Fed Decision Is Relief for Europe

Decision Not to Reduce Bond-Buying Program Eases Pressure on European Recovery

By BRIAN BLACKSTONE And JASON DOUGLAS

The Federal Reserve's unexpected decision to keep its bond-buying program intact gives central banks in Europe more time to nurture still-fragile economic recoveries. Central banks in developing countries will face less pressure to raise interest rates to defend their currencies, but are unlikely to significantly alter their policy stances.

The U.S. central bank said Wednesday it would keep buying $85 billion a month of Treasury and mortgage bonds, surprising many economists who had expected a reduction of as much as $15 billion in monthly purchases.

Europe's main central banks have struggled in recent weeks to convince investors that that their "forward guidance" promising the retention of low interest rates has teeth, in part because investors assumed tighter Fed policies would filter through to Europe. The Fed's decision to leave in place its current pace of bond buying changed that perception.

The decision helps the European Central Bank and Bank of England cement their verbal assurances that interest rates in Europe will stay at record lows in the near term, analysts said. "The fact that the Fed is now even further away from taking away the liquidity punch bowl obviously is going to make it easier for [the] ECB and BOE to manage rate expectations," said Nicholas Spiro, head of consulting firm Spiro Sovereign Strategy.

The Fed's decision to hold off reducing, or "tapering," its bond buying also takes some of the pressure off the ECB and other central banks in Europe to take additional action on interest rates and other stimulus measures, at least in the near term, economists say.

The Swiss National Bank on Thursday kept interest rates unchanged and made no changes to the floor it has set on the Swiss franc's exchange rate to the euro. Norway's central bank also held rates unchanged Thursday.

The fall in bond yields in Europe that followed the Fed announcement should help support the euro-zone economy, which is slowly emerging from 18 months of contraction that began in 2011.

German and U.K. government bonds, which both typically move in tandem with U.S. Treasurys, rose sharply. The yield on the 10-year German government bond, which moves in the opposite direction from prices, fell 0.14 percentage point to 1.81%, the lowest level in a month. The corresponding yield on U.K. bonds was 0.16 percentage point lower at 2.84%, the lowest level in two weeks.

With the Fed continuing full steam on its bond purchases, the ECB should, at a minimum, maintain its ultra-accommodative policy stance, analysts said. Unlike the Fed, the ECB isn't buying bonds to hold down long-term interest rates. While it has a bond-buying facility, this has yet to be used. The ECB's key interest rate is 0.5%, meaning it does have room to reduce rates if economic and financial conditions worsen.

The Fed move "strengthens the hands of the doves" on the ECB's 23-man Governing Council who tend to place more emphasis on spurring economic growth than bringing down inflation, since it brings market rates down and puts upward pressure on the euro-zone currency, said Christian Schulz, an economist at Berenberg, a private bank, in London.

Before the Fed's decision, central bankers in London had fretted that rising market rates could feed into higher borrowing costs for households and businesses in the U.K., potentially derailing an economic recovery that is beginning to gather speed. In an effort to keep a lid on domestic borrowing costs, the BOE, under its new...
governor, Mark Carney, pledged in August not to consider raising its benchmark rate from 0.5% until unemployment in the U.K. drops to 7%, a threshold officials doubt will be crossed until 2016.

Analysts said Mr. Carney was likely to greet the lower interest rates in Europe resulting from the Fed’s decision with some relief. "From the point of view of the U.K., it takes off some of the pressure we were getting in terms of higher bond yields," said Carl Astorri, economic adviser to the Ernst & Young Item Club. "It’s also good news that monetary conditions globally will be a bit looser."

The Fed hasn’t, however, brought permanent calm to European financial markets and the economy. The euro’s rise against the U.S. dollar will make it harder for exporters to sell their goods and services abroad, weighing on the euro zone’s nascent recovery. In short, the Fed has, for the time being, solved one problem for the ECB—managing rate expectations—while creating another in the exchange rate.

The ECB is unlikely to lower interest rates when it meets in two weeks, said Carsten Brzeski, economist at ING Bank. However, ECB President Mario Draghi "will have to sound dovish, not to talk down [market interest rates] but to talk down the exchange rate," he said.

Despite Wednesday’s decision, the Fed is still likely to begin slowly winding down its bond purchases in coming months, which could reignite volatility in financial markets and put central banks in Europe back where they were in the summer: struggling to get a handle on interest-rate expectations.

"The Fed has simply delayed the day of reckoning," Mr. Spiro said. "Short term it provides a boost, but it’s going to make it much more difficult down the line for the ECB to make its forward guidance regime more credible," he said.

The Fed's decision will also come as a relief to developing-country central banks. Since June, investors have been pulling out of emerging markets in anticipation of a change in the Fed's bond-buying program, weakening many developing-country currencies, and threatening a pickup in inflation. A number of central banks have responded by raising interest rates and intervening in currency markets. That may no longer be necessary.

Central banks in emerging markets "should send flowers to Washington," said Benoit Anne, head of emerging-market strategy at Société Générale. "It reduces the need for them to be worried about their currencies."

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A version of this article appeared September 19, 2013, on page A2 in the U.S. edition of The Wall Street Journal, with the headline: Move Buttresses European Counterparts.