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Building Monetary Transmission in Ethiopia

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Building Monetary Transmission in Ethiopia

Prepared by Deirdre Daly and Bryan Gurhy

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ABSTRACT: This Selected Issues Paper reviews Ethiopia's transition to an interest-rate based monetary framework. For this framework to be effective, monetary transmission—the process through which policy rate changes affect inflation and economic activity—must function reliably. Achieving this, requires a clear, well-communicated policy framework, strong analytical capacity, and continued efforts to address structural features that may hamper transmission.

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SELECTED ISSUES PAPERS

Building Monetary Transmission in Ethiopia

Federal Democratic Republic of Ethiopia

Prepared by Deirdre Daly and Bryan Gurhy

INTERNATIONAL MONETARY FUND

THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

SELECTED ISSUES

June 16, 2025

Approved By
African Department

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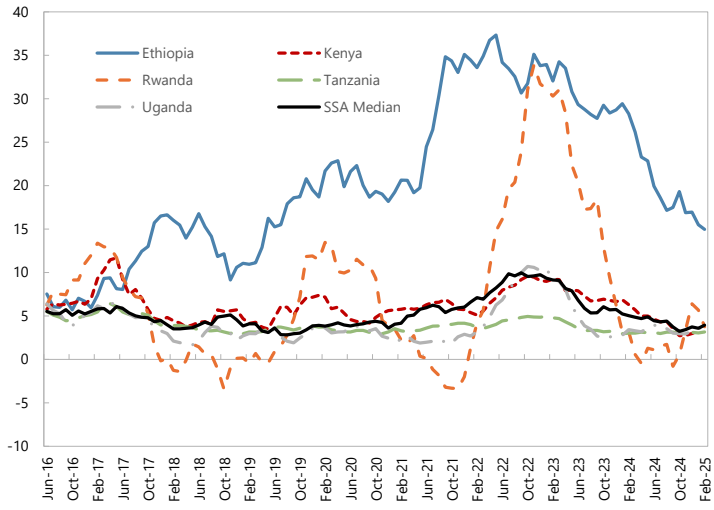
BUILDING MONETARY POLICY TRANSMISSION IN ETHIOPIA

This Selected Issues Paper reviews Ethiopia's transition to an interest-rate based monetary framework. For this framework to be effective, monetary transmission—the process through which policy rate changes affect inflation and economic activity—must function reliably. Achieving this, requires a clear, well-communicated policy framework, strong analytical capacity, and continued efforts to address structural features that may hamper transmission.

1. Although price stability has been an important NBE objective, Ethiopia has struggled to achieve it over the past decade. The NBE has had a legal mandate to deliver stable prices (among other objectives historically including financial sector and exchange rate stability and promoting economic growth). However, inflation has been persistently high, compared with other regional economies, and exceeded double digits since 2018 (Figure 1).

Figure 1. Ethiopia: Inflation versus Sub-Saharan Africa Peers, June 2016–February 2025

(Percent change, y/y)



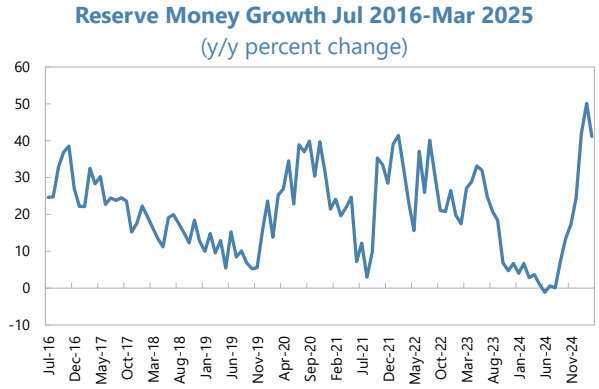
Source: IMF WEO; Haver.

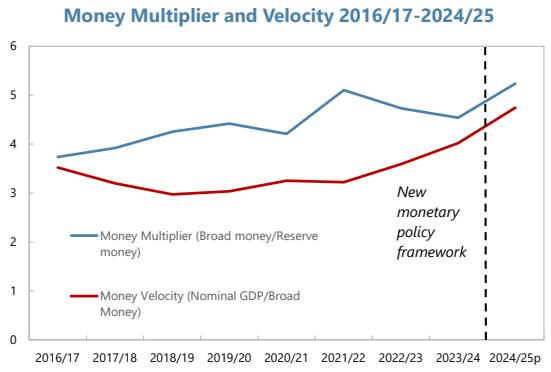
2. Modernizing the monetary policy framework is a key part of the Homegrown Economic Reform Agenda (HGER), launched in 2020, with the objective of correcting macroeconomic imbalances and supporting private sector led growth. Efforts to strengthen monetary policy aim to reduce inflation, including managing potential inflationary impacts from the transition to a flexible exchange rate (another key element of the HGER). In this connection, both monetary and fiscal policy have been tightened to gradually reduce, and in FY2024/25 eliminate, the use of direct NBE advances to finance the budget.

3. Prior to July 2024, the NBE operated under a monetary targeting (MT) policy framework. MT frameworks are grounded in the quantity theory of money, which holds that inflation can be controlled by managing the growth of the money supply, assuming that demand for money has a stable relationship with aggregate output and prices (i.e. a stable velocity of money). Under this framework, the NBE used reserve money as an operational target. While monetary targeting frameworks may be appropriate in some circumstances, stable money demand relationships are rarely observed in practice, making MT frameworks less effective and with often

unpredictable results. In Ethiopia, money demand has shifted over time, reflected in changes in both the money multiplier and velocity of money, which may be due to behavioral changes induced by the long period of high inflation (Figure 2).

Figure 2. Ethiopia: Monetary Aggregates





Source: Ethiopian authorities; IMF Staff Calculations.

4. To support Ethiopia's transition to a modern monetary policy framework, the NBE began using market-based interest rates to guide monetary conditions in July 2024. This marks a shift away from administrative and quantity-based controls toward an interest rate-based framework where the policy rate is used to influence short-term market rates. Broader policy reforms to lay the foundations for this shift are ongoing, including enhancing central bank independence, strengthening the commitment to price stability, deepening financial sector and building technical capacity (Table 1). The framework is supported by open market operations (OMOs), a policy rate corridor, and improvements in liquidity forecasting.

5. To operationalize this new approach, the central bank sets a reference price for money, allowing market forces to determine the quantity of liquidity. This supports more efficient credit allocation by reducing distortions caused by quantity-based controls. To operationalize the new framework, the NBE introduced full allotment liquidity absorbing OMOs, established standing lending and deposit facilities to form a policy corridor at ±300 basis points, and set the overnight interbank lending rate as the operational target. These choices are appropriate for Ethiopia, where financial markets and institutional capacity are still developing. A fixed-rate full-allotment operational framework does not require short-term forecasts of changes in autonomous factors and is robust to changes in banks' demands for excess reserves (IMF, 2022). It was also important that the initial OMO was liquidity absorbing given the structural liquidity surplus and absence of widely available collateral. While a narrower policy corridor can help anchor short term rates, the decision to begin with a wide policy corridor, gradually narrowing over time as operational experience builds, provides flexibility and avoids frequent rate adjustments (which could complicate communication of the policy stance). In October, a new interbank market was launched to support banks' liquidity management. Complementary reforms include improvements to the T-bill market and the introduction of an Emergency Liquidity Assistance framework.

6. While the foundations of the new framework have been established, further reforms are needed to ensure it operates effectively. In the transitional phase, NBE still maintains some quantitative restrictions on lending, including a cap of private credit growth, which it has committed to phase out. The NBE is also taking several measures to further market development and improve liquidity management, including launching a Central Securities Depository (CSD) and fully dematerializing government securities. Given current market structure and the early stage of interbank market development, transitioning to a secured money market provides a practical foundation for a reliable short-term rate. Collateralized transactions can encourage broader participation, enhance confidence among market participants, and support the growth of the government securities market. Ongoing efforts to strengthen inflation forecasting and analytical tools, supported by IMF technical assistance are also critical to help enhance the framework's credibility and effectiveness.

Table 1. Ethiopia: Foundations for Interest-Rate Based Monetary Policy Framework[1]

Component	Policies in Ethiopia
Central bank independence: Need to ensure that central bank policy decisions do not succumb to government's fiscal demands. Requires both strong institutions and fiscal discipline	End to NBE direct advances NBE Proclamation NBE internal organization changes Establishment of the Monetary Policy Committee (MPC)
Clear commitment to price stability: Central bank should avoid targeting other objectives (e.g. exchange rate stability).	NBE mandate enhanced to prioritize price stability over other goals Exchange rate reform Strengthened communication policy
Strong financial sector: Effective and competitive financial sector will help ensure effective monetary transmission.	Gradual reduction in financial repression (phasing out mandatory purchases of T-bonds, ensuring better functioning Treasury bill markets)
Technical capacity: Need to develop capacity to forecast inflation and liquidity developments and the policy response.	Ongoing technical assistance (e.g. FPAS, liquidity forecasting).

[1/] Components adapted from lessons outlined in IMF (2015).

Transmission Channels

7. An effective monetary transmission mechanism will be a key factor in the success of the new monetary policy framework. The transmission mechanism refers to how the instruments used by NBE to implement monetary policy influence financial and economic conditions, and ultimately policy objectives, notably controlling inflation. Transmission typically occurs through the following key channels:

- *Interest rate channel.* Monetary policy rate changes transmit to market interest rates (i.e. interbank rates, Treasury bill rates, deposit and lending rates), influencing the opportunity costs

of lending and saving, and private sector investment decisions. These decisions in turn affect aggregate demand and prices. This is generally considered the strongest and most effective channel of monetary policy transmission in mature interest rate-based regimes. For Ethiopia, however, the low private credit base and the history of financial repression suggests this channel is likely weak and strengthening it will be critical to enhancing the effectiveness of monetary policy.

- *Expectations*. Changes in monetary stance can influence expectations about the economy and inflation dynamics, which in turn may change economic agents' price setting behavior. In Ethiopia, while this channel is still developing, anchoring expectations will become increasingly important as the central bank builds credibility under the new interest rate–based framework.
- *Credit channel*. Monetary policy can transmit into changes in aggregate credit in the economy, influencing aggregate demand and inflation either through bank lending (changes in the policy rate can impact banks' cost of funding and hence their willingness to lend) or firms' capacity to borrow (the balance sheet impact of a policy rate change can affect the value of the collateral they can post to obtain loans). This channel may be less relevant in the context of Ethiopia; the impact on banks' cost of funding is limited given that they do not borrow from capital markets. Firms may also have limited borrowing options, and bank credit has historically been rationed at low interest rates.
- *Exchange rate*. In open economies, an increase in the domestic interest rate relative to the foreign interest rate typically leads to currency appreciation, which can influence inflation directly (by lowering the cost of imported goods) and indirectly (though reduced net exports and aggregate demand). Although Ethiopia currently maintains a closed capital account, the exchange rate channel remains relevant. Transmission may occur through exchange rate expectations and price-setting, with agents using exchange rate changes as "shorthand" for future inflation and the costs of imports, or the parallel market, where interest rate differentials can affect unofficial capital flows and movements in the parallel market exchange rate (IMF, 2020).

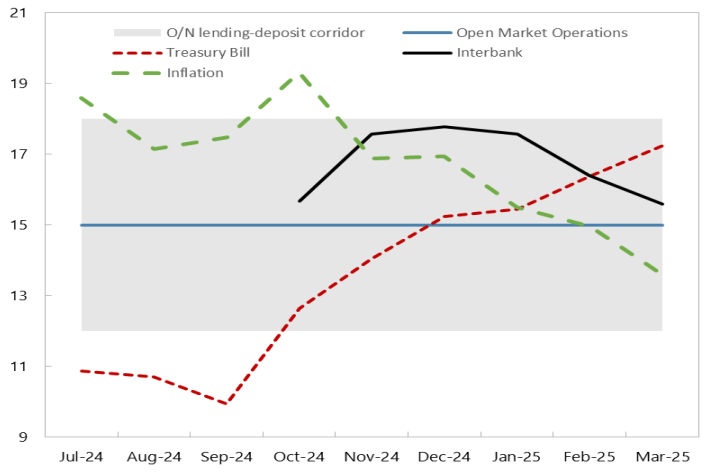
8. Transmission channels tend to be weaker, more volatile, and less predictable in low-income countries (LICs) where financial markets are shallow and monetary frameworks are still evolving. Effective transmission in developing countries is often hampered by the absence of market-based debt issuance, overreliance on central bank financing, and weak institutional capacity to forecast and manage inflation (Debelle et al.,1998). Addressing these constraints is essential for interest rate changes to influence credit conditions, inflation expectations, and ultimately, price stability. Empirical findings are mixed: standard empirical methods often find limited evidence of transmission (Mishra and Montiel, 2013) while more granular analyses show clearer effects (e.g. Berg et al., 2013).

9. In Ethiopia, the first links in the transmission chain are developing. Since the new framework was put in place, both interbank and Treasury bill rates have risen above inflation (Figure 3), while Treasury bill yields also exceeded the policy rate and inflation. While slower to respond, some, some banks increased lending rates in March 2025, the first sign of transmission

through the bank lending channel. With inflation declining quickly and still considerable uncertainty following the exchange rate reform, the strength of the exchange rate channel remains uncertain.

Figure 3. Ethiopia: Interest Rates

(Monthly average percent)



Source: Ethiopian authorities; IMF Staff Calculations.

1/ Treasury bill and interbank rate weighted average across maturities.

Peer Country Experience

10. The experience of other countries that have recently undergone transitions to interest-rate based monetary frameworks may be instructive for Ethiopia as it builds monetary transmission (Table 2). This includes examples from regional peers (Kenya, Tanzania, Rwanda, Uganda) as well as an economy in transition to a more private sector led development model (Uzbekistan). In all cases, building monetary transmission is a process that takes time (Table 3). Many of these peer countries also started their transitions to interest-rate based frameworks at relatively more advanced stages (e.g. with further experience with market determined interest rates).

11. Clarity, consistency, and predictability in the monetary policy framework are essential for strengthening transmission, and the NBE has already taken steps in this direction.

- *Communication.* To influence expectations and behavior, NBEs' policy signal and operating target needs to be clearly communicated. Drawing on experience of cases like Tanzania, Rwanda, and Uganda, which have emphasized communication in their policy frameworks, the NBE has begun publishing Monetary Policy Committee (MPC) statements after meetings to improve transparency and clarity.
- *Consistency and predictability:* Effective transmission relies on consistency between the policy signal (policy rate) and policy actions (OMOs) and predictability in how policy rate changes influence short-term rates. Banks are more likely to adjust lending rates that guide real sector investment and spending decisions when they trust the interest rate structure will be sustained (IMF, 2015). Given the relative importance of the interest rate channel, the central banks' ability to guide economic activity often depends on its control over short-term inter-bank interest rates and how these affects lending rates (Maehle, 2020). This control is strengthened when there is a clearly defined operating target, as (e.g. as in Uganda). In Ethiopia, the NBE has set the operating target as the interbank rate and will phase out the use of quantitative restrictions on bank lending.

12. Credible and consistent implementation is essential for effective monetary policy transmission. To achieve this, central banks must have the capacity to influence short-term interest rates and keep them aligned to the policy rate. This requires progress in three core areas:

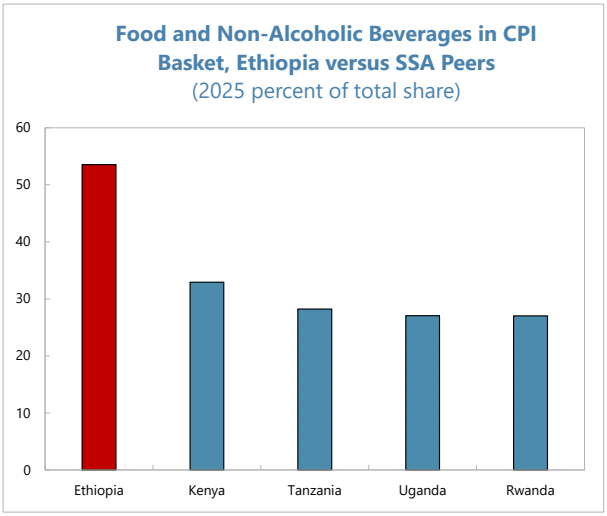
- *Effective monetary policy instruments:* The NBE is making progress in building operational tools (OMOs), standing facilities, and liquidity forecasting. For the policy rate to guide market behavior, it must be complemented by a transparent, market-based reference rate that reflects actual interbank activity such that it serves as a benchmark (as have been implemented in Kenya, Rwanda, and Uganda, for example).
- *Operational autonomy and a sound financial position:* A central bank's ability to guide market rates also depends on its institutional and financial autonomy. Without enough capital, the central bank may need government support to cover losses, such as those from sterilization or exchange rate changes, which can weaken its credibility and expose monetary policy to fiscal and political influence. (IMF, 2015). Some peer countries have taken steps to improve their central bank capital (Uzbekistan, Rwanda), as has Ethiopia under the revised NBE Proclamation to strengthen governance, limit fiscal dominance, and enhance financial resilience.
- *Analytical capacity for forward-looking policy:* monitoring and analyzing the links between the policy rate and inflation outcomes requires technical capacity, tools, and data This may be especially important in Ethiopia, where inflation is often driven by supply side shocks (e.g. drought and floods) and food prices which make up a large share of the CPI index (IMF, 2015) (Figure 4). Responding to negative supply shocks can be complicated since the policy response must balance the inflation shock that challenges the price stability objective with the negative impact on output. Sufficient data and analytical capacity are needed to distinguish between temporary shocks and more persistent inflationary pressures. NBE is updating their quantitative framework for monetary policy analysis through the Forecasting and Policy Analysis System (FPAS). This should be complemented by investment in data compilation and quality, especially to better capture high-frequency and disaggregated inflation drivers. Kenya provides a useful peer example of institutionalizing FPAS to support policy formulation and communication.

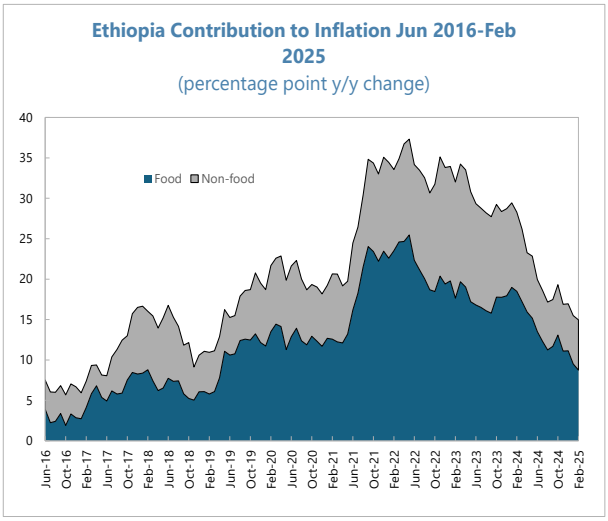
13. Addressing structural features that may weaken monetary policy transmission will also be important.

Structural features include:

- *Shallow money and bond markets.* Deepening of debt and money markets can help develop transmission and is in turn affected by the effectiveness of the monetary policy framework in controlling inflation. A more liquid market enhances NBE's ability to manage liquidity through OMOs and helps to transmit monetary policy rates to broader market interest rates and create trade-offs for banks and investors more quickly and efficiently. Ethiopia should seek to develop a collateralized repo market and encourage interbank trading beyond overnight and 1-week maturities. This will support the development of demand for longer maturities and help the formation of a yield curve from which longer-term private sector lending can be priced. Kenya, Uganda, and Rwanda have stepped up efforts in recent years to develop their local currency bond markets.

Figure 4. Ethiopia: Supply Shocks





Source: Haver; Ethiopian authorities; IMF Staff calculations.

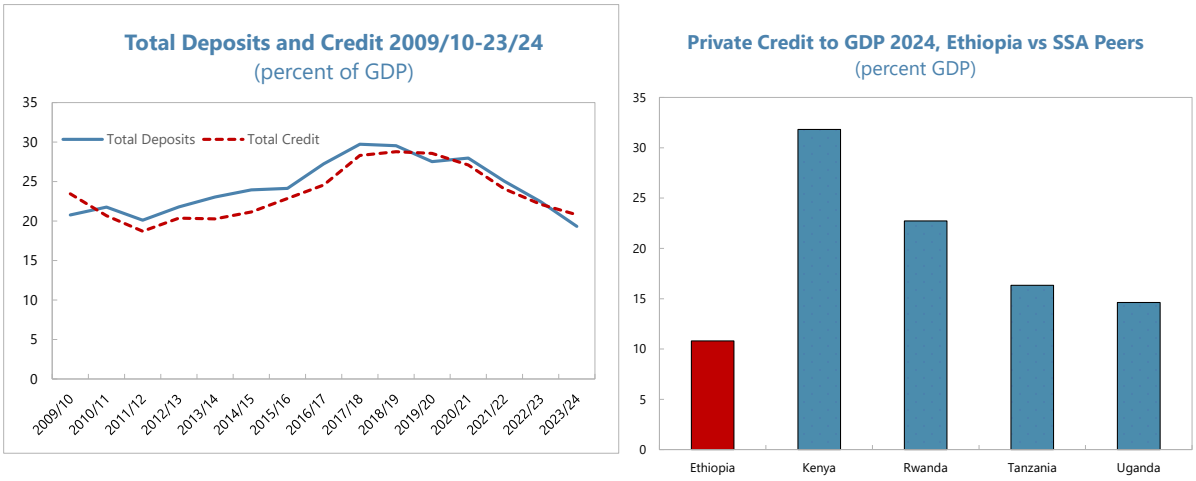
- *Limited financial sector development.* Financial sector development is important for effective monetary policy transmission, as it increases the share of households and firms whose investment and consumption decisions are influenced by interest rates. The Ethiopian financial sector is small with relatively low (and declining in recent years) levels of private sector lending compared with peers (Figure 5). Studies suggest that the interest elasticity of private consumption and investment increases with financial development, indicating that the transmission mechanism strengthens as countries' financial systems develop (IMF, 2015) To support financial sector development, the central bank can play an active role in developing market infrastructure, policy instruments, financial literacy, and access to formal financial services (e.g. as in Rwanda).
- *Risk management and loan pricing.* Transmission requires that banks make risk-based lending decisions that respond to changes in interest rates. However, poor loan quality (e.g. through practices like evergreening) can weaken this link by distorting lending decisions and creating capital constraints that limit banks' ability to lend. To address this, NBE is implementing reforms to strengthen credit discipline, including updated rules on asset classification and provisioning practices, closer monitoring of loan pricing practices, and alignment of capital and regulatory standards with international best practices (e.g. Basel II/III and IFRS).
- *Banking sector competition*. Limited competition can weaken transmission if dominant banks are less responsive to policy rate changes, with profitability not strongly linked to nimble and competitive changes in deposit and lending rates, or lending practices. Lending decisions may be influenced by non-price factors (customer relationships, other business lines, non-economic factors) rather than interest rates. Strengthening competition and ensuring state-owned banks operate on a commercial basis, with explicitly recognized public service obligations where these are needed, will help develop a more market-oriented banking system and improve monetary policy effectiveness. Ethiopia is already taking measures in this regard with ongoing reforms of

CBE to ensure it can operate as a commercially oriented entity, supported by the World Bank's FSSP project.

- *Capital mobility and exchange rate adjustment.* Limited capital mobility and exchange rate flexibility can weaken the exchange rate channel of monetary policy (IMF, 2015). When capital flows are unresponsive to interest rate differentials, and FX interventions limit exchange rate movement, the interest rate parity condition breaks down, dampening the impact of policy rate changes. Limited exchange rate adjustment through FX intervention could also force difficult trade-offs between achieving price stability and letting the exchange rate adjust and confuse market participants on the nominal anchor. While capital account liberalization is not a near-term priority in Ethiopia, greater exchange rate flexibility and smoother FX market functioning will still help strengthen transmission by allowing interest rate changes to influence inflation and exchange rate expectations more effectively as has been found in other cases. In Rwanda, for example, the authorities have conducted a diagnostic assessment of the FX market to strengthen the FX intervention framework. The objective is to limit FX interventions to preventing disorderly exchange rate adjustments and curbing excess volatility, thereby enhancing monetary policy transmission and supporting financial stability.
- *Central bank fiscal financing/policy-based lending.* In environments where central bank financing of government or directed lending to public bodies is significant, monetary policy signals can be diluted or become ineffective (e.g. policy lending in Uzbekistan). NBE has eliminated monetary financing of fiscal deficits and is developing market-based debt issuance. Developing and publishing predictable government financing plans is essential to reinforce these efforts. Over time, coordinating fiscal policy with the new monetary policy framework will help ensure that government financing needs do not undermine efforts to control inflation and stabilize interest rates.

14. Going forward, advancing modernization of the monetary policy framework will help strengthen the monetary transmission mechanism in Ethiopia, though it will take time. Key near-term priorities include continuing to develop a clear, well-communicated policy framework; moving to a single operating target (the policy rate), including with the phase-out of the cap on private credit; and strengthening analytical capacity for policy making. Strengthening NBEs operational autonomy, including by strengthening NBEs financial position and further efforts to support NBE independence (e.g. appointing Board members in accordance with the reformed law) will also enhance the effectiveness of monetary policy. Complementary efforts to develop money and bond markets, expand financial inclusion, financial regulations aimed at reducing financial repression and ensuring a market-oriented financial sector will help address structural features that currently weaken transmission. Over time, these reforms will lay the foundation for more effective and independent monetary policy.

Figure 5. The Federal Democratic Republic of Ethiopia: Financial Sector



Source: Ethiopian authorities; World Bank WDI.

Table 2. Ethiopia: Lessons from Peer-Country Experience in Strengthening Monetary Transmission	
Lesson	**Examples**
Important components for strengthening monetary transmission:	
Communication	**Uganda:** Clear policy statements played a key role in strengthening transmission (Berg and Portillo., 2018). **Tanzania:** Emphasized the importance of communication in its transition to an interest-rate based policy framework by formally publishing its communication strategy in 2023, which includes publishing an annual calendar of MPC meetings as well as monetary policy and MPC meeting statements, and conducting workshops, seminars and other awareness sessions for communicating monetary policy (Bank of Tanzania, 2023).
Consistency between policy signal and policy actions and predictability of the link between policy rate and short-term rate	**Uganda:** Illustrates how a clearly defined operating target can help ensure the central bank has control over short-term rates. The central bank committed to a single operating target (the policy rate), even while experimenting with different implementation tools (e.g. using different repo operations) (Berg and Portillo, 2018).
Effective monetary instruments, including a transparent, market-based reference rate that reflects actual interbank activity	**Uganda:** Introduced a Central Bank Rate (CBR) in 2011, using it to guide the overnight interbank rate via a policy corridor and liquidity operations, while in Rwanda and Kenya, central bank policy rates are similarly supported by observable interbank rates to enhance transmission. Kenya introduced an interest rate corridor around the policy rate in 2023, lowering the discount window rate in tandem.
Central bank autonomy and a sound financial position	**Uzbekistan:** Central bank underwent a major capital injection in 2019[1] to support sterilization and reinforce independence. **Rwanda:** 2017 central bank law stipulates a clear legal framework for now that the National Bank of Rwanda capital can be raised.
Central bank analytical capacity	**Kenya:** The central bank adopted an FPAS in 2013 and the output from the framework serves as a key component of the information base for its MPC meeting and is supplemented with market expectation surveys, providing higher frequency and more granular indicators of the economy.

Table 2. Ethiopia: Lessons from Peer-Country Experience in Strengthening Monetary Transmission (Concluded)[1]	
Structural factors that may complicate monetary transmission:	
Shallow money and bond markets	**Kenya, Uganda**, and **Rwanda:** Have stepped up efforts to address shallow markets in recent years by developing their local currency bond markets. Ongoing reforms have focus on improving primary market practices, issuing benchmark bonds to support pricing and liquidity, diversifying the investor base, and strengthening the legal framework to support repo transactions with greater certainty.
Financial sector development	**Rwanda:** The central bank plays an active role in supporting financing development through engaging in initiatives and awareness campaigns to support financial literacy and inclusion, developing guidelines for women's financial inclusion, and introducing a mobile app that allows consumers to compare cost of financial services across sectors (IMF, 2023). .
Banking sector competition	**Uzbekistan:** State-owned banks had a large footprint (over 80 percent of total assets), and the authorities have taken direct measures to address their size through a banking sector reform program aimed at reducing their role to 40 percent of total assets, including through privatization (Al Rasasi and Cabezon, 2022).
Capital mobility and exchange rate adjustment	**Rwanda:** IMF (2023) found that while transmission through the exchange rate channel was weak, exchange rate passthrough was high. At the time, Rwanda was classified as having a de facto crawl-like exchange rate arrangement, and the country faced FX shortages. Allowing for more exchange rate flexibility was cited as an important way to manage the impact of passthrough on inflation.
Policy-based lending	**Uzbekistan:** the ongoing practice of policy lending, whereby state banks are required to carry out lending at preferential rates to promote social objectives, is cited as a key factor still constraining transmission (IMF, 2024c).

[1/] Authorized capital of the Central Bank to increase by 500 times.

Table 3. Ethiopia: Transition to Interest-Rate Based Monetary Policy Framework Country Examples

Country	Transition time period	Framework	Status of transmission
Kenya	Moved away from a monetary aggregate targeting framework in 2008. Transition has taken time, with interest rate controls imposed during 2016–19.	Forward-looking inflation targeting framework using the policy rate (central bank rate) to signal the monetary policy stance.	Weak but improving with the removal of interest rate controls and the relatively recent introduction and subsequent narrowing of interest rate corridor around the policy rate (IMF, 2024a).
Rwanda	Announced transition to an interest-rate based framework as of 2019. Policy rate and interest rate corridor were introduced in 2008 and 2012, respectively.	Medium-term inflation target (5 percent) with an inflation target band of +/- 3 percent. Operational target to keep interbank rate close to policy rate.	Transmission through the interest rate corridor has improved since the introduction of the new framework but remains limited in the exchange rate channel (IMF, 2023a).
Tanzania	Formally adopted interest-rate based policy framework in January 2024, but transition had been gradual.	Medium-term inflation target of 5 percent. Operational target is to keep the 7-day cash rate within a ±200 bps corridor with the policy rate.	Study before transition to framework found some evidence of active monetary transmission channels, particularly in the interest rate-based channels (overnight interbank and T-bill rates) (IMF, 2023b).
Uganda	Shifted to an inflation targeting regime in 2011.	Policy rate set in response to deviations of the medium-term forecast from the target.	Study on transmission over 2011–23 found transmission to lending rates only in the long run, with stronger transmission through T-bill and exchange rate channels (IMF, 2024b). Earlier studies prior to transition found weak transmission attributed to the lack of monetary policy credibility in the early stages of the regime (Berg and Portillo, 2018).
Uzbekistan	Transition to inflation targeting framework began in January 2020.	Inflation target of 5 percent with the policy rate as the key instrument. Operational objective is to ensure short-term overnight rates remain close to policy rate (within interest rate corridor).	Transmission has been constrained with limited changes to bank lending and deposit rates but improving as reforms have progressed (Al Rasasi and Cabezon, 2022).

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