<u>Business Uncertainty a Roadblock on the Path to Economic Recovery</u>

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The Canadian economy is still mired in a tepid recovery, with real output growing at a rate well below what we saw before the recession. Canadian investment and exports are lagging far below "normal" levels, partly because the U.S. economy, though showing intermittent signs of life, continues to face its own recovery challenges. One crucial factor affecting both economies is widespread economic uncertainty.

Uncertainty about the future path of the economy is a major reason for today's slow growth. When firms are highly uncertain about what the future holds, they decide to delay investment and large expenditure decisions, waiting to see how things unfold before making commitments. As the great British economist John Maynard Keynes observed almost eighty years ago, even very low interest rates are no match for such negative "animal spirits". The delays in private spending lead to a slowing of aggregate demand and to sluggish overall growth.

The U.S. Federal Reserve recently released a very good illustration of the amount of current uncertainty – in what is now referred to as the Fed's "dot plot". The graph shows, by plotting a series of dots, the extent of disagreement among the sixteen members of the Federal Open Market Committee (FOMC) regarding their expectations for the U.S. policy interest rate over the next few years. (FYI: the Bank of Canada provides no similar information about how the six members of its Governing Council disagree.)

Since the FOMC is the group that sets the policy interest rate in the United States, and since it sets the rate differently depending on the state of the economy, the members' disagreement over the future level of the policy rate is essentially a disagreement over the future state of the economy. Thus the range of expectations of the future policy rate indicates the amount of uncertainty regarding the state of the economy, at least among the FOMC members.

For the current year, there is not much disagreement. All but one of the 16 FOMC members believe that 2014 will end with the Fed's target for the federal funds rate stuck at its current level of 0.25 percent. The lone dissenter thinks the policy rate will be 1.0 percent by the end of the year. So pretty much the whole FOMC thinks the U.S. economy will be roughly in its current state six months from now.

Things get more interesting for the next two years. For the end of 2015, there is lots of disagreement, with four of the members expecting the policy rate to be 0.5 percent or below and three members expecting the rate to be 2.0 percent or above. While there is a slight bunching of the remaining predictions within the 1-2 percent interval, there is still a surprising range of disagreement given that they are considering the state of the economy only eighteen months from now.

When we examine their expectations for the end of 2016, we find even more disagreement. You might have expected that the disagreement would decline over time –

because *surely* by the end of next year the U.S. economy will be growing steadily and so there will *finally* be agreement about the Fed's setting for the policy interest rate. No such luck. The sixteen FOMC members disagree plenty, with the expected policy rate for December 2016 ranging from 0.5 percent to 4.25 percent. Three of the members evidently expect the economy to be stumbling along with few inflationary pressures, much like today, while four members apparently expect fast enough growth that inflationary concerns will be leading the Fed to tighten its policy.

Some might argue that drawing inferences about the state of the economy from the individual beliefs of the FOMC members is simply going too far. I disagree. They form their views by examining data from all sectors and regions of the U.S. economy and then putting it all together by using a sophisticated process that combines formal modelling with informal but well-informed judgement. Their disagreements about the right policy actions mirror the underlying uncertainty among firms and households in the U.S. economy. And as long as this uncertainty is so large and widespread, we can expect no solid economic recovery. I'm pretty certain of that.

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