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The current crisis is unprecedented in that it is affecting the heart of the world financial system. I have first-hand experience of a large number of financial crises, including the Latin American crisis of the early 1980s and the very difficult transition and financial crisis in Russia, the Asian financial crisis and the renewed crisis in Mexico, Brazil and Argentina in the 1990s. The current crisis is linked to fundamental structural changes in the global economy, reflecting economic and financial globalisation and integration. What makes this crisis stand out is its extraordinarily large scale, the fact that it is hitting right at the centre of the international financial system and that it is deeply affecting industrialised countries.

I would like to share with you today some thoughts from my perspective as a central banker in terms of the background to the crisis, its management and a number of first lessons to be learned.

Starting with the background to the crisis, I would like to go over a few things that many central bankers said publicly before the crisis, and in particular before the phase that started on 9 August 2007. I frequently summarised the views of my fellow central bank governors from industrial as well as emerging economies in my function as chairman of the Global Economy Meetings during 2006 and early 2007. The sentiment that we expressed at the time was that there was a fundamental undervaluation of risk in the financial system. Financial institutions were underestimating both the quantity of risk involved and the price of that risk. We also said publicly, long before the difficult time we are going through today, that the private sector had to prepare for a market correction, because such a correction was inevitable. The aim of our urging the private sector to prepare was to try to ensure that the correction itself would be as little turbulent as possible. But there was a lack of preparation, and the degree of turbulence and strain we are measuring in financial markets today is very considerable. One of the main questions is why, before the eruption of the turbulence, we were living an international financial system in which financial institutions in general underestimated the quantity of risk they took and the price of that risk.

The reason why financial market participants underestimated risk had to do with the fact that for long time we had experienced remarkable rates of growth with low inflation. Moreover, these rates of growth and inflation were relatively stable, displaying low volatility. As a result, all participants in the market as well as in financial and non-financial institutions were placed in a context that led them to believe through simple extrapolation that risk had progressively diminished compared with earlier and more volatile periods of growth and inflation. A second, and certainly major, reason has been financial development. We have witnessed in recent years a considerable sophistication of financial instruments, which effectively led to risks being spread to a very great extent across a broad spectrum of investors. The increase in the complexity and hence opacity of financial instruments was considerable. Even many professionals found it difficult to understand, and therefore price, a large proportion of these highly sophisticated and complex financial products. For instance, with regard to the instruments called “asset-backed securities”, the assets guaranteeing the negotiable paper were considered as being owned by the issuer, as for hedge funds. Hedge funds can consider the mix of risks they are taking as proprietary. All in all, we were facing the opacity of financial instruments, a large share of financial players that were highly leveraged, and a considerable share of institutions that were unlisted and unregulated. Therefore, a very considerable market developed, especially in credit derivatives, with relatively limited overall transparency. These are some of the main reasons for the underestimation of the quantity of risk that we were facing.

With regard to the pricing of risk, a number of factors played an important role. First of all, over the past few years, we experienced a configuration of the investment-savings balance in which there was an excess of savings over investment in many large economies. So we were in a situation in which capital was looking for investment opportunities. Clearly, an environment in which investment is not looking for capital but in which capital is looking – often quite desperately – for investment opportunities is quite a dangerous one. We have witnessed the phenomenon of savings exceeding investment in many economies for years. As a result, capital was chasing investment abroad for years, with the result that, little by little, the price of risk decreased considerably, and volatility in financial markets diminished. Over time, a fundamental underpricing and underassessment of risk developed.

Another reason for the build-up of the crisis was the rapid expansion of credit derivatives. They permitted financial markets to spread risk on a very broad scale among buyers of risk. Since the overall environment was one of low volatility, there was a lot of interest in buying risk and overall risk became underpriced. I also note not only the fact that there was a great diversification of risks because of the credit derivatives that I have just mentioned, but also that this had an impact on the way the quantity of risk and its price were determined. What happened was an upsurge in the number of institutions that were highly leveraged, that were unregulated, that were operating at leverages of a factor of ten in terms of assets relative to underlying capital. And I conclude my diagnosis by saying that these fundamental phenomena were identified again and again, by central banks and others. The message was that we were in a very delicate situation, in which financial leverage and complexity were high and in which incentives within financial institutions fostered a focus on the very short term, neglecting long-term risks.

My second line of comment relates to crisis management. We are now in the midst of crisis management, where action counts. You know that the decisions that we are taking these days are very considerable. To give you one example, I remind you that we had diagnosed as early as 9 August 2007 that something major was happening in international finance, something that should not be underestimated. As a result, the governing bodies of the European Central Bank reacted immediately, to support the market from the outset of the turmoil. The very same day, after a decision-making process of only a few hours, we lent €95 billion for 24 hours against collateral in the euro area as a whole. Some external observers wondered about the magnitude of this amount, but a day later it had already been validated by reality. As little as a few days later, virtually all global players among the central banks had become involved, and all observers commended us for being right and clear-sighted from the start. To give you another order of magnitude, in December 2007 in order to stem the uncertainty surrounding the year-end the Governing Council of the European Central Bank decided to provide liquidity of €349 billion for 15 days, i.e. a little more than USD 500 billion. This gives you an idea of the order of magnitude of the decisions we have had to take during these difficult times. I could go into much more detail of all these decisions that we have taken, including the lengthening of the maturity profile of our refinancing operations, providing three months or six months' refinancing. As for today, this afternoon we have just decided that the Eurosystem's refinancing at six months will be increased from €25 billion to €50 billion to satisfy an increased demand from commercial banks for longer term refinancing.

Let me now say something about international cooperation. It is extremely intense right now, and we have extremely close relations, very trustful relations, with all central banks. I emphasise that especially in the case of the Federal Reserve System. We currently have a swap agreement for USD 240 billion, which allows us to provide US dollar cash to banks on this side of the Atlantic. We are providing cash not only in euro but also in dollars on the basis of a remarkable and unprecedented agreement. It is a first of its kind on the world financial scene. As I have already said publicly, both the European Central Bank and the other central banks are doing everything they can to make sure that the market remains afloat financially in very demanding circumstances. We are limited, however, in what we can do, as we cannot intervene when there are solvency problems. This also leads us to call upon governments to be up to their responsibilities, and they have acted very boldly and very decisively. These are demanding times. All authorities, all players so far have met their responsibilities, and now more than ever we need to strengthen this message. Yesterday and this morning I took part in the Eurogroup meeting and the ECOFIN meeting with the representatives of, respectively, 15 and 27 countries. A text was drafted by the ministers of finance which sums up the present consensus for everything that pertains to the actions undertaken by public authorities. It is important that all European governments have a common voice, a common doctrine and common principles for everything that is a guarantee and for possible capital injections. This consensus has now crystallised into the text drafted today. We are all together writing the history of the management of this crisis.

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I would now like to turn to the lessons to be learned. First of all, a consensus has been established that the current problem is a global one, and that therefore the solution also needs to be global. We must avoid implementing reforms or transformations in a fragmented manner. In this respect, we need international institutions. We also need the Financial Stability Forum that was set up after the Asian crisis and has turned out to be extremely useful in channelling all the reform energy into a single and coherent set of actions. As far as Europe is concerned, all its actors, the ECOFIN Council, the European Commission and the European Central Bank, are in line with the global consensus for reform. This also helps us preserve unity among Europeans in terms of our methodologies and the lessons we need to learn. The thrust of European reform is compatible with international reforms in general, and the 67 recommendations made by the Financial Stability Forum in particular. Therefore Europe is fully in line with the global consensus that it has helped shape.

Some of the issues that I would like to highlight from the long list of reforms are, first, the fact that we need much more transparency; transparency of institutions, financial instruments and markets, for obvious economic reasons. The allocation of scarce resources is done much more efficiently when there is a higher level of information. But there is another very important reason: a lack of transparency is the best recipe for a large imbalance followed by contagion effects when something bursts somewhere in the financial world. In the Asian crisis we saw the contagion situation that arose after it became known that one country had hidden the exact amount of its reserves. International investors concluded that all other countries had done the same. Since there was no transparency it seemed reasonable to think so. It wasn't necessarily the right conclusion, but it was a reasonable way to think at that time. The result was the withdrawal of funds and the cutting of credit lines. When this happened, the crisis started. You can link that to what we are observing in industrialised countries. A certain number of institutions, markets and financial instruments were opaque. When one area turned out to contain abnormal elements – in this case the detonator was sub-prime mortgages in the United States – the cash crunch and then the credit crunch developed. This is due to a withdrawal from the opaque when general uncertainty is rising. Therefore transparency is the key.

This brings me to the second element I would like to highlight, which is pro-cyclicality. The past few months have highlighted the adverse aspects of pro-cyclicality in international finance. This is true for the rules that we have made, as well as for the spontaneous behaviour of a certain number of institutions. Human nature itself is obviously pro-cyclical. But what is inadmissible is that we should strengthen the booms and busts by the financial and accounting rules we make to organise the actions of financial and economic players. This is also a fundamental lesson to learn. The quest to eliminate all these pro-cyclical elements in international finance is a key to understanding what we are doing.

The third and final element I would like to mention is short-termism. There is a link between pro-cyclicality and short-termism. You increase pro-cyclicality when you oblige players to be more and more short term-oriented. There is a very strict division between institutions which are listed and regulated and those which are unlisted and unregulated. Thanks to the interplay of rules, those that are listed and regulated have an obligation to reason much more in the short term – short term meaning the quarterly publication of reports – whereas those that are unlisted and unregulated can reason for the longer term. We clearly need the market to function well for both those who reason short-term and those who reason long-term. Structural changes such as those we have experienced over the past five to seven years have translated into an amplification of booms and busts, and we are unfortunately witnessing the downside of these swings now.

Let me now end my remarks, in which I have tried to give you a brief overview of the difficult times that we are experiencing, of the actions we are taking and of the lessons we are beginning to learn. We are at the start of a very fundamental reform of the international financial system, and there should be no taboo for reform, whether for markets, institutions or international cooperation. The whole system needs an overhaul so that the right lessons can be learned from the huge real-world stress test that we are experiencing.

Thank you for your attention.