

CHAPTER 2

THE MACROECONOMIC CONTEXT OF SECTOR POLICY

- Macro-Meso-Micro Framework
- Importance of the Macroeconomic Context
- Scope of the Macroeconomic Assessment

A. Introduction

Policy reforms supported by ADB, with the exceptions of “crisis” loans, operate primarily at the mesoeconomic level of the economy. This is where the incentive structures faced by economic agents at the microeconomic level are determined by market mechanisms and related institutions. The functioning of markets is governed by an intricate web of institutional arrangements that support economic transactions. Understanding the interrelationship between the macro-, meso-, and microeconomic levels is important for three reasons: First, macroeconomic policy decisions—especially those made in the face of exogenous shocks and that are channeled through the mesoeconomic level to households and firms—can alter the costs and benefits of a reform program. Second, macroeconomic crisis is often triggered, or at the least, exacerbated by meso- and micro-level problems that highlight the need for sector reforms. Third, structural and micro-level reforms can have macroeconomic feedback effects, such as the effect on relative prices and underperforming institutions, which can affect the costs and benefits of the reform program.

This chapter briefly sets out a macro-meso-micro framework for organizing the discussion, reviews the importance of the macroeconomic context in policy analysis, and identifies the scope of macroeconomic assessment.

B. Macro-Meso-Micro Framework⁴

A useful framework for visualizing sector policy work is one that shows how the

mesoeconomic level of the economy provides a link between the macro- and microeconomic levels. A stylized picture of the process is illustrated in Table 1. This framework shows that the particular characteristics of an economy’s performance are determined at the following levels:

- **macroeconomic**, through the fiscal, monetary, and exchange rate policies that are relatively flexible tools for short-run aggregate demand management;
- **mesoeconomic**, through the institutions where policy measures may entail a longer gestation period, and through more easily alterable market regulations, taxes, and subsidies; and
- **microeconomic**, which are only indirectly influenced by the government, especially in market economies.

Analysis of the macroeconomic level deals with the highest level of aggregation among markets, including goods, services, assets, and labor. The interactions determine the equilibrium levels of several aggregate variables, including price level, real output, real interest rate, real wage rate, employment, and exchange rate.

At the other extreme, the most disaggregated analysis focuses on the microeconomic level of economic agents. At this level, the household is the fundamental agent that, in maximizing its own welfare, incurs costs of and garners benefits from given economic activity. Households decide between work and leisure, savings and

⁴ The framework outlined here is a modified version of that presented in Demery et al. (1993), pp. 4–8.

TABLE 1: Links between Macro-Meso-Micro Levels

	Macroeconomic	Meso-economic	Microeconomic
Focus	Economic growth Inflation Unemployment Exchange rate	Most aggregation ← → Least aggregation Relative prices Resource and income distribution Market structure and conduct	Household welfare Work/leisure Firm's profits Expectations Investment decision
Level of Aggregation	Aggregate demand (consumption plus investment plus net exports) Aggregate supply (function of resources and technology)	Sector Markets: Goods & Services • Agriculture • Industry • Private and public services Assets • Financial assets • Land and property • Durable goods Labor • Unskilled • Skilled	Individual/household - Utility function Firm - Production function - Profit function
Parameters and Policies	Economy-wide resource situation and constraints Fiscal, monetary, and exchange rate policies	Governance and standards Customs, rules, and behavioral norms Enabling legal and regulatory environment, rules Institutions, services, and infrastructure Sector-specific and targeted taxes and subsidies Technology, comparative advantage	Household and business resource situation and constraints Broad-based taxes and transfers
Example of Feedback Effects	1. Reduce fiscal deficit through tax increases →	2. Higher commodity prices →	3. Reduced consumption of these commodities ↓
	← 6. Changes in level of aggregate output	← 5. Lower levels of sector outputs delivered to the market	← 4. Cutback in supply by firms in face of decreased demand

Source: Macroeconomics and Finance Research Division/EREA staff, Asian Development Bank.

consumption, and respond to changes in prices and expectations in accordance with budget constraints. For their part, firms are essentially composed of individuals who produce goods and

services. Key decisions made by firms depend largely on changes in prices and expectations, including investment decisions on physical capital and technology.

Between these two extremes lies the mesoeconomic level where prices are determined and agents exchange goods, services, assets, and labor. The level of aggregation can be thought of as flexible along this spectrum. By successively disaggregating markets according to characteristic, region, and time horizon, one moves down along the spectrum toward a progressively more micro-economic level of analysis.

An economy is not a static phenomenon but a constant flow of activities continually buffeted by exogenous events. Many events are too small to have a measurable impact on the wider economy and can be studied within a partial equilibrium framework. However, systemic changes can be thought of as occurring at the macroeconomic level of analysis, resulting in changes in aggregate economic activity. These then feed back through the whole economy, requiring consideration through a more general equilibrium framework.

Conversely, sector- and meso-level reforms can have feedback effects from the micro level to the macro level, through market mechanisms and institutions. Table I shows an attempt to achieve fiscal balance through tax increases that may be passed on to consumers in the form of higher commodity prices. Price signals, in turn, may reduce consumption of these commodities. A decrease in demand for affected goods may force firms to cut back supply, which then feeds back to the macro economy through lower levels of sector outputs delivered to the market. The extent of the changes in aggregate output depends on how

effectively these changes are transmitted or filtered out by market and institutional factors at the mesoeconomic level. Analysis of the effectiveness of such mesoeconomic filters helps in understanding the macro and micro impacts of reforms, and requires close study of the mesoeconomic conditions that determine how macro-level policies are translated into micro-level incentives (Zezza and Llambi 2001).

C. Importance of the Macroeconomic Context

Since most of ADB's policy operations take place at the mesoeconomic level, the possibility of major changes in macroeconomic conditions that can alter an operation's benefits and costs should be considered. For example, a change in the strength and character of medium-term economic growth or in key macroeconomic prices such as the exchange rate can have implications for the viability of a project that supports export growth, or for the valuation of a state-owned enterprise (SOE) to be privatized under a policy operation. Furthermore, as international trade in goods, services, assets, and labor assumes more importance in the domestic economy, economic interdependence can create new opportunities for economic growth as well as new challenges. Exogenous shocks, or the need to adjust to them, may impose higher costs through, for example, rising rates of interest or higher costs of imported inputs and domestic prices for reasons such as currency devaluation or increasing commodity prices. Such instability may increase uncertainty, choking off

investment and slowing the reform process. For example, a fall in the rate of growth of world trade may adversely impact on export prospects with negative feedbacks for agriculture sector reforms. Overall, various outcomes are possible, which underscores the need to understand the macroeconomic context and how it affects the meso and micro levels.

While changes in macroeconomic conditions are difficult to predict, the risks to the policy operation should be assessed if there is evidence of an unsustainable trend, particularly in macroeconomic policy, or if the economy is thought to be vulnerable to external shocks. So, it is necessary to understand past macroeconomic trends and to be able to realistically assess future prospects. Recent examples in ADB operations (Appendix I), where the macroeconomic context has mattered greatly to the outcome of reform programs, include the following:

- rapid monetary expansion triggered high inflation that eroded balance sheets of commercial banks, subsequently undermining financial sector reforms (LAO: Second Financial Sector Program);
- stabilization and fiscal restraint measures reduced expenditures and reforms in the social sector, that, in turn, hampered transition to a new pension system (KAZ: Pension Reform Program);
- the regional financial crisis reduced economic growth and financial inflows, delaying the implementation of SOE reforms and increasing SOE welfare losses (VIE: State-Owned Enterprise Reform and Corporate Governance Program); and

- the global economic slowdown in 2000–2001 reduced the pace of financial and corporate sector reforms in Asia’s crisis-affected economies while increasing nonperforming loans (INO: Financial Governance Reforms).

Other considerations emphasize the importance of understanding the macroeconomic context for sector-level policy operations. For example, a severe macroeconomic crisis or major changes in the political system can underscore the need for structural changes at the mesoeconomic level. Where several major macroeconomic and structural policy changes are under way, it can be difficult to predict the economy’s response to a further policy change. Assessment of the costs and benefits of a given policy measure in order to gauge the appropriate shape or sequence of policy changes would be needed. Here, it is important to consider the degree to which the policy regime, and the structural characteristics of the economy, are in a state of change, in terms of both speed and direction.

Even for a straightforward investment project, cost-benefit analysis can be difficult if the project is undertaken during a period of great economic stress or rapid structural transformation. The analytical challenge can be more difficult still in policy operations aimed at systemic changes that will alter aggregate economic activity. These may alter the mesoeconomic structure and, in turn, affect the macroeconomic phenomena that arise from exogenous shocks, with the result that observed market behavior and the path of economic development may change. The economic analysis of such

policy operations demands analytical rigor because the time horizon may be long (especially for benefits). Also, the analyst must identify and quantify the linkages through which these effects occur. For example, relative price changes can occur that trigger dynamic shifts in resource allocation, spreading costs and benefits beyond the originating sector and affecting aggregate levels of prices and output.

Similarly, institutional reforms can impact on, for example, revenue collection arrangements and the content and approach to expenditures. The effects of decentralization are a case in point. Depending on the nature and size of the impact, this can change the overall fiscal balance, with possible implications for the macroeconomy.

So, an understanding of the macroeconomic context is essential for sector-level policy operations. This helps in designing the appropriate package of policy changes, by identifying the channels through which the impacts of changes arise, and by assessing the sensitivity of the cost-benefit analysis to these changes.

D. Scope of the Macroeconomic Assessment

To the extent possible, the identification of major macro-meso-micro economic linkages should be done as a part of the macroeconomic assessment.

Aspects that need to be covered in discussing the macroeconomic context include the following “checklist” items:⁵

- review of the **economic growth performance**, including key events or trends in the markets for goods,

services, assets, and labor;

- assessment of the **macroeconomic management performance**, including fiscal, monetary, and exchange rate indicators;
- review of the major **structural policies** or characteristics governing market behavior, with coverage tailored to the particular policy reform context, but including trade, financial, investment, commercial, and labor policies;
- provision of an **outlook for economic performance** over the relevant program period; and
- assessment of the overall **macroeconomic framework**, including explicit identification of macroeconomic factors, linkages, and assumptions.

Specific issues and questions within these aspects are as follows.

I. Economic Growth Performance

- What is the country’s level of economic development?
- What is the character of recent economic performance (real GDP growth)?
- Is growth steady, concentrated, or variable across sectors?
- What are the sources and uses of savings?

Answers to these questions can provide insights into the strength of an economy. For example, the character of investment can give an indication of the health of the

⁵ Appendix 2 provides some key lessons as to how discussion of the macroeconomic context and its integration into the analysis of a policy operation can be improved, as well as providing the basic macroeconomic indicators used to support the assessment.

private sector. If a vibrant private sector is important to a policy operation, the analysis should take a closer look at the sector's performance. The analysis should also compare investment as a share of GDP relative to other countries with similar levels of per capita GDP and look at its breakdown into public and private investment. Additionally, the analysis should look at the proportion of investment that domestic savings finance and the extent and magnitude of foreign investment. The analysis should also check whether investment is concentrated in one sector or diversified.

2. Macroeconomic Management Performance

- Does the country enjoy macroeconomic stability?
Such stability is always a prerequisite for successful reform programs. For example, high and increasing inflation is usually a warning of instability, and is often preceded by a rapidly depreciating exchange rate and a rapidly growing money supply. Indications of instability suggest that a closer look at the health of the financial system is warranted.
- How likely is a future episode of macroeconomic instability?
The presence of an independent and credible monetary authority, with a clear monetary goal and a monetary target appropriate to that goal, reduces the risk of future instability. Further, a weak or underdeveloped

banking sector may limit the ability of the central bank in economic policy making.

- Is government finance sustainable, or are large deficits crowding out private investment, causing inflation and building up public debt?

Large deficits may trigger fiscal austerity measures, unless they are covered by official development assistance. If fiscal targets are ambitious or there is extensive off-budget spending, then it is important to know what changes in fiscal policy, such as cuts in expenditures or additional borrowing, will be made.

- How does government revenue compare, as a share of GDP, to that in other countries with similar per capita incomes?

Very low levels of revenue, often dominated by trade taxes, may indicate that, with trade liberalization, structural changes in the taxation system will change business conditions and relative prices.

- Are there any indications of instability in the balance of payments?

A high current account deficit is often indicative of growth. However, a deficit that is rapidly rising as a share of GDP and is financed by short-term capital inflows may be a sign of future risks.

- What is the exchange rate regime?
Although a fixed exchange rate is prone to becoming misaligned, a floating exchange rate is often volatile, leading to pressures for central bank intervention.

3. Structural Policies

- What are the major elements of trade policy?
Factors to consider include the country's affiliation to international trade bodies and its commitment to trade and capital account liberalization.
- What are the major elements of investment policy?
The rules governing foreign investment can affect the attractiveness of foreign investment relative to domestic investment.
- Are there other structural policies or characteristics relevant to the policy operation?
For example, labor law and the functioning of the labor market are often important aspects to consider where investment climate and competitiveness are the focus of reform.

4. Outlook for Economic Performance

- What is the development outlook for the country?
This should include a discussion of medium-term prospects. Such a discussion can help inform progress with the reform agenda, including projections for indicators that will be used for monitoring reform program performance.

5. Macroeconomic Framework and Linkages

- What macroeconomic feedback mechanisms, if any, will need to be

considered in undertaking the program impact analysis?

These include the microeconomic elements most likely to be affected by the macroeconomic framework through identified channels of effect, and vice versa. Additional linkages may have to be identified, and after an initial review, may require an adjustment to the scope, sequencing, or thrust of the proposed set of policy reforms.

- What mesoeconomic transmission mechanisms and channels of effect are instrumental in supporting macroeconomic to microeconomic effects, and vice versa?
- What are the key assumptions about the macroeconomic context and structural characteristics of the economy that underpin the policy operation?
- What types of systemic risks or macroeconomic vulnerabilities will need to be investigated in the context of a sensitivity analysis?

The above checklist is the minimum necessary assessment for each policy operation. Ideally, the review should be carried out by a country economist. Similarly, coordination with other donors that routinely carry out country and sector reviews will increase the understanding of critical economic linkages. Where significant feedback effects and mesoeconomic filters are identified, the resources and capacity for developing independent judgment must be provided to the program preparation team.