

Dancing on Volcanoes

Johan Van Overtveldt & Dieter Van Esbroeck

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Financial stability is much more fragile these days than often assumed. At least seven developments in the financial markets demand close scrutiny by regulators and authorities. Not paying sufficient attention to them risks big trouble down the road.

With most of our attention focused on Ukraine, Iran, Greenland, Venezuela, the worrying movements on the international geopolitical scene and of course the many trade-related discussions and threats, **we tend to overlook issues related to financial stability**, although, evidently, the latter is certainly also influenced by those other manifold issues and problems of today. With the memory of the **Great Financial Crisis** (GFC) of 2008 receding more and more – as the memories of such painful events always tend to do over time – it is most useful to remember **that financial stability is like electricity or clean water: one only fully realizes how important they are once they go missing.**

Financial stability is a cornerstone of economic progress, societal resilience and political democracy. While there is no immediate need for dark doom-mongering with respect to financial stability, there is certainly no place for smug complacency either. Potential sources of financial stability are relatively easy to detect these days. **We summarize the possible volcanic outbursts in**

seven points emphasizing thereby that financial instability often works through a **chain reaction**: an explosion in one corner of the financial markets easily ignites wildfires in other corners. Hence the importance of being alert and avoid the process from getting started in the first place.

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Credit migration

First, there is the rise to prominence of private credit firms which are part of the so-called NBFIs (Non-Bank Financial Institutions). This relatively new phenomenon of private credit firms is now estimated to account for at least \$2 trillion of outstanding credits. While this represents only a tiny fraction of the overall credit volume outstanding, the sums involved are nevertheless sufficiently large to warrant close attention. The NBFIs as a whole stood in 2023 at no less than 43 trillion euros in assets, representing 41% of the EU financial sector’s assets.

The major NBFIs include investment funds, pension funds, insurance companies, leasing companies, and mortgage brokers. After the GFC and the subsequent eurozone debt crisis, the regulatory framework for traditional banks was rightly tightened with a focus on larger and more solid capital and liquidity buffers. Regulatory arbitrage is a fact of life and hence it can be no surprise that credit activity migrated to areas with less stringent regulations, leading to an explosion in credit activity by NBFIs.

Regulators have only a fragmentary understanding of the real risks and excesses percolating in the NBFIs sphere. Moreover, traditional banks and the

NBFIs are interlinked through a patchwork on funding that runs in both directions. Sufficient insight into these links is sorely lacking as illustrated by a recent report of the BIS (Bank for International Settlements). According to the European Central Bank (ECB), the connections between NBFIs and traditional banks are concentrated in a small group of systemically important banks. Unrest or worse in the NBFIs sector can easily spread to the traditional banking sector and vice versa. It is of vital importance to gain more systematic insights into the risks associated with these developments.

A specific trend in the private credit sector that should draw the attention of regulators relates to the so-called *continuation deals* whereby NBFIs sell debt to themselves as a new way to generate cash on the basis of outstanding loans to highly leveraged companies that are often owned by private equity firms. Such deals amounted to at least \$15 billion in 2025, a volume much larger than the \$4 billion of 2024. The growth in continuation deals has much to do with investors showing increasing concerns over credit quality. There is a Ponzi-scheme-like smell hanging over many of these continuation deals.

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Cryptocraze

Secondly, a really dark corner of finance is the sector of **cryptocurrencies**, digital alternatives to fiat money such as dollars and euros. The crypto-phenomenon is based on blockchain technology that allows users to transact directly without intermediaries such as for example banks. It was indeed, in the slipstream of the trust-busting GFC, the early crypto pioneers’ intention to

democratize finance by breaking the iron grip of central and large commercial banks on financial intermediation. **This ideal has however been largely subverted by subsequent developments.**

Different elements make cryptocurrencies a potentially systemic risk to the entire financial system. They are completely speculative since their value depends solely on investors' expectations of future prices for these vehicles. Hence the huge ups and downs in the value of such vehicles as the Bitcoin price gyrations clearly show. This volatility makes them totally unsuited as a medium of exchange, one of the core functions of money. The practical day-to-day use of cryptocurrencies has also been much hindered by their inability to process large volumes of transactions cheaply.

Furthermore, cryptocurrencies fuel undesirable and even outright destructive activities. Tax evasion and money laundering are evidently facilitated through these crypto-vehicles because of user anonymity, the global reach of the networks and the easiness with which addresses can be changed each time a transaction is executed. Several spectacular, highly sophisticated cases of cross-border money laundering through the use of cryptos have already been discovered by the authorities.

Countries under economic and financial sanctions from the Western world, as well as larger international criminal organizations, increasingly utilize cryptocurrencies to hide from tax and legal authorities. In addition to money laundering, also terrorism financing, drug trafficking, mala fide interference with democratic processes and other illegal activities have all been able to progress dangerously thanks to the dark world of cryptocurrencies and crypto-assets.

A whole new vocabulary has emerged in the slipstream of cryptocurrency activity: money mule accounts (accounts used by criminals in someone else's name), tumblers (actors who combine multiple transactions to complicate

traceability), privacy coins (that further enhance anonymity and obscurity), smurfing (the technique of breaking down payments into smaller payments to avoid detection), etc. Especially law enforcement authorities are increasingly, and understandably, pleading for an outright ban on cryptocurrencies. Their economic and societal added value is negligible, if not even entirely zero, when compared with the disadvantages and negative effects.

(Un)Stablecoins

Thirdly, the rapid expansion of **stablecoins**, particularly in the US, creates opportunities for innovation but also carries important risks. The stablecoin sector amounts to something like \$300 billion early in 2026 but several estimates see its value increase to between \$2 and 3 trillion by the end of this decade. Stablecoins offer in principle a more reliable medium of exchange than cryptos. Their value is underpinned one-to-one by traditional currencies and/or governments bonds. Stablecoins make use of the same blockchain technology as cryptocurrencies but whereas in the cryptos' case a computer algorithm validates the transactions, it is the stablecoin issuer who does this in the case of stablecoins.

Stablecoins undoubtedly offer important potential advantages. They can help to democratize finance by decentralization and easier access to digital payments. They have also already led to substantial downward pressure on the costs of financial transactions and shortened the time interval between payment and reception of funds. Especially the fundamental shift in the regulatory climate in Washington under the Trump administration has led to a steady expansion in the issuance of stablecoins. **However, the risks involved in this development are not to be underestimated.**

There is, to start with, the risk of further **concentration and even monopolization** if and when the large tech companies like for example Meta and Amazon would join in. Given their size and financial firepower such players could easily sweep away smaller issuers. Furthermore, stablecoins offer the possibility to deepen further problems associated with cryptocurrencies like **illicit activities**, terrorism financing and money laundering.

Another risk related to stablecoins is what Adam Posen, President of the reputed Peterson Institute for International Economics, has labelled, with a nod to the “too big to fail” syndrome, the problem of “**too connected to fail**”. In the US there is the reality of President Trump and his family and several of close associates having invested substantial sums in stablecoins, creating the impression among investors that a government rescue in case of trouble is highly likely. Hence overinvestment and a bubble being blown up. Additionally, there is the weakening by the Trump administration of the regulatory agencies augmenting the risk of all this going (very) wrong.

The lack of adequate supervision of stablecoins has led Jean Tirole, the 2014 laureate of the Nobel Prize in Economics specializing in financial regulation, to argue that he is “very, very worried” about stablecoin supervision. More specifically, he fears that at one point “massive government bailouts” might be required. The danger can come from different angles. First there is the risk of decline in value of the underlying assets. The more US government bonds are piled up inside stablecoins the more massive will be the effect if these bonds lose value. It is quite evident that active promotion of stablecoins by the Trump administration is linked to the large budget deficits and the accompanying debt pile-up that needs to be financed. The second risk is linked to the fact that several private companies issuing stablecoins are also engaged in other business

activities, including investments in ... cryptocurrencies. Problems in one activity can easily spill over into the stablecoin business of such entities.

Independent they stand

Fourthly, the independence of central banks is under pressure, most notably in the United States. The actions and verbal outbursts of President Trump against the Fed and its current leadership not only undermine the internal financial stability of the United States but also have major international implications, given the dominant role of the dollar. With the choice of Kevin Warsh as next Fed chairman, the President clearly tried to contain the markets' fear of ending up with a Fed submissive to the demands of the White House. It will have to be seen whether chairman Warsh and his steering committee (the FOMC, Federal Open Market Committee) will give in or not to Trump's extravaganza in matters of monetary policy.

In a fiat money world the credibility of a central bank and the trust it enjoys from the citizenry are crucial assets for a central bank to be able to live up to its task of preserving price stability and financial stability. Direct political interference into the workings of the central bank, as Trump has been trying to do continuously during the past year is highly destructive for that credibility and trust. History is replete with examples that show that direct political meddling with central bank independence always leads to inflation and financial instability.

With respect to the international repercussions of the Trump attack on the Fed two elements need to be mentioned. First of all, loss of trust in the Fed will cause financial markets to shy away from American assets like US Treasuries and the dollar. If pronounced such moves will be destabilizing, not only for the US but for the rest of the world too. Secondly, Trump has on several occasions

threatened to make the Fed withhold from opening dollar credit lines to other central banks in the world. Such a refusal would have dire consequences, most certainly so during periods of crisis and hypertension in the markets. During the GFC of 2008 the availability of such dollar swap lines was crucial in the fight to get that crisis under control.

The independence of central banks becomes more crucial the more we see a relentless debt build-up in the world. More specifically, rising public debt levels augment the risk of *fiscal dominance*, i.e. the risk that fiscal needs and debt financing complications will increasingly dictate monetary policy. **History shows that such fiscal dominance always ends in tears.**

No limit?

Fifthly, the continuous **debt escalation** referred to under the point above has unfortunately become a sad reality. The most comprehensive overview of the overall debt level in the world is produced regularly by the Institute of International Finance (IIF). In its most recent *Global Debt Monitor*, dated December 5, 2025, the IIF calculated that during the first nine months of 2025 worldwide \$26 trillion was added to the debt stockpile which reached at the end of September last year \$346 trillion or 310% of worldwide GDP. By far the largest increase in the overall debt ratio of a country happened in China where in one year's time an increase of the overall debt ratio to 338% of GDP took place or an increase of 10 percentage points (pp).

Whereas, as a percentage of GDP, household, corporate and financial sector debt declined slightly, public sector debt increased by a full 2 percentage points of GDP. The world has not seen global public debt levels as those of today since the Napoleonic wars of the early 19th century. The largest increases in

public debt are to be found in China (from 87% of GDP to 96.5%) followed by Brazil (+ 6pp), France (+ 3.7pp), Italy (+ 2.9pp), the US (+ 2.7pp). As a side remark: Argentina realized a *reduction* in its public debt ratio from 90.7% of GDP at the end of the third quarter of 2024 to 76.7% of GDP one year later.

The pace of the expected increase in defence spending, the burden of demography related outlays and the reluctance to cut other expenditures leads in the tongue-in-cheek IIF phraseology to the conclusion that “investor attention is increasingly shifting toward government bond auctions and government borrowing plans ... Some countries in Europe may be in a particularly challenging position, with limited room to raise additional government revenue given that they already have some of the highest government revenue-to-GDP ratios in the world”.

The IIF also warns in its latest Global Debt Monitor for the “new corporate debt wave on the horizon”. Especially clean-tech firms and even more so AI-linked companies will be the main drivers of a substantial surge in borrowing. This brings us seamlessly to our next potential financial volcano.

The bubble-like nature of AI

Sixth, the global investment boom in **Artificial Intelligence** (AI) is immense. This is a very demanding investment boom since it is wrong to think that AI is only a technology that lives in the cloud and thinks in code. As Thijs Van de Graaf, professor of international politics at the Ghent University, recently pointed out: “Behind every chatbot or image generator lie servers that draw electricity, cooling systems that consume water, chips that rely on fragile supply chains and minerals dug from the earth”.

According to Goldman Sachs Research (GSR) capital expenditures on AI and the related infrastructure amounted to \$250 billion in 2024 and \$400 billion last year. For this year AI investments to the tune of \$525 billion are expected but GSR points out that in recent years estimates of AI investments increased gradually as the year progressed. That happened in 2024 when the initial forecast was \$200 billion and even more pronounced in 2025 with an initial forecast of \$250 billion AI investments. **Markets are increasingly questioning whether these huge investments will be able to produce the revenues needed to cover the consequences of this boom.**

AI will undoubtedly play a critical role in the way in which our technological, economic, social and even political future will work out. Estimates and forecasts of AI's impact on productivity, job opportunities and economic growth in general diverge widely. There is at least as much uncertainty with respect to the answers on questions related to fundamental ethical and human concerns linked to AI developments.

However, this investment boom will also likely lead to significant failures and financial losses over time. Major bets are being placed these days on certain types of AI development paths and some of these bets will turn out to be complete failures. The more we see an investment boom being pushed forward by borrowing, the more devastating the ultimate consequences of the bursting of the bubble will be. As indicated by the IIF but also by, among others, the BIS, the amount of borrowing needed to finance the AI investment boom is increasing at a fast and even accelerating pace.

Cyber(in)security

Seventh, the risk of highly destructive **cyberattacks** on our financial infrastructure increases daily. The effects of such cyberattacks, if successful, would be devastating. In the recent past the so-called *Salt Typhoon* cyberattack on American infrastructure came close to being a complete disaster. It was soon shown quite convincingly that Chinese operators were behind this major cyberattack.

Substantial investments in mechanisms to fend off such attacks are essential. At the EU level we have to be especially careful since the solidity of our cybersecurity is determined by the weakest link in the chain. A major attraction of cyber onslaughts for our enemies is the ever-present “plausible deniability”, meaning that it is almost always very difficult to determine with certainty who was the *real* initiator of the attack.

In conclusion, major risks to financial stability are a reality. At the moment these risks behave largely like volcanoes do most of the time: some beneath the surface rumbling but with a risk of sudden, often unexpected and most of the time destructive outbursts. Authorities and regulators need to beef up their attention to these risk areas, especially in a world where algorithmic trading represents two-thirds of overall trading volumes. Minor shocks and tensions tend to be amplified in such an automated trading environment. Short reaction times always complicate the fight against major outbursts of financial instability.

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