1 The global economic outlook could heighten regional inequalities in OECD countries

The global economy is facing mounting challenges. Growth has lost momentum, core inflation is persistent and confidence has weakened. Russia's war of aggression against Ukraine pushed up prices substantially, adding to inflationary pressures at a time when the cost of living was already rapidly rising around the world. While the global economy seems to be turning a corner, uncertainty is high. This global outlook is translating into different outcomes across places and risks exacerbating already high and persistent regional inequalities in many OECD countries.

The repercussions of Russia's war of aggression against Ukraine are not felt equally across OECD countries

Over a year on from Russia's war in Ukraine, economic and social repercussions have been profound and are likely to be long-lasting. Managing the humanitarian crisis remains an immediate priority. While some key risks, such as persistent large-scale energy and food market disruptions have been mitigated for now, governments at all levels are still grappling with the implications of persistent core inflation, high debt levels and low potential output – jeopardising efforts to rebuild their economies post COVID-19 and to deliver stronger and more sustainable growth. The OECD's latest *Economic Outlook* (2023[1]) highlights how the war continues to overshadow the world economy and how, despite signs of improvement, recovery over the next two years will be weak by past standards. The report projects that growth will remain at below-trend rates in 2023 and 2024, at 2.6% and 2.9% respectively (OECD, 2023[1]).

While headline inflation has declined, it remains elevated and could persist longer across OECD countries. The unexpected persistence of these pressures in 2022 owed largely to the outbreak of the war, which resulted in an immediate spike in a number of key commodity prices: oil, gas and coal, a range of metals, wheat and corn and some edible oils, as well as fertilisers. Inflation is projected to moderate gradually over 2023 and 2024 but remains above central bank objectives until the latter half of 2024 in most countries (OECD, 2023[1]). Even prior to the war, inflation pressures had begun to rise, with both demand- and supply-side factors contributing to price increases in OECD economies. Some of these factors have subsided or begun to reverse over 2022. Uncertainty about the course of the war in Ukraine and its broader consequences is a key concern. Pressures in global energy markets could also reappear, leading to renewed price spikes and higher inflationary pressures.

The ripple effects of the war have not been felt equally across countries over the past months and have important implications for regions and regional development policy, not least in the wake of the spatial challenges caused by the COVID-19 crisis. Russia's invasion has added new layers of complexity to an already rapidly changing and highly unpredictable world and has served to highlight and sometimes compound already wide and persistent regional inequalities in many OECD countries (OECD, 2022[2]).

The energy crisis is taking a particularly heavy toll on some predominantly rural regions

The energy crisis sparked by the war is delivering a shock of unprecedented breadth and complexity. The biggest tremors have been felt in the markets for natural gas, coal and electricity – with significant turmoil in oil markets as well, necessitating two oil stock releases of unparalleled scale by countries to avoid even more severe disruptions. With unrelenting geopolitical and economic concerns, energy markets remain extremely vulnerable, according to the latest *World Energy Outlook* (IEA, 2022[3]).

The global energy crisis is having far-reaching implications for people, places and firms, prompting short-term responses from governments as well as a deeper debate about the ways to reduce the risk of future disruptions and promote energy security. Net energy export positions and exposure to Russian oil and gas disruptions in particular have shaped the consequences of the turmoil in energy markets for individual countries.

Regions in OECD countries have very heterogeneous energy supply mixes. In 2019, over 50 OECD European regions relied on gas – in large part imported – for more than 50% of their electricity generation. Another 20 regions – including Budapest in Hungary, Groningen in the Netherlands and Lazio in Italy – relied on gas for more than 60% of electricity generation (OECD, 2022[2]). Regions specialised in industries and products more dependent either directly or indirectly on energy, and gas in particular, are exposed to the largest declines in output, employment and the stock of firms, through either reduced firm birth or higher

firm exit. Twenty-five percent of regions with the highest employment shares in gas-intensive sectors are particularly concentrated in Central European countries, notably Austria, the Czech Republic, Poland, the Slovak Republic and Slovenia, as well as in Finland, Northern Italy and Sweden (OECD, 2022[2]). The potential closing of firms or industries due to high production costs might spur further the decline of manufacturing and de-industrialisation that was already underway in several OECD regions long before the crisis, with permanent negative effects on labour capacity utilisation.

Because of their less diversified energy mixes and higher incidence of low-income households, rural regions face the highest energy poverty risk. Analysis of 91 regions from the Czech Republic, Portugal and Spain confirms higher energy poverty in rural regions (OECD, 2022[2]). Estimates of energy poverty show that 38% of non-metropolitan regions are energy poor, with an additional 27% of regions being at risk. In general, living in a non-metropolitan region itself increases the chance of energy poverty by 35%. Additional factors that increase energy poverty include the share of elderly people in a region, low average income and high energy expenditures. Some of these elements being prevalent in non-metropolitan regions means that energy poverty imparts an uneven impact across geographies, particularly on regions outside of small and medium-sized cities.

Overall, subnational government finances are in relatively good shape but could deteriorate going forward

Despite the effects of the COVID-19 pandemic on growth, subnational government revenues have already returned to pre-crisis levels (in real terms) or exceeded growth in expenditures in most OECD countries (OECD, 2023[4]). However, despite the overall good health of subnational governments' finances, their debt levels are at historical highs, which can raise substantial risks. On the one hand, subnational governments in many countries do not issue debt but rather obtain loans which may have floating rates. This means that debt costs can react immediately to interest rate hikes, rapidly increasing the historically low interest paid-to-revenues ratio. On the other hand, the costs of other forms of subnational government funding, such as arrears, are likely to decrease with inflation as they are generally not indexed. In addition, this exposure may vary substantially across jurisdictions – meaning that some individual local/state governments could be exposed to such risks while others not. Another important factor to alleviate these risks is the extent of subnational cash balances that can serve as a valuable cushion for shocks.

Looking forward, subnational government finances could deteriorate, and, in some countries, the updated projection indicates a loss in revenues in the same order of magnitude experienced at the peak of the 2008-09 global financial crisis (OECD, 2023[4]). Although subnational government revenues tend to be more stable than those from the central government, their short-term buoyancy (i.e. the sensitivity of government revenues to economic activity in the short term) is still close to unity, meaning that a reduction in gross domestic product (GDP) growth will almost proportionally affect their revenues. However, there are substantial asymmetries across countries, driven mostly by differences in their tax mixes, with the impact being more substantial for subnational governments relying on corporate income tax revenues and less substantial for those that rely mostly on property taxes (OECD, 2023[4]). According to the OECD's latest estimates, revenue collection is expected to deteriorate at the subnational level in member countries. Subnational government revenues are projected to grow by 1.1% to 10.2%, with an average of 4.5%, which represents an average decrease of 2.4 percentage points (OECD, 2023[4]).

The delicate financial situation central governments find themselves in will likely hinder substantial central support to subnational governments in the future. Not only have national governments absorbed most of the COVID-19 shock (de Biase and Dougherty, 2022[5]) but they are also absorbing the fiscal costs of cushioning household living standards at a time of high inflation. There are also limits to the extent to which national fiscal policy can be stretched, as such policy might also put pressure on prices, prompting reactions from central banks to further raise policy interest rates and, thus, affect debt servicing costs.

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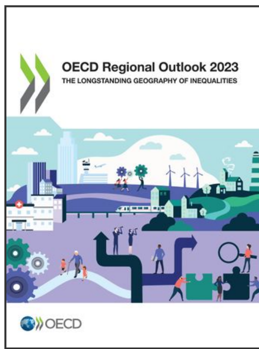

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