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## War Bonds in the Second World War: A Model for Hurricane Recovery Bonds?

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### Summary

Severe damage and dislocations resulting from Hurricanes Katrina and Rita have rekindled congressional interest in the concept of the sale of a Treasury security to finance recovery and relief operations. The question has been raised whether or not the issuance of war bonds during the Second World War serves as a good model for new "hurricane recovery bonds." Two bills have been introduced that would permit the issuance of some form of hurricane relief bond: H.R. 3892 and H.R. 3935.

During the World War II, 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. Their primary purpose 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 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. As mentioned previously, war bonds were marketed primarily to reduce consumer spending. Today, despite concern about the low personal savings rate, many federal officials are more concerned about maintaining consumer spending. Furthermore, no savings bond or any other Treasury security issue has ever had its funds earmarked for any specific purpose; rather, all funds raised have been placed in the general fund.

In summary, the war bonds program in World War II is a problematic model for hurricane relief bonds. This report will not be updated.

The severe damage and dislocations caused by Hurricanes Katrina and Rita have resulted in renewed congressional interest in the concept of selling Treasury securities to finance recovery and relief operations in the federally designated disaster areas of Louisiana, Mississippi, Alabama, Texas, and Florida. During the first session of the 109th

Congress (as of October 17, 2006), two bills have been introduced which authorize the issuance of bonds in response to Hurricanes Katrina and Rita.

H.R. 3892, Hurricane Katrina Bond Act of 2005, was introduced by Representative Roger F. Wicker. This act

> Amends federal law governing the public debt to authorize the Secretary of the Treasury to designate one or more series of bonds or certificates (or any portions thereof) as "Hurricane Katrina Relief Bonds."
>
> Requires proceeds from such bonds and certificates to be used for expenditures authorized for relief and reconstruction relating to the impact of Hurricane Katrina along the Gulf Coast of the United States in 2005.

H.R. 3935, Hurricane Relief Bonds Act of 2005, was introduced by Representative Harold Rogers. This act states:

> The Secretary [of the Treasury] may designate one or more series of bonds or certificates (or any portion thereof) issued under this section as 'Hurricane Relief Bonds' in response to Hurricanes Katrina and Rita in 2005 and the subsequent flooding and displacement of residents along the Gulf Coast of the United States.

In response to congressional attention, this report describes the use of war bonds during the Second World War, examines their relevance as a model for new bonds for Hurricane relief, and presents alternative policy options. This analysis concludes that war bonds issued during the Second World War are a problematic model for hurricane recovery bonds.

## 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.[1] 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

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

the President to provide defense material to foreign governments "whose defense the President deems vital to the defense of the United States."[2]

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."[3] On May 1, 1941, the Treasury issued a new savings bond (Series E).[4] 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.[5]

After the United States entered the 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.[6]

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.[7] 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

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

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

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

[5] U.S. Dept. of the Treasury, Savings Bond Division, p. 7.

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

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

securities industry were established in each Federal Reserve district to assist the Treasury in marketing both war bonds and market-risk securities, which were called "victory loans."[8] 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.[9]

> 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.[10]

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.[11]

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

Currently, Series EE and Series I savings bonds are being issued. Series EE is the dominant series, as measured by sales. Effective May 1, 2005, Series EE bonds issued on or after May 1, 2005, earn a fixed rate of interest. Interest accrues monthly and compounds semiannually and is payable at the time of redemption. The Treasury guarantees that a bond's value will double after 20 years. 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.

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[8] Ibid.

[9] Ibid.

[10] Ibid.

[11] 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].

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 consumer price index for all urban consumers (CPI-U).

No savings bond issue or any other Treasury security issue has ever had its funds earmarked for any specific purpose; rather, all funds raised have been placed in the general fund.

# Patriot Bonds

After the terrorist attacks of September 11, 2001, both houses of Congress considered and passed differing measures authorizing the sale of so-called 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."[12] The only change, however, was to place a picture of a patriot on the front of a Series EE bond.[13] This designation forestalled further congressional legislative action.

# Summary

## Sale of Hurricane Bonds

Congress could decide that a specific statutory endorsement of the decision to issue "hurricane relief bonds" (or some other name) would add to these bonds' attractiveness as a savings alternative. Some funds used to purchase these hurricane relief war bonds would likely represent the substitution of these bonds for some other form of savings. The U.S. Treasury estimates that the U.S. saving bond program is cost effective; that is, the savings in interest costs exceed the extra administrative costs.[14] These savings, however, have an insignificant effect on the total budget.

The opportunity to buy "hurricane relief bonds" would give the public a direct sense of participation in relief and recovery from the effects of hurricanes Katrina and Rita.

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

[13] Detailed information about Patriot Bonds is available at [http://www.publicdebt.treas.gov/sav/savpatriotbond.htm].

[14] The reliability of Treasury's estimates are controversial. See U.S. Government Accountability Office, *Savings Bonds: Actions Needed to Increase the Reliability of Cost-effectiveness Measures*, GAO report GAO-03-513 (Washington: June 2003).

Spending for hurricane relief and recovery, however, is expected to be far higher than funds raised from the issuance of "hurricane relief bonds."[15]

## War Bond Model

Economic and financial market conditions today differ so much from those of the Second World War that the war bond model is problematic for a hurricane relief debt issue.

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 low rate of 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.

Moreover, the U.S. financial system is more complex, sophisticated, diverse, and deregulated than in the World War II era. Small savers have an array of savings vehicles. For example, they can invest in money market funds and certificates of deposit (CDs) of financial institutions. Today savings bonds are almost always a substitute mechanism for other forms of personal savings.

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[15] For an estimate these expenditures, see U.S. Congressional Budget Office, *Macroeconomic and Budgetary Effects of Hurricanes Katrina and Rita*, Statement of CBO Director Douglas Holtz-Eakin before the House Committee on the Budget, Oct. 6, 2005.