Research on the Impact Pathways of European Sovereign Debt Default Risk on China's Financial Stability

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Abstract: Since the 1980s, global sovereign debt crises have undergone a significant shift from emerging economies to developed economies, with their influence continuously strengthening and their scope expanding from initial regional impacts to a global scale. Entering the new century, China has rapidly expanded its foreign economic cooperation and creditor relationships through initiatives such as the "Belt and Road," becoming an important participant in global economic governance. As of 2023, China has become a major creditor to several European countries, holding substantial amounts of European sovereign bonds. This close financial linkage makes the new wave of European sovereign debt risks highly relevant to China, as potential sovereign debt defaults could impact China's financial stability through multiple channels. This study will analyze the pathways through which European sovereign debt default risks affect China's financial stability, aiming to provide theoretical foundations and practical guidance for formulating relevant policies.

Keywords**:** European sovereign debt; default risk; financial stability

1. Introduction

According to the OECD's "Global Debt Report 2024," the total government debt of OECD countries reached $54 trillion by the end of 2023, an increase of $30 trillion since 2008. The IIF's "Global Debt Monitor" report highlights that global debt amounted to $313 trillion in 2023, a $15 trillion rise compared to 2022, with government debt accounting for $89.9 trillion. Approximately 55% of this debt is concentrated in mature markets such as the United States, France, and Germany, while debt accumulation in emerging markets like China, India, and Brazil has also been significant. Mature markets collectively accumulated $208.3 trillion in debt, $103.7 trillion more than the $104.6 trillion in emerging markets.

Table 1. Global Debt Scale in 2023 (Unit: Trillion USD)

Strillion	Households		Non-financial coporates		Government		Financial sector		Total	
	Q4 2023	Q4 2022	Q4 2023	Q4 2022	Q4 2023	Q4 2022	Q4 2023	Q4 2022	Q4 2023	Q4 2022
Mature markets	40.2	39.0	50.7	49.4	61.7	58.3	55.6	53.3	208.3	200.0
Emerging markets	19.1	18.0	43.6	40.7	28.2	25.3	13.8	13.8	104.6	97.7
Global	59.3	57.0	94.4	90.0	89.9	83.6	69.4	67.1	313.0	297.7

2. Brief Description of Relevant Implications

In a narrow sense, sovereign debt refers to government external debt, which is financing obtained from international markets (foreign governments, financial institutions, etc.) under sovereign credit guarantees; in a broad sense, it encompasses the total of government internal and external debt. Sovereign debt default occurs when a government fails to repay its debt on time, while a sovereign debt crisis arises when high levels of debt lead to a sudden increase in default risk, causing a sharp rise in government bond yields within a short period[1]. From the 1980s to before the European debt crisis, the international community primarily focused on dollar-denominated external debt defaults in developing countries (narrow sovereign debt issues); after 2010, the problem of government debt defaults in developed countries became prominent (broad sovereign debt issues).

3. Analysis of the Causes of Sovereign Debt Default

The analysis of sovereign default events is presented in Table 2, which lists some countries that experienced sovereign debt defaults between 1998 and 2021 along with their reasons for default. Except for defaults triggered by isolated incidents, most sovereign defaults were the result of a combination of factors, including debt crises, currency crises, fiscal crises, economic crises, political crises, and insufficient government willingness to repay debts[2].

Table 2. List of Sovereign Countries That Experienced Defaults from 1998 to 2021

Defaulting Country	Year of Default	Default Amount (in billion USD)	Currency of Default	Regional Distribution	Reasons for Default
Russia	1998	727.09	Foreign currency, domestic currency	Europe	Financial crisis, debt crisis
Venezuela	1998	2.70	domestic currency	Latin America	delayed payment
Ukraine	1998	12.71	Foreign currency, domestic currency	Europe	currency crisis
Pakistan	1999	16.27	foreign currency	Asia	debt crisis
Côte d'Ivoire	2000	156.00	foreign currency	Africa	political crisis
Argentina	2001	822.68	Foreign currency, domestic currency	Latin America	economic crisis, debt crisis
Uruguay	2003	57.44	foreign currency	Latin America	currency crisis
Belize	2006	2.42	foreign currency	Latin America	debt crisis
Ecuador	2008	32.10	Foreign currency, domestic currency	Latin America	weak government willingness to repay debts
Côte d'Ivoire	2011	23.00	foreign currency	Africa	political crisis
Belize	2012	5.47	foreign currency	Latin America	weak government willingness to repay debts
Cyprus	2013	13.11	Foreign currency, domestic currency	Europe	economic crisis
Venezuela	2020	500.00	foreign currency	Latin America	Currency crisis□economic crisis
Samoa	2021	1.00	foreign currency	Oceania	-

4. Analysis of the Pathways through which European Sovereign Debt Default Risks Impact China's Financial Stability

4.1 International capital flow channels

The theory of international capital flows indicates that under normal circumstances, capital moves from countries with abundant resources to those with scarcity. However, during sovereign debt crises, special patterns emerge:

Taking the US dollar as an example, in the initial stages of a crisis, international capital tends to flow into the US as a safe haven, driving the appreciation of the dollar. This trend reinforces itself, exacerbating the risk of capital outflows from crisis-hit countries. Historical data shows that during the 1980s Latin American debt crisis, the 1997 Asian financial crisis, the 2009 Dubai crisis, and the 2010 European debt crisis, the US dollar index significantly rose. Even China, with its relatively low risk, could not completely avoid short-term capital outflows.In the later stages of the crisis, capital begins to flow out of the US. On one hand, the decline in asset prices in crisis countries creates "value depressions," and on the other hand, the US may implement loose monetary policies. The expectation of dollar depreciation accelerates capital outflows. Emerging markets face greater impacts from capital flow fluctuations in the short term, exhibiting clear "short-term vulnerability," which affects China both in the short and long term.

4.2 Import and export trade channels

Sovereign debt crises can have a dual impact on China's economy through trade channels. On the export side, the contraction in consumer demand in crisis-hit countries directly affects China's exports. Developed countries, as the primary global consumer markets, experience a sharp decline in import demand during debt crises; if emerging markets simultaneously face external debt crises, China's exports will face even greater pressure[3]. .On the import side, fluctuations in the yuan's exchange rate have differential impacts. The initial depreciation followed by appreciation of the yuan during crises affects various industries to varying degrees. Data shows that import prices for industries such as coal and paper are more sensitive to exchange rate changes, while labor-intensive industries like textiles and chemicals are also affected to some extent.

4.3 Price fluctuation channels

Global commodities are mostly priced in US dollars, and during sovereign debt crises, fluctuations in the US dollar index can lead to instability in global commodity prices, thereby exerting imported deflationary and inflationary pressures on

China.In the initial stages of a crisis, the appreciation of the US dollar causes imported deflation. Since the 2008 international financial crisis, China has experienced imported deflation multiple times due to the appreciation of the US dollar, as the stronger dollar led to a decline in global commodity prices, shifting imported inflation in emerging countries to imported deflation. After the initial crisis phase, the depreciation of the US dollar brings imported inflation. As the crisis transitions, the US dollar weakens, and the US initiates quantitative easing policies, causing global commodity prices to rise. The depreciation of the US dollar drives up global commodity prices, and the consequences of the US's loose policies are shared globally, bringing imported inflation to emerging countries.

5. China's Strategies to Address Sovereign Debt Default Risks

5.1 During special periods, a "peg to the US dollar" exchange rate policy can be initiated

The US dollar holds a dominant position in the international monetary system. In an open economy, when the US dollar appreciates, emerging countries become the "ATM" for developed nations; when the US dollar depreciates, developed countries turn into the "money printers" for emerging nations. Once a global sovereign debt crisis erupts, the US dollar enters an appreciation phase, international capital flows back to the United States, and the currencies of emerging countries depreciate accordingly, leading to continuous capital outflows. The external debt crises in emerging countries indicate that, in cases of severe capital flight, stabilizing capital is more critical than stabilizing trade[4]. Currently, China implements a managed floating exchange rate system based on market supply and demand, with reference to a basket of currencies. In the event of a global sovereign debt crisis, a "pegged to the US dollar" exchange rate policy could be initiated during exceptional periods.

5.2 Establishing a government debt ceiling

Although China faces extremely low external debt risk and relatively low government debt risk, it is still necessary to impose a debt ratio ceiling to constrain government debt. Firstly, set a debt ratio ceiling for local governments at no more than 60%. The European Union stipulates that the government debt ratio of its member states should not exceed 60%, and China can refer to this standard for local government management. Secondly, establish a ceiling for China's government debt ratio that does not exceed the average of the Bank for International Settlements (BIS) sample. As of March 2021, the average of the BIS sample was 103.8%, while China's government debt ratio was 66.7%. Even if the central and local governments increase leverage, the cumulative debt ratio should be ensured to remain within this average. Finally, set a ceiling for implicit debt. China's local government implicit debt ranges between 30 trillion and 50 trillion yuan. If this debt is included, China's government debt ratio might exceed the warning line. Therefore, it is essential to strictly regulate local government guarantees for debt issuance.

5.3 Managing Inflation and Deflation Expectations Effectively

In the management of inflation expectations, monetary policy should play a central role by setting boundaries for the quantity and price of incremental money supply. The People's Bank of China follows the empirical formula of "M2 growth rate = GDP growth rate + CPI + 2% to 3%." In the future, the M2 growth rate can be flexibly adjusted based on GDP and CPI expectations, while tools such as targeted reserve requirement cuts and lending facilities can be utilized to enhance policy precision. In terms of price-based tools, the deposit interest rate can be moderately reduced, maintaining a rate 1% higher than that of the United States, while also mitigating the risk of capital outflows. In managing deflation expectations, a dual approach targeting both demand and supply is necessary, with a comprehensive effort to expand domestic demand and build a new development paradigm centered on domestic circulation, supported by both domestic and international circulations. By driving progress in production, distribution, circulation, and consumption, domestic circulation can be streamlined, consumption can be upgraded, investment can be optimized, and private investment vitality can be stimulated.

6. Conclusion

In today's increasingly interconnected global economy, the European sovereign debt crisis has demonstrated immense destructiveness and widespread contagion. The fiscal deficits and debt pressures of major developed economies continue to grow and escalate, while aging population structures increasingly demand enhanced social welfare policies, inevitably leading to worsening fiscal conditions. Implementing robust fiscal measures, alongside strengthening reforms in welfare and taxation systems and enhancing macro prudential regulation, is urgently needed for highly indebted economies.

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