EUROPEAN CENTRAL BANK
EUROSYSTEM

COURTESY TRANSLATION

Mario DRAGHI

President

Ms Rodi Kratsa-Tsagaropoulou
Member of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

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Re: Your letter

Dear Ms Kratsa-Tsagaropoulou,

Thank you for your letter passed on to me by Ms Sharon Bowles, Chairwoman of the Committee on Economic and Monetary Affairs, and accompanied by a cover letter dated 25 October 2012.

Regarding your question on the International Monetary Fund's assessment that financial risks have increased since the publication of its April 2012 Global Financial Stability Report (GFSR), we have indeed observed a further deterioration in, and increasing fragmentation of, euro area financial markets since April 2012. Over the summer a number of financial market indicators pointed to the emergence of redenomination risk affecting financial prices in several euro area countries. Moreover, the growing financial market fragmentation in the euro area, in particular with respect to bank funding conditions, implied a severe impairment of the transmission of our monetary policy to the real economy. However, important policy decisions to contain the crisis in the euro area have been taken both by the EU Heads of State or Government and by the European Central Bank over recent months. In this context, and in order to assuage redenomination fears and improve the functioning of the monetary policy transmission mechanism, the ECB announced its Outright Monetary Transactions (OMTs) on 6 September 2012.

Following the announcement, market conditions have clearly improved. The staunch resolve of EU Member States to complete the architecture of the Economic and Monetary Union, inter alia through the fiscal

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compact and the establishment of the Single Supervisory Mechanism, and to carry out necessary structural and fiscal reforms at the national level, will also contribute to mitigating uncertainty in the financial markets.

Regarding the ECB's opinion of the International Monetary Fund's assessment of bank deleveraging needs, in our view some deleveraging by euro area banks over the medium term is to be expected, owing to funding and capital-related pressures of a cyclical and, in particular, a structural nature. The externalities associated with some forms of deleveraging need not necessarily be negative. Deleveraging can reflect a more efficient allocation of financial resources, a correction of over-inflated asset prices or a reduction of debt overhangs, all of which would bring the economy onto a more sustainable growth path. A more detailed analysis of this matter is provided in Special Feature (A) of the ECB Financial Stability Review June 2012.[1]

As regards the role of the OMTs in protecting distressed countries against increased deleveraging, the aim of the OMTs is precisely to address the severe malfunctioning observed in the price formation process in bond markets, which is related in particular to unfounded fears about the reversibility of the euro. Asset prices that do not reflect such unfounded fears reduce bank funding costs and hence the interest burden of bank borrowers. This may in turn alleviate the capital and liquidity constraints currently hampering bank intermediation activity in several euro area countries and thus reduce the immediate pressures on banks to abruptly deleverage their balance sheets.

Yours sincerely,

[signed]

Mario Draghi

[1] http://www.ecb.int/pub/fsr/shared/pdf/ivafinancialstabilityreview201206en.pdf?961a812fd3ec4d0435fbe4d43e4f4cf5