

# Research US

## Midterm elections unlikely to have a major impact on fiscal policy

- Latest ballots suggest Republicans are the favourites to win control of the House of Representatives in the upcoming midterm elections 8<sup>th</sup> of November.
- Even if the Democratic Party manages to win a clean sweep, we do not foresee significant changes to the US fiscal outlook.
- As illustrated by the deficit-reducing Inflation Reduction Act, the aim to constrain inflation will likely outweigh push for further deficit spending.

All 435 seats in the House of Representatives and 35 seats in the Senate will be contested in this year's election. In the senate, 21 of the contested seats are currently held by the Republicans, which means that Democrats are the favourite for maintaining the control for two more years. The House will be a closer call, but the latest polls suggest that Republicans are the modest favourite, making a lame duck government the most likely scenario.

In any case, the implications for fiscal policy could be more modest than usual. US fiscal deficit is set to decline markedly from the pandemic-era highs, but the still-elevated aggregate demand will keep the emphasis on further tightening no matter the election result.

As we outlined in *Research US - Fed continues to guide US economy towards a recession*, 1 September, US risks an extended period of stagflation characterized by elevated inflation and below-trend growth due to the persistent need to tighten monetary policy, unless clear tightening of economic policies will bring aggregate demand lower to a new equilibrium with supply. The primary responsibility rests naturally on Fed's shoulders, but the rapid rise in costs of living will encourage politicians to follow on Fed's tightening footsteps.

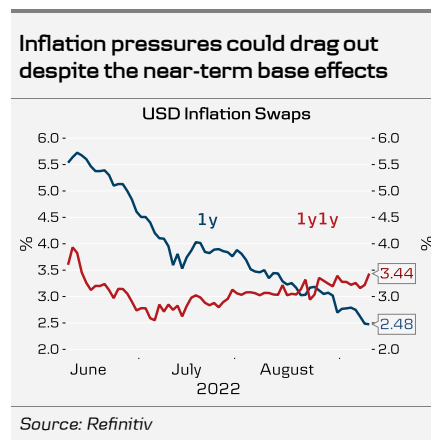
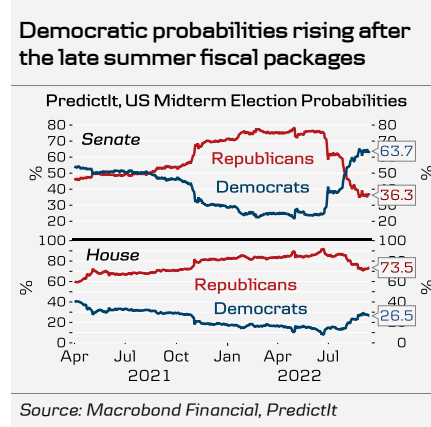
This was most evident with the Inflation Reduction Act, passed in the congress during August. The package included sizable investments into diversifying US energy supply towards renewables as well as support for high healthcare costs, but it was funded with an increase in corporate tax rates – leading to a slight net reduction in deficit. **While we think the near-term inflation-reducing implications of the package will be marginal, the package was broadly seen as a political victory for the Democratic party**, evident also in the party's rising implied probabilities in the election prediction markets.

**This is in clear contrast to the political sentiment in Europe**, where governments across countries are pushing for increased deficits to subsidise consumption amid the worsening energy crisis. This week, we expect US August CPI to print near 0.0% m/m, which would mark a 2<sup>nd</sup> consecutive month of recovering real incomes, further highlighting how US politicians are not under similar easing-pressure as their European colleagues.

**Even if the Democrats will be able to maintain the full control of the congress, we doubt the focus will switch from inflation-reduction towards large deficit-taking.** As we note in *Research Global - High inflation flashbacks*, 5 September, we continue to see risks tilted towards underlying price pressures being stickier than expected. While negative base effects will push headline US inflation clearly lower in the coming months, there is a risk of a renewed rebound in inflation towards 2023-2024, which is already evident in 1y1y USD inflation swap forward trading at a higher level than the 1y point.

Most likely election outcomes		
	Likely scenarios	
House	Democrats win	Republicans win
Senate	Democrats win	Democrats win
Presidency	Not contested	
Outcome	Democratic-control (25%)	Lame Duck (75%)

Source: FiveThirtyEight, assuming Democrats win Senate



Analyst, US Economy  
Antti Ilvonen  
+358 445 180 297  
antti.ilvonen@danskebank.com

While inflation remains the highest priority issue for voters overall, **non-economic topics such as abortion rights and gun violence are seen increasingly important**, with the former now being clearly the most pressing issue for democratic-leaning voters (See *NPR's poll* released 8 September). The US Supreme Court's June decision to overturn constitutional rights for abortion has further improved the Democratic Party's odds over the summer.

In terms of foreign policy, the most relevant issue remains US relations with China, but **as highlighted by the recent escalation in tensions over Taiwan, we do not foresee a clear shift in the overall negative sentiment** (see *Research China: The risk of a Taiwan war and what it implies - part 1*, 11 August). This week, the current administration announced a plan to limit the exports of US-manufactured microchips to China (see *Reuters*), following the increased investments into domestic production announced in late July's *Chips and Science Act*. In our view, the long-term decoupling in the countries' bilateral ties will continue no matter the outcome of the midterm elections.

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