding investments over the next few years.

This time last year predictions of change in house prices in 2012 ranged from several pessimistic forecasts, including Capital Economics of -5.0%, to a solitary optimist of +5%. The specialist house price surveys were generally pessimistic - Nationwide expected prices on the "downside", Hometrack expected an "acceleration of price falls", and LSL said "the outlook for transactions in 2012 is that they might weaken slightly in the light of reduced confidence, tighter household budgets and restricted lending". Similarly the Bank commented that "forward looking indicators of housing market activity have remained weak",

The outturn to November 2012 varies amongst the index providers between – 1.7% Halifax to +2.3% LSL Academetrics. The widely used Nationwide records -0.9%. Of the indices, the Land Registry (+1.1%)is the only one that tracks solely properties previously sold and uses geometric means so reducing the influence of "outlying" prices. In contrast all the major Scottish house price indices show falls to September 2012: -2.9% LSL/Acadametrics; -3.9% Nationwide; a colossal -6.6% Halifax; and -1.4% Registers of Scotland. LSL/Acadametrics adjust their figures for seasonal variations and for "mix" variations e.g. standardise the number of small flats and mansion-houses, but Registers of Scotland use the actual data unadjusted. The two mortgage providers use prices at mortgage offer.

There have been significant differences in price changes among the regions and among house types. In England and Wales, in the twelve months to September, prices have risen in Greater London by 8.3%, but falls of 1.5% have occurred in the North West and of 1.3% in Wales. Anomalously, the average price of flats has increased by 8% in the three months to October 2012, due probably to high prices in London, but detached houses are unchanged. In London houses in the two most expensive boroughs, Kensington and Chelsea, and City of Westminster increased by over 20% in twelve months, but the lowest price borough, Barking and Dagenham, had no change. The only fall, 0.5%, occurred in Tower Hamlets, a borough in the mid-price range.

LSL report that Scottish prices have fallen 2.9% in the twelve months to September 2012, the monthly prices oscillating around a downward trend line from £148k to £144k. Current prices are below trend and an upward oscillation is a high possibility. Of the thirty-two local authority areas, prices rose in ten, the highest being Inverclyde by 5.5% and fell in 22, notably 5.5% in Glasgow. Edinburgh prices were almost unchanged. In Scotland the peak price in the

Halifax index was £199,600 in August 2007, and, as inflation to 2012 has been 17.8%, the average price adjusted for inflation would be £235,129. The Halifax House Price of £159,467 in September 2012 implies a fall of 32.2% in real terms.

Forecasts of house prices in 2013 vary widely. The average December forecast in HMT, Forecast for the UK Economy, is 0.4%, interestingly the same as in February, but the City forecasters within the sample, notably Capital Economics and Merrill Lynch at -5% and -4% respectively, are less optimistic and their average is -0.4%. The average rise of all the medium-term forecasts is about 2% in 2014, 3% in 2015 and 4% in 2016. The OBR forecast prices to rise by 0.7% in 2013 with steady rises to 4% in 2016. LSL expects little change in 2013 and say there is "little likelihood of sustained growth until 2014 at the earliest" for both the UK and for Scotland, and Halifax and Nationwide expect little change. Cluttons, Jones Lang Lasalle and Knight Frank expect prices to fall in 2013 with growth of 2% or more for the following four years. Savills expect the UK prices to increase 0.5% with growth rising over the next three years to 3.5% pa . The Economist argues that UK prices may not yet have reached a "floor" and, even if they have, they may go lower by undershooting "fair value", as occurred by 33% in the mid-1990s. The Economist compares long-term average house prices against rents and disposable income. Current UK prices are still 23% higher against "rents" and 17% higher against "disposable income". By comparison France is +49% and +38%; Germany is -18% and -21%; and USA -15% and -24% respectively.

House prices depend on the balance between supply and demand. The long-term supply of houses is relatively inelastic and slow to respond to changes in demand largely due to the long production cycle time which includes negotiating land purchases, securing planning consents, so often subject to years of delay, and construction. The long-term demand for houses, according to the currently used econometric models, is likely to continue to grow at a rate which may have been reduced, but is unlikely to have been appreciably altered, even by a depression of such continuing length as at present and a cumulative supply shortage by 2022of 1.4m houses in England and 400,000 in Scotland is forecast by Savills. Demand also increases as time, convenience, amenity and quality of location all become more valued as affluence increases. Because of this persistent fundamental imbalance between the supply and demand prices will be higher in the long term.

The short-term market is supplied by recycling existing houses and by new houses increasingly built for established demand. Existing house supply is derived from owners exercising their discretion to move house – larger, smaller, smarter, relocation – who buy other such houses so effectively recycling them. Another supply source, but a "non-discretionary" one, is from estates, from household "break-ups" and from repossessions. The volume from the first two should be relatively steady, but supply from repossessions varies with economic conditions particularly unemployment. In spite of the continuing depression unemployment levels remain surprisingly low, two to four percentage points below those of the previous recessions and house repossessions are currently at a four year low of 8,200 per quarter compared with 9,600 last year. Fortunately low prospective interest rates – the Bank rate implied until 2016 by forward market rates is less than 1% - and continuing forbearance by lenders is limiting the supply of repossessions.

Short-term demand will be determined primarily by mortgage cost and by credit availability. Fortunately mortgage costs are likely to remain low although SVRs have increased about 0.2% but credit for house purchase seems likely to continue to be restricted and subject to rationing, so restricting demand, when supply is at best steady. Thus the short-term outlook for the housing market is not favourable and I expect some price falls in 2013. The Bank expect FLS to ease mortgage credit from 2013 but only moderately initially,but, if credit did ease significantly, demand would increase and prices would rise.

The housing market is a paradox: demand rationed by credit is the major influence on short-term prices and supply rationed by institutional factors is the major influence on long-term prices. In the short term credit rationing, together with deteriorating economic conditions, is likely to depress prices. Credit rationing is a major contributory factor to the current house price falls and, when it eases, probably coincidental with stronger economic growth, then supply will again become limiting. Thus the key determinant of the long-term housing market will be a shortage of supply resulting in higher prices.

Future Progress

The Group has completed three major objectives. Our investment portfolio has been realised apart from two high-yielding multi-let retail parades, which will be retained. Sales have taken place primarily when development or special opportunities occurred or when the investments matured. Bank loans have been repaid and the Group has no bank debt. Our development portfolio contains a very high proportion of sites with excellent planning consents, many of these gained in the last few years. Our several strategic land sites have been extensively promoted for inclusion in Local Plans and we have secured bridgeheads there. The investment in these long planning processes has been considerable and will be further reduced next year.

Our emphasis has shifted to the completion and realisation of development opportunities which can be marketed shortly. Within our development portfolio there are sufficient opportunities to allow several years of such minor sales. As these sales take place other development opportunities will be brought forward to provide replacements for the realisations. This, together with the income from our investment portfolio, will provide stability during the continuing prolonged depression.

We will not commission any major development until market conditions stabilise, or at least until the probability of another downward lurch in the economy is significantly reduced. We do not depend on a 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. The main component of the possible development value lies in the grant of planning permission, and in its extent, and 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 Group has completed its withdrawal from the investment market, a policy introduced in the mid-2000s. As long ago as 2005 I said "Investment property seems fully priced .. .."; in 2006 "a further disadvantage of investment property is that recent price rises are arguably due to a short-term speculative serial correlation – a momentum effect – which ultimately will be susceptible to a long-term reversal"; and in 2007. "Returns have been very high; a relatively specialised asset class has been opened up to retail investors who have invested heavily; funds have aggressively promoted commercial property investment; bank investment has increased; more and more complex geared investment vehicles have been created; and reasonable expectation of returns has diminished progressively and depended more and more on increasing capital values". The crash of 2008, the Second Great Contraction and the long continuing period of depression has proved that policy prescient.

We will deploy the same care in determining future decisions and 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 20 December 2012 was 70p a discount to the NAV of 75.6p. The Board does not recommend a final dividend, but will restore dividends when profitability and consideration for other opportunities and obligations permit.

Conclusion

The UK and other Western economies are in the midst of the longest depression for over a hundred years. 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. The consequences of that instability included social unrest and upheaval which facilitated the establishment of extreme centralist regimes in certain countries. Policy interventions and inherent fiscal and social stabilisers now ameliorate such conditions, but the innate contradictions within the Eurozone lead to largely inflexible economic conditions which may become very destabilising in some countries. The resolution of this instability within the Eurozones is hindered both by political differences relating to fiscal transfers and by economic policies still largely based on contractionary deflationary prejudices. The US, subject to avoiding a sudden fiscal contraction, has successfully deployed a wide range of policies now facilitating economic growth. The UK is muddling through without the maximum benefit from either monetary or fiscal policy, but facilitating both of these seems likely to change. The autumn statement released some amelioration of fiscal conditions. The appointment of a replacement for the Governor is likely to give the opportunity to embrace a wider monetary stimulus, as adumbrated by FLS, as well as a more appropriate, and more flexible mandate for the MPC – a single target has never been functional. These improvements will gradually take hold over the next few years when economic growth will return, but these growth rates are likely to be lower than those prior to the boom, because of the destruction of economic capacity and the absence of the previous artificial credit stimulus. Fortunately I do not foresee a Japanese-style stasis.

The Group continues to negotiate the worst economic crisis for a century. The implementation of considered strategies should permit us to operate on a cash-neutral basis over the remainder of the depression while still affording us the possibility of realising major opportunities even while it persists.

I D Lowe
Chairman
21 December 2012

Group income statementfor the year ended 30 June 2012

	Note	**2012**		2011
		£000		£000
Gross rental income		**348**		682
Service charge income		**23**		22
Property charges			**(310)**	(368)
Net rental and related income			**61**	336
Administrative expenses			**(821)**	(896)
Other income			**85**	43
Net operating loss before investment property disposals and valuation movements	5		**(675)**	(517)
Loss on disposal of investment properties		**(362)**		(273)
Valuation gains on investment properties			**-**	175
Valuation losses on investment properties			**(225)**	(50)
Net valuation losses on investment properties			**(225)**	125
Operating loss			**(1,262)**	(665)
Financial income	7		**22**	-
Financial expenses	7		**(184)**	(260)
Net financing costs			**(162)**	(260)
Loss before taxation			**(1,424)**	(925)
Income tax	8		**-**	-
Loss for the financial period attributable to equity holders of the company			**(1,424)**	(925)

Loss per share			
Basic and diluted loss per share (pence)	9	**(11.98p)**	(7.78p)

Consolidated statement of comprehensive income for the year ended 30 June 2012

	2012	2011
	£000	£000
Loss for the year attributable to the equity holders of the parent company	**(1,424)**	(925)
Change in fair value of equity securities available for sale	**-**	(1)
Total other comprehensive loss	**-**	(1)
Total comprehensive income for the year	**(1,424)**	(926)

Consolidated balance sheetas at30 June 2012

	Note	**2012**	2011
		£000	£000
Non current assets			
Investment property	10	**8,125**	11,650
Property, plant and equipment	11	**28**	35
Investments	12	**4**	4
Total non-current assets		**8,157**	11,689
Current assets			
Trading properties	13	**11,365**	11,131
Trade and other receivables	14	**140**	65
Cash and cash equivalents	15	**691**	577

Total current assets		**12,196**	11,773
Total assets		**20,353**	23,462
Current liabilities			
Trade and other payables	16	**(324)**	(512)
Interest bearing loans and borrowings	17	**(2,725)**	(1,497)
		(3,049)	(2,009)
Non current liabilities			
Interest bearing loans and borrowings	17	**-**	(2,725)
Total liabilities		**(3,049)**	(4,734)
Net assets		**17,304**	18,728
Equity			
Issued share capital	21	**2,377**	2,377
Capital redemption reserve	22	**175**	175
Share premium account	22	**2,745**	2,745
Retained earnings	22	**12,007**	13,431
Total equity attributable to equity holders of the parent company		**17,304**	18,728

The financial statements were approved by the board of directors on 21 December 2012 and signed on its behalf by:

ID Lowe
Director

Company registration number 1040126

Consolidated cash flow statement for the year ended 30 June 2012

	2012	2011
	£000	£000
Cash flows from operating activities		
Loss for the year	**(1,424)**	(925)
Adjustments for :		
Loss on sale of investment property	**362**	273
Losses/(Gains) on fair value	**225**	(125)

adjustment of investment property		
Depreciation	**12**	9
Net finance expense	**162**	260
Operating cash flows before movements in working capital	**(663)**	(508)
Increase in trading properties	**(234)**	(240)
(Increase)/decrease in trade and other receivables	**(70)**	69
(Decrease) in trade and other payables	**(170)**	26
	(1,137)	(653)
Interest paid	**(207)**	(260)
Interest received	**22**	-
Net cash flows from operating activities	**(1,322)**	(913)
Investing activities		
Proceeds from sale of investment property	**2,938**	4,612
Acquisition of property, plant and equipment	**(5)**	(22)
Cash flows from investing activities	**2,933**	4,590
Financing activities		
Repayment of borrowings	**(1,497)**	(4,175)
Increase in other long term borrowings	**-**	825
Cash flows from financing activities	**(1,497)**	(3,350)
Net increase in cash and cash equivalents	**114**	(327)
Cash and cash equivalents at beginning of year	**577**	250
Cash and cash equivalents at end of year	**691**	577

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

Notes to the consolidated financial statementsas at 30 June 2012

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 2012 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 as adopted by the EU ("Adopted IFRSs"). The Company has elected to prepare its parent company financial statements in accordance with UK GAAP.

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. 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 notes17 and 23). During the current year, two third party debt facilities were repaid in full.

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. Valuations at the balance sheet date are based on independent external valuations as at 30 June 2010, updated by the Directors to 30 June 2012. 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 32 years during which time he has specialised in commercial property.

- *Valuation of trading properties (note 13)*

  Trading properties are carried at 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.

- *Taxation (note 8)*

As noted in note 8, the company has treated a dilapidations payment from a tenant as a capital receipt and accordingly no taxation has been provided in these financial statements. In the event that HMRC do not agree with this treatment the directors will vigorously challenge any such contrary view. The tax that would be payable if the receipt were to be treated as revenue is approximately £615,000.

4 Accounting policies

The accounting policies below have been applied consistently to all periods presented in these consolidated financial statements, and have been applied consistently by Group entities.

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 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 are classified as available for sale financial assets. They are initially recognised at fair value plus any directly attributable transaction costs. Subsequent to initial recognition they are measured at fair value and changes therein, other than impairment losses, are recognised directly in equity. The fair value of available for sale investments is their quoted bid price at the balance sheet date. When an investment is disposedof, the cumulative gain or loss in equity is recognised in profit or loss. Dividend income is recognised when the company has the right to receive dividends either when the share becomes ex dividend or the dividend has received shareholder approval.

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 following new standards, amendments to standards and interpretations have been issued, but are not effective for the year ended 30 June 2012 and have not been adopted early by the Group:

- *IFRS 9 Financial Instruments* issued in December 2009. This addresses the classification and measurementof financial assets. The standard is not applicable until 1 January 2013 but is available for early adoption.
- Amendments to *IAS 1 Financial Statement Presentation* issued in June 2011. These amendments improvehow components of other comprehensive income are presented. The new requirements are effective forannual periods beginning on or after 1 July 2012.
- *IFRS 13 Fair Value Measurement.* IFRS 13 defines fair value, sets out in a single IFRS a framework for measuring fair value and requires disclosures about fair value measurements. The new requirements are effective for annual periods beginning on or after 1 January 2012, with earlier application permitted.
- *IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements* and *IFRS 12 Disclosure of Interests in Other Entities*, issued in May 2011. IFRS 10 provides a single consolidation model that identifiescontrol as the basis for consolidation for all types of entities. IFRS 10 replaces IAS 27 *Consolidated and Separate Financial Statements.* IFRS 11 *Joint Arrangements* establishes principles for the financial reporting by parties to a joint arrangement. IFRS 11 supersedes IAS 31 *Interests in Joint Ventures* and SIC-13-*Jointly Controlled Entities-Non-monetary Contributions by Venturers.* IFRS 12 combines, enhances andreplaces the disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidatedstructured entities. As a consequence of
- these new IFRSs, the IASB also issued amended and re-titledIAS27 *Separate Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures.* The new requirements are effective for annual periods beginning on or after 1 January 2013, with earlier application permitted.

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 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 loss**	**2012**		2011
			£000	£000
	The operating loss is stated after charging:			
	Depreciation	**12**	9	
	Amounts received by auditors and their associates in respect of:			
	- Audit of these financial statements (Group and Company)	**20**	19	
	- Audit of financial statements of subsidiaries pursuant to legislation	**15**	15	
	- All other services	**15**	-	
			======	======

6	**Employees and employee benefits**	**2012**		2011
			£000	£000
	Employee remuneration			
	Wages and salaries	**373**	380	
	Social security costs	**46**	43	
	Other pension costs	**58**	58	

	477	481

Other pension costs represent contributions to defined contribution plans

The average number of employees during the yearwas as follows:

	No.	No.
Management	**2**	2
Administration	**2**	2
Other	**4**	4
	8	8

	2012	2011
Remuneration of directors	**£000**	£000
Directors' emoluments	**250**	234
Company contributions to money purchase pension schemes	**52**	52

Director	Salary and Fees £000	Benefits £000	Pension Contributions £000	**2012 Total £000**	2011 Total £000
ID Lowe	110	5	27	**142**	142
MJ Baynham	125	2	25	**152**	152
RJ Pearson	8	-	-	**8**	8
	243	**7**	**52**	**302**	**302**

7 Finance income and finance costs

	2012 £000	2011 £000
Finance income		
Interest receivable:		
- on bank balances	**22**	-
Finance costs		
Interest payable:		
- Bank loans and overdrafts	**71**	200
- Loan stock repayable within five years	**113**	60

	184	260

8 Income tax

No tax charge/(credit) in the current or preceding year.

	2012	2011
	£000	£000
Loss before tax	**(1,424)**	(925)
Current tax at 24% (2011 : 26%)	**(342)**	(241)
Effects of:		
Expenses not deductible for tax purposes	**12**	40
Losses carried forward	**220**	-
Deferred tax asset not recognised	**54**	41
Other deferred tax charges related to properties	**87**	160
Timing differences	**(31)**	-
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.

The 2012 Budget on 21 March 2012 announced that the UK corporation tax rate will reduce to 22% by 2014. A reduction in the rate from 26% to 25% (effective from 1 April 2012) was substantively enacted on 5 July 2011, and further reductions to 24% (effective from 1 April 2012) and 23% (effective from 1 April 2013) were substantively enacted on 26 March 2012 and 3 July 2012 respectively

Factors affecting the future tax charge

The group received a damages payment from the former tenants of an investment property amounting to £2,100,000 during the year ended 30 June 2005. The payment was made to compensate the group for the tenant's breach of obligations in relation to, principally, dilapidations under the repairing lease held by them. The directors successfully promoted a development brief for the island site of which the property forms part which was formally adopted by the Planning Authority in August 2009.

The directors have been progressing an outline planning consent for the site owned by the group which forms part of this island site and this was issued on 12 September 2011.

Accordingly the repair work to the property has not been carried out and it is unlikely that they will be undertaken. The receipt was treated as a capital receipt for taxation purposes on which basis no taxation was payable or has been provided. HMRC has queried the tax treatment of this receipt and there has been ongoing dialogue with the HMRC local inspector on the matter. The directors continue to be of the opinion that the receipt is a capital receipt and accordingly no taxation has been provided in these financial statements. The directors will vigorously challenge any such contrary view. HMRC have concluded that they do not agree with this treatment therefore the decision has been appealed and a Tribunal hearing is due to be held in 2013. The tax that would be payable if the receipt were to be treated as revenue is approximately £615,000.

9 Loss per share

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

	2012	2011
	£000	£000
Lossfor financial period	**(1,424)**	(925)
	========	========
	No.	No.
Weighted average no. of shares: for basic earnings per share and for diluted earnings per share	**11,882,923**	11,882,923
	========	========
Basic (loss) per share	**(11.98p)**	(7.78p)
Diluted (loss) per share	**(11.98p)**	(7.78p)

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

10 Investment properties

	2012	2011
	£000	£000
Valuation		
At 30 June 2011	**11,650**	16,410
Revaluation in year	**(225)**	125
Sold in year	**(3,300)**	(4,885)
Valuation at 30 June 2012	**8,125**	11,650
	========	========

The carrying amount of investment property is the fair value at the balance sheet date based on external independent valuations at open market value made by Montagu Evans, independent property consultants, at 30 June 2010 updated by the Directors to 30 June 2012.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 32 years during which time he has specialised in commercial property. 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.

Fair values were calculated having regard to recent transactions for similar properties.

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 *(2011: £684,000)*.

11 Property, plant and equipment

	Motor Vehicles £000	**Fixtures and fittings £000**	**Other equipment £000**	**Total £000**
Cost				
At 30 June 2010	18	52	48	118
Additions in year	3	1	18	22
At 30 June 2011	21	53	66	140
Additions in year	4	1	-	5
At 30 June 2012	**25**	**54**	**66**	**145**
Depreciation				
At 30 June 2010	17	49	30	96
Charge for year	1	2	6	9

At 30 June 2011	18	51	36	105
Charge for year	2	2	8	12
At 30 June 2012	**20**	**53**	**44**	**117**
Net book value				
At 30 June 2012	**5**	**1**	**22**	**28**
At 30 June 2011	3	2	30	35

12 Investments

	2012	2011
	£000	£000
Available for sale investments		
At the start of the year	**4**	5
Loss on investments recognised in equity	**-**	(1)
Available for sale financial assets	**4**	4

13 Trading properties

	2012	2011
	£000	£000
At start of year	**11,131**	10,891
Additions	**234**	240
At end of year	**11,365**	11,131

14 Trade and other receivables

	2012	2011
	£000	£000
Amounts falling due within one year		
Other debtors	**24**	6
Prepayments and accrued income	**116**	59
	140	65

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

15 Cash and cash equivalents

	2012	2011
	£000	£000

	2012	2011
Cash	**691**	577
	======	======

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

	2012 £000	2011 £000
Accruals and other creditors	**324**	512
	======	======

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 costs. More information about the Group's exposure to interest rate risk and liquidity risk is given in note 18.

Current liabilities

	2012 £000	2011 £000
Floating rate Loan Notes	**2,725**	-
Current portion of secured bank loans	**-**	1,497
	=======	=======

Non current liabilities

	2012	2011
Floating rate unsecured loan stock	**-**	2,725
	-	2,725
	=======	=======

Terms and debt repayment schedule

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

	Currency	Nominal interest rate	2012 Fair value £000	2012 Carrying amount £000	2011 Fair value £000	2011 Carrying amount £000
Secured bank loans	GBP	LIBOR + 0.95 to 4.5% Base +1.5%	**-**	**-**	1,497	1,497
Floating rate unsecured loan stock	GBP	Base + 3%	**2,725**	**2,725**	2,725	2,725
			2,725	**2,725**	4,222	4,222

The bank loans were secured by standard securities and charges over the assets of certain subsidiaries and by an unlimited guarantee by Caledonian Trust Plc and were repaid in full during the year.

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:

	2012 Fair value £000	2012 Carrying amount £000	2011 Fair value £000	2011 Carrying amount £000
Available for sale financial assets	**4**	**4**	4	4
Trade and other receivables	**140**	**140**	65	65
Cash and cash equivalents	**691**	**691**	577	577
	835	**835**	646	646
Secured bank loans	**-**	**-**	(1,497)	(1,497)
Loan from related party	**(2,725)**	**(2,725)**	(2,725)	(2,725)
Trade and other payables	**(324)**	**(324)**	(512)	(512)
	(3,049)	**(3,049)**	(4,734)	(4,734)

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.

Secured bank loans and 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. The Group's investments had a fair value of £4,000 at 30 June 2012 *(2011: £4,000)* and so the Group does not have significant exposure to credit risk in relation to these assets.

Bank facilities

At the year end the company had no loan facilities available *(2011:£1.5 million).*

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
Available for sale investments	
Other receivables	
Cash and cash equivalents	

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 it, including additional support from the major shareholder if necessary, to ensure continued compliance with these conditions.

The group's exposure to liquidity risk is given below

30 June 2012 £'000	**Carrying amount**	**Contractual cash flows**	**6 months or less**	**6-12 months**	**1-2 years**
Secured bank loans	-	-	-	-	-
Floating rate unsecured loan stock	2,725	2,774	48	2,726	-
Trade and other payables	324	324	324	-	-

30 June 2011 £'000	**Carrying amount**	**Contractual cash flows**	**6 months or less**	**6-12 months**	**1-2 years**
Secured bank loans	1,497	1,560	1,560	-	-
Floating rate unsecured loan stock	2,725	2,822	48	48	2,726
Trade and other payables	512	512	512	-	-

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:

	2012	2011
	£000	£000

Floating rate instruments – financial liabilities	**2,725**	4,222
	=======	=======

The weighted average interest rate of the floating rate borrowings was 4.1 % *(2011: 3.98%)*.

A 1% movement in interest rates would be expected to change the Group's annual net interest charge by £27,000 *(2011: £42,000)*.

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:

	2012	2011
	£000	£000
Less than one year	**168**	222
Between one and five years	**495**	670
Greater than five years	**328**	501
	991	1,393

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 2012, the group has a potential deferred tax asset of £1,216,000 (2011: £1,007,000) of which £516,000 (2011: £488,000) 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 £700,000 (2011: £519,000).This has not been recognised due to the uncertainty over the availability of future taxable profits.

Movement in unrecognised deferred tax asset

£'000	Balance 1 July 10 at 28% £000	Additions £000	Balance 30 June 11 at 26% £000	Additions £000	**Balance 30 Jun 12 at 24% £000**
Investment properties	351	137	488	28	**516**
Tax losses	515	4	519	181	**700**
Total	866	141	1,007	209	**1,216**

21 Issued share capital

	30 June 2012		30 June 2011	
	No	**£000**	No.	£000
Authorised				
Ordinary shares of 20p each	**20,000,000**	**4,000**	20,000,000	4,000
Issued and fully paid				
Ordinary shares of 20p each	**11,882,923**	**2,377**	11,882,923	2,377

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

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 and can only be reduced with court approval.

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 £113,000 *(2011: £60,000)* interest in respect of its holding of Floating Rate Unsecured Loan Stock. The balance due to this party at the year end was £2,725,000 (2011: £2,725,000).

The Annual Report and Accounts will be posted to shareholders together with a Notice of Annual General Meeting on or before 31 December 2012 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.

The Annual General Meeting of the Company will be held at 61A North Castle Street, Edinburgh EH2 3LJ on Friday 25 January 2013at 12:30pm.

A copy of this announcement and the Company's annual report and financial statements for 2012 will be made available on the Company's website http://www.caledoniantrust.comshortly.

For further information please contact:

Caledonian Trust Plc
Douglas Lowe, Chairman and Chief Executive Officer Tel: 0131 220 0416
Mike Baynham, Finance Director

Execution Noble & Co Limited
John Riddell
Harry Stockdale

Tel: 0207 456 9191