Order Code RS21046
Updated January 8, 2002

CRS Report for Congress

Received through the CRS Web

War Bonds in the Second World War: A Model for a New War Bond?

James M. Bickley
Specialist in Public Finance
Government and Finance Division

Summary

During the Second World War, war bonds were sold to help finance the cost of national defense. War bonds were simply a new name for already existing U.S. savings bonds. War bonds were aggressively marketed through well organized campaigns, which appealed to citizens' sense of patriotism. The primary purpose of their issuance was to reduce consumer spending in order to lessen inflationary pressures and black market activity. Also, campaigns to sell war bonds were intended to raise morale by creating a sense of participation in the war effort. The sale of war bonds did reduce consumer spending.

Current economic and financial conditions differ from those of the early 1940s. During the Second World War, high inflation and over employment prevailed. The federal government imposed price and wage controls, production controls, rationing, controls on the level of interest rates on Treasury securities, and regulations on installment loans. War bonds were marketed to reduce consumer spending. Today, although there is concern about the low personal savings rate, many federal officials are more concerned about maintaining consumer spending. Nevertheless, during the first session of the 107th Congress, both houses of Congress considered and passed differing measures authorizing the sale of war bonds to help give the public a greater sense of participation in the war effort and to provide revenues that could be earmarked for disaster relief and anti-terrorist actions. On December 11, 2001, the Department of the Treasury designated Series EE savings bonds as "Patriot Bonds," whose purpose is "to fight the war on global terrorism." This designation will likely forestall further congressional legislative action. This report will not be updated.

The recent terrorist attacks have resulted in congressional interest in the concept of the sale of a Treasury security to finance recovery and relief operations and anti-terrorist actions. During the first session of the 107th Congress, several bills were introduced in Congress that authorized the issuance of bonds in response to the terrorist attacks. H.R. 2930 would "provide for creation of a Counter-terrorism Trust Fund, ... provide for the issuance of Freedom Bonds, ... [and] allow taxpayers to contribute income tax refunds and other amounts to support counter-terrorism efforts ...." H.R. 3021 would "authorize the issuance of United States Defense of Freedom Bonds to aid in funding the war against terrorism ...." S. 1432 would "authorize the issuance of United States Defense of Freedom Bonds to aid in the funding of the war against terrorism ...."

S. 1430 would "authorize the issuance of Unity Bonds in response to the acts of terrorism perpetrated against the United States ...." S. 1431 would "authorize the Secretary of the Treasury to issue war bonds in support of recovery and response efforts ...." Both S. 1430 and S. 1431 were introduced and approved as amendments (S.Amdt. 1574 and S.Amdt. 1573, respectively) to the Senate version of H.R. 2590, the "Treasury and General Government Appropriations Act of 2002," which passed the Senate on September 19, 2001. However, the war bond amendments were deleted from the final legislation that passed as P.L. 107-67 on November 12, 2001.

H.R. 2899 would "authorize the Secretary of the Treasury to issue Freedom Bonds in response to the September 11, 2001, hijackings and attacks on the Pentagon and the World Trade Center ..." On October 23, 2001, H.R. 2899 passed the House, was received in the Senate, and was referred to the Senate Committee on Finance. On December 11, 2001, the Department of the Treasury designated Series EE savings bonds as "Patriot Bonds."[1]

In response to congressional interest, this report describes war bonds during the Second World War, examines their relevance as a model for a new war bond, and presents policy options.

War Bonds in the Second World War

On March 1, 1935, the first savings bonds (Series A) were issued to provide a savings instrument for small savers and to lower interest costs to the Treasury by expanding the potential market for Treasury securities.[2] This bond was registered and accrued interest at a fixed rate until redeemed. Series B, C, and D, which were similar to Series A, were issued subsequently.

Before the Second World War started in Europe, the U.S. economy was still in the Great Depression; hence, unemployment was high, unused productive capacity was extensive, and wholesale and retail prices were declining. After war started in Europe on September 1, 1939, the United States increased defense spending, which was financed by new and higher taxes, cuts in nondefense spending, and an expansion in the national debt. On March 11, 1941, Congress passed the "Lend–Lease Act", which empowered the

---

[1] U.S. Department of the Treasury. Treasury Department Unveils Patriot Bond on Anniversary of September 11 Attacks, *Treasury News*, Dec. 11, 2001, p. 1.

[2] U.S. Dept. of the Treasury, Savings Bond Division, *A History of the United States Savings Bond Program* (Washington: Sept. 1984), p. 5.

President to provide defense material to foreign governments "whose defense the President deems vital to the defense of the United States."[3]

Despite higher taxes and cuts in nondefense spending, the large increase in defense related spending plus the absorption of a significant proportion of the manpower pool by the armed forces, began generating inflationary pressures as unemployment fell and unused plant capacity diminished. The U.S. Government attempted to lessen inflationary pressure by encouraging the general public to buy savings bonds, which were now called "defense bonds."[4] On May 1, 1941, the Treasury issued a new savings bond (Series E).[5] Because of the comparatively high rate offered on these securities, a limit of $5,000 (maturity value) was placed on the amount one person could acquire in any one calendar year.[6]

After the United States entered the Second World War in December 1941, defense spending soared. Savings bonds were renamed "war bonds." During the Second World War, existing taxes were raised, new taxes imposed, and price and wage controls implemented. In addition, production controls were instituted and a rationing system established. The production of many consumer products such as automobiles and refrigerators ended. Controls were imposed on consumer credit and stock market credit.[7]

The Treasury and the Federal Reserve fixed interest rates on Treasury securities at low levels to keep interest costs low. The Federal Reserve conducted an "easy" money policy; hence, the banks had plenty of reserves. Although this policy kept interest costs low, it contributed to inflationary pressures because the money supply expanded.

As war production expanded, inflationary pressures increased dramatically. Rising employment and extensive overtime resulted in surging growth of wage incomes. Despite higher taxes, workers had more disposable income. In order to assist in lessening inflationary pressures and reducing black market activity, the War Savings Staff at the Treasury managed a series of eight war loan drives. Employees were encouraged to purchase war bonds through payroll deduction plans.

While the general population purchased war bonds, the U.S. government decided to promote the purchase of Treasury market-risk securities (notes, bills, bonds, certificates, and tax notes) to large individual and corporate investors.[8] These market-risk securities were simply regular Treasury marketable securities; that is, they were bought and sold on financial markets. Victory Fund Committees consisting of bankers and members of the securities industry were established in each Federal Reserve district to assist the Treasury

---

[3] Paul Studenski and Herman E. Krooss, *Financial History of the United States* (New York: McGraw–Hill Book Company, Inc., 1963), p. 441.

[4] U.S. Dept. of the Treasury, Savings Bond Division, p. 11.

[5] For a description of E Bonds, see: *Questions and Answers about War Savings Bonds*, [http://www.ww2homefront.com/topics-bonds.html], visited Sept. 26, 2001.

[6] Ibid., p. 7.

[7] Margaret G. Myers, *A Financial History of the United States* (New York: Columbia University Press, 1970), pp. 333–359.

[8] U.S. Treasury, Savings Bond Division, p. 15.

in marketing both war bonds and market-risk securities, which were called "victory loans."[9] Henry Morgenthau, Secretary of the Treasury, combined the War Savings Staff managed by the Treasury and the Victory Fund Committees into a new organization called the War Finance Division, which reported to the Treasury.[10]

> From May 1, 1941 through December 1945, the War Finance Division and its predecessors were responsible for the sale of nearly $186 billion worth of government securities. Of this, more than $54 billion was in the form of War Savings bonds. E Bonds alone accounted for $33.7 billion.[11]

According to most economic historians, the war loan drives were successful in encouraging the average workers to purchase war bonds and those with greater financial resources to purchase victory loans. These sales absorbed potential consumer spending that would have exacerbated inflation and expanded black–market activity. The purchase of war bonds represented much new net savings because small savers had limited alternative saving instruments.

The war loan drives had a strong patriotic appeal, involved 6 million volunteers, and utilized extensive donated advertising. Each war loan drive

> ... was a unique fusion of nationalism and consumerism. Seeking to stir the conscience of Americans, it invoked both their financial and moral stake in the war. The sale of war bonds provided a way in which patriotic attitudes and the spirit of sacrifice could be expressed.[12]

Neither war bonds nor victory loans were earmarked for defense spending. During the Second World War, however, defense related spending reached over 90% of federal outlays.

Current Savings Bonds

Today, three series of savings bonds are being issued.[13] Series EE is the dominant series as measured by sales.[14] Effective May 1, 1997, Series EE bonds earn a variable interest rate. EE bonds earn interest based on 90% of the average yields on Treasury securities maturing in five years over the preceding six-month period. Interest accrues

---

[9] Ibid.

[10] Ibid.

[11] Ibid.

[12] War Bonds (Loans), *World War Two Advertising History*, A project of the Digital Scriptorium: Rare Book, Manuscript, and Special Collections Library, Duke University, [http://scriptorium.lib.duke.edu/adaccess/.html], visited Oct. 9, 2001.

[13] For current information on U.S. savings bonds, see U.S. Savings Bonds Online, [http://www.publicdebt.treas.gov/sav/sav.htm], visited Oct. 9, 2001.

[14] For background information on variable rate EE bonds, see CRS Report 97-605, *Savings Bonds with Variable Rates: Background, Characteristics, and Evaluation*, by James M. Bickley.

monthly and compounds semiannually and is payable at the time of redemption. The bond owner has the option of either deferring income taxes on interest earnings until the time of redemption or paying federal income taxes as interest accrues.

Series HH bonds are current income securities that pay interest every six months. The interest rate is set at a fixed rate on the day the bond is purchased. HH bonds cannot be purchased. They can be obtained only in exchange for Series EE, Series E, and savings notes, or upon reinvestment of the proceeds of matured Series H bonds. The owner of HH bonds has the option of continuing to defer paying federal income taxes on the interest accrued on the exchanged EE/E bonds or savings notes.

Series I bonds are securities that accrue earnings based on both a fixed rate of return and a semiannual inflation rate. A single, annual rate, called the composite rate, reflects the combined effects of the fixed rate and the semiannual inflation rate. The fixed rate is selected by the Treasury and is in effect when a bond is issued and applies until the bond matures. The semiannual inflation rate reflects the percentage change in the CPI–U (Consumer Price Index for All Urban Consumers).

Current Economic and Financial Conditions

The present economy is vastly different from that of the Second World War. War bonds were then marketed to reduce consumer spending. The current economy, however, has a low rate of inflation and rising unemployment. No controls exist on prices, wages, production, interest rates on marketable Treasury securities, or installment loans. No goods and services are rationed. Instead of attempting to reduce consumer spending, many federal officials are concerned about maintaining consumer spending.

Currently, the U.S. economy is in a recession with rising unemployment and declining real gross domestic product. The Federal Reserve has implemented an expansionary monetary policy through numerous reductions in the federal funds rate and an increase in the rate of growth of the money supply. Many macroeconomists are advocating federal actions to raise aggregate demand such as further interest rate cuts, increased federal spending, and additional tax cuts.

Moreover, the U.S. financial system is more complex, sophisticated, diverse, and deregulated than in the World War Two era. Small savers have an array of savings vehicles. For example, they can invest funds in money market funds and certificates of deposit (CDs) of financial institutions. Today savings bonds are almost always a substitute mechanism for personal savings. From that perspective, the sale of "war bonds" would be expected to have minimal effect on national savings and the economy.

Policy Options

The Treasury Department's designation on December 11, 2001, of Series EE savings bonds as "Patriot Bonds," to contribute to the war on global terrorism, will likely forestall further congressional legislative action. Congress could still pass legislation to achieve the same purpose, or it could rely on charitable donations. A brief discussion of these two options follows.

Create a War Bond

Congress could decide that a specific statutory endorsement of the decision to issue "Patriot Bonds" (perhaps under a different name) would add to the bonds' attractiveness as a savings alternative. Some funds used to purchase these war bonds would likely represent the substitution of the war bonds for some other form of savings. The U.S. Treasury estimates that for every $1 billion of savings bonds sold, the Treasury saves $7 million annually in interest costs over the financing cost of alternative Treasury instruments.[15] These savings, however, have an insignificant effect on the total economy. Many economists believe the macroeconomic effects of the issuance of war bonds would be negligible.

The opportunity to buy war bonds would give the public a direct sense of participation in recovery from the September attacks and the pursuit of terrorists. Spending for disaster relief and anti-terrorism, however, is expected to be far higher than funds raised from the issuance of war bonds.

Rely on Charitable Donations

Some would argue that because economic and financial market conditions today differ so much from those of the Second World War, a new war bond issue is unnecessary. An alternative would be to have citizens contribute to charitable organizations. In his televised speech on September 15, 2001, President George Bush stated that people could make donations through the web site [http://www.libertyunite.org/]. This web site, titled American Liberty Partnership, lists numerous charities and allows people to make online donations. Private donations would give people a sense of participation and sacrifice for the common good and permit activities that are not under government's control. Some economists believe the macroeconomic effects would be limited because much of the money donated would merely substitute for other charitable causes. To the extent that contributions reduced private consumption, this decline in aggregate demand would be largely offset when the donations are spent for disaster relief.

---

[15] Telephone interview with a Treasury official on Sept. 26, 2001. This estimate was made by the Treasury in May 2001 using a model developed by the Treasury.