TECHNICAL ASSISTANCE REPORT

The Federal Democratic Republic of Ethiopia

Forecasting Policy Assessment System (FPAS) Scoping Mission

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Prepared By

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Glossary

AFE	AFRITAC East
ARIMA	Autoregressive Integrated Moving Average
BoP	Balance of Payments
COICOP	Classification of Individual Consumption by Purpose
CPI	Consumer Price Index
CIEA	Composite Indicators of Economic Activities
ECM	Error Correction Model
EMSAD	Economic Modeling and Statistical Analysis Directorate
FPAS	Forecasting and Policy Analysis System
GDP	Gross Domestic Product
MCM	Monetary and Capital Markets
MIDAS	Mixed Data Sampling
NBE	National Bank of Ethiopia
NBG	National Bank of Georgia
NTF	Near Term Forecasting
PCA	Principal Component Analysis
TA	Technical Assistance
QPM	Quarterly Projection Model

Preface

At the request of National Bank of Ethiopia (NBE), a Monetary and Capital Markets (MCM) Department mission visited Addis Ababa, Ethiopia from November 4 to November 8, 2024, to assist the authorities in developing a Forecasting and Policy Analysis System (FPAS).

The mission met with Mr. Mamo E. Mihretu, Governor; Mr. Fikadu Digafie, Vice Governor and Chief Economist, Monetary Stability Cluster; as well as heads of directorates and staff involved in FPAS. The mission wishes to thank the NBE for their cooperation, productive discussions, and warm hospitality.

Executive Summary

The purpose of this mission was to assess the capacity and needs for a Forecasting and Policy Analysis System (FPAS) at the National Bank of Ethiopia (NBE). Considering the ongoing modernization of the monetary policy framework at the NBE, the mission aimed to review the existing FPAS components and identify gaps needing technical assistance (TA) to adjust to the new framework.

While the NBE has a macroeconomic model and some nowcasting tools, several key components of FPAS are still to be developed. The current macro model is an econometric model that does not incorporate structural fundamental economic relationships. Consequently, the inflation forecast does not encompass policy impacts, nor does policy reflect inflation dynamics. For the new interest-based monetary policy framework, an additional macro model that includes interest rate variables is needed. The NBE needs to develop a Quarterly Projection Model (QPM). The NBE currently uses an ARIMA approach for short term inflation forecasting and an Error Correction Model (ECM) for medium term forecasting, which includes disaggregated inflation analysis covering food and non-food inflation. Although quarterly Gross Domestic Product (GDP) data is unavailable, the NBE estimates it using a real sector Composite Indicators of Economic Activities (CIEA) derived from available real sector data using ridge regression and lasso regression methodologies.

The Economic Modeling and Statistical Analysis Directorate (EMSAD) has been established at the NBE, but it requires enhancement in manpower. Strengthening the EMSAD will involve clarifying the roles and responsibilities of various experts to enable deeper and broader analysis. Establishing a dedicated nowcasting team and transferring ownership of the nowcasting framework to sector experts will promote the development of additional tools and models for analysis, judgment support, and near-term forecasts of key domestic variables. Additionally, a dedicated modeling team focusing on the core macro model and medium-term forecasts will contribute to building a Quarterly Projection Model (QPM) and improving medium-term forecasting. Finally, there should be a well-defined team responsible for international forecasts/assumptions, including external factors affecting commodity prices and key macro developments in trading partners.

The NBE should leverage available data to create more analytical indicators that support expert judgment and enhance economic analysis. The NBE possesses monthly data on key Balance of Payments (BoP) items. While this data is currently used to forecast pressures on the exchange rate, it can also be used to estimate external demand. The NBE should evaluate whether the quality of BoP-based trade statistics allows for the creation of proxies for real variables related to exports and imports, which can be used to measure external demand. Additionally, the NBE should develop a monthly Real Effective Exchange Rate (REER) index with a shorter lag than the current three-month lag. Furthermore, if inflation data is available at a detailed COICOP level, including weights, the NBE should develop various sub-indexes to assess the underlying factors driving inflation.

The NBE also needs to establish a proper monetary policy/forecasting process. The NBE started to conduct monetary policy meetings (MPC) four times per year and to publish monetary policy statements, since the inaugural MPC meeting on December 31, 2024. NBE's MPC press release should be preceded by a comprehensive monetary policy/forecasting process. A well-structured forecast process will facilitate the analysis of new information and current developments in both domestic and foreign economies, improve medium-term forecasts, communicate risks to the forecasts, and present policy recommendations to the NBE management.

Table 1. Recommendations

Recommendations and Authority Responsible for Implementation	Priority	Timeframe 1/
Forecasting Process		
Establish a simple forecasting process that includes interactions with the new MPC and NBE Board.	High	Near term
Align the MP process and MPC/Board meetings with important data releases.	High	Medium term
Establish an annual cycle and publish calendar of regular monetary policy meetings.	High	Near Term
Set up a forecasting team, including international, nowcasting, and modeling teams.	High	Near term
Strengthen EMSAD as needed when tools, models, and the forecasting process evolve.	Medium	Medium term
Build a proper database for FPAS in Excel, dedicate data managers.	**High**	**Near term**
Forecasting Tools and Models		
Review the core model and adapt it to the new interest-based framework.	High	Near term
Develop additional tools and models for nowcasting and analyzing inflation.	**High**	**Near term**
Develop a QPM and enhance the nowcasting framework for GDP.	High	Medium term
Communication		
Publish a monetary policy report after each monetary policy meeting.	High	Medium term

1/ Near term: < 12 months; Medium term: 12 to 24 months.

I. Introduction

1. As part of the AFRITAC East (AFE) FPAS work plan for the NBE, a scoping mission was conducted from November 4 to 8, 2024. The aim of the mission was to assess the status of the FPAS and identify developmental needs considering the ongoing transition to an interest rate-based framework. This TA mission reviewed the status of key components of FPAS at the NBE, revealing that both forecasting models and a dedicated forecasting team are in place. The commitment of the Governor, Vice Governor, management, and staff to enhance the NBE's FPAS is promising for the seamless implementation of efficient FPAS, which will include the introduction of additional nowcasting and satellite models, development of a structural macro model, and establishment of a structured monetary policy and forecasting process.

2. The mission integrated scoping with workshops about the features of FPAS and the QPM. The goal was to prepare the NBE for the development and implementation of FPAS, providing presentations to both staff and senior management regarding the FPAS and the QPM, and the transition experience of Georgia (Appendix I). The scoping component of the mission involved reviewing existing models, the forecasting team, recent communications, and forecasting processes.

3. The mission illustrated the FPAS process using the National Bank of Georgia (NBG) as a case study. It detailed all steps of the FPAS process, including planning, setting deadlines, conducting internal discussions, reviewing issues during meetings, and updating forecasts and alternative scenarios (refer to Appendix I). Furthermore, the mission showcased the presentation from the Georgian MPC meeting as an example of how to effectively communicate current economic analysis and forecast scenarios to MPC members.

4. The mission presented Georgia's QPM, comprising four blocks: Aggregate Demand, Phillips Curve, Uncovered Interest Rate Parity, and Monetary Policy Reaction Function. It was emphasized that the primary advantage of the QPM over econometric single-equation models is its dynamic and intra-temporal consistency, ensuring that future expectations are aligned with current realities.

5. The mission shared insights from Georgia's experience in establishing an inflation-targeting monetary policy framework. It outlined the steps taken to create a robust monetary policy operational framework, establish a Monetary Policy Committee, and progressively develop the FPAS. The mission elaborated on how these steps and reforms reinforce monetary policy transmission to the real economy.

6. Under Ethiopia's global policy agenda moving to a market-based economy, the NBE started modernizing its monetary policy in July 2024. The new monetary policy framework includes interest rate-based monetary operations and a floating exchange rate. Under the new proclamation, the MPC will assume an advisory role, while the Board, appointed by the Prime Minister, will be responsible for monetary and financial stability policy. The Board will approve the MPC's recommendations on monetary policy moving forward. The effective implementation of the FPAS framework will be vital to support the NBE's policy agenda in efficiently achieving its primary objective of price stability.

II. Assessing the Key Components of FPAS at the NBE

7. The NBE has already established an economic analysis function to support the monetary and exchange rate framework that existed before the monetary policy reform. It utilizes several statistical models and manages a significant amount of data to inform its processes. Specifically, the ARIMA model is applied for short-term inflation forecasting, the ECM is used for macroeconomic variable forecasting, and the Elastic Net method is employed for nowcasting GDP using the CIEA index. The current forecasting process begins two weeks prior to the MPC meeting. Additionally, the NBE has improved its external communications by updating its website and starting to publish press statements after MPC meetings.

A. Data and Models

8. There is no FPAS database at the NBE, and no data managers have been appointed. The FPAS is heavily dependent on data, making data management essential. Currently, he data used for forecasting at the NBE is scattered, it takes unnecessary time from the forecasters to update it before each forecast exercise and it is prone to human errors.

9. Quarterly National Accounts data, including GDP data, is not yet available. The Ministry of Planning and Development compiles data on GDP and inflation and shares it with the NBE. However, quarterly GDP data is not produced in Ethiopia and it is not expected until 2026. To estimate quarterly GDP, the NBE utilizes a real sector CIEA index. The CIEA index was developed during the IMF technical assistance mission in 2016 and it is designed to provide a quarterly estimate of the trend-cycle of economic growth in volume terms, two quarters ahead of the planned publication timetable for the official quarterly GDP estimates. The CIEA is constructed using high-frequency indicators, which include electricity production, petroleum imports, total airport passenger flows, cement production, import and export flows, tourist arrivals, car registrations, and tax revenues.

10. The NBE has developed a macro econometric model based on ECM methodology since 2009. This model captures short-term adjustments and long-term relationships within key economic sectors, including agriculture, industry, services, fiscal operations, external trade, monetary policy, and price dynamics. The model comprises 37 equations—23 behavioral and 14 identities. Agriculture is modeled based on cultivated land, fertilizer consumption, and the rural active population, while structural breaks, such as droughts, are incorporated using dummy variables. The industrial sector includes labor costs, capital stock, and exchange rates as key determinants. In contrast, the services sector considers urban population growth and linkages with other sectors, such as industry and agriculture. Different sectors are interrelated and consolidated for real output forecasting, employing a similar disaggregated approach for the demand side of the economy. However, the complexity of the model poses significant challenges. The high number of variables increases reliance on judgmental assumptions for external inputs, potentially affecting the consistency and reliability of forecasts.

11. The ECM econometric model was originally constructed using annual data, and staff have since modified it for quarterly use. Some variables within the model retain an annual frequency, presenting challenges for staff in dividing these annual variables into quarterly figures. This difficulty arises due to the limited availability of price indices necessary for constructing real variables. Currently, staff

employ the Denton statistical approach in EViews to address this issue. While the Denton method is acceptable, it tends to smooth out quarter-over-quarter seasonality and patterns.

12. The NBE uses ECM as a core model to inflation forecasting. The NBE has access to detailed inflation data, including weights. The ECM model has a detailed inflation forecasting block, capturing both short- and long-term relationships among key macroeconomic variables. Explanatory variables include broad money supply, real GDP at factor cost, nominal and real effective exchange rates, and global price indices, including trading partner inflation. The model disaggregates inflation into food and non-food components. Food price inflation is modeled based on domestic monetary conditions and external factors, while non-food inflation reflects the availability of foreign exchange and fluctuations in exchange rates. Additionally, the NBE has been forecasting inflation on a monthly and quarterly basis using univariate (disaggregated ARIMA) models by examining the structure of the general, food, and non-food components of the Consumer Price Index (CPI) independently. The Root Mean Square Error is used to assess the accuracy of predicted figures using EViews.

13. The Directorate responsible for BoP statistics computes a REER based on the main trading partner countries. The REER is computed on a quarterly basis, with a significant time lag, as CPI data from some of the countries in the basket is available with a three-month lag. The directorate currently constructs BoP forecasts independently, while the forecasting team conducts separate current account forecasts using the macro model.

B. The Forecasting Team and the Forecast Process

14. Given that the NBE is already engaged in forecasting, a forecasting Directorate is in place. This Directorate consists of eight staff members responsible for all models and the provision of inflation forecasts. The team demonstrates high capacity and is proficient in EViews. However, there is a need to enhance knowledge in EViews and to introduce MATLAB, which is the standard software for QPM.

15. The forecast round takes two weeks. The forecast process starts by the Vice-Governor and Chief Economist presenting policy issues to the relevant directorate for detailed analysis. Then, the directorate will do the analysis and get back to the Vice-Governor and Chief Economist. Second, the Vice-Governor and Chief Economist will present the monetary policy issues to the NBE's Executive Meeting chaired by the Governor. After the Executive Meeting, relevant comments and feedback will be incorporated. The relevant analysis and materials will then be submitted to the NBE Board, and the Board will make a final policy decision.

C. Communications

16. The NBE is in the process of improving external communications. The NBE started to publish monetary policy statement since the inaugural MPC meeting on December 31, 2024. The press statement includes an assessment of current economic developments, as well as the near-term outlook and the policy decision. The statement includes the date of the next policy meeting.

17. The staff prepares a macro forecast report that includes detailed econometric analysis. This report covers re-estimated output results, statistical properties, and forecast evaluations, followed by model output forecasts. The report is backward looking and descriptive, without a clear story about the driving forces behind the forecast, its implications, and the interconnections among the forecasted variables.

III. Recommendations

18. The NBE already has some element of FPAS, but most key components of FPAS are still to be developed. The NBE should establish a well-structured FPAS database to ensure efficient data management and clarity of data quality, while also enhancing the CIEA index and refining the ECM model to align them with monetary policy changes. Continuous evaluation of model variables and exploration of methods for disaggregating GDP data into quarterly figures are essential for improving forecasting accuracy. The forecasting team should become more specialized, with dedicated groups focusing on different economic areas, supported by appropriate software training and staffing. Additionally, a clear forecasting process and timetable, are necessary for successful policy analysis and decision-making (see Table 1).

D. Data and Models

19. Efficient data management and clarity of data quality are critical components for accurate economic analysis and forecasting. A well-structured approach to data collection and organization is essential for maintaining consistency and reliability across economic models and analyses. The NBE should build an FPAS database that includes all relevant data, such as monetary, fiscal, real sector, inflation, external sector, and financial variables. The database should be a single Excel file, updated regularly as new data become available, having sufficient staff. This will ensure data availability on a shared drive and set up a forecast database for storing real-time forecasts (including judgments) for future evaluation. The FPAS database should include metadata for all variables, such as source, frequency, unit, format, etc. If transformations are included, the transformation method and type should also be part of the database.

20. The CIEA index needs to be further enhanced, and the model reviewed. The index was developed with IMF support in 2016 and has not been reevaluated since. The NBE should reassess the model for the composite index, removing some variables that are no longer accessible and incorporating additional high-frequency variables that capture real economic activities as needed. The NBE should also utilize other models using high-frequency data, such as Principal Component Analysis and constructing a MIDAS (Mixed Data Sampling) approach for forecasting real GDP growth.

21. The ECM model needs refinement to respond to changes in the monetary policy framework. To enhance clarity and reduce forecast uncertainty, prioritizing core relationships and explanatory variables is recommended. Refining the model through simplified approaches, such as aggregated explanatory variables, could strengthen usability while maintaining policy relevance. Furthermore, varying methods for data adjustment—specifically the use of both the CPI and GDP deflator—underscore the necessity for methodological standardization. Streamlining the model will improve its functionality and analytical precision. This will bolster the NBE's model robustness, enabling it to serve as a more effective tool for macroeconomic analysis and policy formulation.

22. For future ECM model refinements, it will be important to continuously evaluate the explanatory power of model variables. This could involve incorporating additional relevant high-frequency indicators to improve predictive accuracy and removing variables that demonstrate weak or inconsistent relationships with economic activity. Such iterative adjustments will ensure the robustness and reliability of the composite index in capturing real-time economic dynamics.

23. The NBE should explore various methods for disaggregating annual GDP into quarterly data. The NBE needs to identify high-frequency variables that potentially capture real sector activities. The seasonality of these variables can enhance the quarterly distribution of real GDP, providing a more accurate representation of economic trends.

24. Although the ECM model effectively analyzes price dynamics and provides insights for near-term inflation forecasting, it does not fully align with the requirements of inflation-targeting frameworks. A notable limitation is its absence of an endogenous interest rate reaction function, which is crucial for evaluating monetary policy adjustments in response to inflation deviations. In its current form, the model is more suitable for near-term inflation forecasts than as a comprehensive tool for monetary policy formulation under inflation targeting. Future enhancements should concentrate on incorporating an endogenous policy interest rate, potentially through the development of a QPM model. This evolution would enhance the NBE's ability to link inflation outcomes to monetary policy actions, thereby improving the model's utility in supporting a forward-looking, rule-based monetary policy framework.

25. To improve the NBE's capacity for effective policy analysis and decision-making, the NBE should develop a QPM that incorporates interest rate variables and structural economic relationships. This model will enhance the NBE's ability to forecast inflation and assess the impact of monetary policy decisions. Most central banks have started with a relatively simple New Keynesian semi-structural quarterly gap model – the QPM. The model provides dynamic and intra-temporal consistency, ensuring that future expectations are aligned with current realities. The model explicitly distinguishes equilibriums, or "trends," driven by long-term fundamentals from the deviations from these equilibria, known as the "gaps," which are interpreted as business cycle fluctuations. The semi-structural nature (that is, exclusion of some restrictions) makes these models more flexible in terms of replicating the data and adding country-specific features compared to fully micro-founded models. The development of the QPM model will take significant time; meanwhile, the NBE can rely on the ECM model for inflation forecasting and explore SVAR models for understanding monetary policy transmission channels.

26. The NBE needs to use more analytical data sets. Developing measures to assess underlying inflationary pressures will be part of the FPAS. Examples include standard excluding measures, trimmed inflation measures, and other slow-moving or low-variance measures of CPI. The NBE should also focus on developing additional inflation nowcasting models, incorporating indicators such as commodity prices, export and import prices, trading partner inflation, nominal exchange rates, and other relevant variables. The NBE may disaggregate the CPI forecast into its various subcategories. By applying disaggregated ARIMA models, different types of price-level shocks can be more accurately represented, leading to more precise forecasts.

27. The NBE could build on its detailed customs database to construct export and import price indices. The NBE should evaluate whether the quality of BoP-based trade statistics allows for the creation of proxies for real variables related to exports and imports, which can be used to measure external demand. The REER index is important for evaluating external demand. The NBE should produce REER statistics with a shorter time lag and on a monthly basis.

E. The Forecasting Team and the Forecast Process

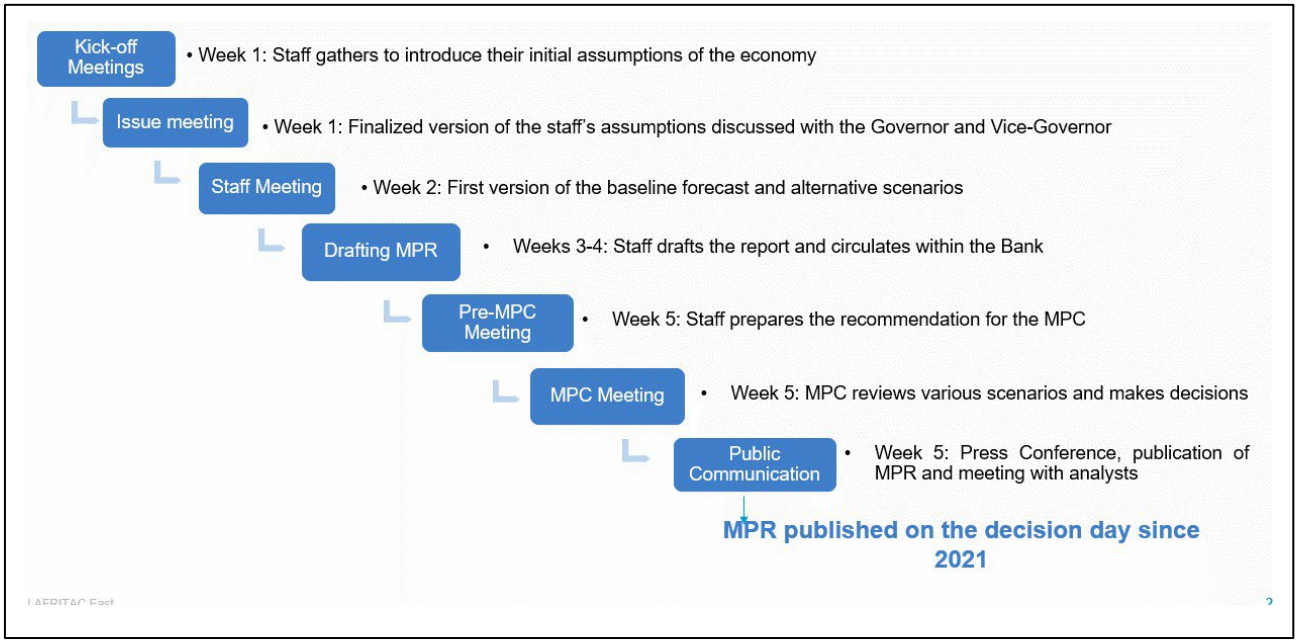
28. The mission recommends that the NBE ensure all forecasting team members have access to software training and acquire licenses tailored to their specific needs. Since the forecasting team should have specialized roles, not all members will require both software. To achieve this specialization,

the forecasting team should be augmented with additional staff. Hiring new personnel at the beginning of the FPAS implementation process will facilitate training for incoming team members.

29. Moving forward, the forecasting team should become more specialized. The team should consist of groups focusing on different areas, such as international and external developments, domestic sector experts responsible for nowcasting their respective sectors, and a specialized team for macro modeling and medium-term forecasting. This specialization will enable team members to develop expert knowledge within their areas of responsibility. For the domestic expert team, there should be an appropriate number of staff members for each sector, including real sector (GDP), fiscal, inflation, labor market, and financial variables. Similarly, the modeling and international teams should have multiple members to ensure backup, institutional memory, and rotation for development and maintenance work.

30. The well-structured and predictable forecasting process and timetable for main meetings is an important element of the FPAS framework. The NBE's new proclamation and framework will require regular monetary policy meetings. This necessitates a preceding monetary policy process to produce analyses and forecasts that inform policymakers about economic developments and the necessary monetary policy for price stability. This process includes several parallel elements, where the forecasting process leads communication and policy-making efforts, which may be formalized to varying degrees. See the example of the NBG, Figure 1.

Figure 1. The FPAS at the National Bank of Georgia



31. The NBE should establish a structure for its forecast process that aligns with its tools and models, as well as the respective roles of the MPC and the Board. Currently, meeting timings do not align with important QNA releases, but once quarterly GDP data becomes available, this will be critical for planning policy meetings to ensure recent data is incorporated into forecasts. This process should allow for: (i) early inputs from policymakers; (ii) a stepwise forecast derivation; (iii) a pre-MPC meeting; and (iv) staff interactions with policymakers. Such a setup will ensure policymakers own the final forecast and that

it reflects their views. Additionally, it will ensure that the medium-term forecast is based on well-analyzed and scrutinized assumptions and forecasts for international developments, external assumptions, and nowcasts for key domestic variables. Future TA missions will assist the NBE in establishing these processes.

32. A forecast coordinator and a detailed schedule incorporating all relevant information will help organize the monetary policy process. The NBE should appoint a forecast coordinator to oversee, coordinate, and plan the monetary policy processes. This coordinator should be a senior individual capable of making decisions regarding the forecast, reconciling differences, and allocating necessary resources. The internal schedule, which is the coordinator's responsibility, should be approved by relevant heads of directorates before the policy round, ensuring necessary resources and shielding participating staff from other work. The schedule should include all relevant meetings and provide details on responsible staff for various tasks during the process, such as presenters, database updaters, meeting chairs, and report drafters. This schedule will help all staff involved in the policy round plan their work and clarify the stepwise nature of the forecast process.

F. Communications

33. The macro forecast report has scope for enhancement. The forecast summary and graphs require refinement. The current graphs display variable levels, making it difficult to interpret underlying values. Moreover, the inflation-targeting FPAS needs forward-looking analysis, explaining the forces driving inflation and transmission channels. Once the NBE develops more economic analysis capacity and improves forecasting models, the report can be transformed into a Monetary Policy Report. It is not necessary to immediately begin publishing a monetary policy report. For now, the NBE could publish a policy statement disclosing the monetary policy decision, the rationale behind it, assessments of current developments, and expectations for inflation and exchange rates.

34. The NBE should explore the type of monetary policy/inflation report that best suits its framework, capacities, and available tools/models. Inspiration could be drawn from regional central banks, such as those in Rwanda and Uganda, as well as from institutions like the Reserve Bank of Australia, Riksbank, Czech National Bank, and the National Bank of Georgia. Once a monetary policy report is published and data is disclosed in Excel format on the NBE website, the NBE may consider discontinuing its quarterly statistical bulletin, as it could divert resources from forecasting and analytical work.

35. The monetary policy process entails three parallel, overlapping, and interacting processes. The forecast process, communication (drafting a monetary policy report), and decision-making process need to be integrated during the forecast round. Currently, there is no established monetary policy process due to the lack of need under the existing framework. The NBE should establish a meeting calendar for the next year and publish it on its website. To ensure predictability, the meeting dates must remain unchanged once published, necessitating effective planning and awareness of the commitments of the Governor, MPC, and Board for the upcoming year. If quarterly GDP data becomes available, meeting dates should align with these releases to facilitate effective forecasting prior to meetings. Additionally, meeting dates right before new inflation releases should be avoided, as near-term forecasts may become obsolete.

IV. Future Steps

36. Key components of FPAS could be further strengthened or developed to better support the ongoing transition from monetary targeting to inflation targeting. The IMF technical assistance will be available to support the NBE in the transformation process and in developing an efficient FPAS framework. Future missions will maintain a near-term and longer-term perspective divided into different work streams (see Table 1 for main recommendations). The near-term focus will involve making necessary adjustments for the NBE FPAS to function effectively during the transition period. The longer-term focus will prepare the NBE FPAS for a purely interest-based framework used for inflation targeting. Key areas of focus will include: (i) structure and process, (ii) nowcasting tools and models, (iii) data and data management, (iv) core macro model, and (v) communication.

Appendix I. Presentations


Monetary Policy Development in Geor


What is FPAS.pdf


Session_1.FPAS_in_georgia.pdf