Economics

IN FOCUS

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A divided Congress and the US fiscal outlook

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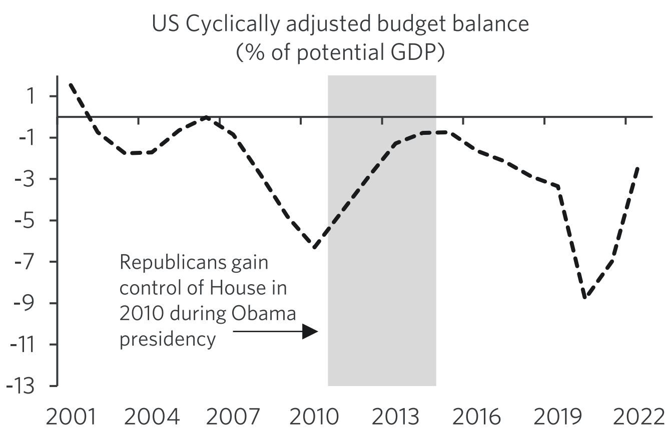
To twist a historical phrase, a Congress divided against itself cannot stand for much. With the Republicans controlling the House, but Democrats retaining a slim Senate majority, the legislative branch of government is likely to be a barrier to major policy swings in the next two years. But fiscal policy will still have an important bearing on financial markets and the economy, both from here to 2024, and beyond.

The debt ceiling: yes, its baaack

On the fiscal front, the climb down from massive stimulus earlier in the pandemic will continue to weigh on activity in the coming years, adding to the effects of monetary policy tightening in cooling growth and inflation. That will likely remain the case in the context of a divided Congress, with Republicans likely to block any major new spending initiatives, while also preventing tax or energy sector policy moves that would have been less favorable to near-term growth.

Chart 1: Divided Congress during Obama's early presidency a blueprint for today's situation?



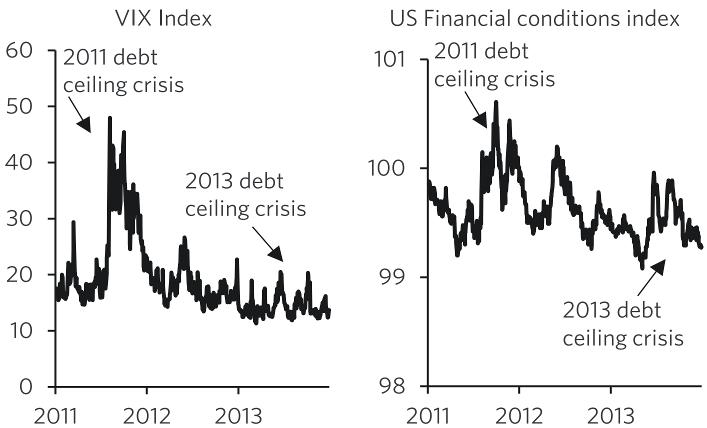
Source: IMF, CIBC

The most recent example of an analogous midterm election outcome dates back to Obama's presidency in 2010, when the Republicans attained a majority in the House, and the Senate remained under Democratic control until the 2014 midterms. What followed were contentious battles around tax cuts, sequestration, government shutdowns, and the debt ceiling. The 2011 debt ceiling crisis, in which Republicans demanded deficit reductions in order to raise the debt ceiling, culminated in the Budget Control Act that did just that. That resulted in a shrinking of the cyclically-adjusted federal deficit, a measure that captures the impact of fiscal policy decisions after controlling for the influence of the business cycle (Chart 1).

The GOP's leverage over spending levels might be less effective in 2023, in part because the ability to stand in the way of increases in the debt ceiling carry less clout. The Biden administration might decide to call the House's bluff over threats of a shutdown, understanding that past shutdowns have been political losers for those that precipitated them, and an outright default would be worse.

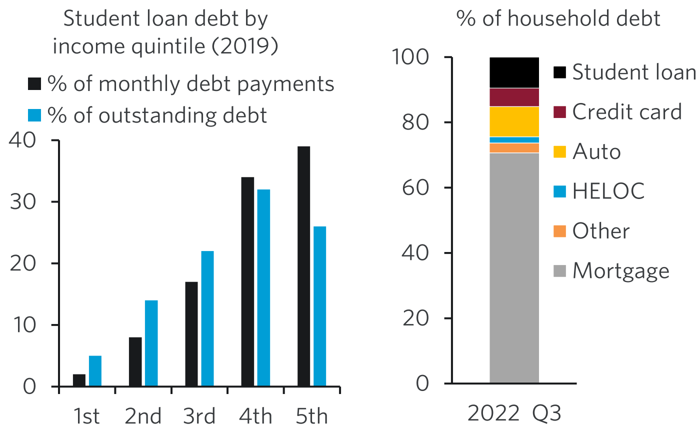
Markets have come to see the threat of default as a boy who cried wolf story. In 2011, when Republicans effectively wielded the debt ceiling weapon, financial markets were roiled around key deadlines, increasing equity volatility and tightening financial conditions. But two years later, financial markets paid little heed when the 2013 debt ceiling crisis played out (Chart 2). Still, the ability of the House majority to call attention to the deficit and the rising interest burden will likely act as a restraint on spending, particularly while spending hikes can also be seen as inflationary.

Chart 2: Financial markets paid attention to debt ceiling debate in 2011, but largely ignored it in 2013



Source: Bloomberg, CIBC

Chart 4: Low and middle-income student loans are small in aggregate (l), and in terms of total household debt (r)



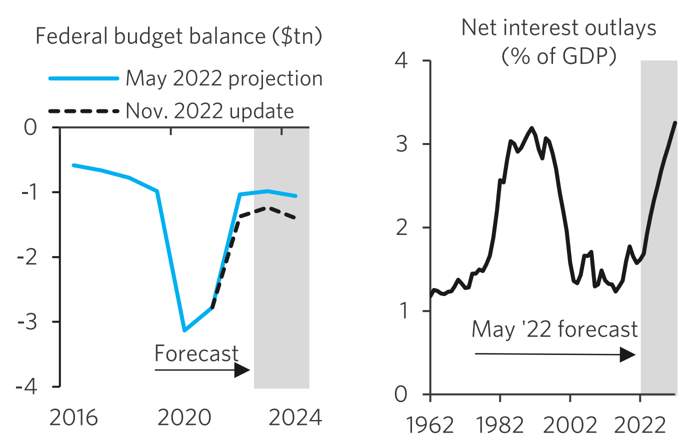
Source: Brookings, Federal Reserve, FRBNY, CIBC

The fiscal outlook: protracted red ink

Even with Republicans refocussing on the deficit and government spending during the next two years, the fiscal recovery seen during Obama's years with a divided legislative branch might not be a good guide to what now lies ahead. The considerable progress made on the deficit since its spike during the COVID recession isn't going to be as readily continued as we look ahead.

The federal deficit narrowed in FY2022, as COVID-era stimulus dried up, and revenues were buttressed by high inflation. All told, the federal budget deficit in the FY2022 stood at 5.5% of GDP, down from COVID's peak and the 12.3% recorded in FY2021. The FY2022 result was slightly above the 4.6% of GDP seen in 2019, and it also exceeded the CBO's expectations as laid out in its May 2022 forecast, as higher interest costs, amongst other items, added to outlays.

Chart 3: Federal fiscal position has deteriorated (l), with higher interest costs being a factor (r)



Source: CBO, CIBC *Nov. forecast update is average of CBO projected range under new economic conditions

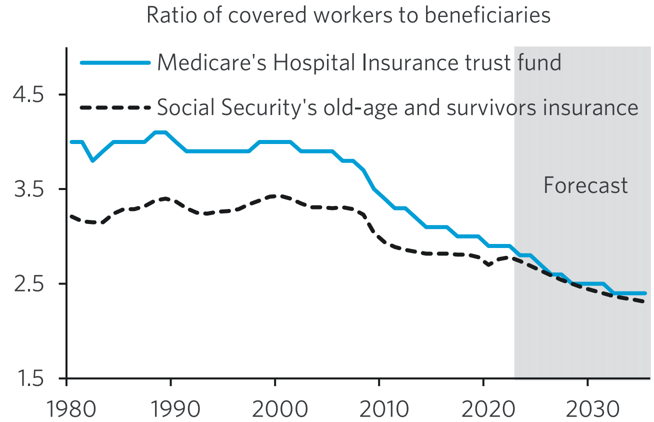
In stark contrast to the situation more than a decade ago, interest outlays are quickly escalating, and are projected to exceed their previous peak relative to GDP ahead, resulting in a more modest slimming of the deficit in FY2023 than thought back in May (Chart 3).

The federal student loan debt forgiveness for low and middle-income borrowers was another factor behind the larger-than-expected deficit in FY2022, adding $426bn in costs. However, having been implemented without a Congressional vote, it could be blocked by the Supreme Court ahead. Whether it gets a red or green light isn't likely to mean much for GDP growth. Low and middle-income earners who would qualify account for a small share of total student debt, and student debt is in turn a small share of total household debt (Chart 4). Student loan payments have also been on hold since the pandemic began, so there wouldn't be any immediate change in household budgets, diluting the benefits of any initial forgiveness.

A more contentious spending item lately has been the generosity of Social Security outlays, the single-largest item in expenditures, and of growing importance given the aging population, along with Medicare. Republicans could press for spending cuts in these areas as a potential bargaining chip, in exchange for raising the debt ceiling, although we expect such efforts to be unsuccessful during a Democratic presidency.

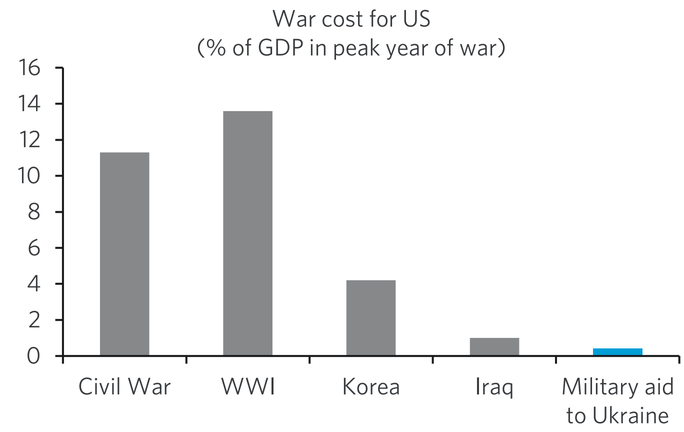
Social Security trust funds are estimated to be drained by 2035, while Medicare trust fund depletion could occur as soon as 2028, as lower birth rates and slow immigration have resulted in slow growth in the working population relative to retirees (Chart 5), while longer life expectancies have also prolonged the period of receiving benefits. These "funds" are not really a barrier for the programs, in the sense that they are really pay-as-you-go entitlements, but unfavorable demographics mean they will be a greater burden on the fiscal balance in the long run.

Chart 5: Demographic pressures on key safety net programs



Source: Social Security Administration, Centers for Medicare & Medicaid Services, CIBC

Chart 7: Ukraine war spending is relatively small



Source: CBO, CIBC

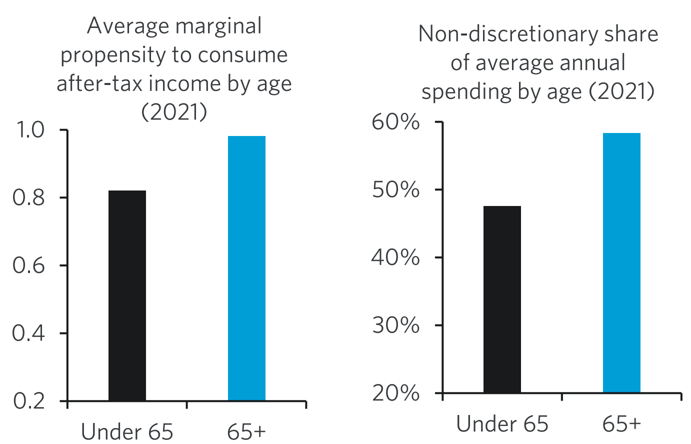
The Congressional Research Service estimated that payments of Social Security would need to be reduced by at least 20% permanently starting in 2035, or payroll taxes would need to rise immediately, in order for Social Security trust funds to remain solvent over the 75 year projection period. Any reduction in benefits would have an impact on those saving for retirement, as well as consumption by those who are already retired. On average, over half of income in the 65+ age group is derived from Social Security, and the marginal propensity to consume after-tax income is close to 1.0 (Chart 6), with most of the spending on non-discretionary areas, particularly healthcare and housing.

National defense expenditures rose for the first time since the Trump presidency in Q2 and Q3 2022, and are set to increase further in response to the war in Ukraine. In addition to the $68bn in aid to Ukraine that has already been enacted, including almost $40bn in military aid, the White House is asking Congress for another $38bn, which will also create demand for goods and services stateside. However, this a small amount of spending in the context of the overall economy and past spending on wars (Chart 7), suggesting a small multiplier effect within the US economy.

Ghosts of Trump's past presidency

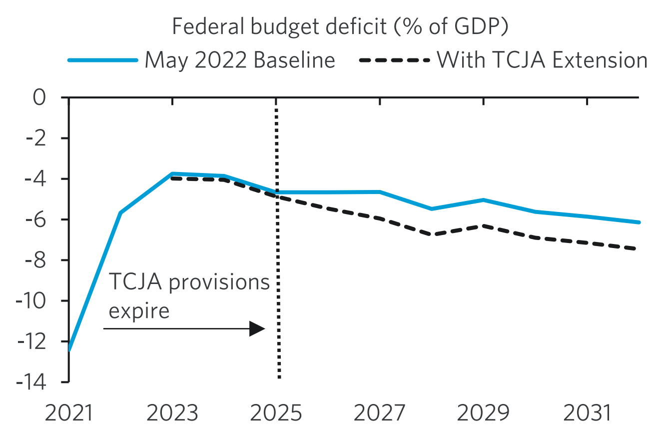
With tax hikes ruled out now that Republicans control the House, the next major debate around taxes will come when the Trump tax cuts are set to expire, in 2025. If extended, the provisions in the Tax Cuts and Jobs Act (TCJA) will compound revenue shortfalls, with the CBO estimating an additional $2.2tn in costs through 2032 from the extension of individual income and estate taxes, and another $0.5tn from the extension of business tax provisions (Chart 8).

Chart 6: Any reduction in Social Security would dent non-discretionary consumption



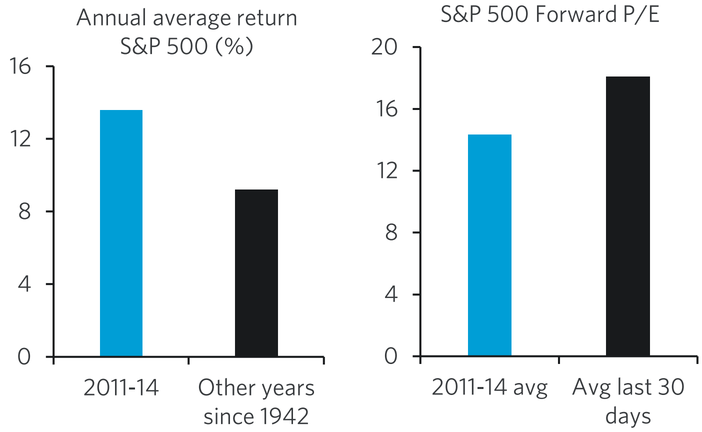
Source: BLS, CIBC

Chart 8: Deficit impact of TCJA extension



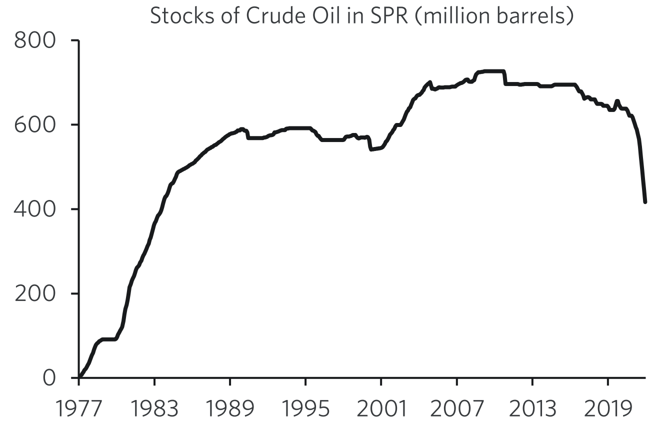
Source: CBO, CIBC

Chart 9: Stocks outperformed during Obama presidency with a divided Congress (l), but valuations weren't stretched back then (r)



Source: Bloomberg, CIBC

Chart 10: Unprecedented release of oil from the SPR



Source: EIA, Bloomberg, CIBC

That would leave the longer-term fiscal outlook back on a deteriorating path through the next decade, which at this point seems to be the path of least resistance for a divided government. But even if rolled back completely, deficits will be creeping towards 6% of GDP in FY2032, a level that looks promising only when compared to the outsized flow of red ink at the height of the pandemic. And that will have to be funded without the benefit of QE from the Fed, a reason, along with the lack of below target inflation, why bond yields are unlikely to return to where they were in the prior cycle.

Equities and regulatory gridlock

The Republicans' ability to prevent regulatory measures might have been part of the backstory for the strong performance of the equity market during the last equivalent Democratic-Republican split in the 2011-14 period (Chart 9, left). But it's not clear that the divided Congress was really decisive in that rally. There was no obvious cheer from financial markets on the GOP's capture of the House in the midterm elections, in part because that result had long been anticipated, but also because interest rates are higher and forward P/Es are stretched relative to 2011-14 (Chart 9, right).

Still, there are some sectors that are viewed as potentially benefitting from the Republicans capture of the House. Energy permitting processes could be fast tracked, with Republicans aiming to catalyze domestic oil and gas production, in order to bolster energy security and reduce the reliance on OPEC and Russia.

Biden's agenda to accelerate clean energy development under the Inflation Reduction Act is likely to see the allocation of funds scrutinized by Republicans, but ultimately with the law set in stone, there is little room for an about face, at least in the next two years. Moreover, many of the states that will gain from the development of clean energy are red states. Republicans are also seeking faster approvals for low-carbon energy sources, and are seeking to shorten environmental reviews for mining projects that would support EV material mining.

The cannabis sector is another one that has the potential for gains ahead, as the SAFE Banking Act would prohibit federal banking regulators from penalizing banks for providing services to cannabis businesses. Although the decision to forgo its inclusion in the recent defense spending bill weighed on cannabis stocks, the bill retains bipartisan support and is likely to see progress in 2023.

The political debate around energy extends to the unprecedented drawdown of the Strategic Petroleum Reserve (SPR) that is underway, which has worked to artificially suppress oil prices, and has cushioned the impact of high gasoline prices on consumers (Chart 10). The Treasury estimates that the SPR release lowered the price of gasoline by 17-42c/gallon, and the drawdown is set to extend into 2023, as the White House is looking for oil prices to average roughly US$70/bbl on a sustained basis before starting to replenish inventories.

What's next?

For the most part, the next two years will see a divided government generating few major accomplishments on the policy front. For some sectors, that might be a plus, particularly those that might escape a tougher regulatory backdrop. But for tackling America's long-term fiscal imbalance, either through spending restraint or revenue measures, inaction isn't a virtue. Republicans aren't likely to be able to use the debt ceiling to get a deal to slash spending, particularly in key entitlement programs that the Democrats will be committed to protect. But the GOP might be able to restrain Congress from an aggressive roll back of previous tax cuts.

The election in 2024 has the potential to deliver a less-divided Washington, since the closeness of recent presidential and congressional votes shows that either party is within reach of winning the White House, the Senate, and the House. So one way or another, fiscal and regulatory policy could see more material change in 2025. Stay tuned.

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