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Congressman George Miller
House Education and Labor Committee
2205 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Miller,

You asked about my views about where U.S. output and unemployment are heading. They are not very sanguine.

Data lags make it treacherous even to assess the *current state* of the economy around cyclical turning points, much to less forecast its *future path*. Furthermore, the unprecedented recent financial events make this turning point anything but normal. So the uncertainties facing us right now are enormous

That said, recent readings from both official government data and anecdotal reports paint a pretty bleak picture. It is beginning to look like the US economy—in particular, the consumer—fell off a cliff in September. I do not think it is a coincidence that this precipitous drop occurred just as the failures of Lehman Brothers, Washington Mutual, and Wachovia were grabbing the headlines—and the stock market was tanking.

Until very recently, the weakness in our economy was confined mostly to three afflicted sectors: housing, financial services, and automobiles. For example, during the first two quarters of this year, real GDP growth averaged 1.8% at an annual rate, even though residential investment ("housing"), which is now less than 4% of GDP, declined at a catastrophic 19.6% annual rate. Exports, which expanded at an 8.6% annual rate, saved us, while consumer spending limped along at 1% annual rate. Now, however, economic weakness looks to be broadening rapidly. And, with the rest of the world slipping, rapidly rising exports can no longer be relied upon to prop us up.

Most worrisome to me, the consumer seems finally to have given up—or rather been frightened to death—in the third quarter, and especially in September. It now appears that consumer spending declined notably in the third quarter; and I expect it to fall even faster in the fourth quarter. With consumption accounting for 71% of GDP, declining consumer spending more or less dooms GDP growth. The arithmetic is simple and compelling: If the growth rate of consumer spending falls by 5 percentage points (e.g., from +1% to -4%), that takes 3.5 percentage points off the GDP growth rate—which spells recession. The only questions are how deep and how long it will be.

Of course, no one knows either what will happen to consumer credit or how households will react to the credit stringency. And more than credit tightening is in play right now; consumers are just plain scared. But I find the following historical parallel disquieting. In March 1980, President Carter, in an act of desperation, invoked powers that Congress had granted in 1969 to impose credit controls on store charge accounts, credit cards, and the like. He also urged Americans to spend less. What followed, more or less immediately, was not pretty. In the second quarter of 1980, consumer spending plunged at an 8.6% annual rate (for a single quarter) and GDP fell at a 7.8% annual rate—the second-

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worst quarter in post-war history. My worry is that something like that may be happening again right now.

A one-quarter event, such as we experienced in 1980, is one thing. A long and deep recession is quite another. And we are probably in one already. What might a deep recession mean for joblessness?

For reference, the two worst postwar recessions came in 1981-1983, when the unemployment rate skyrocketed from 7.2% in July 1981 to a high of 10.8% in November-December 1982, and 1973-1975, when the unemployment rate soared from 4.8% in November 1973 to a high of 9% in May 1975. The increases were thus 3.6 percentage points and 4.2 percentage points, respectively. In the current episode, the unemployment rate stood at 4.4% in March 2007 and is now up to 6.1%. If the 2008-2009 recession turns out to be about as severe as the previous two big ones, unemployment will top out in the 8-8.5% range. My worry is that we may be heading in that direction.

Another way to put the point is this: The game has changed for the worse; we are no longer fighting to stave off recession, as was the case when Congress passed a timely fiscal stimulus bill earlier this year. Recession is now inevitable. Instead, I think of the manifold efforts that Congress, the Treasury, and the Fed are making to fix the financial system, plus whatever stimulus bill passes Congress next, as aimed at a far less ambitious target: stopping the rise of unemployment before it reaches 8%. The way things look now, I would consider that an achievement.

Regarding the policy choices before Congress today, I would emphasize just two points. First, the winter 2008-2009 stimulus package needs to be a large one—something in the range of 1½ to 2% of GDP seems about right. Second, there should be a strong emphasis on ameliorating the effects of rising unemployment. Extending unemployment insurance benefits is just one obvious component.

I hope these brief comments are helpful to you and to the Committee.

Yours very truly,

Alan S. Blinder