

The Political Economy of Debt Maturity and Sovereign Default Risk^{*}

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Abstract

This paper studies how political conflict shapes sovereign borrowing, default and debt maturity. We develop a dynamic politico-economic theory where the accumulation of short- and long-term sovereign debt arises from an intergenerational conflict between workers (the young), who favor fiscal discipline, and retirees (the old), who favor high public expenditures financed through labor income taxes and debt accumulation. Subsequent generations of young and old voters elect a new government in every period. Incumbent government have neither commitment to future policies nor to current debt repayment. Default risk stems from a stochastic cost of default. Our main theoretical contribution is to show that, even in the absence of income risk, the debt maturity structure is determinate in the political equilibrium: short- and long-term debt is issued, and the maturity of issued debt shortens during debt crises. This result contrasts with existing normative theory showing that governments facing no income risk should remain passive in long-term bond markets.

The key mechanism operates through debt dilution and the fiscal discipline of the young. For a given value of outstanding debt, a maturity structure with legacy long-term debt raises the marginal revenue from new issuance, because additional borrowing lowers the value of legacy bonds. Governments therefore borrow more, spend more

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