Fed Presses Ahead With Bond Buys as Inflation Slows

By JON HILSENRATH, VICTORIA MCGRANE and BRIAN BLACKSTONE

A&G Capital president Hilary Kramer says the Fed's decision to continue its bond-buying program is a 'crutch' and a wise investment play would be to buy big banks. Photo: Getty Images.

The Federal Reserve said it would press forward with an $85 billion-a-month bond-buying program and hinted it might even dial it up if the job market or inflation figures fail to meet the Fed's expectations.

The Wednesday pronouncement after a two-day policy meeting marked a shift in the U.S. central bank's public tone. In March, with U.S. labor markets apparently on the mend, central-bank officials started discussing how and when they might begin pulling back the bond programs.

But the Fed, in a statement released after Wednesday's meeting, evinced no sign it is leaning toward pulling back. Instead, it struck a more neutral tone and emphasized it could "increase or reduce" the size of its monthly bond purchases, depending on inflation and job growth in the months ahead.

U.S. inflation has moved noticeably below the Fed's 2% goal, part of a global slowdown. This has taken pressure off the Fed and other central banks to pull back from their efforts to boost growth by pumping new money into the world economy.
The European Central Bank could be the next to act. It is widely expected Thursday to cut a short-term benchmark interest rate in response to the shrinking euro-area economy and slowing inflation.

The Bank of Japan, meanwhile, has drastically ramped up bond purchases this year in an effort to lift inflation to 2% after long stretches of falling consumer prices during the past two decades.

Federal Reserve officials said they would press ahead with their $85-billion-a-month bond-buying program and signaled they could either increase or decrease the amount they purchase monthly depending on the job market and inflation. WSJ chief economics reporter Jon Hilsenrath has details.

The Fed's bond-buying programs are aimed at driving down long-term interest rates and pushing up stock and other asset prices, which officials hope will spur borrowing, spending and hiring.

One threat the Fed highlighted: the rest of the U.S. government. "Fiscal policy is restraining economic growth," the Fed said bluntly about U.S. tax and spending policies aimed at short-term budget-deficit reduction. Fed Chairman Ben Bernanke has called on the Obama administration and Congress to agree to a budget plan that reduces deficits in the long run without cutting much right away while the economy is weak.

The global inflation slowdown is one of the more surprising developments confronting the Fed and other central banks, and has become more apparent in recent few weeks.

Should investors be worried about the growth prospects for the economy? Sudeep Reddy and Neal Lipschutz discuss what the most recent Fed decision says about long-term growth.

The U.S. Commerce Department reported Monday that consumer prices rose just 1% in the 12 months ending in March, well below the Fed's 2% target. In the 17-member euro
zone, inflation hit 1.2% in April, the lowest rate in more than three years and also well below the ECB's target of just under 2%.

In theory, when central banks increase the supply of money flowing through the financial system, that should reduce the purchasing power of that money and thus create inflation. But weak global demand is making it harder for many businesses to raise prices.

"Inflation has been running somewhat below the [Fed's] longer-run objective," the Fed noted in its policy statement.

It might be a temporary blip, but some businesses are taking a wait-and-see approach. Chipotle Mexican Grill Inc., CMG -0.28% a U.S. burrito restaurant chain, has been mulling price increases since January to offset earlier increases in the cost of ingredients such as salsa and chicken. Instead, the firm has held off on trying to pass those increases on to customers.

"The economy is sending mixed signals again," said Jack Hartung, the firm's chief financial officer, in a conference call with analysts April 18. "It seems like the economy is off to a great start and then every time about this time, every year for the last few years in the spring, we get mixed signals on consumer confidence and job creation and things like that."

He said the company's food costs declined in the first three months of 2013—though they are still higher than they were a year ago—and the firm has decided to "let some time pass" before deciding whether to raise its prices. If there is a price increase, it won't come until late summer or early fall, he said.

Several indicators suggest inflation pressures have receded in recent weeks. Futures prices for commodities, including oil, cotton, sugar and gold, are all down from a year earlier. Meanwhile, yields on inflation-sensitive 10-year U.S. Treasury notes have fallen to 1.638%, reversing an uptick that started last December.

Several factors are behind the global inflation slowdown. Many economists expect the euro-zone economies collectively to contract this year, for the second straight year. Meantime, growth in developing-market economies, including China, is showing little lift after slowing last year.

"Economics 101 tells you that if you have subpar global growth for a while, you're going to get lower inflation," said Bruce Kasman, chief global economist for J.P. Morgan Chase JPM -2.04% & Co.

His team of economists see 2013 inflation globally of 2.3%, down from 2.4% last year, and 3.1% in 2011. And Mr. Kasman said he might shave the projection further. "There is still more downward pressure," he said. "We're probably still a little high on our forecast."

The Fed tries to keep inflation stable near 2%, a level that central-bank officials believe supports steady economic growth and hiring. Big moves either above or below that make it hard for businesses and households to plan for the future.
Very few economists are sounding alarms that the U.S. inflation slowdown could turn into a deeper deflationary downturn, in which prices drop along with wages and hiring. After the financial crisis, the Fed lowered interest rates aggressively to prevent such a spiral.

This time, the economy possesses enough pockets of strength to suggest such a scenario remains highly unlikely, and the economy might pick up later this year.

German-based HeidelbergCement, HEI.XE +1.03% one of the world's biggest cement producers, has raised prices this year in Southern California, Oregon, Texas and Florida, and sees more on the way in the U.S., executives said in a mid-March call with investors. The company said it expects that continued economic recovery in the U.S. will boost demand for the building materials it produces, especially from residential construction projects and raw-material producers. "We are confident on the cement prices," Bernd Scheifele, the firm's chief executive, said on the call.

Europe is a different story for many firms. Even if inflation rises a bit this month, as many analysts expect, further declines are likely later in the year as deep recessions and soaring unemployment in southern Europe hit wages and prices.

Another restraint: The euro is well above its long-term average even after more than a year of recession in the euro zone. A strong currency makes it hard for businesses in Europe to raise prices, for fear of losing market share to cheaper imports.

"There's not a lot of domestic demand, and you have a currency that is strong rather than weak," said Holger Schmieding, economist at Berenberg Bank in London. If the bloc's economy doesn't find its footing later this year, inflation may "fall significantly to zero or modestly negative," he said.

The ECB is expected to respond to the sudden plunge in inflation by shaving by one-quarter percentage point the rate at which it lends to commercial banks, to 0.5%, when it meets Thursday.

Healthy banks can already get even lower rates by going to private lenders, but the ECB might help some weaker banks that depend on it if it lowers its "refinancing rate."

Still, many ECB officials feel deeply constrained. Europe lacks common rules for bank regulation and deposit insurance, leading to fragmented lending markets. Firms in crisis-hit countries such as Spain and Portugal face especially high borrowing costs. Unless broader problems at banks in these countries are repaired, even more dramatic steps by the central bank would have a limited effect, some analysts warn.

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