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# Inflation, inequality and divergence in electoral year 2024

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In past years, I tried on several occasions and through various publications to highlight the importance of a conceptual distinction that I believe is pivotal for its ability to explain recent political and economic upheavals in Western democracies.

This conceptualization keeps the notions of *inequality* and *divergence* of income (and wealth) distinct. While the first notion – inequality - is rather common and intuitive, the second, that of divergence, needs to be qualified to understand its key role: in my interpretation, divergence is a different form of inequality of income or wealth, one that persists over time as a consequence of its structural nature, and is, or appears to be, hardly reversible.

In terms of political economy, the implications of this distinction are very profound. For example, if I want to contrast inequality, or an income distribution that I do not like, either because I consider it too unequal or because it appears too egalitarian to me, it would be enough for me to cast my vote accordingly, giving my support to a party that conforms to my distributional preference and control the implementation of its policies. The choice about equality-inequality is thus perfectly ingrained in the nature of the democratic system of alternated powers.

If, however, my concern is the perception/observation of being in a condition of permanent or long-lasting decline, it will not be sufficient to redistribute resources for a few years. It will be necessary to change the entire political-economic system that produces such a structural divergence. Consequently, an elector concerned by her or his relative divergent situation will be tempted to adhere to anti-system calls or inclined to indulge populist temptations, that is, proposals for changes in the political-social approach – reverting the decline or consolidating the superiority - whose effects are often not subjected to rational planning and ex-post verification.

The problem with the distinction I proposed is that, while measuring income inequality is relatively easy, measuring divergence is more complex. This is because behind divergences lie and intersect structural factors of a different nature. Among these factors, the geographical localization of groups and communities stands out as very relevant: for example, through the marginalization from growing wellbeing of rural communities compared to urban ones; the degree of diffusion of technologies, which characterizes in a different extent not only states or local communities, but traditional professions and activities compared to more recent and modern ones; or the educational level of individuals or communities, which can irrevocably determine the destiny of a worker since her or his youth.

In the last two decades, as a consequence of the extraordinary technological and geo-economic transformation that occurred in a context of liberalization of trade and financial flows, the level of acquired divergence is now so high that the aggregate data of the States are not very revealing of the degree of decline of some communities. In most cases, the decline of some is overcompensated by the enrichment of others, without much osmosis between the two layers.

In the years of the European crisis, this phenomenon was very evident, with divergences at the sub-regional level that disappeared in the aggregate data at the national level. The result was that the pro-European rhetoric according to which the EU member countries were stably converging thanks to common support policies was often true, but was contradicted by the decline experienced at a local level by a majority of communities and citizens. Those citizens inevitably felt let down by the political system and turned away from the pro-European rhetoric.

More recently, other dramatic upheavals – wars, pandemic crisis, new technologies - have impacted on western democracies. Gauging the impact would require disaggregated data capturing the citizens' reaction to the changes underway. The latest factors of structural change in the system, however, are too recent and unrelated to the internal dynamics of the economy to be analyzed in disaggregated data. This is obviously the case with the consequences of the wars in Ukraine and the Middle East and, before them, the global pandemic crisis. In all these cases, individual production sectors have been affected to an asymmetric extent and so have individual professional specializations or even demographic groups, for example, young people who have studied remotely with sub-optimal results, or elderly people who have been slowed down in their vitality by health risks. It is still too early to assess the consequence of all those geopolitical or health events to pin down their disaggregated impact.

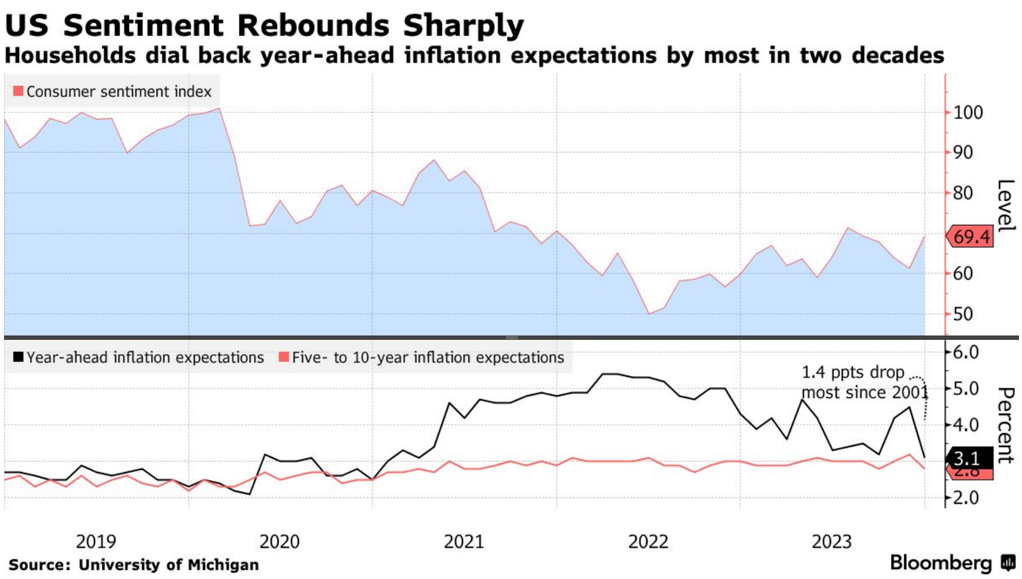
For this reason, it is inevitable as a first approximation to stick to the use of aggregate data, unsatisfactory as they are, to move toward an explanation of the current interaction between politics and the economy. To ponder the aggregate data through the distinct notions of "divergence versus inequality" we must rely on a rudimental criterion that is the different duration of the observed trends, assuming that a long duration may be revealing of a structural feature, and thus contribute to divergence, rather than to inequality. A further correction is considering the lifespan of a legislature so that economic data (or their perception) can be tentatively paired with the attribution of political responsibility.

Temporal mismatch and lags between causes and effects of economic events are of obvious and great relevance. In these months, economists are digging into several countries' national data to understand why people's sentiments are, allegedly, largely out of line with the state of the economy. Obviously, analysts find this kind of discrepancy of greater interest in years like 2024, when a multitude of electorates are called to cast their vote in the ballots. In this regard, 2024 is indeed a historic election year: over half the world's population lives in countries where elections are expected to be held. Voters will choose leaders in the European Union and in 40 national elections, including the United States, India, Mexico, Indonesia, Russia, Pakistan, South Africa, the United Kingdom, Belgium, and Taiwan. In liberal democracies, political sentiments are conventionally identified with the state of the market economy, the connection between political satisfaction and economic growth is often taken for granted.

Based on historic data, the real economy tends to offer better signals than the financial markets about how elections will pan out. Broad economic indicators including income, employment, GDP growth, and consumption matter more than the performance of stock exchanges, or bond markets and exchange rates. The absolute level of an economic variable usually does not reveal as much as its change, and economic data late in the year prior to the election and early in the election year have the strongest relationship with the ultimate vote. Real consumption and real disposable income are more predictive over a longer horizon. However, as past decades showed, the strongest statistical relationship with election outcomes is often with variables measured in the second quarter of an election year.

After 2020, a new economic factor – the unexpectedly strong surge in prices - has had great influence on consumer sentiments and, consequently, on people's satisfaction with the way politics manages the economy. Normally, inflation is not the best forecaster of political outcomes, especially if compared to real variables. However, inflation is more predictive of election results when it is unusually strong and unexpected, exactly like in the recent post-2020 episodes.

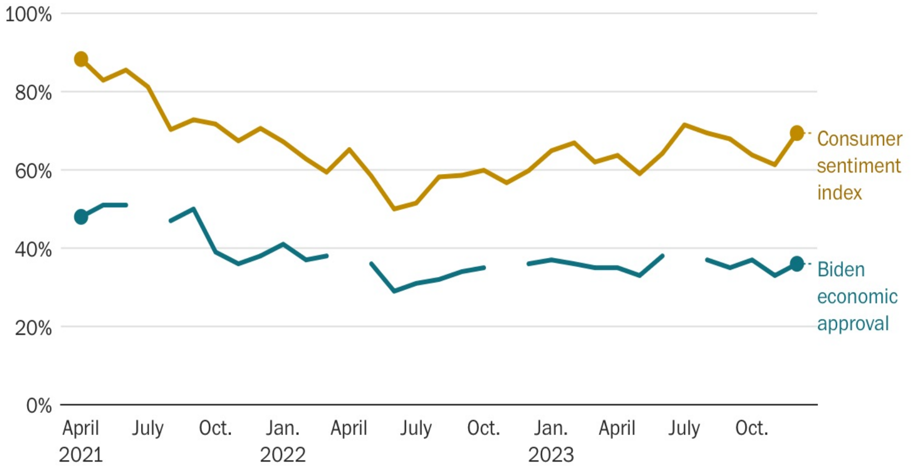
Inflation's impact should be more significant if high prices hit incomes against the backdrop of a weak labor market. This was not the case in Western economies during the post-pandemic recovery, when employment held on better than expected. Still, inflation has had a strong impact on consumer sentiments, as the figure below shows. Trying to predict the US election outcomes based on the latest data, analysts are observing a strong rebound in consumer sentiments coinciding with a dramatic downward forecast of expected inflation by American households.




The question is particularly relevant as President Biden's chances to be re-elected appear to be declining. US consumer sentiment rebounded sharply in early December 2023, topping all forecasts as households dialed back their year-ahead inflation expectations by the most in 22 years.

The University of Michigan's consumer sentiment index jumped 8.1 points to a four-month high of 69.4, as the preliminary December reading showed. Consumers see prices rising at an annual rate of 3.1% over the coming year, the lowest level since March 2021. The 1.4 percentage points decline from the prior month was the largest since October 2001.

In fact, the upturn in consumer sentiment is probably too recent. Since the beginning of Biden's presidency, the consumer sentiment has mostly walked down in parallel with a weakening approval of Biden's economy, as shown in the graph below.

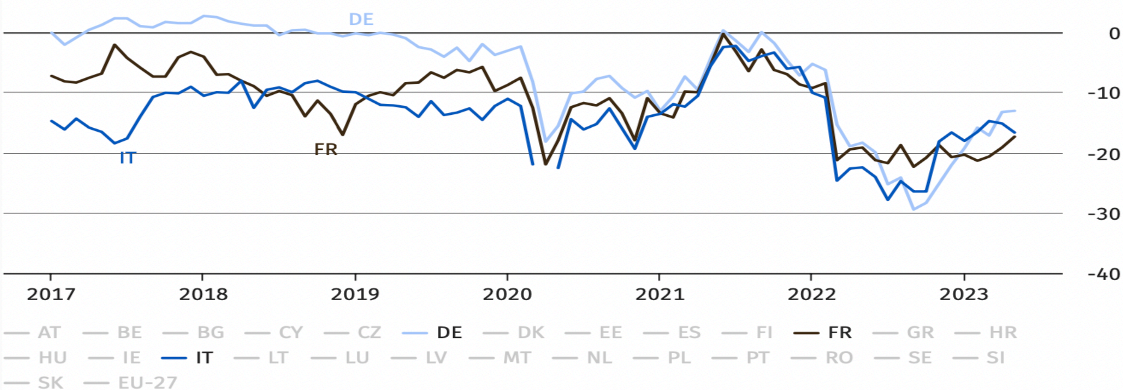



Source: Fox News Poll; University of Michigan Surveys of Consumers CLARA ENCE MORSE / THE WASHINGTON POST

Similarly, in the largest European economies, the consumer sentiment indicator has been growing since the beginning of 2022, but this upturn compensates for the fall of the indexes in the preceding five years only in Italy. France and Germany are still significantly below the 2017 level. Political consensus for the governments in each of those countries reflects the longer-term assessment, more than the recent change of direction.

**Consumer sentiment indicator**

Balance of positive and negative answers (+ mainly positive, - mainly negative)




Country codes. Click or tap on the legend to show or hide variables. Partly provisional values. Source, most recent data: Eurostat (DG ECFIN)

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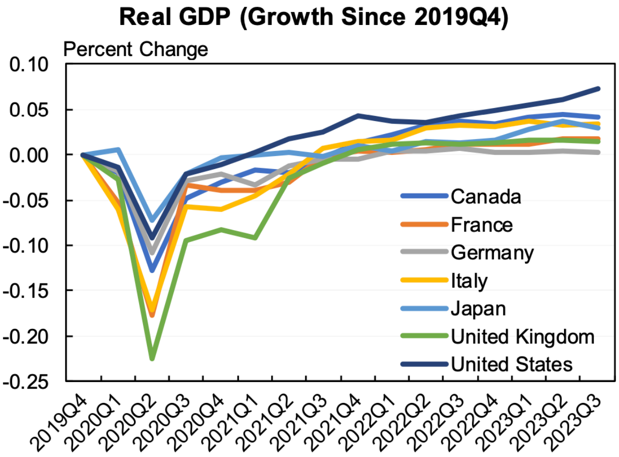
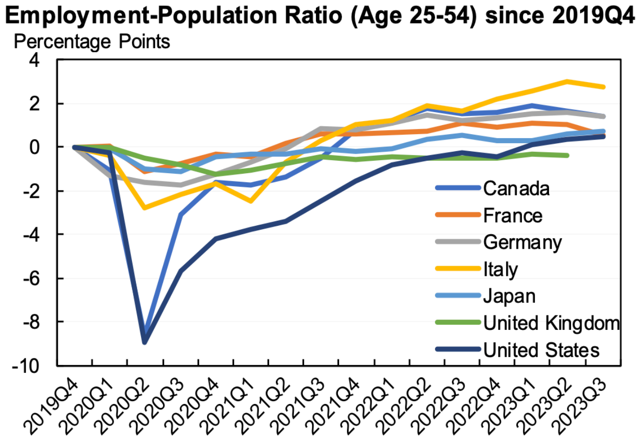
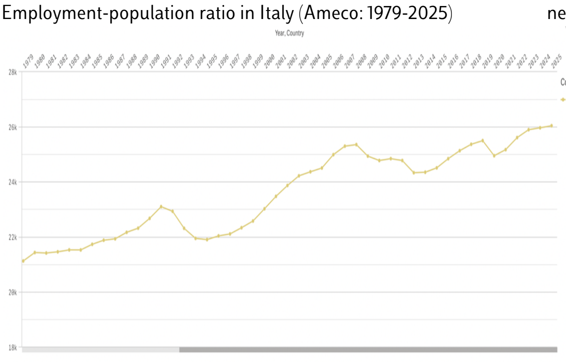
The dynamics behind sentiments are obviously elusive. Among the G7 countries, Italy and the United States are at the opposite poles if real GDP growth is considered together with the increase in the employment-population ratio. The involvement of a larger number of people in the labor market may be considered a sign of social convergence (the opposite of divergence). However, the distribution among more workers of lower real growth may contribute to the sense of a “rigged system” not contributing to welfare and equality and thus become a source of disquiet among the citizens.



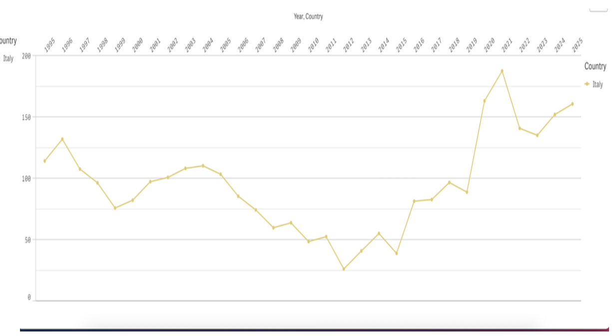




Italy’s special condition is probably not related to political choices or preferences, but rather to a long-term phenomenon of increase in employment-population ratio (left-hand panel below) and to the use of savings by households (right-hand panel) compensating for the lower real growth, as shown in the figure below. The second factor, the availability of savings, is running out of steam and may be close to its end.

Employment-population ratio in Italy (Ameco: 1979-2025)



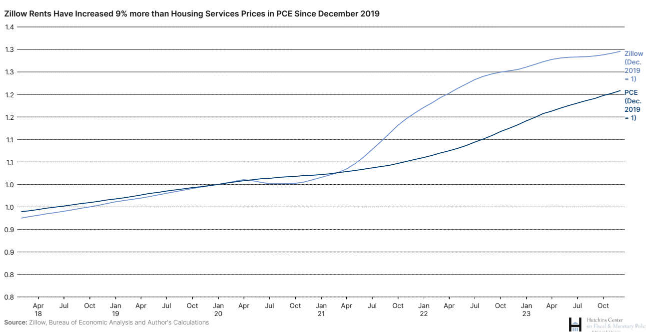
net-savings private (Ameco: 1979-2025)

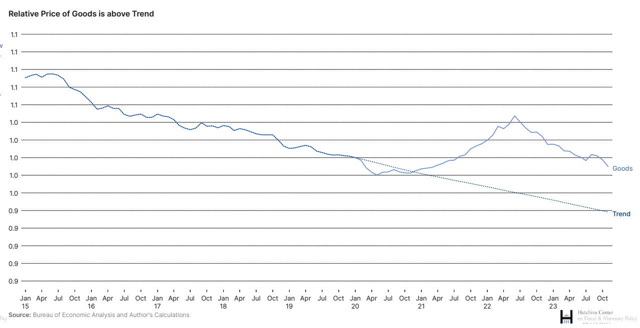


Using 2022 as the base-year for the data analysis can be misleading in forecasting the next US election outcome. In 2022, the University of Michigan's average annual current economic conditions index was the lowest it had been in 60 years. Meanwhile, the state of the economy has surely changed. As my colleagues at the Brookings Institution noticed recently, while it is certainly true that inflation was very elevated for much of 2021 and 2022, it receded quickly, and it is now fairly close to the target of the Federal Reserve. In parallel, nominal wages are rising and roughly keeping pace with or even exceeding price increases. Other indicators are also very positive. The unemployment rate is just above historical lows. Household wealth is soaring. The economy continues to expand. And most measures of household financial distress are similar to pre-pandemic levels. Still, even if the economy is doing better than usual, people are unhappy about their situation and their perception of things. In fact, data on the impact of inflation changes radically depending on the time scale. If we consider the last 12 months, it is clear that Americans' real incomes have increased, while if we consider the beginning of President Biden's mandate, January 2021, the result is that average real incomes are still negative. According to calculations presented by a panel of economists at the Brookings Institution, if the median voter looks at the real increase in wages of the last twelve months (1.7%) and projects it over the last three years, he sees that his income should have increased by 5.1%, while it only grew by 1.4%. A loss of income of 3.7 percentage points during Biden's term can affect people's sentiment and provoke a substantial loss of consensus for the Administration.

Replicating the same exercise for the governments of Germany and Italy, and the French Presidency, one might reach similar results. Moreover, introducing a distinction based on the impact of inflation on the localization of single communities in France or on single professions in Germany (workers in the agricultural sector now protesting, for instance), one could explain the declining consensus for the governing forces in Germany and France.

The question is how long will inflation last and what will happen to the citizens' sentiment (and electoral choices of course) once prices go back to normal increases, or within the target of the ECB or the Fed, which is around 2% yearly.




Considering the long-term impact of economic dynamics – those that I consider closer to structural divergence phenomena – can be key to understanding how people really feel about the way the economy has been managed and, in this specific case, if the drastic drop of inflation in the next months (statistically the second quarter is the most relevant for the electoral choices in the US) will bode well for Biden's chances of re-election or give impetus to Donald Trump. The two figures above, produced by researchers for the Hutchins Center of the Brookings Institution, show how inflation, though declining, has permanently raised the level of prices, either in durable or consumer goods, eroding the real income.

Thus, the recent positive change in consumer sentiment is challenged by the sedimented and perduring disquiet for the loss of disposable income suffered by many Americans during the Biden Administration, if compared to the expected increase of real income at the beginning of Biden's presidency. In terms suitable to electoral campaigns, many Americans would respond "no" to the classic question "are you better off now than at the beginning of Biden's term?" even if inflation was not caused by Biden's economic agenda and his policies have prevented other negative shocks: unemployment and recession.

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