British GDP fell in fourth quarter

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News that UK Gross Domestic Product (GDP) fell by 0.5 percent in the fourth quarter of 2010 sent sterling and share prices falling on Tuesday.

The figures, released by the Office for National Statistics (ONS), came as a shock because economists had forecast growth of between 0.2 percent and 0.6 percent. Of particular concern was that much of the decline came in co nstruction, which slumped 3.3 percent in comparison to the third quarter, while services declined by 0.5 percent. Over the last year, construction has accounted for more than a third of the growth in GDP.

The statistics raised fears that the economy was on the verge of sliding back into recession, under conditions in which the coalition government's plan to cut £111 billion from public spending over the next four years will tip it over altogether.

The Conservative/Liberal-Democrat government sought to dismiss such claims, attributing the fall solely to the cold snap in December. Chancellor George Osborne insisted that there would be no retreat from the planned massive cuts in public sector spending and jobs.

"There is no question of changing a fiscal plan that has established international credibility on the back of one very cold month. That would plunge Britain back into a financial crisis", he said. "We will not be blown off course by bad weather".

During Prime Minster's Questions yesterday, David Cameron told MPs, "the worst thing to do would be to ditch your plans on the basis of one quarter's figures".

The ONS report made clear that, even accounting for the impact of December's cold weather, the economy had flatlined.

The report came just one day after the chief of the Confederation of British Industry (CBI) launched an attack on the coalition government's failure to articulate a "vision" for economic growth. Sir Richard Lambert, appointed just two months ago by the government to be a trade ambassador on behalf of Britain, used his final speech in office on Monday to make the surprise criticism.

Lambert made clear the CBI was wholly in support of the coalition's "single minded—some might say ruthless" approach to spending cuts, which he said were "strongly supported by business".

"But it has so far failed to articulate in big picture terms its vision of what the UK economy might become under its stewardship", preferring "a few vague ideas" in support of "predictable sectors".

The big issue, he said, was where the UK's growth would come from under conditions in which domestic consumption—by government and households—would "be under pressure for years to come".

The emphasis had to be placed on private sector investment and trade, Lambert said. Business investment had collapsed by "an astonishing 28 percent over the period of the recession", he said. Companies now needed "right signals from the market and from government to give them the confidence" to invest.

The government should also build on the fall in sterling, which had made "exports much more competitive—and our imports more costly—over the past three years".

Lambert's call was echoed elsewhere, especially as the ONS report showed the manufacturing had accounted for the largest area of growth, with output rising by 1.4 percent, compared to 1.1 percent in the previous quarter.

But the ONS figures raised alarm because they indicate that there is no way that the private sector can be expected to offset the cuts in public spending, as the government claims. As for manufacturing, it now accounts for just 12 percent of UK GDP, making its real contribution to growth in the last quarter 0.1 percent.

Even as regards bank lending, plans by the government to announce a "consensus" with the banks on executive bonuses and bolstering credit lines have been delayed due to lack of agreement. The major banks have previously rejected proposals for the disclosure of the salaries of their highest-earning staff. They have also reportedly only agreed to lend a maximum of £180 billion to businesses. The banks and financial sector generally were handed some £1 trillion in various credit and stimulus packages

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following the collapse of Lehman Brothers in 2008.

Labour's new shadow chancellor, Ed Balls, nominated after the sudden resignation of Alan Johnson last week, sought to use the GDP figures to his advantage. The government "must urgently rethink their reckless plan to cut the deficit too far and too fast", Balls said. "Simply slamming on the brakes is not a credible economic policy".

However, it was Labour that recklessly made the massive subventions of social funds to the banks and financial sector in 2008—money that was then used to fuel further speculation and restore the fortunes of the super-rich. Before the May 2010 election, Labour outlined spending cuts that went further than anything attempted under Margaret Thatcher in the 1980s.

Hetal Mehta, economist at Daiwa Capital Markets Europe, described the new GDP figures as "horrendous". "An absolute disaster for the economy…. With the fiscal tightening yet to fully bite, we will have to brace ourselves for a bumpy ride", she said.

Jonathan Loynes, chief European economist at Capital Economics, said the figure was "shockingly bad" and would "raise serious concerns over whether the economy is in a strong enough position to withstand the coming fiscal tightening".

Howard Archer, of IHS Global Insight, described the GDP numbers as a "stunningly bad outcome: it is a performance far worse than even the most pessimistic of forecasts…. Given that the contraction in GDP in the fourth quarter occurred even before the fiscal tightening had really kicked in, it reinforces already serious concern over the economy's ability to grow significantly in the face of the spending cuts and tax hikes that will increasingly bite as 2011 progresses".

The GDP figures led to speculation as to the response of the Bank of England (BoE). Inflation is currently running at 3.7 percent, almost double the BoE's target, and is likely to rise further in the coming months.

Christina Fincher, for Reuters, said the problem of "weakening growth and rising inflation is an acute one that leaves the Bank unable to deal with one problem without potentially exacerbating the other".

This made the issue of whether to raise interest rates increasingly problematic, threatening either outright recession or higher inflation. "Although a return to recession is unlikely and inflation remains far from the double-digit rates seen in the 1980s, some economists are already dubbing it 'stagflation-lite' ", Fincher said.

Maurice Pomery at Strategic Alpha said the figures were "really bad news" as no central bank wanted to "deal with the prospect of stagflation, rising inflation and a contracting economy". He warned that a rush by investors into gilt prices may not last, "as to me the UK could be in enough trouble to attract the bond vigilantes as this could derail the governments chance of dealing with the deficit".

Speaking in Newcastle on Tuesday evening, BoE chief Mervyn King dismissed such concerns and defended the government's austerity measures as the right course for the economy.

Bizarrely, King reportedly began his remarks by quoting comedian Ken Dodd, saying, "When it comes to measuring success, don't count money, count happiness", before going on to outline a significant decline in living standards even before the austerity measures bite.

Real wages in 2011 would be at the same rate as in 2005, King said. One would "have to go back to the 1920s", he continued, to find a comparable fall in real wages over a six-year period. The decline is due to a pay freeze in the public sector and pay cuts across the private sector, combined with rising inflation that had squeezed real take-home pay by around 12 percent, he said.

Things would be more difficult over the next period, as inflation was expected to rise to 5 percent. While inflation was the "immediate concern" for the Bank, he rejected any claim that its Monetary Policy Committee could have prevented the decline in living standards by raising interest rates.

"[O]ne way or another, the squeeze in living standards is the inevitable price to pay for the financial crisis and subsequent rebalancing of the world and UK economies", he said.

He warned that the BoE would intervene against any attempt by workers to press for wage claims to keep up with inflation.

"Further rises in world commodity and energy prices cannot be ruled out", he said. "Attempts to resist their implications for real take-home pay by pushing up wages would require a response [from the MPC]".

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