Global Macro Insight

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US midterms: fiscal challenges and policy gridlock may lie ahead

Opinion polls for the midterm elections (3 November) are pointing to a high probability that the Republicans will lose control of Congress. Midterm elections normally show a swing away from the president's party. This is particularly the case with the House of Representatives where all 435 seats are up for election. Across varying polls, Democrats are widely expected to make strong gains with some polls indicating they will win 235 or more seats. Affordability issues are at the heart of voter dismay. The race for the Senate, where 35 of the 100 seats are up for election, is closer. The Democrats need a net four-seat gain to win a Senate majority. On average, polls are predicting the Democrats will take control of the Senate too. Either way, Democrat control of Congress or a divided Congress looks likely.

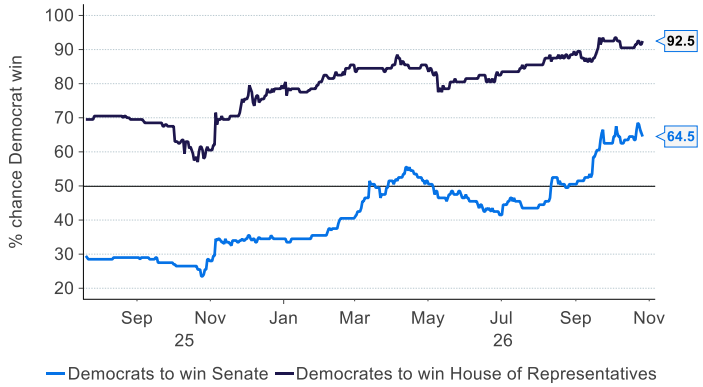
Both outcomes would raise constraints on President Trump's policy agenda leading to the possibility of gridlock on important issues. Trump holds a veto on legislation, so a Democrat clean sweep does not automatically mean that Democrat policies will prevail. Trade policy will remain in the President's control. He will also be responsible for shaping foreign policy. It is also possible that Trump may further test the boundaries of his executive powers. However, a Democrat sweep or a divided Congress would impose greater constraints on the President through greater oversight and funding.

The White House's fiscal latitude will be greatly constrained if the Republicans lose control of Congress, while the presidential veto will constrain Democrat fiscal policy. To overturn the veto, the Democrats would need a two-thirds majority in both chambers of Congress. We think the most likely outcome is that major fiscal initiatives will be lacking over the next two years. We also anticipate little and slow progress on Democrat proposed budget reform.

We expect there will be a shift away from partisan fiscal policies to negotiated deals, constrained by debt ceiling limitations. Future government shutdowns can't be ruled out. The federal debt ceiling (USD41.1trn) is expected to be reached anytime between February and mid-summer next year. The National Taxpayers Union has a central date of May 2027. The wide range of timing estimates relates to uncertainty over the extent and speed of military expenditure, tariffs and federal outlays and receipts. US national debt reached USD40.17trn at the end of September, equivalent to 124% of nominal GDP.

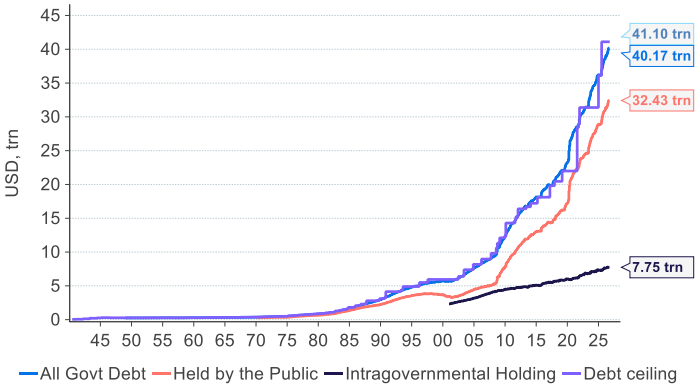
Our expectation is that if either or both chambers of Congress change hands after the midterm elections, there will be little progress on reducing the budget deficit. We expect that talks on the debt ceiling will start quickly. In fiscal year (FY) 2026, the federal budget deficit amounted to USD1.99trn, up from USD1.78trn in FY2025. The current arithmetic from the US Treasury Department is that it will rise to USD2.17trn for FY2027.

Figure 1. Polymarket predicts a Democrat clean sweep



Source: Polymarket, Macrobond, ANZ Research

Figure 2. Debt ceiling will be early focus of new Congress



Source: U.S. Treasury, Macrobond, ANZ Research

Budget deficits in the region of 6.0% of GDP or higher have become the norm in recent years. If the deficits are not addressed, they will remain a persistent concern for financial markets. Net interest payments amounted to USD1.052trn last FY. That made interest costs the third largest item of expenditure after social security (USD1.67trn) and medicare (USD1.07trn) and larger than the national defence budget (USD0.97trn).

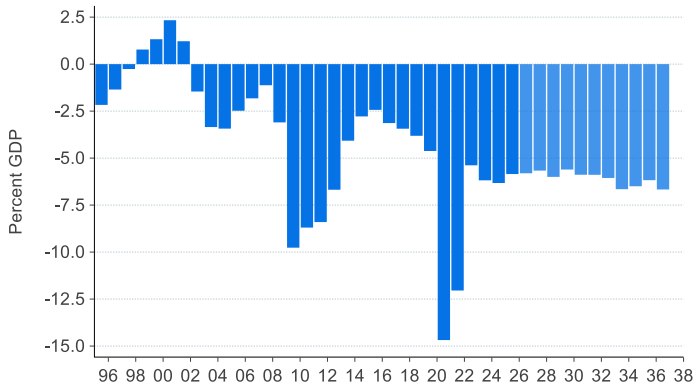
The White House's budget submission for FY2027 highlights some of the areas where fiscal differences will be contentious in the early stages of the new Congress. Over the 10-year 2027–36 period, the budget proposals increase discretionary defence spending by USD2.4trn, reduce discretionary non-defence spending by USD2.6trn and increase mandatory spending by USD351bn (mainly on defence).

For the current fiscal year, the FY2027 budget proposes USD1.5trn of defence spending including an uplift on regular defence spending to USD1.15trn and an additional USD350bn on investment in defence and the Department of Homeland Security. The White House wants the additional USD350bn to be passed in a reconciliation bill. The FY2027 budget also proposes a 10% cut in discretionary non-defence spending to USD660bn. It is arguing that its budget holds the line on discretionary spending ex-defence.

Unsurprisingly, Democrats have objected strongly to these budget proposals. If, as expected, the Republicans lose one or both chambers of Congress, large parts of the budget will have to be redrafted, and budget negotiations will again become front and centre of fiscal anxieties in the US Treasury market.

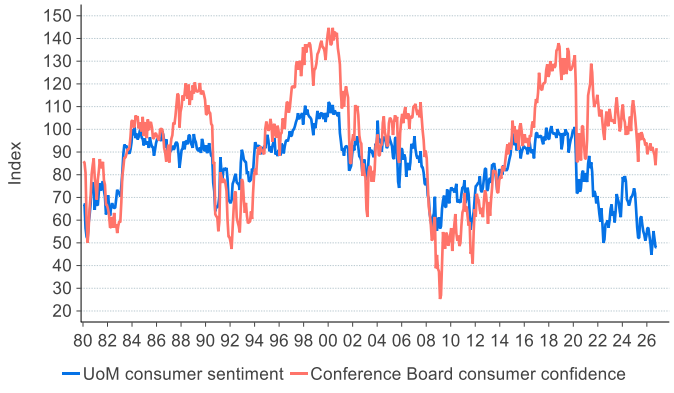
Outside of fiscal policy, other areas of contention are (de)regulation, energy policy, AI and the President's immigration and border security policies. Deregulation is one of the central pillars of the White House's growth program. Currently it requires that 10 regulations are eliminated for every new one that is introduced. Areas of focus include but are not limited to the environment, speed of permitting for housing, infrastructure and ensuring legislation doesn't interrupt the AI build out. Much of the deregulation agenda is carried out through executive agencies and orders, but a change in Congress could make it more difficult through legislation, appropriations and oversight. Democrat control of the Senate would also deprive Trump of Republican support in confirmation hearings for key appointments. However, it would not impact the Fed's ability to alter bank capital requirements.

Figure 3. CBO projects persistent deficits of around 6% of GDP



Source: CBO, Macrobond, ANZ Research

Figure 4. Unconfident consumers want change



Source: University of Michigan, TCB, Macrobond, ANZ Research

Conclusion

The Republicans are widely expected to lose control of Congress at the midterm elections on 3 November. A Democrat clean sweep or mixed Congress would indicate policy gridlock may lie ahead with protracted budget cross-party negotiations. Historically, financial markets have taken midterm congressional swings away from the president's party in their stride. However, the US debt burden has surged since COVID-19, and gridlock on fiscal policy would serve to reinforce anxiety over the trajectory of the deficit and debt sustainability.

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