

Applying the Concept: The History of Government Bonds

While private debt has been in existence for thousands of years, government debt as we know it is a relatively recent phenomenon. We can trace the roots of public borrowing to the Republic of Venice in the 12th century. The Venetians issued interest-bearing debt secured by revenue from the state-owned monopoly on salt. Over the centuries, this developed into a system in which future salt tax revenues were sold at auction.

But it wasn't until the sixteenth century that government debt financing started to take off.¹ This was when the Dutch republic, in order to finance their lengthy war of independence against Spain, was able to issue bonds secured either by specific tax revenues or by the general credit of the state. These Dutch bonds promised fixed annual coupon payments into the indefinite future, never repaying the principal borrowed – what we call *consols* or *perpetuities*. Interest rates were initially around 8 percent, but fell as the trust in the government increased. (Remember, risk requires compensation so the lower the risk, the higher the price; and the higher the price, the lower the interest rate.) Since they offered an indefinite flow of interest payments, the Dutch consols became popular among wealthy families who would buy them with the idea that they could live comfortably off the income for generations.

The success of the Dutch system led to its inevitable adoption by other countries, including the British, who were able to solve one of the major problems that existed in the Dutch system. While marketable in principle, each of the Dutch bonds represented a unique contract. Lack of standardization limited trading. In the middle of the 18th century, the English converted the majority of the outstanding debt to a single issue of consols, making them interchangeable. Concern over standardization led the British to replace their 1726 and 1751 issues with the 2½ percent perpetual bonds of 1853 that you can still buy today.

¹ For a detailed description of the evolution of public debt and its consequences, see Naill Ferguson, *The Cash Nexus*, New York: Basic Books, 2001.