War on Iran could trigger a financial crisis, European Central Bank warns

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The Financial Stability Review (FSR) issued by the European Central Bank (ECB) this week says the Iran war, combined with the other disruptions to the global economy resulting from the Trump administration, could set off a major financial crisis as it points to a series of potential triggers.

According to the report, at the start of the year the global financial system had been "remarkably resilient" despite a series of "uncertainty shocks" all of which had been set off by the Trump administration. These included the issue of Greenland's sovereignty, the US military intervention in Venezuela, the threat to US central bank independence and uncertainty over US tariff policy.

But this resilience was "now being tested by a major geoeconomic shock triggered by the war in the Middle East" which posed upside risks to inflation, downside risks to global growth which could also "increase market volatility and challenge debt servicing capacities as financing costs rise."

The numerous growing risks and potential triggers for the eruption of a financial crisis are detailed throughout the FSR. They encompass not only banks, hedge funds and others operating in the financial markets but the financial position of governments as well.

The FSR warned that "a further escalation in and/or more prolonged geopolitical tensions, along with growing concerns about the sustainability of public finances, could undermine financial market sentiment, potentially triggering an abrupt market sell-off and exposing sovereign vulnerabilities." This is a reference to the growth of government debt, dependent financing through the bond market, which has grown to record levels.

It said that liquidity and leverage in the nonbank financial sector, including "opaque" (like all other major financial institutions the ECB has very limited knowledge of what is going on in this area of the market) "could amplify any market stress through fire sales, increasing the risk of spillovers to other financial and economic sectors."

Another danger was that while euro area banks appeared to have been resilient to recent shocks, exposure to the nonbanking sector, comprising hedge funds and private credit "together with the effects of geopolitical tensions on the debt servicing capacity of borrowers, could expose credit, liquidity and funding vulnerabilities."

The immediate impact of the Iran war has been the rise of inflation and in the view of the ECB this is going to worsen.

In an interview with Reuters last week Isabel Schnabel, a member of the executive board of the central bank, said that inflation was set to rise further, reaching 4 percent by the end of the year as a result of the war.

"Our hope that this conflict would be resolved quickly has not materialized. The shock," she said, "is much more persistent and we have actually moved beyond the adverse scenario, which assumed a rapid normalization of prices with the futures curve of oil prices suggesting they are expected to remain elevated over a significant period of time."

Foreshadowing a rise in the ECB interest rate, she said that "given the size and persistence of the current shock, looking through [in which central banks treat inflation as a one-off occurrence and not a persistent trend] is no longer an option."

"From today's perspective, I think a rate hike in June will be needed," she said.

The FSR identified a number of areas that could trigger a crisis including in the development of AI. Its application could render existing business models and jobs obsolete as seen in the sharp decline in the stock prices of some large technology firms and weakness in software-related stocks.

It said that market sentiment was being driven by expected AI productivity gains with investors “pricing in a short-lived war in the Middle East.”

But it warned that energy prices could “weigh on the optimistic AI narrative, as AI infrastructure and data centers are highly energy-intensive and sensitive to persistent cost shocks.”

With inflation on the rise, global bonds are being sold off, lifting their yields or interest rate in contrast to the elevation of stock markets. The FSR characterized bond markets as a “central transmission mechanism through which adverse shocks spill over globally, including to the euro area bond markets.”

The growing presence of price-sensitive hedge funds in the euro area bond market could “amplify” an abrupt repricing of sovereign risk and raise the risk of spillovers to the funding costs of corporations and banks.

“The potential for these highly interconnected risks to materialize simultaneously, possibly amplifying each other further, increases the risk to financial stability.”

So far, it said, US treasuries had served as a safe haven, but this could change because “market concerns about US fiscal credibility as a result of persistently high fiscal deficits, expectations of higher debt service costs and high borrowing needs could lead to changing risk expectations and a repricing of sovereign risk globally.”

Increased military spending in the euro area, which the ECB completely supports while advocating cuts in other areas and expressing opposition to all but the most limited measures to combat the effects of inflation on the living standards of the mass of the population, “could strain public finances further.”

So far nonbank financial institutions had been able to weather the storm of war “but face risks from broad-based market downturns” but in an uncertain environment “sudden and correlated price drops in financial markets and spikes in volatility—potentially leading to margin calls [where banks demand more collateral from hedge funds and others to which they have lent money to finance their operations]—could quickly trigger liquidity stress.”

The growth of nonbank financial institutions and the valuation of their assets which are increasingly not market tested and the “opaque” nature of their operations, of which there is precious little knowledge let alone supervision, is of concern for the ECB as it has been for other major central banks.

“High portfolio valuations and concentrated exposures on nonbanks’ balance sheet increase the risk of forced asset sales that could amplify market stress,” the FSR said.

In a globally interconnected financial system, there is no national or regional solution to the mounting threat of a major crisis. The FSR noted that while private credit markets in the euro area remained relatively small, despite their recent rapid growth, “the risks stemming from spillover from the United States are significant,” and it could be said the same applies to every other “national” financial system.

The FSR report of the ECB is along the same lines as other analysis in the recent period. It reveals a financial system in which the potential for a crash, even more significant than that of 2008, not least because of the growth of debt and complex financial mechanisms since then, hangs over the global financial structure. And moreover, that financial authorities have very incomplete information on what is taking place and certainly no measures to deal with it.