Growing number of potential flashpoints in global financial system

Nick Beams
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As the US war in Iran moves well into its second month and the warnings of its long-term effects on the global economy grow louder, the international financial system is increasingly coming to resemble a mine field. There are a growing number of potential flashpoints and vulnerabilities any one of which, or a combination, could set off a crisis.

In a speech delivered on Monday in Japan, Pablo Hernández de Cos, the general manager of the Bank for International Settlements (BIS), the umbrella organisation of central banks, added another to the list.

He warned that stablecoins “raise serious risks for financial integrity and can facilitate regulatory circumvention” making it easier to evade capital control imposed in emerging markets and developing countries.

Stablecoins are a form of crypto currency which supposedly provide greater stability because they are tied to an asset, generally the US dollar. The use of stablecoins has been boosted with their promotion by the Trump administration, which last year saw passage of the so-called Genius Act giving them an official stamp of approval by setting up regulations for their use.

But according to the BIS chief the growing use of stablecoins “opens up new avenues for tax evasion.” There are estimates, he said, that stablecoins now account for most illicit transactions within the crypto system.

On their broader implications for the monetary system, he noted: “If widely adopted in their current form, stablecoins would pose policy challenges in several key areas, ranging from credit provision to monetary policy.”

In remarks to the *Financial Times* (FT), Tobias Adrian, the director of the monetary and capital market department of the International Monetary Fund, said that in some emerging market countries stablecoins already accounted for “a significant share of payments, including cross-border payments.”

The issue of the role of stablecoins and their potential to cause financial disturbances is part of a broader discussion in financial circles about what could trigger the next global financial crisis.

In the question-and-answer session during a Harvard economics class on March 30, US Fed chair Jerome Powell was asked precisely this question. His answer focused not on immediate subjects of concern, such as the role of private credit, the possibility that the massive investments in AI are a bubble which will burst or immediate problems of liquidity in credit markets, but on the longer-term stability of the US reflected in the inexorable rise in its debt.

“It will not end well if we don’t do something fairly soon,” he said.

According to Powell, the present level of debt of $39 trillion, having risen from around $9 trillion in 2007 on the eve of the global financial crisis, was sustainable but the rate of increase was not.

He did not know what was the absolute level of debt that could be maintained.

“I don’t think we know what that number is … but the ratio of debt to GDP that would be a problem—but what is clear is that federal government debt is growing substantially faster than the economy and that is the definition of unsustainable.”

Others share Powell’s views on the rise of US debt which is threatening the status of the US dollar and Treasury bonds as the safe haven for the global financial system.

“Eventually you will get a crisis where the world says safe assets are no longer considered safe, that is US

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dollar-denominated sovereign debt," Yale economics professor Andrew Metrick, who specialises in financial stability, told the FT.

"If that happens we don't really have the tools to deal with it. That's the biggest risk," he said.

The war against Iran has increased interest rates at the longer end of the market and that is set to continue as the Trump administration plans to increase military spending by 50 percent to $1.5 trillion in 2027.

"We are seeing Treasury yields going up again," Metrick said. "It is clear that we can't keep borrowing like there is no tomorrow. At some point the market will say that is enough."

There are growing issues in the short term. The European Systemic Risk Board, which monitors the European Union's financial system, has said if the Iran war continues it could trigger "sharp and disorderly asset price corrections."

In his Harvard remarks, Powell downplayed immediate risks, including from the private credit market, which has been the subject of concern of late, saying he was "relatively relaxed" about it because the risk "we know about is something we are already trying to do something about."

Others, however, are not so sanguine. S&P Global Ratings issued a report earlier this month in which it warned that the exposure of major banks to hedge funds and trading firms with high levels of debt was creating dangers.

The banks' exposure to hedge fund and trading firms runs into the trillions of dollars, the S&P report noted.

Prime brokerage borrowing, which involves lending by banks to institutional clients, mostly hedge funds to facilitate their leverage and provide the money for their activities in financial markets went over $2.5 trillion in 2024, doubling in the past four years, it said.

One of the areas of greatest activity is the so-called basis trade used by hedge funds to exploit the difference between the price of Treasury bonds and their associated futures contracts. But because the difference is so small, very large amounts of loans from banks are needed to make a large profit.

According to the S&P report: "The surge of this strategy increases second-order risks across the industry. In the event of market volatility or counterparty failure, banks' prime brokerage and securities financing desks could face substantial risks if these leveraged positions unwind rapidly."

And the longer the war on Iran continues, the greater the likelihood of increased volatility.

A recent letter to G20 finance ministers and central bankers from Bank of England governor Andrew Bailey in his capacity as the chairman of the Financial Stability Board, a global watchdog, noted that while the war had delivered a "substantial shock" to the global economy, the financial system, so far, had absorbed it.

But the letter went on to warn of vulnerabilities including: "stretched asset valuations; the build-up in the non-bank sector of high and increasingly concentrated leverage; and liquidity mismatches [the use of short-term money to finance long-term illiquid assets], opacity and growing complexity in certain markets, notably private credit."

It said there was "an increased likelihood that multiple vulnerabilities could crystallise at the same time, thereby amplifying the threat to financial stability and the provision of critical financial services."

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