

# The Debt Ceiling, Extraordinary Measures, and the Spectre of 2011



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## Overview:

“Extraordinary measures” are becoming commonplace. As the debt ceiling, now \$31.4 Trillion, is reached once again the U.S. Treasury must undertake “extraordinary measures” of shuffling money around to finance the government since net new Treasury debt issuance will drop to zero. The fiscal gymnastics are expected to remain viable until June, give or take, at which time the government would be faced with starker set of choices – perhaps the starkest of which is defaulting on its debt obligations. From 2011 to 2022, such “extraordinary measures” have occurred in several years with little in the way of lasting repercussions. Nonetheless, it is the events surrounding the debt ceiling negotiations in 2011 that is typically held out as the boogeyman. As we detail below, however, even that case has a very particular set of circumstances. *We believe that it is highly unlikely that lasting damage to the markets or economy will result from the current debt ceiling negotiations. We nonetheless remain vigilant for signs of negative scenarios gaining traction.*

## A game of chicken along side the abyss:

The stakes surrounding debt default are extremely high. That most people realize this is, ironically, a comforting thought. There will be no lack of drama, positioning, and using the bully-pulpit, but in the end – rather than a “grand bargain” – the debt ceiling is likely to be suspended for a year after negotiations that result in modest concessions on government spending caps. The deal may be “last minute” or even possibly extend beyond “last minute” where the Treasury can no longer move money around and is forced to choose which bills to pay and which not to pay. The whiff of financial Armageddon could be in the air, but even if pushed all the way to the edge, we expect with high probability that debt payments will be prioritized and a deal will be reached before default. Teetering on the edge is highly uncomfortable, but still much different than going over it.

## The spectre of 2011

*Since the President wanted to cut spending but also increase taxes and the Republicans insisted on cuts with no new taxes, they were for months too far apart to find much agreement on a budget plan to be attached to the debt ceiling increase—which had to be enacted by August 2 to avoid a default. No one could quite believe that this would happen, because it was so unthinkable; it was assumed that the two parties would reach agreement. Each side actually expected the other to be more flexible.*

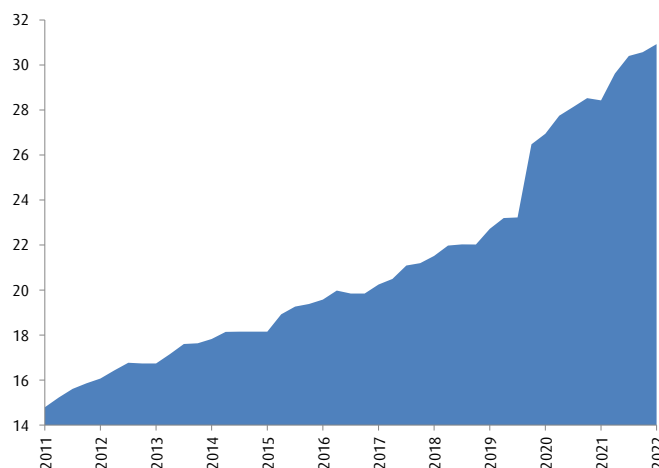
*“What were they thinking?,” Elizabeth Drew, The New York Review, 8/18/2011*

Four aspects are noteworthy from the 2011 episode: 1) The unexpectedness of the negotiation developments; 2) the shock and awe of U.S. debt downgrade by Standard and Poor’s (S&P), 3) that the debt downgrade was not due to default, but rather inadequate spending cuts and a gridlocked political environment that could make default possible, and 4) U.S. Treasuries actually rallied and rates fell sharply in a flight-to-safety trade despite the downgrade.

Equities fell sharply as well, but interestingly the decline in equities was much greater after the deal to avoid default was announced, driven by concerns surrounding the downgrade of U.S. debt that quickly followed the deal. Fragilities associated with the European debt crisis featured prominently as well. After dropping over 10%, U.S. equities bounced around at those low levels for a few months before embarking on a multi-year uptrend. The debt downgrade proved to be the last great opportunity to buy equities cheaply following the Great Financial Crisis of 2008-2009 ([Exhibit 1](#)). For the record, Standard and Poor’s (one of the three major debt rating agencies) still has U.S. debt rated as AA+, so not AAA. Moody’s and Fitch still assign a AAA rating to U.S. debt.


**Exhibit 1: S&P 500® Index: 2011 to 2013**


Source: Bloomberg L.P. (2023), BMO Wealth Management (2023)

**Exhibit 2: Total U.S. Debt as of September 30, 2022 (\$ trillions)**


Source: Federal Reserve (2023), U.S. Department of Treasury (2023), BMO Wealth Management (2023)

We agree that should a default of U.S. debt occur that financial market turmoil could quickly ensue. Also, our assessment of “highly unlikely” is not the same as “completely impossible.” It is also unclear whether the same script from 2011 of a flight-to-safety trade into Treasuries would be repeated or whether – now that debt levels are so much higher than in 2011 (*Exhibit 2*) – the knee-jerk reaction would be to sell rather than to buy Treasuries. If debt default begins to increase in probability, Dollar weakness may be more likely to ensue, so currency markets may serve as a gauge to understand how such extreme tail risks are being viewed as the default timeline draws closer. Market reaction to any statements or changes in outlooks by debt rating agencies will also be noteworthy in assessing vulnerabilities.

Compared with 2011, elected officials should better understand the implications of the debt ceiling negotiations. Conversely, the current political environment may be more polarized, offsetting the benefits of greater understanding. The spectre and imperfect memory of those 2011 events probably instills more fear than the actual events as they played out, which is also helpful for negotiations. We believe that a debt-defaulting fall into the abyss remains a very low probability scenario.



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