Ethiopian Economics Association

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ETHIOPIA'S MACROECONOMIC PERFORMANCE AND OUTLOOK

Mezid N. Keraga and Jeleta G. Kebede

September 2026

Addis Ababa, Ethiopia

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Disclaimer

The findings, interpretations, and conclusions expressed in this report are strictly those of the authors and do not necessarily reflect the official position, policy, or views of the Ethiopian Economics Association (EEA).

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ACKNOWLEDGMENTS

The research team wishes to express its sincere gratitude to all individuals and leadership whose support and constructive input made this report possible.

As the 1st edition of the Ethiopian Economics Association (EEA) Macroeconomic Outlook, this report marks a significant milestone in the Association's commitment to delivering timely Ethiopia's macroeconomic analysis and evidence-based policy insights. We extend our appreciation to the Executive Committee (EC) members for initiating and championing this long-overdue flagship initiative.

We are grateful to Prof. Mengistu Ketema for his trust and support in executing this research in a short time frame. We also extend our sincere appreciation to Dr. Naser Yenus for his rigorous review and valuable feedback. Special thanks are also to the EEA Research and Policy Analysis (RPA) team, whose internal reviews and detailed feedback enhanced the quality and clarity of the report.

We acknowledge the valuable contribution of Amanuel Tafesse, who meticulously compiled and prepared the secondary datasets in line with our analytical framework.

Finally, the team extends its heartfelt thanks to the participants of the 23rd International Conference of the Ethiopian Economics Association (July 2026) for their constructive comments, which helped refine our core findings and recommendations.

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ABBREVIATIONS AND ACRONYMS

AfCFTA	African Continental Free Trade Area
ARDL	Autoregressive Distributive Lag
ARMA	Autoregressive Moving Average
CPI	Consumer Price Index
CUSUM	Cumulative Sum
DIFTZ	Djibouti International Free Zone
ECT	Error Correction Term
EPSE	Ethiopian Petroleum Supply Enterprise
FDI	Foreign Direct Investment
GCC	Gulf Cooperation Council
G2G	Government-to-Government
GTP	Growth and Transformation Plan
HGER	Home-Grown Economic Reform
ICE	Internal Combustion Engine
IMF	International Monetary Fund
KPC	Kuwait Petroleum Corporation
LC	Letter of Credit
LIC	Low-Income Country
NBE	National Bank of Ethiopia
NEER	Nominal Effective Exchange Rate
PASDEP	Plan for Accelerated and Sustained Development to End Poverty
PPP	Public-Private Partnership
REER	Real Effective Exchange Rate
SDG	Sustainable Development Goals
SEZ	Special Economic Zone
UAE	United Arab Emirates
US	United States
VAT	Value Added Tax
WB	World Bank

EXECUTIVE SUMMARY

Ethiopia has been one of the fastest growing economies in Africa in the last two decades despite a recent growth slowdown due to several factors including macroeconomic imbalances, conflicts, political instability and structural bottlenecks. The monetary sector of Ethiopia's economy (1993-2025) is characterized by low liquidity growth and managed floats in early 2000s; and monetization of public infrastructure deficits and series of devaluations in the post-2010. The fiscal sector analysis indicates that the country experiences several fiscal challenges including weak tax mobilization capacity and debt distress. The external sector has expanded over the past three decades, with exports and imports achieving average nominal growth rate of 33.25% and 24.2%, respectively.

Ethiopia's economic growth has experienced challenges related to improving labor market outcomes and enhancing structural transformation despite experiencing sustained economic growth for the last two decades. Agriculture exhibited a shrinking GDP contribution while continuing to employ the largest proportion of the labour force. The industry's share of GDP has increased, albeit fluctuations, while its contribution to total employment has been modest. The service sector exhibited expansion in terms of contribution to both GDP and employment. The recent sectoral dynamics of GDP and employment shares largely exhibit modest changes reflecting lagging structural transformation.

Despite labor productivity in agriculture sector is relatively low, the sector continues to employ the largest proportion of the labour force. The industry sector exhibited an increasing contribution to GDP and relatively high labour productivity; however, it has shown a modest contribution to employment creation, even shedding employment in some cases. On the other hand, the service sector experienced expansions in GDP and employment contributions while the overall growth rate of employment share of the service sector is higher than the growth rate of its contribution to GDP. The shift analysis of employment shows that national employment growth is primarily due to the within sector effect while the contribution of structural effect is modest. The findings jointly indicate that Ethiopia faces challenges related to achieving the highly sought structural transformation.

The country's economy, despite experiencing strong growth, performed weakly in terms of employment creation, further manifesting the country's structural problem. The employment elasticity of GDP is modest, albeit heterogeneous across sectors. The average agriculture, industry, service, and overall economy employment elasticity of growth from 2000 to 2025 are 0.04, 0.28, 0.51, and 0.27, respectively. The result of overall economy shows that a 1% increase in economic growth led to 0.27% increase in employment creation indicating that the economic performance has been modest in terms of employment creation. The real sector outlook of Ethiopia reveals mixed prospects. The country will experience a robust economic growth rate in the coming years while its structural challenges will largely persist.

A strong long-run relationship between broad money supply and inflation was observed where a 1% increase in broad money supply yields a 1.55 percentage point rise in headline inflation. Inflation remains agro-centric, as food price dynamics consistently anchor total Consumer Price Index (CPI). However, since 2020, non-food inflation has played an increasingly prominent role in Ethiopia's inflation dynamics. Examining non-food inflation trend is one way to assess exchange rate pass-through effect, while our empirical findings reveal that movements in the Nominal Effective Exchange Rate (NEER) have no statistically significant impact on overall inflation of Ethiopia. July 2024 forex

liberalization corrected long-standing overvaluation, sending quarterly Real Effective Exchange Rate (REER) growth to -38% while non-food inflation exhibits a delayed pass-through from imported inputs. Moreover, post-2020 public credit growth surged while private sector credit was capped at 14% in 2023. This may imply the public debt has been monetized into inflation drivers. Rigid nominal rate ceilings, coupled with high inflation created persistent negative real interest rates, penalizing savers and distorting resource allocation and its efficiency.

Ethiopia faces several fiscal challenges, as evidenced by key fiscal indicators. Its domestic revenue generation is limited, severely constraining the government's ability to finance development priorities and maintain fiscal stability. The country experiences a low tax to GDP ratio, that has continued to be less than 10% since 2018, reflecting that the state capacity to mobilize government revenue has been dwindling in recent years. This limits the government's ability to finance essential infrastructure, social programs, and development priorities. Revenue mobilization through taxation also faces structural challenges as it disproportionately relies on indirect tax posing risks related to regressive consumption taxation, thereby potentially adversely impacting income distribution.

Government expenditure to GDP ratio has declined, reflecting shrinking government size. The expenditure composition has structural challenges as spending is increasingly dominated by recurrent expenses at the expense of long-term investments. The dominance of recurrent expenses at the expense of long-term investment (that boosts future government revenue) potentially poses fiscal sustainability risks. The percentage share of social development in total capital expenditure has been recently falling; it reflects that government priorities are relatively shifting away from spending on social developments such as education and health, posing potential risks of slowing down long-term social progress.

The overall budget deficit and primary deficit to GDP ratio of the country have experienced a falling trend. However, the fact that Ethiopia experiences primary balance deficit reflects that the government cannot cover its day-to-day expenses let alone pay its previous debt. The government experiences debt distress when gauged against key indicators; particularly currency decomposition of debt that shows increasing foreign debt to GDP ratio recently, while domestic debt to GDP ratio is falling, poses several risks including exchange rate risk. Additionally, debt distress is more revealed through the debt service to export ratio; Ethiopia, a low-debt carrying capacity country, surpasses the threshold of even high-debt carrying capacity countries in terms of debt service to export ratio, posing further exchange rate risks. The fiscal outlooks show that the country's fiscal challenges will largely persist in the coming years.

Ethiopia's foreign exchange earnings remain heavily dependent on primary commodity exports. Despite coffee ($1.28 billion period average) and gold ($701.1 million period average) expanding in post-2018. Conflicts across the country disrupted core farming zones, shrinking sesame exports from 359,000 tons to 210,000 tons. Leather exports reduced from $132.4 million in 2018 to $17.4 million in 2025. The number of operating tanneries reduced from 35 to 7 due to input shortages and the 2022 U.S. AGOA revocation ($83 million direct export contraction). On the other hand, the bilateral trade balance with major trading partners reveals that Ethiopia's trade position remains in persistent deficit. Bilateral trade surplus isolated to the Netherlands (+$62.6 million annual average) via floriculture exports. Substantial net deficits dominate with China (-$2.5 billion annual average), India (-$1.5 billion), Kuwait (-$873.7 million), Saudi Arabia (-$639.7 million), and the UAE (-$609.8 million).

The series of devaluations executed by the Ethiopian has failed to improve the performance of the export sector due to the underlying structural bottlenecks in the Ethiopian economy. Over 50% of Ethiopia's imports consist of intermediate and capital goods, and 52% of domestic manufacturing relies on foreign inputs. Depreciations (NEER averaging -5.9% for the period) rapidly transmitted to imported inflation and domestic factor costs, and offsetting price competitiveness. Exporters align their pricing with parallel market rates due to the sizable premium over official rates. However, depreciating the official exchange rate narrows the parallel market premium, reducing the incentives for illicit trade and under-invoicing. As this rate gap closes, businesses become far more willing to accurately declare their full export earnings through official financial channels, thereby improving export recording and, consequently, measured export performance Imports also display a one-quarter lag to NEER shocks owing to bank Forex queue rationing, credit constraints, and trade-financing lead times. Forex rationing forces multi-activity firms to cross-subsidize low-margin primary exports with domestic retail margins on parallel market-priced imports.

Inflation remains locked in double digits, easing only slightly from 16.5% in 2026 to 14.9% by 2030. The external sector performance (imports and exports) largely continue as the baseline in the short run with export performance may be performing less in the coming three years while the imports will continue to keep growing on the average of the historical trend. Achieving single-digit inflation by 2030 (9.2%) requires controlled monetary expansion. Based on the analyses, the following major policy recommendations are suggested.

To enhance structural transformation and job creation, thereby promoting inclusive economic growth and achieving the Sustainable Development Goals (SDGs), designing and implementing labor-intensive industrial policy that accounts for the structural challenges of the country are essential. Moreover, promoting revenue mobilization and administration capacity of the government and enhancing fiscal transparency and compliance are vital to addressing the fiscal challenges. Promoting fiscal policies that prioritize capital expenditure over recurrent expenses is also essential to enhance long-term investments that in turn boosts future government revenue mobilization and hence enhances fiscal sustainability. Moreover, a proportionate allocation of capital budget to social development is imperative to promote social progress through human capital formation, thereby building an inclusive economy that in the long-term boost government revenue base and fiscal sustainability. Furthermore, promoting long-term development finance through prioritizing concessional borrowing and utilizing alternative development financing such as Private Public Partnerships (PPP) is vital.

Decelerates money supply growth below the historical average and adjust nominal policy rates to restore positive real interest rates. Encouraging investment in agricultural value chains to relieve food supply shocks and deploy targeted social buffers to absorb forex unification pass-through effects. Moreover, full Forex market unification is critical to narrow down distortionary parallel market premiums, end cross-subsidization incentives, and allow supply-demand market clearing.

Address the trade imbalances with major partners (China, India, Gulf states) by negotiating local-currency settlement frameworks, and countertrade agreements. Initiate diplomatic efforts to restore U.S. AGOA access while expanding commercial and logistics corridors across GCC and the African Continental Free Trade Area (AfCFTA). Furthermore, re-establish secure agricultural supply corridors to restore sesame export capacity, and provide priority foreign exchange allocations, raw hide collection incentives, and duty drawbacks to rebuild domestic tannery factories.

GENERAL INTRODUCTION

Ethiopia recorded one of Africa's highest growth rates in the last two decades despite a recent growth slowdown due to several factors including macroeconomic imbalances and structural bottlenecks. This report presents the performance of the Ethiopian macroeconomy in the last three decades and provides macroeconomic outlook. The report covers the real and monetary sector performances and evaluates the performance of the fiscal and external sectors. Moreover, the report provides the medium-term macroeconomic outlook for GDP growth, inflation, expenditure, budget balance, debt, export, and import.

This macroeconomy performance and outlook report of Ethiopia is organized in five chapters. The first chapter deals with the real sector of the Ethiopian economy, presenting economic growth and standard of living, sectoral composition of the economy, employment dynamics and labor market conditions, structural analysis, growth-employment nexus, and the outlook of the real sector.

The second chapter provides an empirical analysis of broad money supply growth, real interest rates, foreign exchange dynamics, and inflation in Ethiopia over the 32-year period from 1993 to 2025. It systematically examines how monetary expansion, exchange rate adjustments, and domestic credit allocation interact to drive price volatility. The chapter establishes four distinct policy regimes using statistical tests for structural breaks: the Post-Command Transition Phase (1993–2002), the State-Led Growth Phase (2003–2009), the Devaluation Phase (2010–2017), and the Market Liberalization Phase (2018–present). The chapter also discusses the monetary transmission channels, evaluating the co-movement between money supply growth, inflation, the parallel market exchange rate premium, and Nominal/Real Effective Exchange Rate adjustments. Moreover, the chapter presents medium-term inflation projections for the 2026–2030 horizon by employing the Autoregressive Distributed Lag (ARDL) econometric framework under baseline and monetary, exchange rate, and policy shift scenarios. Finally, it outlines strategic policy recommendations for the National Bank of Ethiopia and the Ministry of Finance to rein in persistent double-digit inflation and restore macroeconomic stability.

Chapter three deals with the fiscal sector of the economy. It presents fiscal stance detailing the government expenditure and revenue dynamics, fiscal balance focusing on overall government budget balance and primary balance, public debt and sustainability analyses, and the fiscal outlook.

Chapter four analyses the performance, trajectory, and structural dynamics of Ethiopia's external sector over a 32-year period from 1993 to 2025. The chapter analyzes the export sector's performance across four distinct structural regimes: the Post-Command Transition Period (1993–2002), the State-Led Growth Period (2003–2009), the Devaluation Period (2010–2017), and the Market Liberalization Period (2018–2025). It evaluates disaggregated trends across seven major exporting commodities coffee, oilseeds, gold, pulses, leather and leather products, meat and meat products, fruits and vegetables alongside major export destinations. Furthermore, the chapter examines the transmission channels of the Nominal Effective Exchange Rate (NEER), Real Effective Exchange Rate (REER), and the parallel market exchange rate premium on export growth. The chapter also analyses the trends of Ethiopia's import sector, disaggregating imports by major product categories and key geographic trade partners. It assesses the one-quarter lagged sensitivity of import growth to exchange rate adjustments and examines bilateral trade balances to highlight structural deficits with major capital- and energy-supplying nations. Finally, the chapter reviews the historical growth trajectory of Ethiopia's trade deficit

over the past three decades and concludes with key findings and strategic policy recommendations to rebuild export competitiveness, address supply-side rigidities, and reduce systemic balance-of-payments constraints.

The final chapter summarizes key findings, presents the conclusions, and draws key macroeconomic policy implications.

CHAPTER ONE

REAL SECTOR PERFORMANCE AND PROSPECTS

1.1. Introduction

In the last two decades, Ethiopia recorded one of Africa's highest growth rates despite recent growth slowdown due to several factors including macroeconomic imbalances and structural bottlenecks; the growth has been underpinned by public sector investments in physical and social infrastructure (Note & Polic, 2022; IMF, 2025; IMF, 2026; AfDB, 2026a; AfDB, 2026b; WB, 2026). The country's real GDP growth performance, which has been driven by different factors including large scale public investment and rapid urbanization, has consistently outperformed regional peers over the past two decades (Hegab, 2025). The overall real sector performance of the country exhibits mixed results: robust and sustained economic growth along with labor market condition challenges, structural challenges, and lagging structural transformation (AfDB, 2022; WB, 2024). The labor market condition of the country is characterized by rising overall unemployment, reducing labor market participation rate and higher urban unemployment rate compared to national level unemployment.

In terms of sectoral contributions to overall economy (GDP) and national employment, the country experienced challenges to achieve the desired structural transformation. While the agricultural sector has continued to shrink at least until around 2018 in terms of its contribution to GDP, it continues to employ the largest proportion of the country's labor force. Despite an increased share in its contribution to GDP while fluctuations were observed, industry's share in national employment creation has been modest. The service sector has exhibited expansion both in terms of its contribution to GDP and employment creation. While the overall dynamics shows increasing contribution of industry and service sectors to GDP and that of agriculture has been shrinking over time, recent performance shows that sectoral dynamics regarding their share in the overall economy have largely stagnated. Similar trends have been observed in recent years in terms of sectoral dynamics related to their contribution to employment creation.

The dynamics of sectoral relative GDP contribution and employment creation nexus of the country also augment the structural challenges that the country is facing. While agriculture showed a shrinking role in terms of its contribution to GDP and exhibited relatively lower labor productivity, employment has continued to be trapped in this low-productivity sector. Although the contribution of industry to GDP has shown an increasing trend and labor productivity has been rising in the sector, it has shown just modest contribution to national employment and in some cases even shedding employment. The service sector has relatively shown an expansion in both GDP and national employment contributions. The overall growth rate of employment share of the service sector is higher than the growth rate of its GDP share reflecting that workers are relocating from low-productive agriculture to low-productive service-sector signaling that the labor shift is horizontal from one low-productive sector to another low-productive sector. This likely limits the progress of structural transformation of the Ethiopian economy.

Moreover, shift-share analysis of employment shows that national employment growth is primarily due to the within sector effect while contribution of the structural effect is modest reflecting that the country experiences challenges related to achieving the highly desired structural transformation. Moreover, despite strong and robust real GDP growth being observed, the economy performed weakly in terms of

employment creation. The employment elasticity of economic growth shows that the overall economy performed modestly in terms of job creation while heterogeneity is observed across sectors.

1.2. Economic Growth and Standard of Living

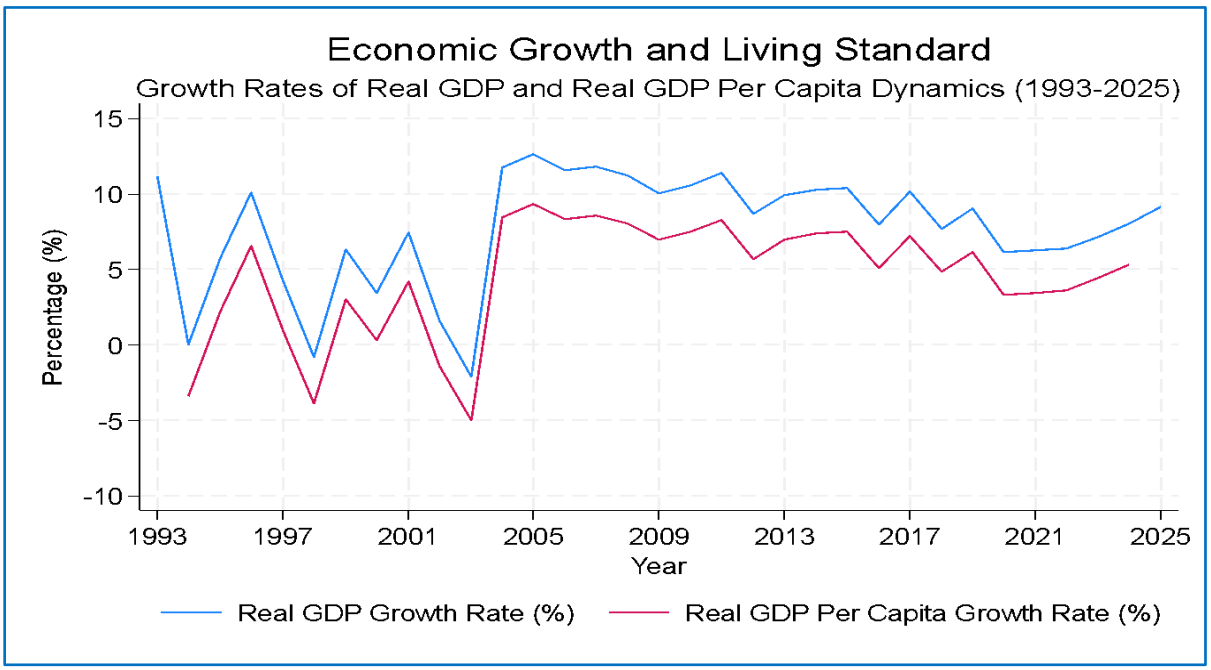
Economic performance of Ethiopia over the past three decades is characterized by an upward trend while some volatilities have been observed. Figure 1.1 shows that Ethiopia experienced robust and sustained economic growth over the time under consideration despite observed fluctuations[3]. Based on structural break tests, we present the results for before and after 2003: while a modest economic growth rate (3.6% on average growth rate) was observed before 2003, close to ten percent (9.48% average growth rate) was experienced after 2003. The structural break timing is associated with the lowest economic growth rate that coincided with the drought that the country experienced in 2002-2003. After 2003, the economic growth rate of the country dramatically increased to double digits; the robust growth rate persisted despite fluctuations and gradually declined, ultimately experiencing single digit growth rate.

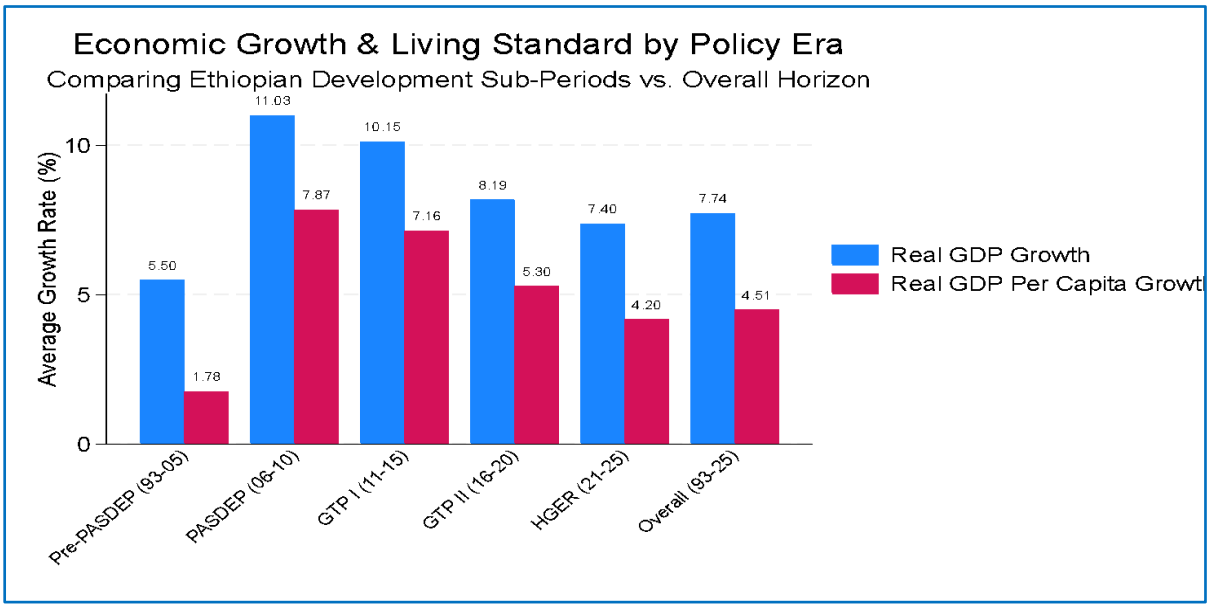
To contextualize the fluctuations of the economic performance of the country, following the literature (Gebreeyesus & Abegaz,2025), we present real sector performance of the country by categorizing the time period into five policy regimes: (i) *pre- Plan for Accelerated and Sustained Development to End Poverty (pre-PASDEP) (1993–2005)*, (ii) *PASDEP (2006–2010)*, (iii) *Growth and Transformation Plan (GTP) I (2011–2015)*, (iv) *GTP II (2016–2020)*, and *Home-Grown Economic Reform (HGER) (2021–2025)*. While the lowest average economic growth rate of 5.5% was observed during pre-PASDEP, the highest economic performance was observed during PASDEP where the country on average experienced a double-digit growth rate of 11.3%. GTP I observed the second highest economic growth rate, which is double-digit, that on average amounts to 10.15%.

In GTP II, the country experienced single-digit growth rates that on average amounted to 8.19%. The gradual decline of economic growth rate from double-digit during GTP I to single-digit during GTP II may be explained by political instability that the country was going through and the COVID-19 pandemic during the policy regime. A combination of internal and external factors (such as growing trade and savings-investment deficits, rising inflation, which were largely driven by expansive public investment, and increasing macroeconomic imbalances) contributed to the deceleration of economic performance during this policy regime. The challenges were deepened by political uncertainty and peace concerns that adversely impacted investor confidence and disrupted economic activity of the country.

[3] We undertook structural break tests of multiple structural breaks vs one structural and found that a single structural break was observed in 2003. The timing of the structural break is associated with the drought and associated shocks that Ethiopia experienced.

Figure 1. 1: Economic Growth and Living Standard





Source: National Bank of Ethiopia

The economic growth rate of the country declined further during HGER (2021 - 2025), reaching an average of 7.40%. This further decline in economic growth is likely attributed to the continued adverse effects of the COVID-19 pandemic shocks coupled with political instability, conflicts, and civil war. Despite still being single digit, the economic growth rate of the country has recently experienced an upward trend; specifically, following the end of the civil war, the economy started recovering showing an upward growth trend. Overall, despite fluctuations, the economic performance of the country has continued to exhibit robust and persistent growth. The growth rate of real GDP per capita follows similar patterns to that of real GDP. Overall, the strong and sustained growth rate of the GDP per capita over the last two decades indicates continuous improvement in living standards of average citizens.

1.3. Sectoral Composition of the Economy

The sectoral decomposition of Ethiopia's economic performance shows contributions of agriculture, industry, and service during the time under consideration exhibit varying trends. Figure 1.2 presents the results. Agriculture covered more than 50% of real GDP until around 2007 while experiencing a persistently falling trajectory, reaching about 33% around 2020 after which it showed modest decline without observing notable falling. The figure shows Ethiopia's economy has become less agriculture-dominated in terms of GDP share, though agriculture remains the largest employer.

The service sector was the second largest sector, contributing to around 35% in 2000 while showing an increasing trend since then, except for stagnation in recent years. Starting from 2015, in terms of contribution to the overall economy, service sector contribution surpassed that of agriculture; its contribution to GDP further rose to about 40% in 2020. The increasing service sector's contribution to the economy reflects strong expansion in trade, transport, telecommunications, and financial services in the country, albeit stagnation of its contribution in recent years.

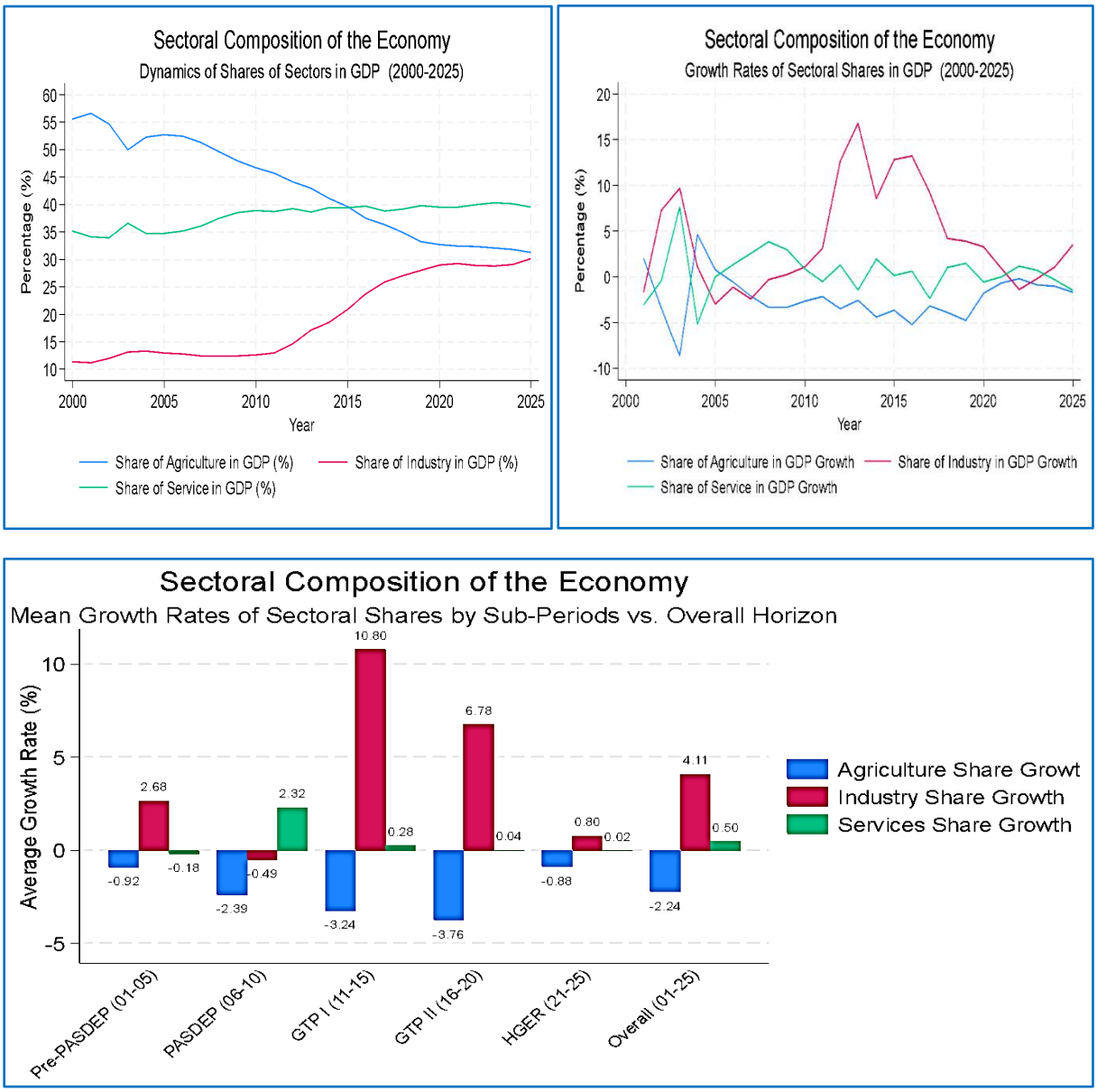
The industrial sector's contribution to the economy increased from around 12% in 2000 to about 29% in 2020 with persistent increase for about two decades. Specifically, years after 2010 to 2020 are characterized by relatively rapid industrialization in the form of expansion of Special Economic Zones (SEZs) (Abagna, 2025). After 2020, the contribution of the sector hovered around 30% of GDP, making it the smallest sector in terms of contribution to the overall economy. According to Lorato et al. (2025), despite designing and implementing different industrialization strategies, Ethiopia has not shifted the economy from dominance of agriculture to industry. Studies show that most of industry's contribution to GDP came from construction, mining, and utilities rather than from manufacturing; although positive, the contribution of the manufacturing sub-sector to the economy remained relatively modest (Gebreeyesus & Abegaz, 2025). Accordingly, although Ethiopia has achieved remarkable and sustained economic growth over the last two decades, the manufacturing sub-sector, long hailed as the main engine of structural transformation (Gebreeyesus, 2017), has contributed modestly to the economy.

The dynamics of sectoral GDP contribution can be better understood when analyzing policy regimes separately. During the pre-PASDEP, the contribution of the agricultural sector experienced negative average growth rates reaching a minimum of around -9% in 2003 that coincided with the 2002-2003 drought. Overall, despite fluctuations, agriculture and service sectors experienced negative growth rates in terms of their share in the overall economy during pre-PASDEP; negative growth of agricultural and service sectors share in GDP was compensated for by positive average growth rate of industry contribution in GDP. The PASDEP policy regime observed a declining contribution of agriculture to GDP. The industrial sector that showed positive average growth during pre-PASDEP experienced negative average growth rate during PASDEP; the negative growth of agriculture and industry contributions to GDP were compensated for by increasing share of the service sector.

The average growth rate of industry's contribution to GDP accelerated during GTP I, experiencing double-digit growth. During this period, while the share of the service sector exhibited a moderate growth rate, the agricultural sector's contribution to GDP observed a huge reduction. The contribution of the industrial sector increased further through GTP II attaining its second highest growth rate peak while service contribution showed very modest positive growth. Agriculture contribution exhibited the highest reduction during GTP II. Accordingly, peaks of growth in industry contribution to GDP are associated with GTPs: the highest and second highest growth rates of industrial contribution to GDP were observed during GTP I and GTP II, respectively. The expansion in industrialization and industry

share in GDP, which are outcomes of deliberate policy strategies, during these periods was largely fueled by heavy investments in infrastructure, industrial parks, and public enterprises (Abagna, 2025).

Figure 1. 2: Sectoral Composition and Dynamics of the Economy



Source: National Bank of Ethiopia

However, as observed from the HGER policy regime results, the industrial sector could not sustain the robust growth rate of its GDP contribution observed during the GTPs; the contribution of the sector to GDP experienced a persistent downward trend ultimately experiencing a negative growth rate around 2021/22, with an up-ticking trend recently. The sharp increase in industry's share in GDP starting from 2010 for about a decade and then exhibiting stagnation after 2020 potentially signals the presence of premature de-industrialization, a situation that characterizes many developing economies. Accordingly, the positive structural transformation, gradual decline in agriculture share and rise in industry's share, stagnated after 2020. The flattening of all three sectors' contributions over the last five years suggests that Ethiopia's structural transformation has stalled, at least when measured by sectoral GDP shares.

Therefore, Ethiopia's structural transformation is not in line with the robust and sustained growth rate it experienced for the last two decades. In general, the recently increasing growth rate of agriculture share, declining industry share, and stagnating service share in GDP indicate challenges that Ethiopia is facing related to structural transformation—the process by which economies shift labour and output from low-productivity sectors to high-productivity sectors. While rising industrial sector share in an economy is an indication of structural transformation, the continuously falling share of the sector over the last close to a decade, despite a recent up ticking, might have adversely impacted economic structural transformation of Ethiopia. Ethiopia's experience in this perspective is similar to that of other African countries as observed by Newfarmer et al. (2018). The authors note that Africa's experience in terms of industrial sector in general and manufacturing sub-sector in particular—which economies have historically relied on at an early stage of the structural transformation process—has been disappointing, triggering a question about the durability of growth prospects of the continent.

Against this background, Newfarmer et al. (2018) argue about the importance of industries without smokestacks in driving structural transformation in Africa. In the context of Ethiopia, despite the fact that industrial sector in general and manufacturing sub-sector in particular is known to have a unique role in structural transformation, Gebreyesus (2017) notes that industries without smokestacks such as horticulture, agro-industry, and tradable services that include IT, tourism, and transport can drive economic growth and provide new opportunities for export development. The author argues that Ethiopia is well positioned to exploit opportunities in industries without smokestacks because of its diversified agroecological advantages and vast tourist attractions—man-made and natural—given the huge unexploited potential that the country is endowed with regarding these sub-sectors.

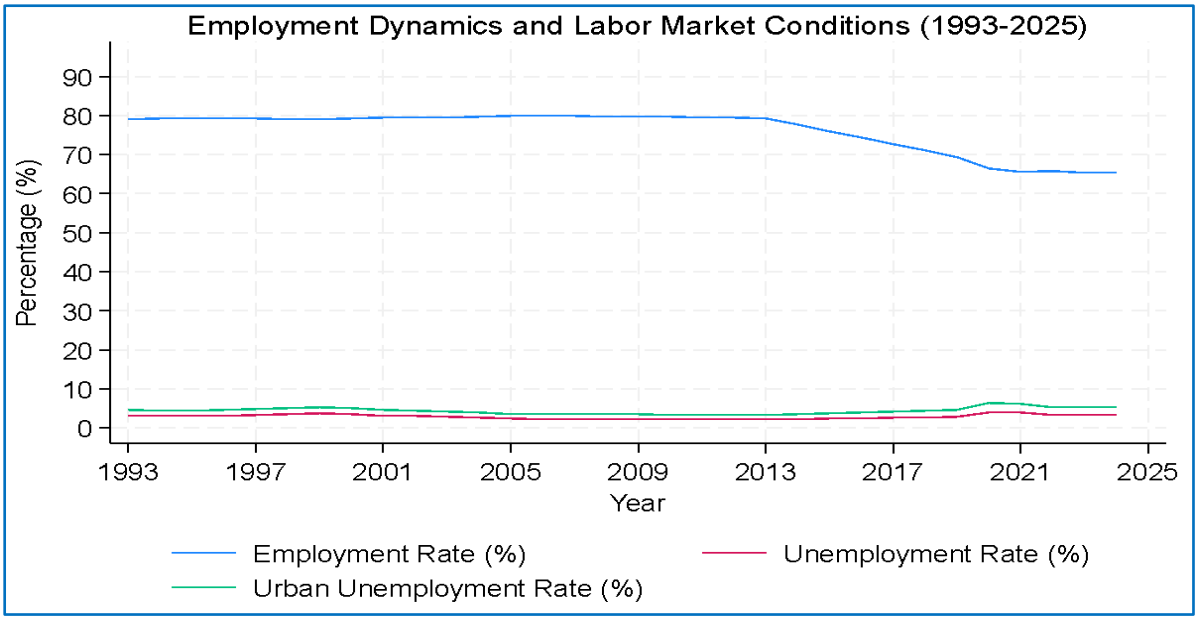
1.4. Employment Dynamics and Labor Market Conditions

1.4.1. Overall Employment Dynamics

Figure 1.3 presents the employment and unemployment trends in Ethiopia for the last three decades. The employment rate persistently hovered around 80% until about 2013, after which the figure started to drastically decline reaching around 65% in 2020 and showed persistence since. Unemployment rate persisted roughly 5% until around 2019; it rose to 7% in 2020 and has exhibited no tendency of falling since. The recently falling employment rate and increasing unemployment rate jointly indicate that labor market conditions of the country are not healthy. The falling employment rate signals that the economy is experiencing challenges related to creating job opportunities. This is related to structural transformation challenges that the country has continued to experience in the last more than half of a decade. Such an increase in the unemployment rate, coupled with structural transformation challenges, may pose concerns related to achieving inclusive economic growth because rising unemployment potentially adversely impacts income distribution.

Urban unemployment rate is consistently greater than the aggregate national unemployment rate indicating the presence of structural challenges related to unemployment rates. As presented in Figure 1.3.A. in the Appendix, growth rate of the labor market indicators reveals more insightful points. The growth rate of overall unemployment rate and urban unemployment rate experience fluctuations over course of time, attaining their respective peaks during shocks: around 1998/9 which is associated with Ethio-Eritrea war and around 2020 that was characterized by multiple global and domestic shocks including COVID-19, political instability, conflicts, and civil war.

Figure 1. 3: Employment Dynamics



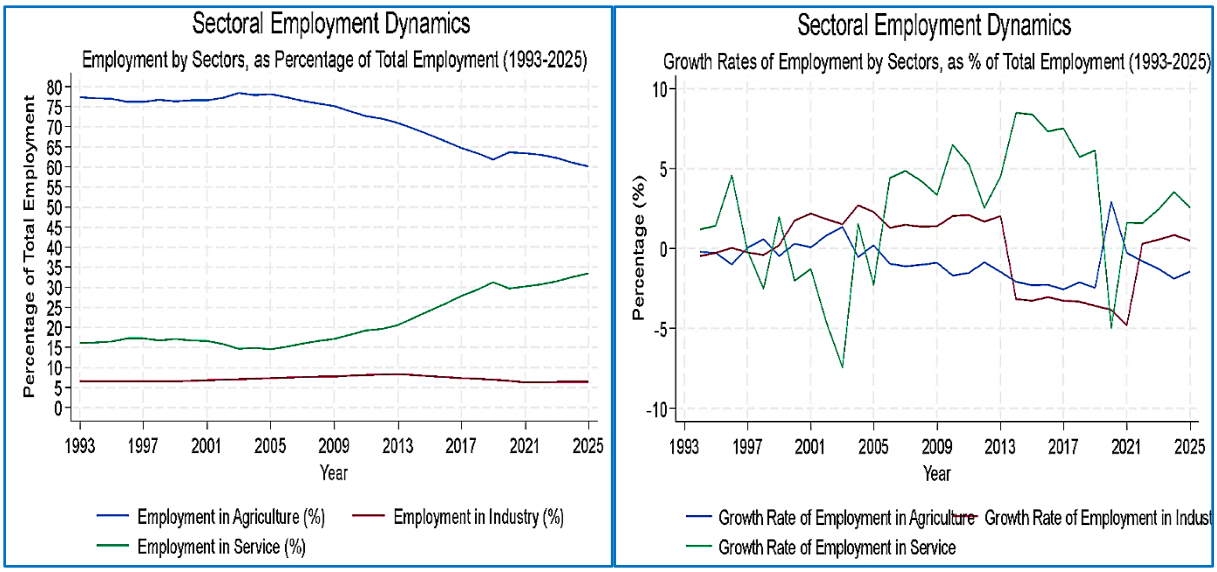
Source: National Bank of Ethiopia

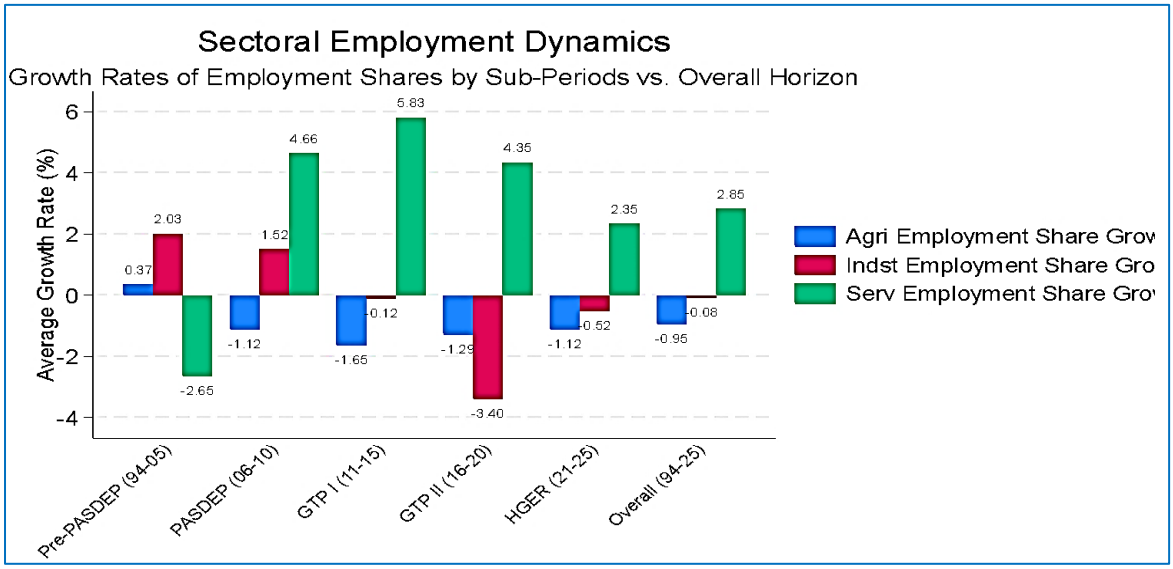
1.4.2. Sectoral Shares in Total Employment

Figure 1.4 presents sectoral shares in employment dynamics of Ethiopia. Sectoral contributions to employment creation of Ethiopia show predominance of agriculture despite gradual decline over time. Despite showing a declining trend, the sector has continued playing the dominant role in employment contribution. While agriculture share in employment decreased from around 78% in 1993 to around 60% in 2025, which is an 18 percentage-point reduction, the decrease is modest, signaling slower labor reallocation compared to the sector's sharper drop in its contribution to GDP during the same period. The results show that while there has been gradual decline from 1993 to 2025, from a period of heavily agrarian country where almost 8 out of 10 workers engaged in agriculture to a period when 6 out of 10 workers engaged in agriculture, the bulk of labor force is still tied to low-productive agricultural activities in the country.

While the share of service sector in employment creation has shown considerable increase from around 18% in 1993 to 37% in 2025 in terms of percentage of employed workers engaged in the sector, the literature (Gebreeyesus & Abegaz, 2025) shows that a significant portion of the sector that is absorbing labor force leaving agriculture is low-productive service sub-sector. Given that there has not been considerable change in the share of industry in employment creation, the dynamics indicate the transformation primarily from the agriculture sector to service sector.

Figure 1. 4: Sectoral Composition and Dynamics of Employment





Source: National Bank of Ethiopia; and Own Computation

The result shows that the country faces challenges related to structural transformation given that the industrial sector's contribution to job creation has experienced a declining trend for about a decade. The overall contribution of the sector to employment creation remained less than 10%, the maximum being 8.4% in 2013. Given that Ethiopia is characterized by a high youthful population (Yeshineh & Bekele, 2025), the fact that the industrial sector contributes the least to job creation and showing a largely stagnant trend poses potential challenges related to job creation.

Looking at average growth rates of sectoral contribution to employment by policy regimes reveal similar outcomes. Except during pre-PASDEP and PASDEP, industry share in overall employment creation on average exhibits a negative growth rate. The more striking result is that GTP I and II, which experienced the highest growth rate of industry contribution to GDP, exhibited a negative growth rate in terms of contribution to employment creation. The overall results show that the shrinking

employment contribution of agriculture and industry is absorbed by an increasing share of services. The growth rates of sectors' contributions to employment creation reveal clear information related to challenges Ethiopia is facing related to achieving structural transformation. The negative growth rate of the industry's contribution to job creation poses challenges to the highly sought structural transformation particularly in the face of unemployment and growing working-age populations.

1.4.3. Shift Share Analysis of Employment

To understand the contribution of labor reallocation to employment growth, we apply a shift share decomposition of total employment growth into two components: the within-sector effect and structural change effect. Following Gebreeyesus and Abegaz (2025), using the following formula, we apply a shift-share decomposition of total employment growth into two components: the within-sector effect and the structural change effect:

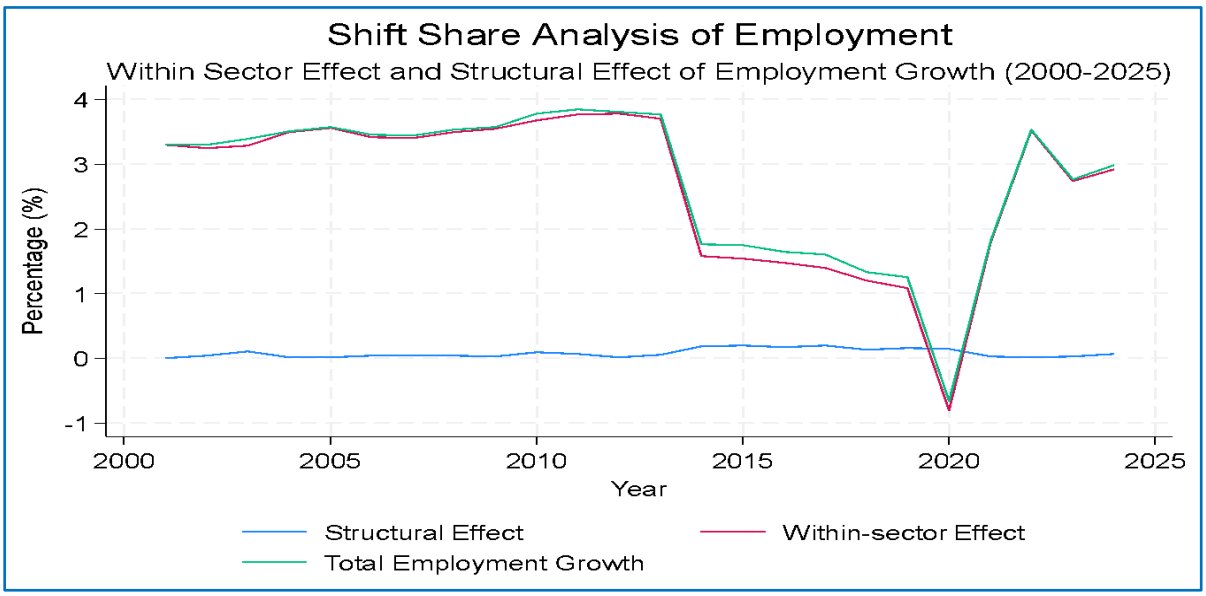
$$g = \sum_s (S_{s,t-1} \; x \; g_s) + \sum_s (\Delta S_s \; x \; g_s)$$

Where:

- g = total employment growth rate over the period
- g_s = employment growth rate of sector s
- $S_{s,t-1}$ = employment share of sector s in the initial period (t-1),
- ΔS_s = $(S_{s,t} - S_{s,t-1})$ change in employment share of sector s over period.

The first term $\sum_s (S_{s,t-1} \; x \; g_s)$ captures the within-sector effect that denotes the proportion of employment growth due to sector expansion, assuming employment shares remain constant. This component of the equation isolates the contribution of sector-specific growth without labor reallocation. The second component of the equation term $\sum_s (\Delta S_s \; x \; g_s)$ represents structural change, that quantifies the extent to which labor shifting across sectors contributed to overall employment growth. Figure 1.5 and Table 1.1 present shift share analysis of employment for the entire time period under consideration and by policy regimes, respectively.

Figure 1. 5: Shift Share Analysis of Employment



Source: National Bank of Ethiopia; and Own Computation

The result shows that employment growth in Ethiopia is mainly due to the within-sector effect while the role of structural effect is modest throughout the time under consideration. Table 1.1. shows that the highest share of structural effect was observed during GTP II and GTP I. These highest share of structural effects during GTP II and GTP I are associated with the reallocation of the labor force from agriculture and industry to the service sector, as can be seen from Figure 1.4.

Table 1. 1: Shift Share Analysis of Employment by Policy Regimes

	Within-sector Effect	Structural Effect	Total Employment Growth
Pre-PASDEP (2001-2005)	3.376	0.036	3.412
PASDEP (2006-2010)	3.506	0.050	3.556
GTP I (2011-2015)	2.875	0.110	2.985
GTP II (2016-2020)	0.873	0.161	1.034
HGER (2021-2025)	2.744	0.032	2.776
Overall (2001-2025)	2.672	0.080	2.752

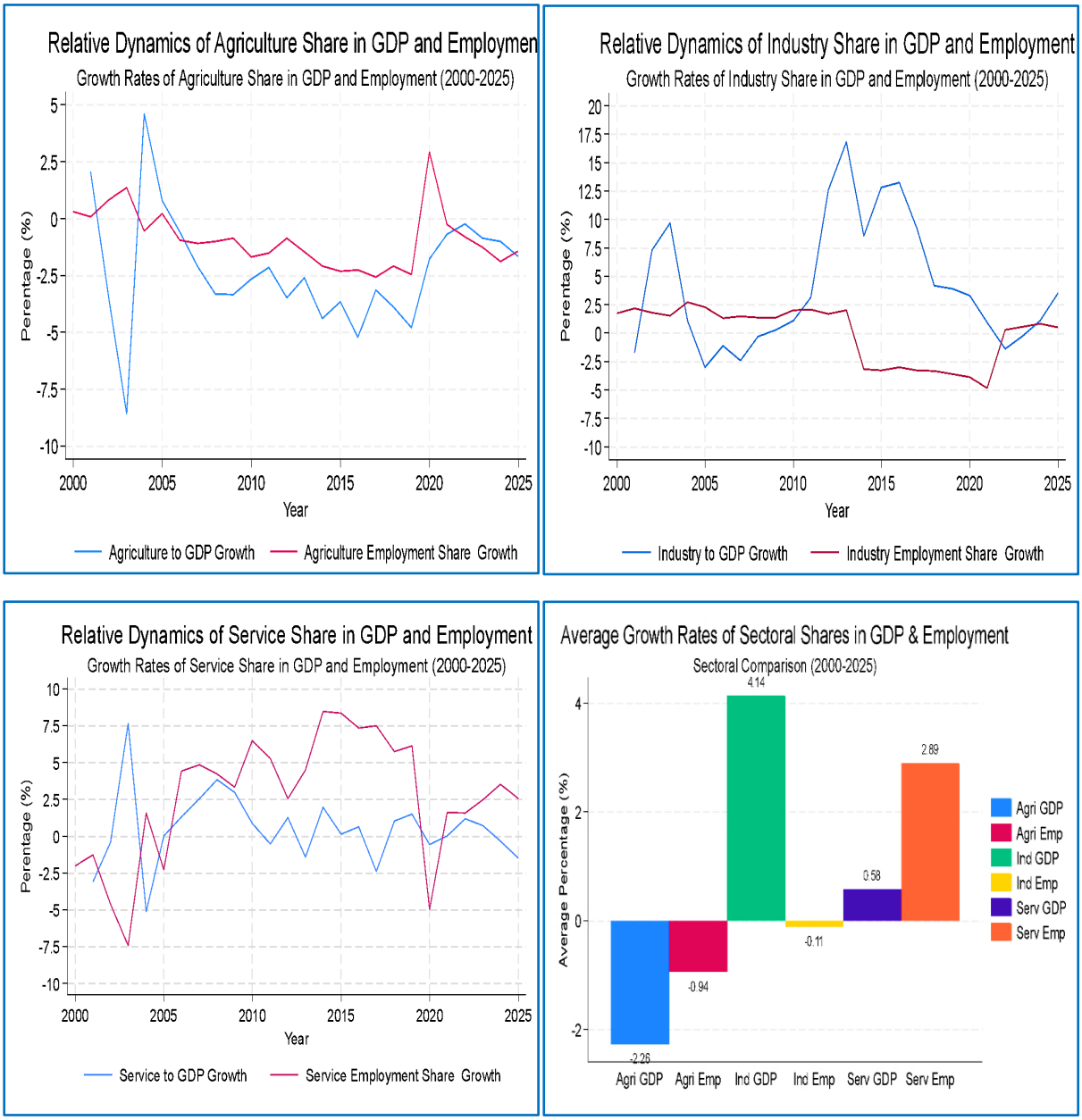
Source: National Bank of Ethiopia; and Own Computation

1.5. Growth-Employment Nexus

1.5.1. Relative Sectoral Contributions to GDP and Employment

Figure 1.6 presents relative sectoral growth rates of contribution to GDP and employment. Overall, the employment share of agriculture is growing faster than its GDP share, indicating that relative labor productivity in this sector is falling. Moreover, given that overall growth rates of the sector's employment share and GDP share are negative, agriculture is shrinking in terms of its contribution to GDP and employment. The results reflect challenges related to structural transformation, given that labor is trapped in a shrinking and low productivity agricultural sector instead of transitioning to high-productivity service or industry sector.

Figure 1. 6: Relative Sectoral Growth Rates of Contribution to GDP and Employment



Source: National Bank of Ethiopia; and Own Computation

Although fluctuations have been observed, the overall trend shows that the industrial sector's GDP share is growing faster than its employment share; relative labor productivity in this sector is rising. The combination of positive growth in industry's GDP share and negative growth in its employment share indicates that industry is producing more value with fewer workers; while this is good from the sector's productivity perspective, it poses challenges related to employment creation and structural transformation.

In the case of the service sector, the overall trends show that the sector's employment share is growing faster than its GDP share. Relative labor productivity is falling in the sector, potentially indicating the prevalence of informal and low productivity service sector. Despite relatively falling labor productivity, overall positive service sector growth in terms of its GDP and employment shares indicates that the sector is expanding both its economic footprint and successfully pulling in the workforce.

Table 1. 2: Sectoral Growth Rates of Contribution to GDP and Employment by Policy Regimes

Sectoral Metric (Growth Rates)	Pre-PASDEP (2001-2005)	PASDEP (2006-2010)	GTP I (2011-2015)	GTP II (2016-2020)	HGER (2021-2025)	Overall (2001-2025)
The share of agriculture to GDP (in percentage)	-0.92	-2.39	-3.24	-3.76	-0.88	-2.24
The share of agriculture to employment (in percentage)	0.40	-1.12	-1.65	-1.29	-1.12	-0.95
The share of industry to GDP (in percentage)	2.68	-0.49	10.80	6.78	0.80	4.11
The share of industry to employment (in percentage)	2.11	1.52	-0.12	-3.40	-0.52	-0.08
The share of service to GDP (in percentage)	-0.18	2.32	0.28	0.04	0.02	0.50
The share of service to employment (in percentage)	-2.80	4.66	5.83	4.35	2.35	2.88

Source: National Bank of Ethiopia; and Own Computation

In general, positive structural transformation occurs when agricultural share gradually declines, manufacturing share expands, modern service share expands, and productivity rises; Ethiopia's experience in the last decades exhibits challenges related to many of these indicators. Lorato et al. (2025) note that labor productivity in Ethiopia is low in different sectors of the economy including in the agriculture and industrial sectors.

Despite experiencing impressive economic growth for about two decades, structural transformation of Ethiopia has not been even and complete when measured in terms of several indicators. In terms of employment dynamics, while labor has shifted out of agriculture, the shift is mainly into low-productivity informal services; manufacturing's employment share also declined in the country despite policy support. This is in line with the stylized fact that the informal sector substantially contributes to job creation in Ethiopia (Yimam, 2024). Therefore, the shift from agriculture to service is also predominantly not from low-productivity agriculture to high-productivity service, but rather to low-productivity service. Moreover, high-productivity sectors such as manufacturing and modern services in Ethiopia remain small, capital-intensive, and poorly connected to employment. In general, over the last two decades, in a similar pattern consistent with other low-income countries in general and those in SSA and Latin America in particular, employment structure of Ethiopia has undergone a broad transition primarily from agriculture toward service (Yimam, 2024; Gebreeyesus & Abegaz, 2025).

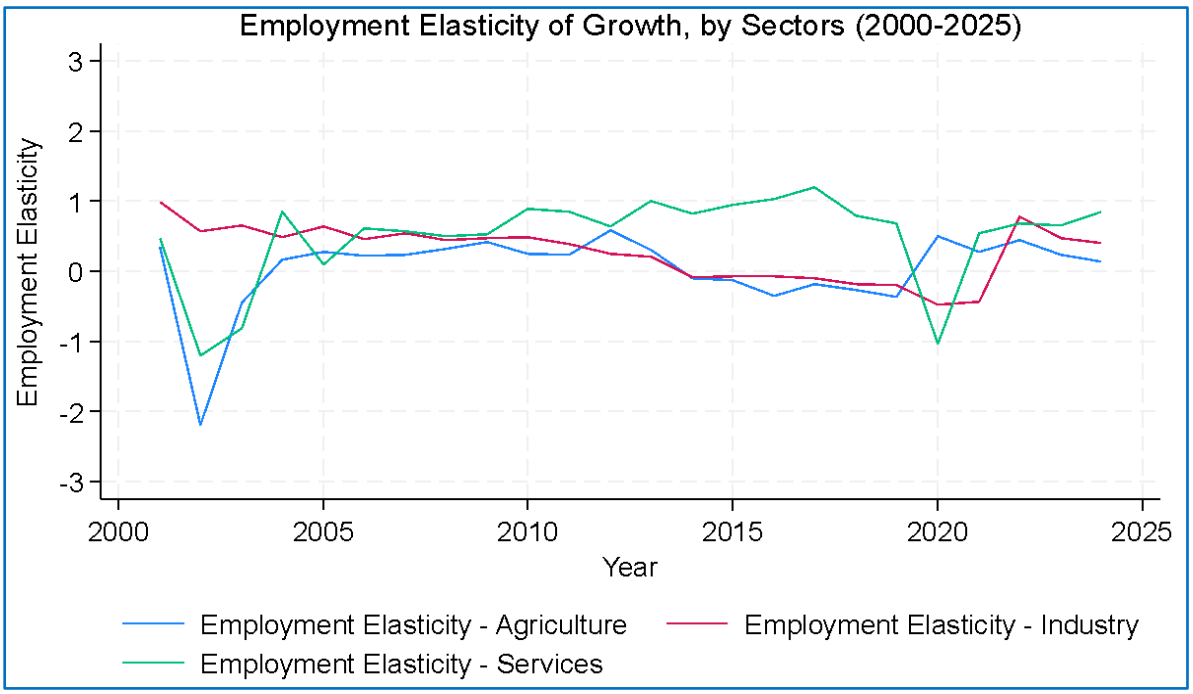
1.5.2. Employment Elasticity of Growth

Figure 1.7 presents trend of employment elasticity of growth while Table 1.3. presents associated average values by policy regimes. Overall, employment elasticity of agricultural and industrial sectors is modest over the course of time, indicating that these sectors employ workers modestly while increasing their output. The service sector performs better in terms of employment elasticity of growth. The employment elasticity of service sector growth surpassed 1 in some years, indicating that a 1% increase in service sector growth led to more than a 1% increase in employment creation in the sector

during those time periods. In summary, average agriculture, industry, service, and overall economy employment elasticity of growth from 2000 to 2025 are 0.04, 0.28, 0.51, and 0. 27, respectively. On average, the result related to the overall economy shows that a 1% increase in economic growth led to 0.27% increase in employment creation reflecting the economic performance of Ethiopia (which has been robust from economic growth perspective) has been modest in terms of employment creation.

The results in general show that while Ethiopia outpaced many African peers in economic growth, the country lags in employment absorption, indicating a disconnect between output growth and structural inclusion that has implications related to achieving inclusive and sustainable economic growth. Accordingly, achieving sustained transformation depends not only on impressive and strong economic growth but also on how economic growth reallocates labor and resources toward more productive sectors such as industry—given its dual capacity of driving productivity growth and absorbing surplus labour from the agricultural sector—and high-productivity service sector. Equally important is ensuring that sustained economic growth accounts for employment creation. The results highlight the need for designing macroeconomic economic policies that accelerate structural transformation through employing relevant strategies such as expanding labor-intensive manufacturing and aligning skills with market demand.

Figure 1. 7: Employment Elasticity of Growth



Source: National Bank of Ethiopia; and Own Computation

Table 1. 3: Average Employment Elasticity of Growth by Policy Regimes

Elasticity Metric	Pre-PASDEP (2001-2005)	PASDEP (2006-2010)	GTP I (2011-2015)	GTP II (2016-2020)	HGER (2021-2025)	Overall (2001-2025)
Employment Elasticity - Agriculture	-0.37	0.29	0.18	-0.13	0.27	0.04
Employment Elasticity – Industry	0.67	0.49	0.14	-0.20	0.31	0.28
Employment Elasticity – Service	-0.12	0.62	0.85	0.53	0.69	0.51
Employment Elasticity - GDP	0.29	0.32	0.29	0.09	0.40	0.27

Source: National Bank of Ethiopia; and Own Computation

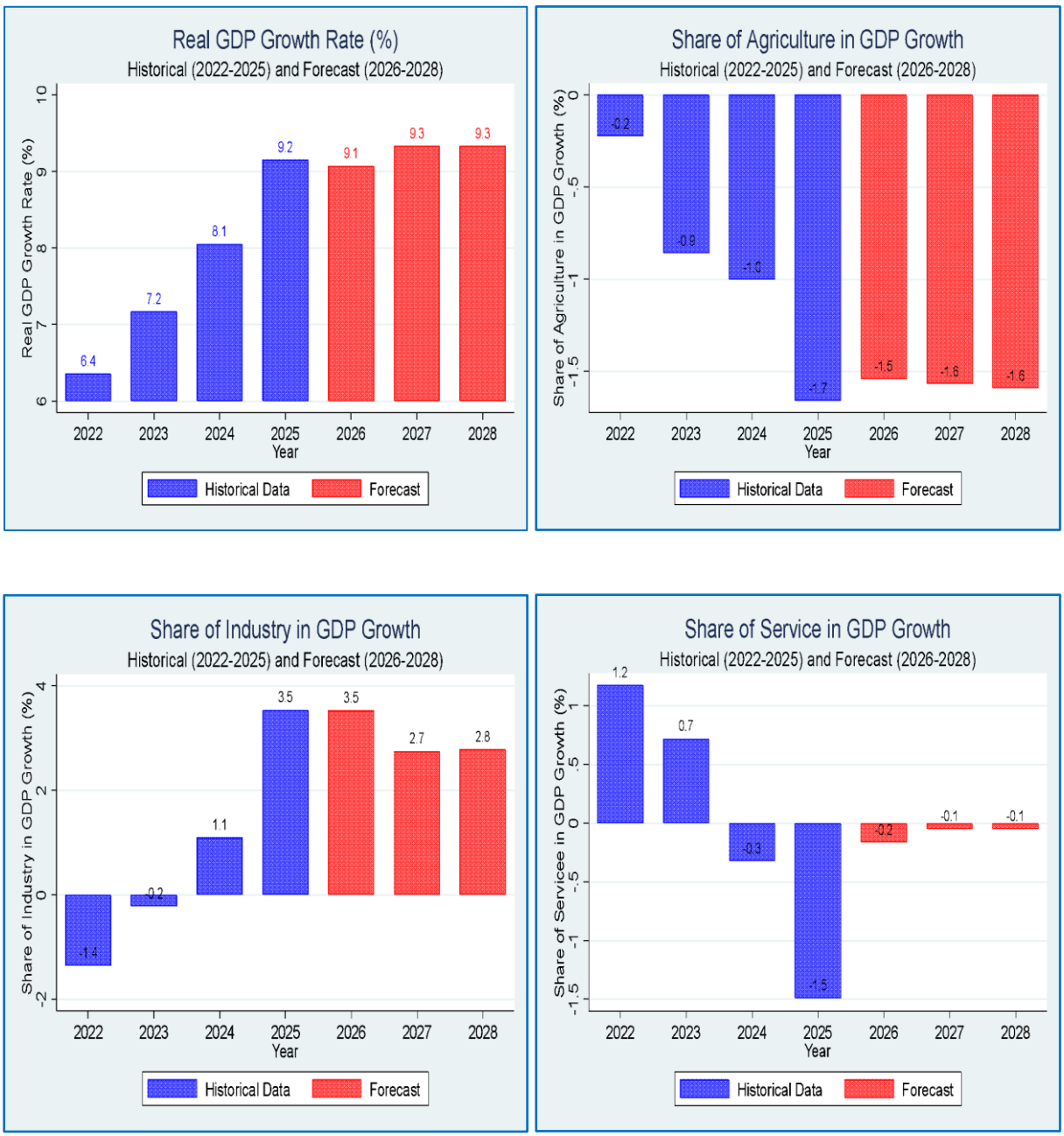
1.6. Real Sector Macroeconomic Outlook

1.6.1. The Outlook

The outlook of Ethiopian economy in the coming three years shows that the country will continue recording strong and sustained economic growth. The forecast was undertaken using Autoregressive Integrated Moving Average (ARIMA). Given the short time horizon of the sample, though attempts were made, alternative forecasting strategies such as Vector Autoregression, (VAR) and Autoregressive Distributed Lag (ARDL) do not yield better forecasts. In conducting the forecast using ARIMA, we controlled for the Ethio-Eritrea war of 1998 to 2000, the 2003 drought, the 2008 global financial crisis, the 2018 political change, the 2020 COVID-19 pandemic, and the 2020 to 2022 civil war.

The outlook shows that the country will experience a strong economic growth rate greater than 9%. The outlook for sectoral decomposition shows that agricultural contribution to GDP will continue to persistently shrink over the coming years as it experiences negative growth rates. Similarly, although modestly, service contribution to the overall economy will fall. The outlook shows that the shrinking roles of agriculture and service contributions to GDP will be compensated for by expanding industry share in the overall economy of the country in the coming three years; the predicted expansion of industry share in GDP of the country is potentially explained by the recent booming mining sub-sector of industry.

Figure 1. 8: Economic Outlooks, In Terms of Overall and Sectoral Economic Growth



Source: Own Estimation

1.6.2. Risks to the Outlook

1.6.2.1. Downside Risks

While the real sector's outlook is expected to hold, there are potential downside risks to the outlook. Downside risks stem from different sources including domestic, regional and global factors. Global downside risks include slowing global growth, rising import costs, and geopolitical uncertainties, while regional risks arise from security uncertainties. Domestic security uncertainties are also downside risks to the outlook. According to the World Bank (2024), as in the case of many African countries, growth headwinds in Ethiopia are compounded by escalating conflict and violence. Moreover, the prevalence of unemployment and its structural manifestation due to higher urban unemployment compared to the

national figure poses risks to the outlook. This risk may be exacerbated by challenges related to achieving structural transformation and the modest elasticity of employment growth. These combined challenges may pose risks associated with unemployment and income inequality.

Furthermore, given that Ethiopia relies on imports for strategic inputs including fuel and fertilizers, rising import costs are headwinds that pose downside risks to the macroeconomic outlook. These rising import costs may contribute to inflationary pressures thereby increasing business costs and weighing on household spending in the country, in turn adversely impacting demand. In general, downside risks to the economic outlook encompass external and internal factors including global geopolitical and geoeconomic uncertainties, regional and domestic security uncertainties, and structural problems.

The country can mitigate these downside risks by strengthening institutional quality to support political stability and address insecurity problems thereby promoting investment and sustainable economic growth that address structural challenges. Moreover, it can develop economic policies such as promoting labor-intensive industrialization that enhances inclusivity through creating more job opportunities thereby reducing inequalities.

1.6.2.2. Upside Risks

While the risks to the outlook tilt toward the downside, there are also several upside risks to the macroeconomic outlook. Potential booms in the service sector, particularly from the tourism sub-sector, are tailwinds that create upside risks to the macroeconomic outlook of the country. These upward risks are conditional on improved security situations due to the sensitivity of the tourism sector to security situations. The recently booming mining sub-sector of industry is a tailwind that serves additional upside risk to the macroeconomic outlook.

1.7. Conclusion

Ethiopia experienced rapid and sustained economic growth during the last more than two decades, positioning itself among the fastest growing economies globally. Despite this success story, Ethiopia faced challenges related to employment creation and structural problems including a higher urban unemployment rate compared to the national average. While sectoral composition dynamics of the country's economy show a falling share of agricultural sector and that of industrial and service sectors experienced increasing trends for around two decades, only modest dynamics have been observed in the last decade. This poses challenges related to achieving structural transformations given that shifting the economy away from low-productive agriculture to high-productive industry and service sectors seem to have been very modest in the last close to ten years. Similarly, while the role of agriculture in total employment has been shrinking for close to two-decades and that of the service sector has been rising (and that of industry showed no notable changes), the dynamics of sectoral contributions to the labor market has been very modest in the last close to a decade. This reflects that the country is facing structural transformation challenges given that labor is not being reallocated from low-productive to high-productive sectors.

Moreover, the contribution of agriculture to GDP is falling at a higher rate than its contribution to national employment, reflecting that workers are trapped in a low-productive agriculture sector. On the contrary, while the overall contribution of industry to GDP has exhibited positive growth rate, its contribution to job-creation has experienced negative growth rate reflecting that Ethiopia is experiencing job-less industrial growth. The service sector exhibits a positive growth rate in terms of

its contribution to GDP and overall employment while the growth rate of contribution to job creation is higher than that of contribution to GDP reflecting that the sector is on average experiencing low labor productivity. The overall results reflect that labor experiences a horizontal shift: from low-productive agriculture to low-productive service.

Moreover, shift share analysis of employment shows that overall employment growth in Ethiopia is by and large associated with within-sector effect, the role of structural effect being very modest. The results reflect that the country has struggled to achieve the highly sought structural transformation. Furthermore, the robust and sustained economic growth that Ethiopia experienced has not translated into commensurate employment creation. The employment elasticity of economic growth shows that the country experienced modest economic growth translated into job creation: over the period of 2000 to 2025, employment elasticity of the overall economic growth is 0.27 indicating that a 1% economic growth translates only into 0.27% employment creation. The service sector performs relatively well in terms of employment elasticity of economic growth compared to industry and agriculture. The challenges related to achieving structural transformation and the modest employment elasticity of growth potentially pose risks related to achieving inclusive and sustainable development because these challenges may adversely affect income distribution.

To sustain robust and strong economic growth along with achieving structural transformation and meeting inclusive and sustainable growth, designing economic policies that account for structural bottlenecks of the country is vital.

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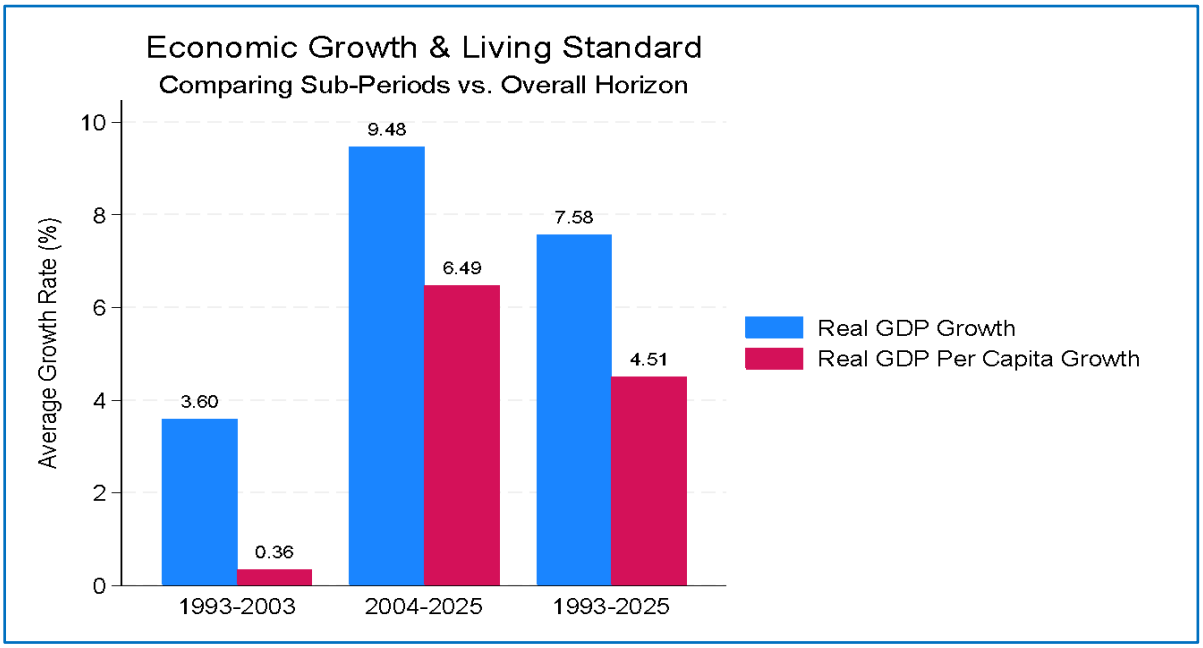
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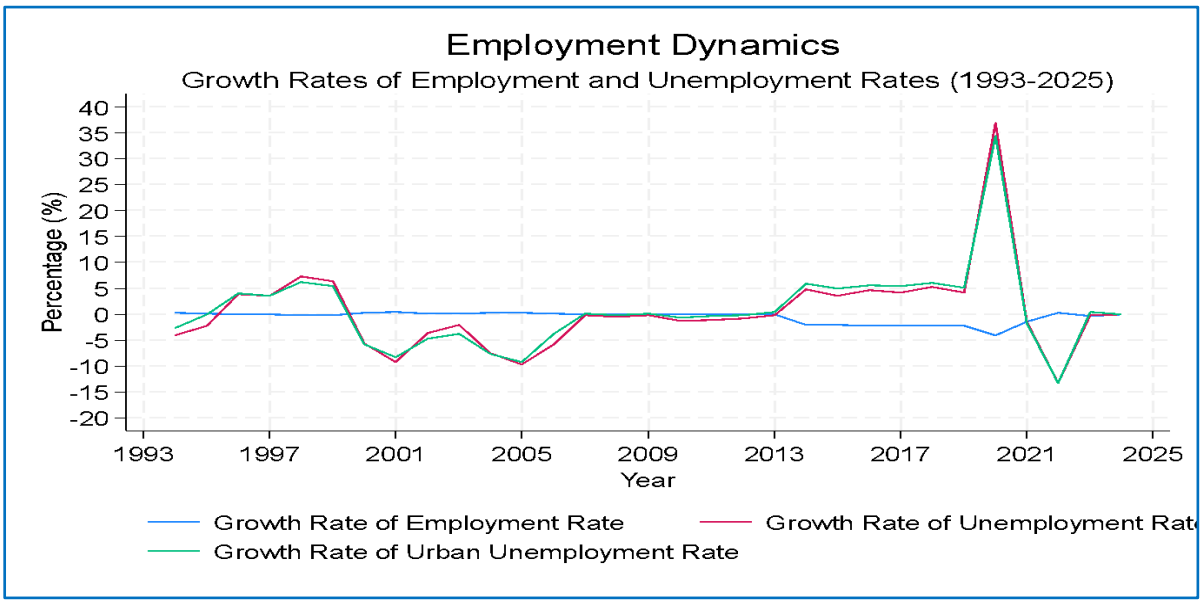
Annex

Figure A1.1: Real GDP and Real GDP Per Capita Growth by Sub-Periods



Source. National Bank of Ethiopia

Figure A1.2: Employment and Unemployment Dynamics



Source: National Bank of Ethiopia; and Own Computation

CHAPTER TWO

MONETARY POLICY, FOREX AND INFLATION IN ETHIOPIA

2.1. Introduction

This chapter provides an empirical analysis of broad money supply growth, real interest rates, foreign exchange dynamics, and inflation in Ethiopia over the 32-year period from 1993 to 2025. It systematically examines how monetary expansion, exchange rate adjustments, and domestic credit allocation interact to drive price volatility.

The chapter establishes four distinct policy regimes using statistical tests for structural breaks: the Post-Command Transition Phase (1993-2002), the State-Led Growth Phase (2003-2009), the Devaluation Phase (2010-2017), and the Market Liberalization Phase (2018-present).

The chapter also discusses the monetary transmission channels, evaluating the co-movement between money supply growth, inflation, the parallel market exchange rate premium, and Nominal/Real Effective Exchange Rate adjustments.

Finally, the chapter presents medium-term inflation projections for the 2026-2030 horizon by employing the Autoregressive Distributed Lag (ARDL) econometric framework under baseline and monetary, exchange rate, and policy shift scenarios. The chapter concludes by outlining strategic policy recommendations for the National Bank of Ethiopia and the Ministry of Finance to reduce persistent double-digit inflation and restore macroeconomic stability.

2.2. Structural Breaks

To map the trends of core macroeconomic variables, methodologically, it is imperative to identify and account for endogenous structural breaks across the 1993-2025 period horizon. Analyzing the structural transitions would facilitate a comprehensive dual-dimensional analysis: it allows us to evaluate the macroeconomic shifts occurring *between* distinct policy regimes while simultaneously assessing the behavioral stability and parameter variation of key variables *within* each individual structural break**.**

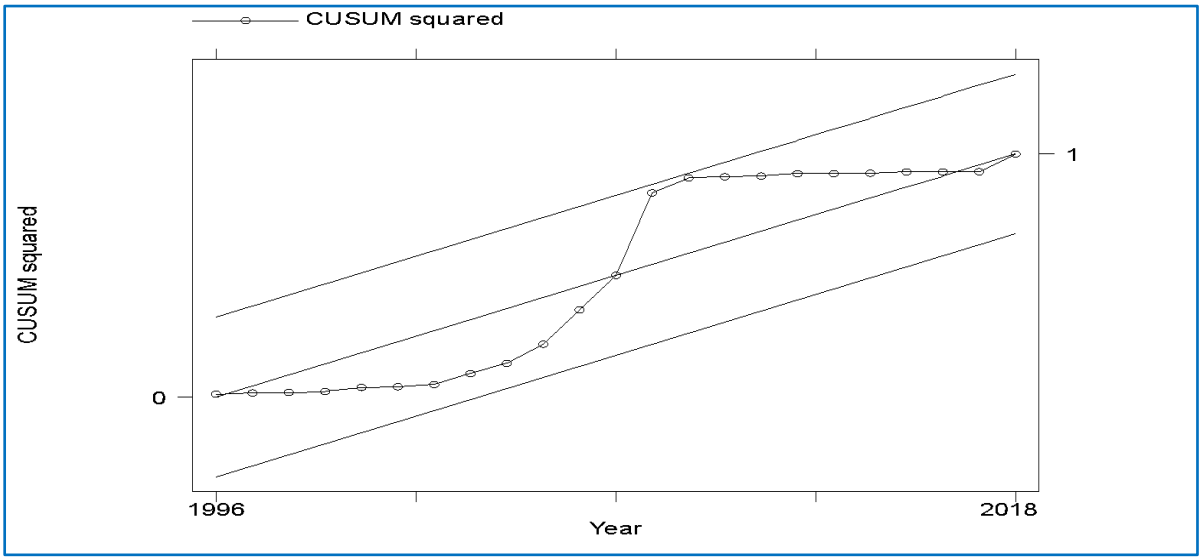
We applied the Quandt-Andrews unknown breakpoint test to identify structural break between 1993-2018. Unlike the Chow test, which requires a pre-specified break point, the Quandt-Andrew's test estimates the structural break within the 1993–2018 sample period. The test trims 15 percent of observations from both the beginning and end of the observations. Therefore, the estimated break was tested over the 1997–2015 period. Since the earliest and latest observations are excluded, the break is expected to occur near the middle of the sample period. The results presented in Table 2. 1 show a statistically significant structural break that occurred in 2006 in the relationship between money supply and the exchange rate. The Quandt-Andrews test results confirm the presence of at least one statistically significant structural break during the EPRDF regime (1993-2018). Given that the test applies sample trimming at the series boundaries, the identified breakpoint serves as an indicative structural window rather than a deterministic single year. Consequently, establishing the existence of a structural shift across the period takes analytical priority, though the estimated breakpoint year still offers valuable empirical context for further macroeconomic evaluation.

Table 2. 1: Quandt-Andrews Test Result for the Series (1993-2018)

Test	Statistics	p-values	Null Hypothesis	Exogenous variable
Swald	26.8965	0.0000	No structural break	Money Supply(M2)

The possible structural breaks in the monetary sector of Ethiopia in the period (1993-2018) would be 2003 and 2010. Starting from 2003 Ethiopia achieved double digit economic growth and in 2010 the local currency depreciated by 16 percent. We have also checked this year specific structural breaks and found that statistically significant breakdown was observed in the money supply and exchange rate dynamic of Ethiopia.

Figure 2. 1: Cumulative Sum Test of Parameter Destabilization



Source: NBE (2026); Author's Estimation

We have also conducted a Cumulative Sum (CUSUM) test where the parameters start to destabilize. Figure 2.1 presents the CUSUM test results. Looking at the CUSUM residual visualization, the year 2003 is a clear departure from 1996, and this coincides with the theoretical explanation though 2006 was also on the steep side of the line. We also had another break which was in 2010. This is also well aligned with depreciation of the local currency. Thus, we have three structural breaks in the monetary sector of Ethiopia in the time series of 1993-2025. These are 2003, 2010 and 2018. Therefore, the analysis was done in four categorized periods of time. These are:

- **Post Transition Phase (1993-2002):** Transition from a command economy and introduction of managed floating exchange rate.
- **State led Growth Phase (2003-2009):** Shift toward aggressive public-infrastructure spending and introduction of massive central bank credit advances.
- **Devaluation Phase (2010-2017):** 16.7% official devaluation (Sept 2010) and introduction of the 27% NBE Bill Directive capping private bank lending.
- **Market liberalization (2018- to present):** Market determined Forex and an interest rate based monetary framework.

2.3. Trends of Money Supply Growth

The trajectory exhibits clear cyclical shifts aligned with the structural sub-periods. Figure 2.2 and 2.3 present broad money supply growth for the whole series and structural breaks, respectively.

Post-Command Transition Phase (1993-2002): Characterized by low and volatile monetary expansion, dipping to its historic trough of approximately 4.5% in 1999 before stabilizing near 10-15%.

State-Led Growth & Devaluation Phases (2003-2017): Featured a sustained, aggressive expansion in liquidity. Money supply growth accelerated continuously to peak at an all-time high of nearly 39% in 2011, reflecting aggressive central bank monetization of public investment infrastructure deficits. Following 2011, the growth rate entered a highly volatile consolidation range between 20% and 30%.

Market Liberalization Phase (2018-2025): Shows an initially tightening stance dropping to around 14.15% in 2024, followed by a sharp, late-stage surge approaching 35% in 2025, capturing the liquidity expansion accompanying major foreign exchange market reforms of Ethiopia in July 2024.

Figure 2. 2: Trend of Money Supply Growth (1993-2025)

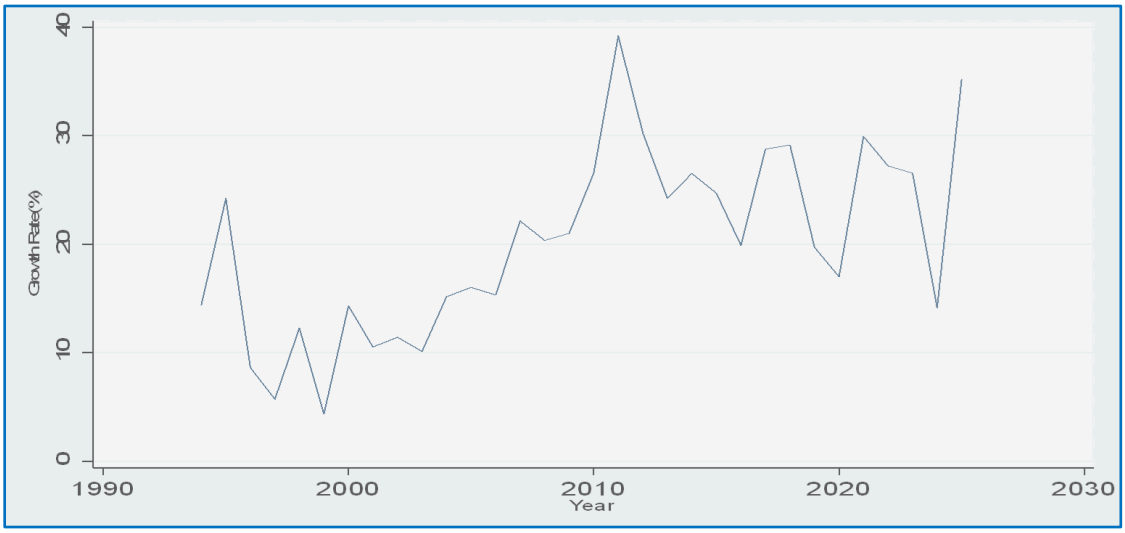
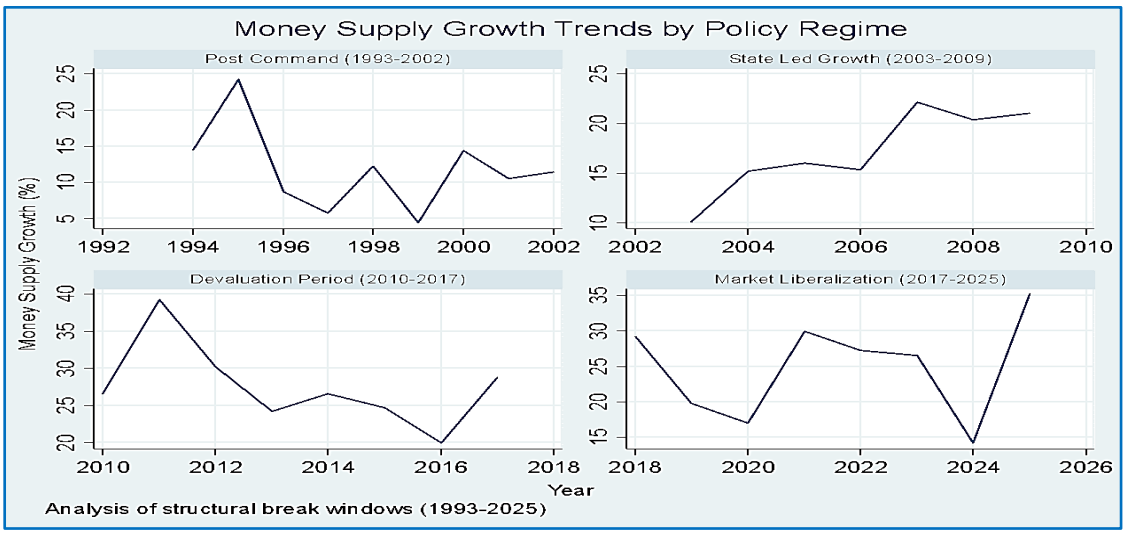


Figure 2. 3: Trends of Money Supply (M2) by Structural Break



Source: NBE (2026); Own Computation

2.4. Real Interest Rate Growth Trends

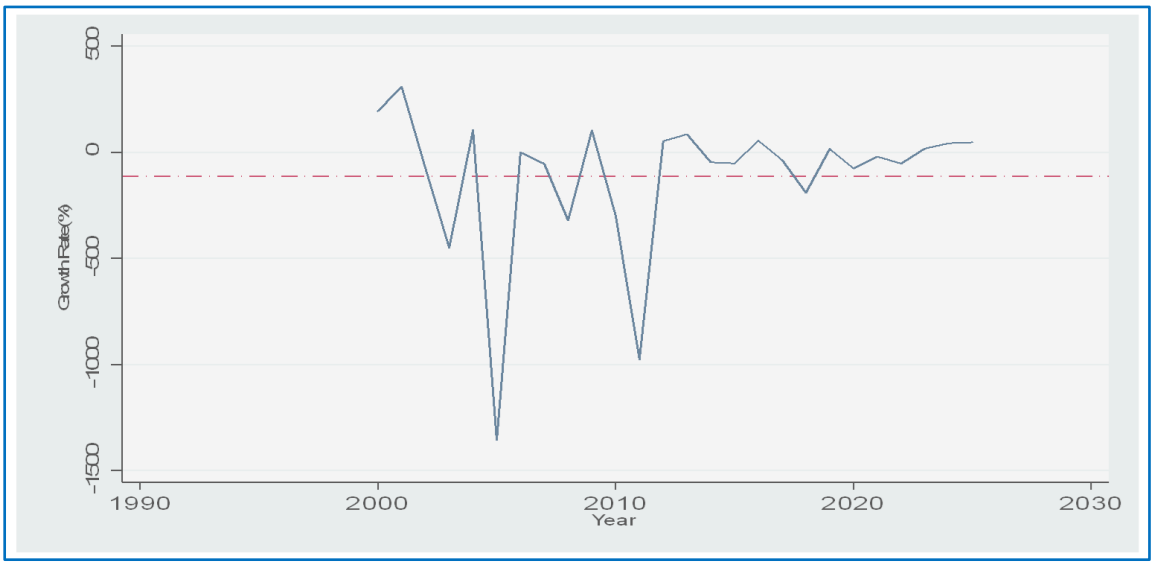
Over the analyzed horizon, as shown in Figure 2.4, Ethiopia's real interest rate environment experienced a profound contraction, deeply intensifying into negative territory. Figure 2.5 presents the growth rate of real interest rate disaggregated by structural breaks. The historical data reveals that a positive average real interest rate was sustained exclusively during the post-transition period, averaging a robust positive baseline. However, as the macroeconomic regime shifted toward state-led growth, the real interest rate plummeted to its deepest structural deficit, registering an extremely negative real rate of growth owing to surging inflation outstripping rigid nominal interest rate ceilings. During the recent market liberalization period, this real interest rate deficit underwent a partial compression, moderating upward by approximately 27.5 percentage points, though remaining firmly negative.

This prolonged regime of deeply suppressed negative real interest growth rates carries severe systemic implications for domestic financial architecture. High inflation systematically eroded nominal returns, transforming formal saving instruments into a guaranteed loss of purchasing power. This distortion disincentivized domestic resource mobilization while creating an artificial, highly subsidized incentive for credit acquisition.

Crucially, this dynamic induces regressive distributional consequences. Because access to credit lines in a constrained financial market is heavily dependent on high-value collateral requirements, the implicit subsidy embedded in negative real borrowing rates is captured almost exclusively by affluent economic agents, effectively penalizing low-income savers and exacerbating wealth inequality.

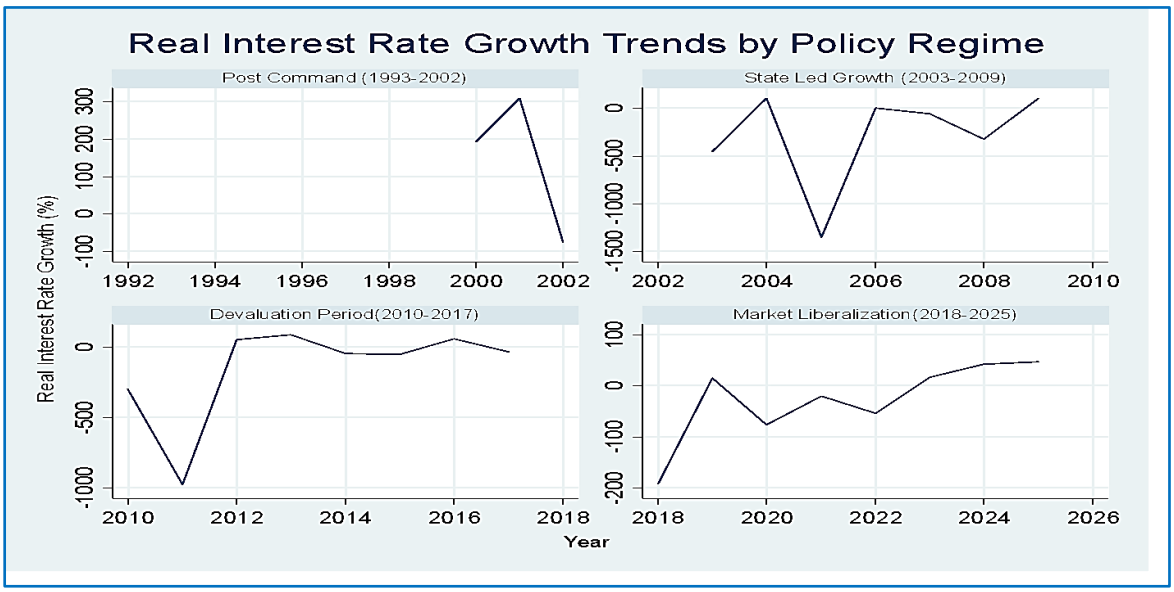
Furthermore, from an external sector perspective, persistent negative real returns severely deter foreign capital inflows and private portfolio investments, as the real return on domestic capital fails to compensate for exchange rate risks, thereby compounding the country's structural foreign exchange shortages.

Figure 2. 4: Real Interest Rate Growth Trend



Source: NBE (2026); Own Computation

Figure 2. 5: Trends of Real Interest Growth Rate by Structural Break

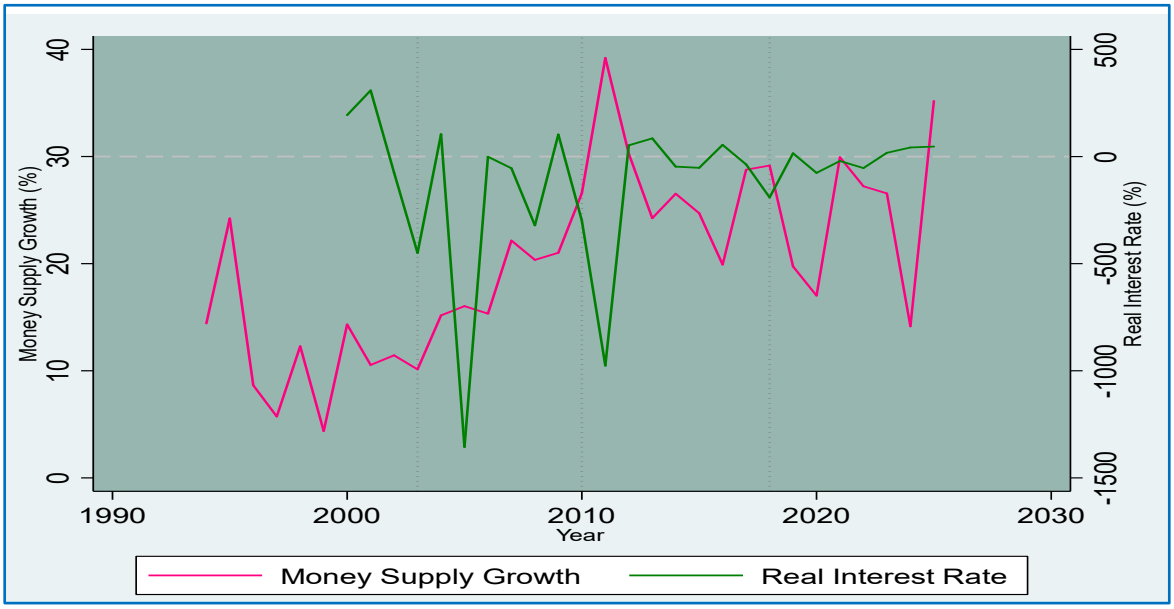


Source: NBE (2026); Own Computation

2.5. Trends of Money Supply and Real Interest Growth Rate (1993-2025)

As shown in Figure 2.6 the trends of money supply and real interest growth rate over the period of three decades (1993-2025) are somehow unclear. The expectation is that as the money supply growth rate rises, the return on real interest rates will decline because the response of nominal interest rates for inflation rates move takes some time. As a result, we may not be able to observe a one-to-one move between money supply growth and real interest rate growth. Consequently, money supply growth and real interest rates do not exhibit a direct one-to-one pass-through (Mishkin, 1981). This pronounced in developing economies where institutional rigidities and regulated nominal rates prevent immediate market clearing (McKinnon, 1973; Shaw, 1973).

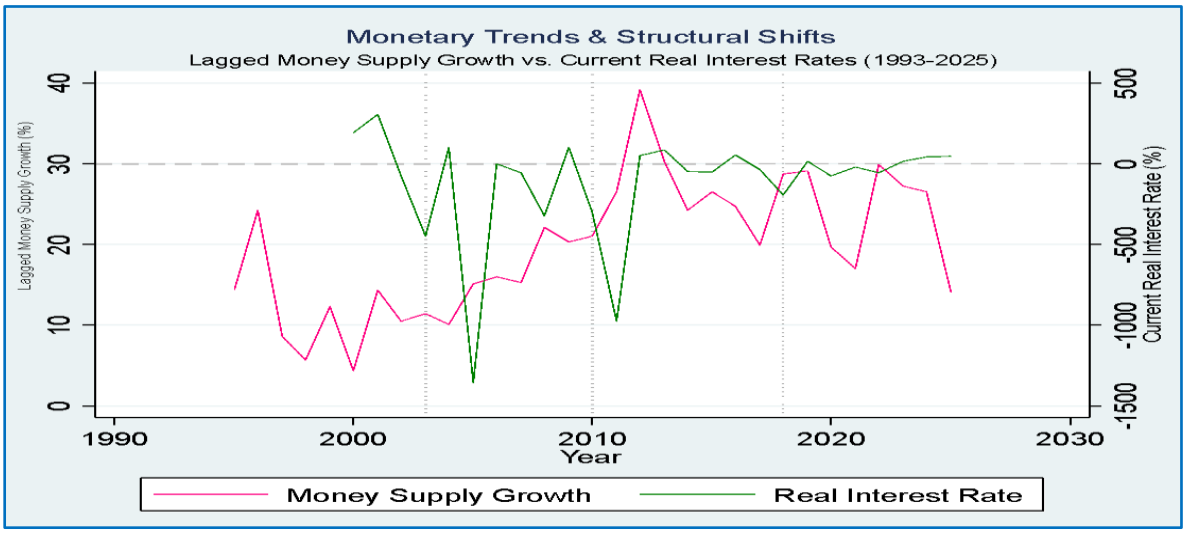
Figure 2. 6: Trends of Money Supply and Real Interest Growth Rate



Source: NBE (2026); Own Computation

However, looking at the relationship between one period lagged money supply and real interest rates, the relationship becomes relatively clear and aligns with a less price flexibility model. That is as money supply increases, the real interest rate becomes lower and after sufficient time, it will return to the long run equilibrium interest rate. Figure 2.7 demonstrates that the real interest rate responds to monetary shocks. Thus, money supply has been influencing the real variables in the short run which is in line with the Monetary School of Economic Thought.

Figure 2. 7: Trends of Lag Money Supply and Real Interest Growth Rate

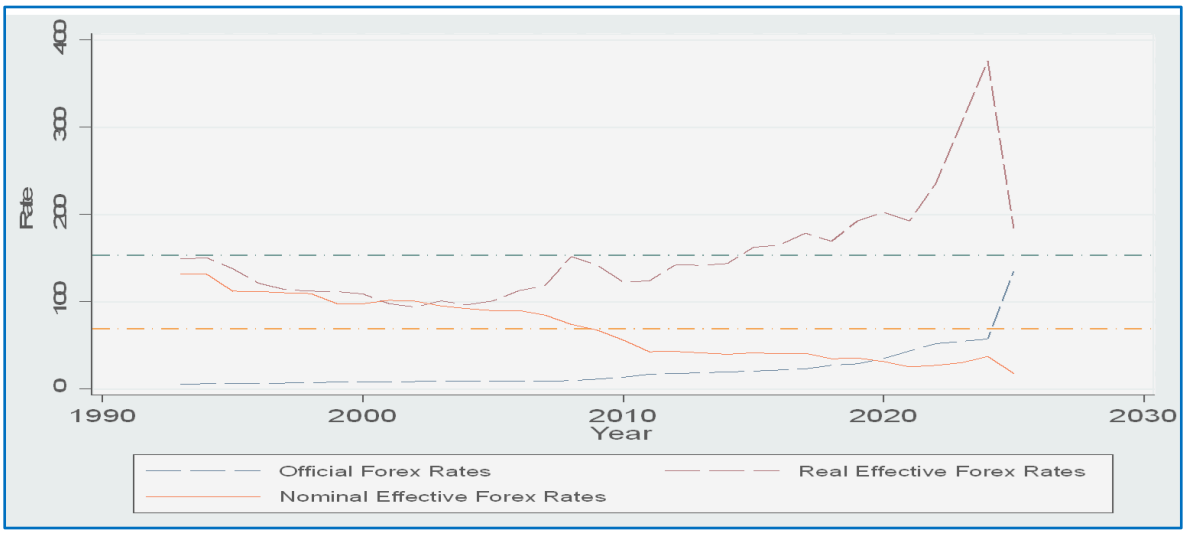


Source: NBE (2026); Own Computation

2.6. Exchange Trends (1993-2025)

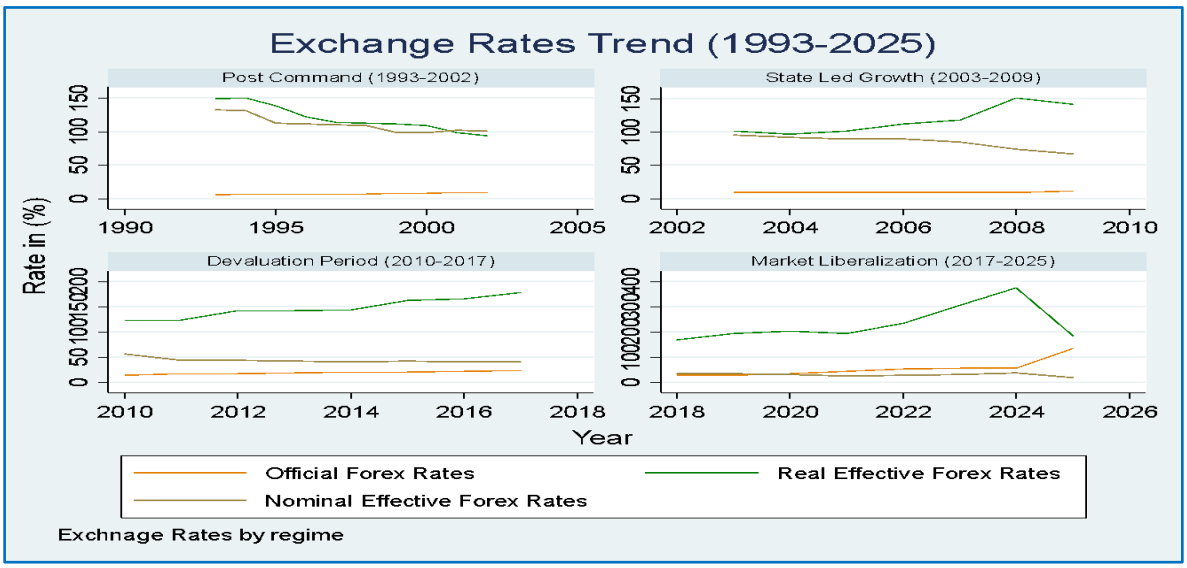
Figure 2.8 below shows the trends of nominal, real and official exchange rate overtime. The real exchange rate is the opposite of the mirror image of the official exchange rate. This is very interesting to look very closely and in detail. On the other hand, the nominal effective exchange rate has been in sharp decline since 1993. However, following the exchange rate reform in July 2024, it has somehow similar trends to that of real effective exchange rates.

Figure 2. 8: Exchange Trends (1993-2025)



Source: NBE (2026); Own Computation

Figure 2. 9: The Trends of Exchange Rates by Structural Breaks



Source: NBE (2026); Own Computation

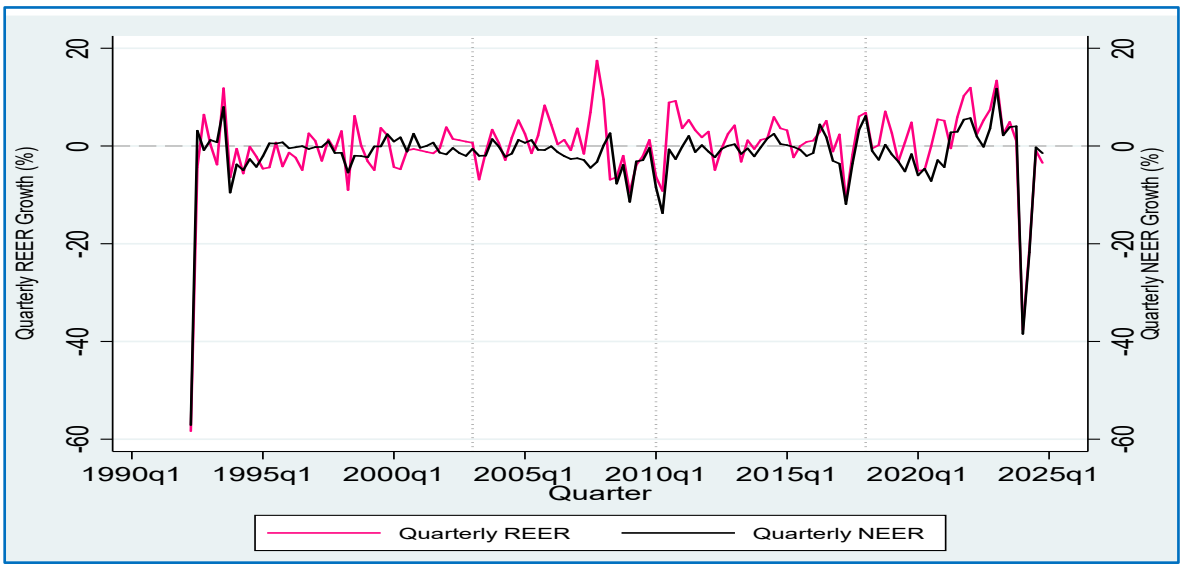
2.7. Quarterly REER and NEER

Over the full observation period, the average quarterly growth rates for the Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) were -1.793% and -0.094%, respectively. This indicates a secular depreciation across both metrics, though the pace of real depreciation remained marginal relative to nominal trends. Disaggregating these quarterly growth rates across structural break yields far richer analytical insights than relying on full-sample averages.

Specifically, during the post-transition period, average quarterly REER and NEER growth stood at -0.92% and -0.50%, respectively. In contrast, under the state-led growth period, REER appreciated at an average quarterly rate of 0.84%, while NEER depreciated by -1.83%. During the devaluation period, NEER recorded an average quarterly depreciation of -1.41%, whereas REER was appreciated by 1.12%. Finally, during the market liberalization period (covering the last eight years), REER and NEER recorded average quarterly growth rates of 0.74% and -1.86%, respectively.

With the sole exception of the post-transition period, the REER exhibited persistent real appreciation on average across all sub-periods, including the post-exchange rate reform years. Conversely, NEER depreciated continuously, remaining invariant to underlying policy shifts and regime breaks. This persistent nominal weakness underscores the ongoing erosion of domestic currency purchasing power relative to major trading partners. Crucially, however, the real appreciation of the REER does not signify enhanced external competitiveness for Ethiopian exports in international markets; rather, it reflects a tightly managed, inflexible nominal exchange rate regime coupled with elevated domestic inflation differentials.

Figure 2. 10: The Trends of Growth Rate of REER and NEER

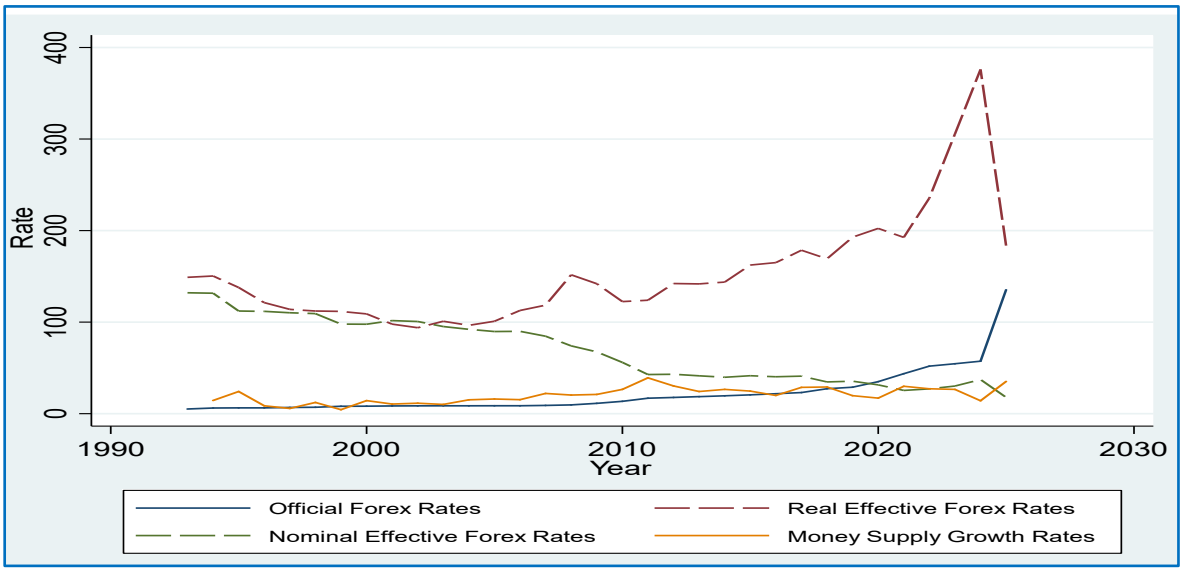


Source: NBE (2026); Own Computation

2.8. Money Supply and Exchange Rates

As illustrated in Figure 2.11 below, broad money supply growth rates do not exhibit a definitive trend across any of the designated structural break windows. In 2010, a year marked by an official devaluation, money supply grew significantly. This observation aligns with macroeconomic theory: to defend the new peg or absorb foreign assets at a higher nominal rate, the central bank engaged in accumulation of foreign assets, injecting substantial domestic liquidity into the banking system and thus driving up the monetary aggregate. A mirroring phenomenon is observable in 2024 following a major exchange rate regime shift. The government transitioned from a heavily managed peg to a market-determined managed float, dismantling the legacy framework of multi-tiered, managed foreign exchange allocations. This liberalization triggered a sharp structural adjustment, similarly, expanding domestic monetary aggregates as the formal economy calibrated to the depreciated market rate.

Figure 2. 11: Money Supply and Exchange Rate Growth Trend (1993-2025)

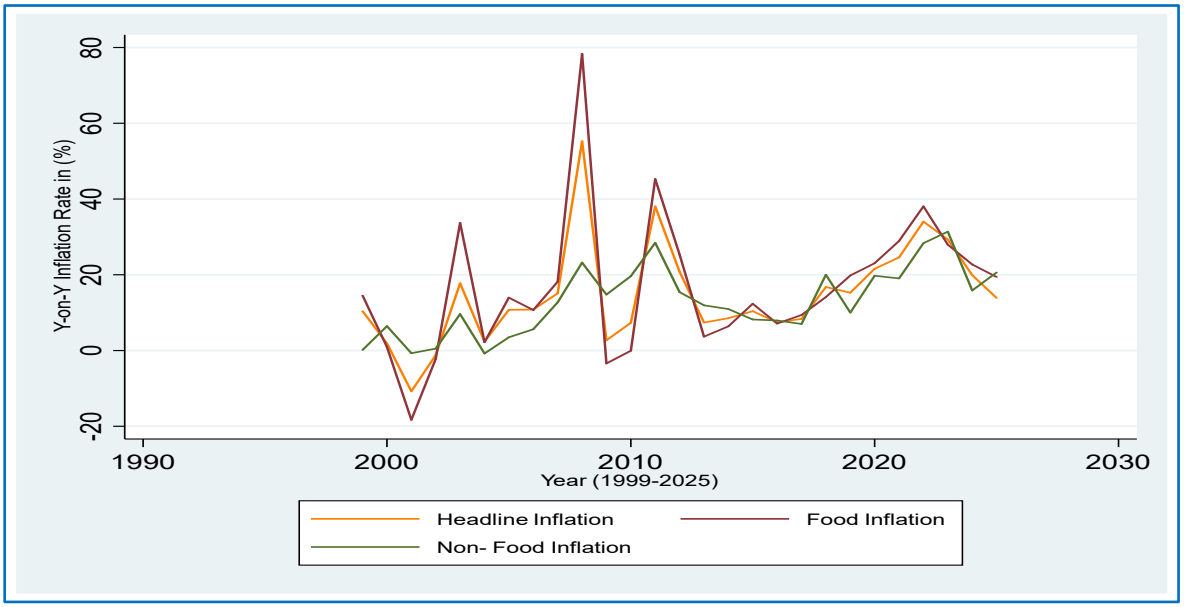


Source: NBE (2026); Own Computation

2.9. Inflation

Following Ethiopia's transition away from a centrally planned (command) economic framework, inflation emerged as a persistent structural challenge. Notably, beginning in 2003, the headline inflation rate exhibited a modest yet steady upward trajectory. This inflationary pressure culminated in a severe macroeconomic shock during the 2007-2008 period, during which Ethiopia experienced staggering and high inflationary peaks approaching 40%. To contextualize these dynamics, this section provides an empirical and visual analysis of the long-run co-movement between inflation and money supply growth over the past three decades and explores the potential monetary transmission channels at play.

Figure 2. 12: Inflation Dynamics in Ethiopia (1993-2025)



Source: NBE (2026); Own Computation

2.10. Inflation Dynamics Across Disaggregated Indices and Policy Regimes (1999–2025)

2.10.1. Post-Command Period (1999–2002)

During the post-command economic phase, the macroeconomic landscape was defined by an acute deflationary cycle, peaking in 2001. During this window, both headline and food inflation plummeted into negative territory, with food deflation serving as the primary anchor. However, non-food inflation decelerated but maintained a positive trajectory. This structural divergence confirms that the deflationary pressures were predominantly driven by supply-side factors. This could be due to expansion in agricultural productivity and output facilitated by favorable rainfall patterns and improved input distribution networks rather than systemic demand contraction**.**

2.10.2. State-Led Growth Period (2003–2009)

The state-led growth regime exhibited a tight, highly synchronized co-movement between headline and food inflation. Throughout this period, non-food inflation systematically lagged both headline and food inflation growth rates, illustrating that aggregate price indices were primarily indexed to domestic food supply chains within a relatively insulated domestic market. However, a distinct structural shift occurred

between 2004 and 2008, during which non-food inflation climbed steadily, reflecting rising integration with global commodity markets. This inflationary cycle culminated in a severe macroeconomic shock in 2008, where the headline, food, and non-food indices reached historic, synchronized peaks.

2.10.3. Devaluation Period (2010–2017)

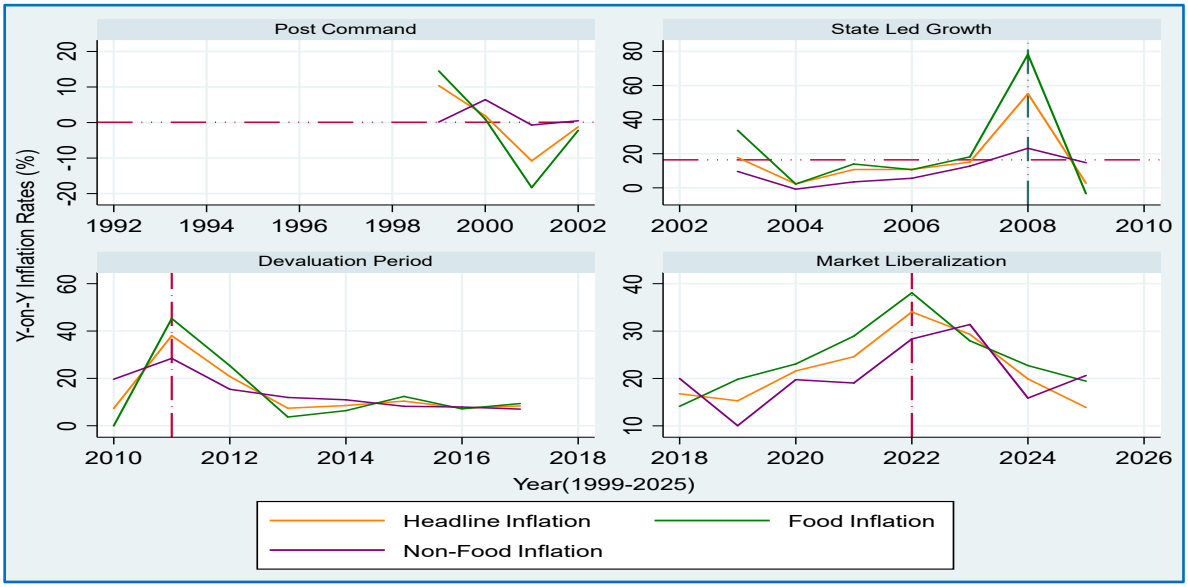
Following the 2010 exchange rate adjustment, all inflation categories experienced an immediate shock, spiking sharply between 2010 and 2011 before embarking on a downward trajectory through 2013. From 2014 to 2017, non-food inflation entered a low-volatility, stabilized plateau. Food inflation experienced a secondary cyclical resurgence between 2013 and 2015 before tapering off after 2016. Mirroring historical patterns, non-food inflation remained below the period's average headline rate, confirming that structural agricultural supply conditions continued to dictate the baseline inflation rate over industrial or imported components.

2.10.4. Market Liberalization Period (2018–2025)

The recent market liberalization epoch introduces a highly volatile regime break. Between 2018 and 2022, headline and food inflation advanced in a steep parallel trajectory, peaking simultaneously in 2022 before entering a deceleration phase through 2025. Interestingly, non-food inflation exhibited a lagged response, climbing continuously from 2019 to peak later in 2023. After a brief moderation, non-food inflation shows a distinct upward inflection toward 2025. This divergence represents a classic delayed exchange-rate pass-through effect, where the liberalization of the foreign exchange market directly elevated the cost of imported inputs and non-food industrial goods, decoupling it temporarily from domestic food price cycles.

A comprehensive evaluation of this 26-year (1999-2025) horizon price dynamics reveals that food inflation consistently outpaced non-food and headline inflation across all non-deflationary regimes. This long-run structural reality indicates that inflation in Ethiopia remains fundamentally a supply-side, agro-centric phenomenon rather than an exclusively demand-pull or externally imported crisis.

Figure 2. 13: Inflation Dynamics by Structural Break



Source: NBE (2026); Own Computation

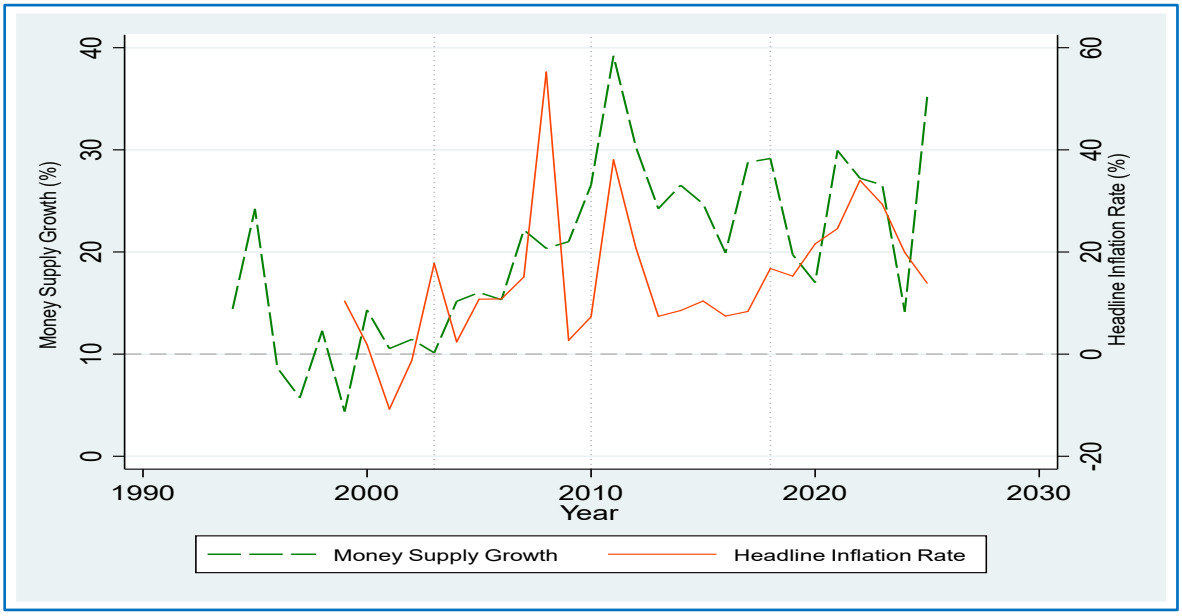
Headline inflation is fundamentally anchored to agricultural productivity and structural domestic bottlenecks, aggressive contractionary monetary or fiscal policies alone may prove insufficient. Sustainable price stabilization will require a coordinated policy mix: balancing central bank liquidity management with targeted fiscal interventions aimed at mitigating agricultural supply shocks, modernizing domestic value chains, and managing the structural pass-through effects of the ongoing foreign exchange market liberalization.

2.11. Money Supply and Inflation Dynamics in Ethiopia

As can be seen from Figure 2.14, broad money supply growth consistently outpaced headline inflation throughout the majority of the sample period, with two notable exceptions in 2003 and 2008. The 2001-2002 fiscal years were characterized by a deflationary spiral, featuring negative inflation rates; consequently, the subsequent rebound in 2003 represented a sharp inflationary correction that surpassed historical averages. Conversely, in 2008, headline inflation reached an unprecedented historic peak of 55.24%. This decoupling suggests that the inflationary surge during this specific episode was predominantly driven by exogenous supply-side shocks such as domestic agricultural shortfalls rather than purely demand-pull pressures induced by monetary expansion.

Furthermore, a disaggregated analysis reveals that food inflation consistently outpaced headline inflation across all observed periods, except during the deflationary years. This structural divergence indicates that the consumer basket is highly sensitive to agricultural supply dynamics. Ultimately, while money supply growth and inflation do not exhibit a perfectly synchronized, one-to-one contemporaneous relationship to short-run nominal rigidities and transmission lags (Friedman, 1961; Mankiw, 1985), the long-run trajectory suggests that monetary expansion partially translates into persistent inflation (Lucas, 1980; McCandless and Weber, 1995). Consequently, these dynamics imply that monetary policy in Ethiopia exerts a potent, non-neutral influence on both the short-run stabilization and long-run performance of the macroeconomy.

Figure 2. 14: Inflation and Money Supply Growth Dynamics in Ethiopia

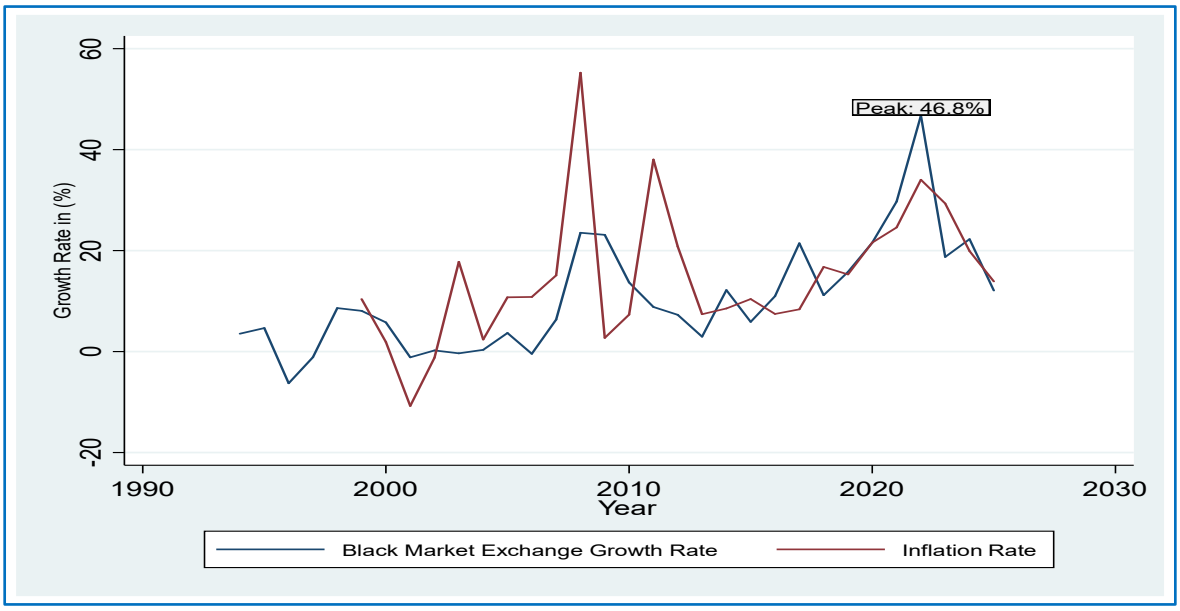


Source: NBE (2026); Own Computation

2.12. Inflation and Black-Market Exchange Rate in Ethiopia

As can be seen from Figure 2.15 below, the growth rate of black-market exchange was negative in 2001 (-1.14%) and 2003 (-0.34%). This deceleration in black market exchange rate aligns with the period of deflation in Ethiopia where the inflation rate was -10.77% in 2001 and -1.22% in 2002.

Figure 2. 15: Trend of Black-Market Exchange Rate and Inflation



Source: NBE (2026); Own Computation

The highest exchange rate growth was recorded in 2024, during the exchange rate reform where inflation had a lower peak compared to the growth rate of exchange rate. In 2009, 2016 and 2017, black market exchange rates grew at a higher rate than CPI did. Similarly in 2017, 2019, 2021, 2022, and 2024, black market exchange rate grew at a higher rate than inflation. During the macroeconomic reform period, nominal exchange rate depreciation outpaced headline inflation as targeted administrative interventions, such as credit growth caps and transaction volume limits, constrained aggregate demand and dampened the exchange rate pass-through to domestic price levels.

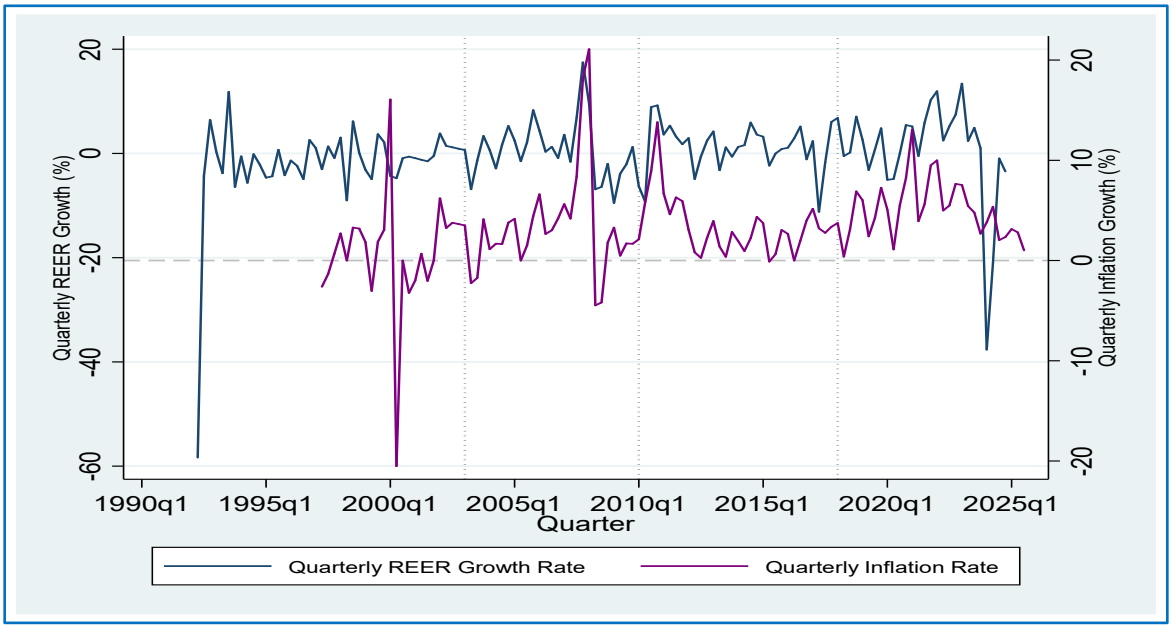
The empirical trends demonstrate strong co-movement between inflation and black-market exchange rate growth. In economies with structural foreign exchange shortages, the black-market rate serves as the true marginal pricing benchmark for imported goods and shapes forward-looking inflation expectations (Dornbusch et al., 1983; Kiguel and O'Connell, 1995), thereby driving cost-push inflation through elevated import procurement costs (Goldberg & Knetter, 1997).

2.13. Quarterly Inflation and REER Growth Rate

In Figure 2.16, the quarterly growth rate of the Real Effective Exchange Rate ($REER$) historically functioned as a near-perfect mirror image of quarterly domestic inflation. Standard open-economy macroeconomic theory dictates that, assuming foreign trading partner price levels remain relatively constant, an increase in domestic price levels automatically drives up the $REER$, inducing real currency appreciation. To maintain the $REER$ at a constant, competitive equilibrium during inflationary episodes, the Nominal Effective Exchange Rate ($NEER$) must adjust dynamically via an offsetting nominal depreciation.

However, due to severe structural rigidities and institutional inertia in Ethiopia's monetary framework, official policy rates and nominal exchange rate crawling mechanisms failed to respond to surging domestic price levels. Because the central bank did not allow the nominal exchange rate to adjust flexibly to offset domestic price shocks, the nominal component remained effectively fixed in the short run. As a result, the quarterly $REER$ growth rate became a passive reflection of domestic price movements, tracking quarterly inflation growth almost symmetrically across major economic cycles, most notably during the 2008 food price shock.

Figure 2. 16: Quarterly Inflation and REER Growth Rate



Source: NBE (2026); Own Computation

This long-standing linkage underwent a fundamental structural break in the post-reform period (2024-2025). Following the transition toward a market-determined exchange rate regime, the quarterly $REER$ growth rate decelerated far more aggressively than the growth rate of domestic inflation, plunging to an unprecedented low of -38%.

This post-reform period represents a transition in the underlying driver of real exchange rate dynamics. In the pre-reform phase, the $REER$ movements were primarily inflation-driven due to nominal exchange rate suppression. Whereas in post-reform period, the $REER$ dynamics became nominal effective exchange rate depreciation-driven, because the initial market-clearing adjustment of the nominal exchange rate was far larger in magnitude than prevailing quarterly inflation rates. The real exchange rate decelerated at an extraordinary rate, which effectively corrected decades of accumulated real overvaluation of Birr in a single policy shift.

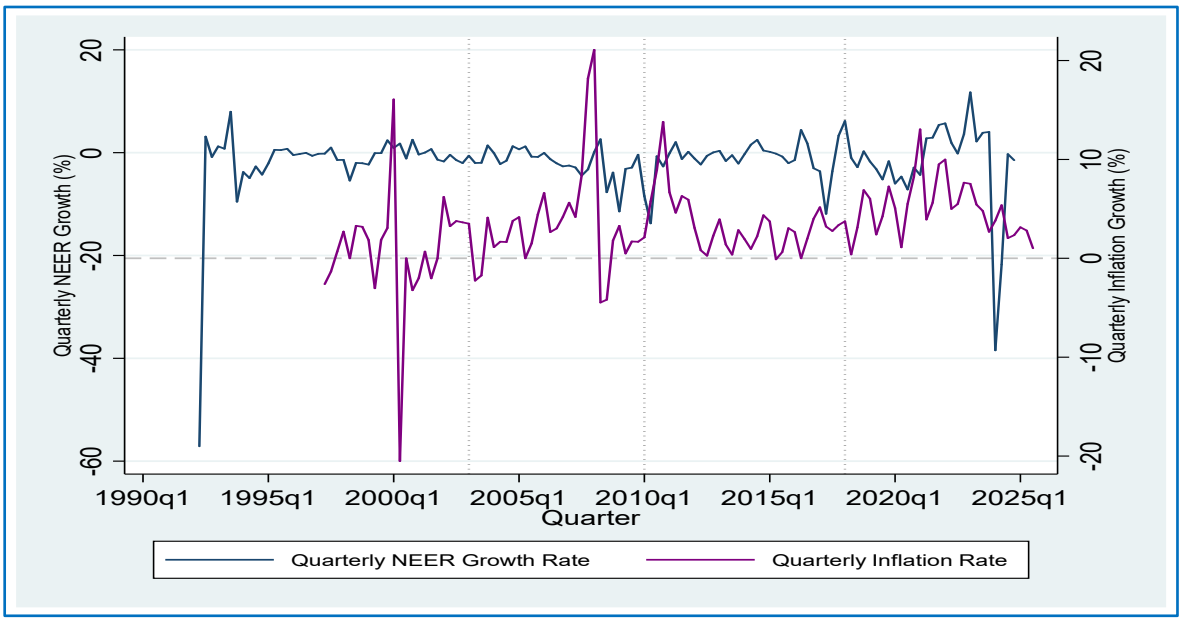
2.14. Inflation and NEER

The joint trends of inflation and the Nominal Effective Exchange Rate (NEER) are depicted in Figure 2.17 below. Over the full sample period, the NEER recorded an average quarterly growth rate of -1.793%, while the corresponding quarterly inflation rate averaged 3.3%[4]. During the post-transition

[4] Note: This quarterly inflation rate is computed from the quarterly Consumer Price Index (CPI) and may not strictly align with the year-on-year (YoY) inflation series reported by the National Bank of Ethiopia (NBE).

period, the series did not display a clear inverse co-movement; nonetheless, NEER growth remained negative while quarterly inflation averaged 0.68%. Across the remaining three structural regimes, however, a pronounced inverse co-movement between inflation and NEER growth is evident. For instance, during the devaluation period, average quarterly inflation rose to 3.41% while NEER growth contracted to -1.41%. This pattern aligns directly with theoretical expectations: as the domestic currency depreciates relative to trading partners, domestic price levels increase via the exchange rate pass-through mechanism. Consequently, nominal exchange rate adjustments exert immediate inflationary pressure on the domestic economy, with transmission occurring contemporaneously within a single quarter since there are no clear lagged inverse responses between the variables.

Figure 2. 17: Quarterly NEER and Inflation Growth Rate



Source: NBE (2026); Own Computation

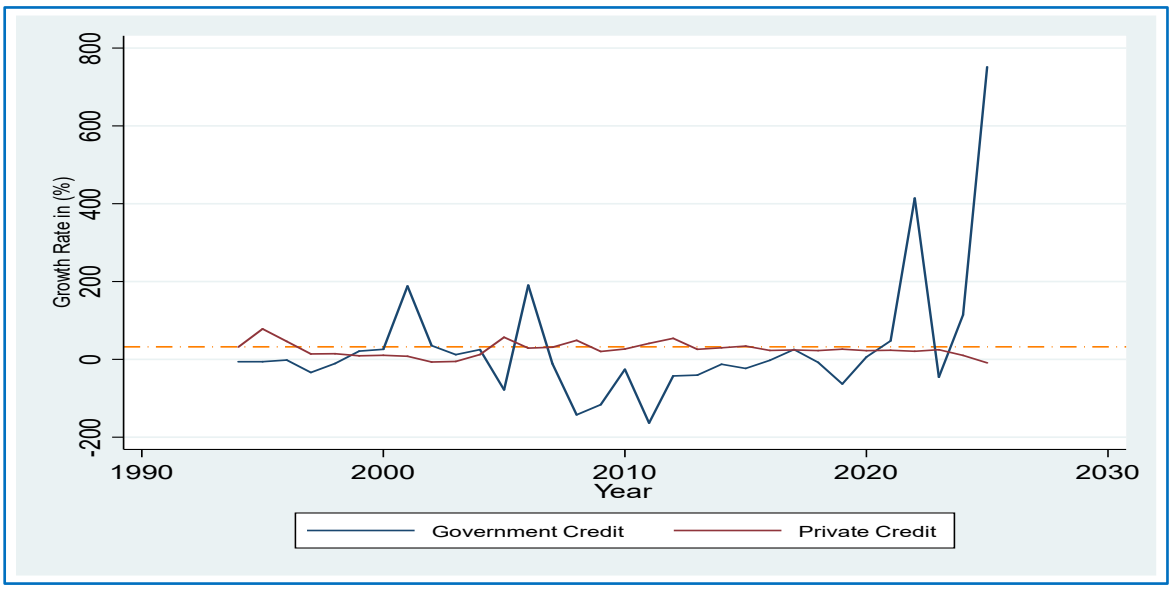
2.15. Credit Growth Trend (1993-2025)

This study analyzes government fiscal and credit trends over the past three decades (1993–2025). Figure 2.18 below shows that between 2008 and 2020, credit to the private sector consistently outpaced credit to the government. Notably, during the devaluation era of 2010–2017, government credit growth turned negative as public sector domestic borrowing contracted relative to both the private sector and historical trends. Given that an expansionary monetary policy stance was already underway, authorities enacted a tighter fiscal posture, containing public expenditure by curbing the state's reliance on central bank direct financing. This policy of architecture persisted for nearly a decade ostensibly creating favorable liquidity conditions for private sector expansion while it came at a steep opportunity cost to public goods and social welfare. In an economy where the public sector plays a foundational role in development and livelihoods (e.g., healthcare, education, and employment), this fiscal retrenchment exacerbated infrastructural deficits. This period directly coincided with heightened domestic social unrest, wherein questions surrounding the equitable distribution of national resources and public investments took center of the stage.

On the other hand, the post-2020 landscape marked a stark structural reversal with government credit growth significantly outstripping private sector credit growth. Remarkably, to curb escalating

inflationary pressures, the National Bank of Ethiopia (NBE) issued a restrictive monetary policy directive on August 11, 2023, explicitly capping annual commercial bank credit expansion at 14%. However, empirical observation reveals a fundamental contradiction: the private sector faced highly constrained credit access under this ceiling while public sector borrowing from the banking system continued to expand aggressively. Rather than achieving its stated objective of sustainable inflation reduction through aggregate demand management, the policy mechanism effectively institutionalized fiscal dominance, systematically redirecting loanable funds from commercial banks to fulfill state financing requirements. This outcome directly undermines the broader macroeconomic reform agenda and compromises high-level policy commitments aimed at leveraging private sector credit as a primary engine for long-run economic growth.

Figure 2. 18: Credit Growth Trend (1993-2025)



Source: NBE (2026); Own Computation

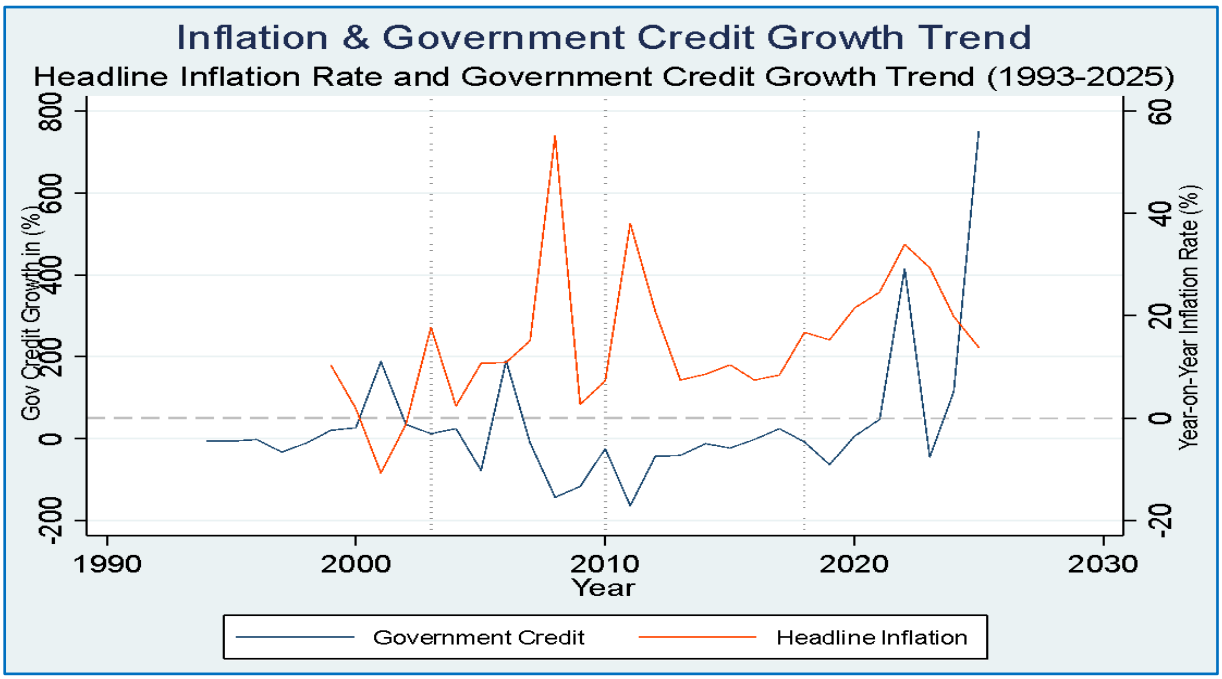
2.16. Government Credit growth and Inflation in Ethiopia

Figure 2.19 reveals a compelling structural shift in Ethiopia's macroeconomic landscape. Prior to 2021, the relationship between government credit expansion (left axis) and year-on-year headline inflation (right axis) was distinctly counter-cyclical. During the historic inflationary surges of 2008 and 2011, government credit growth pulled back sharply into negative territory, dropping to troughs of -100 % and -160 %, respectively. This inverse co-movement strongly confirms that fiscal and credit adjustments were utilized as active counter-cyclical stabilization tools to cool aggregate demand and tame price volatility. Thus, prior to 2021, variations in government borrowing and public expenditure cuts functioned primarily as countercyclical macroeconomic stabilization instruments to rein in price volatility rather than acting as primary drivers of inflation.

However, the 2021–2024 interval marks a profound departure from this historical trend. During these latter four years, both inflation and government credit growth surged in tandem along a remarkably parallel trajectory. Government credit growth experienced an unprecedented acceleration, skyrocketing to over 400% by 2022, closely mirroring the elevated inflationary plateau. While headline inflation has shown initial signs of deceleration toward the 2025 tail, government credit has continued an aggressive

upward trajectory toward 751%. This tight alignment strongly indicates that the nature of the relationship has inverted: rather than serving as a tool for stabilization, aggressive government credit expansion has likely emerged as a primary, endogenous driver of chronic inflation in Ethiopia.

Figure 2. 19: Inflation and Government Credit Growth Trend



Source: NBE (2026); Own Computation

2.17. Money supply, Inflation, and Exchange Rate

This section discusses the relationship between money supply, inflation and exchange rates. All relationships were examined using the Autoregressive Distributive Lag (ARDL) econometrics model, given the model efficiency in small observations where n=33 in this case. The short-term forecasting scenario was used and integrated into ARDL to forecast at least for the short term. The average growth rate of the entire observation was used as a baseline scenario. In addition, the growth rate in the recent period was also used to forecast inflation in the coming five years (2026-2030).

The ARDL model has unique econometric advantages for small-sample time series datasets, such as our 33-year annual data. Traditional structural cointegration frameworks like the Johansen VECM require all endogenous variables to be integrated strictly of order one (I(1)) and demand substantial degrees of freedom due to system-wide parameter proliferation.

Dependent variable is inflation and is denoted by inf and endogenous regressors are exchange rate (ex), and money supply (m) with exogenous regressor structural breaks. The empirical specification is given by:

$$\text{Inf}_t = \beta_0 + \sum_{i=1}^{p} \gamma_i \, \text{Inf}_{t-i} + \sum_{j=0}^{q_1} \beta_{1,j} \log(\text{M2})_{t-j} + \sum_{k=0}^{q_2} \beta_{2,k} \log(\text{ex})_{t-k} + \beta_3 \text{Break}_t + \varepsilon_t \quad \textbf{Eq. 1}$$

Where Inf_t is the inflation rate at time t. $\log(M2)_t$ and $\log(ex)_t$ are the logarithm of money supply, and exchange rate, respectively. Break_t is a dummy variable capturing a structural break (treated as an

exogenous/contemporaneous term). β_0 is the intercept/constant term; p, q_1, q_2 are the optimal lag lengths determined by information criteria (e.g., AIC or BIC), and ε_t is the white noise error term $\varepsilon_t \sim \text{i.i.d}(0, \delta^2)$.

Money supply, export and nominal[5] effective exchange rate values are transformed into their log value. Inflation measured by actual rates since the actual inflation rates were negative for some years and the rate being close to zero value for some years when transformed into logarithm. Unit root tests were conducted on transformed values. We used both Augmented Dickey-Fuller and Phillips-Perron unit root tests. To use the ARDL model, all variables should be stationary at level and first difference. Accordingly, a level test was performed, and we found that all variables have unit roots at level except inflation and the result of test statistics is attached to the appendix. The variable nominal effective exchange rate and money supply are stationary at first difference while the variable export isn't stationary at first difference. Thus, we cannot accurately estimate the relationship between exports and other variables using the ARDL model; as a result, the variable export was dropped from the analysis.

2.17.1. Estimation and Bounds Testing

2.17.1.1. Estimation of ARDL

To preserve statistical power and prevent the excessive loss of degrees of freedom, the maximum lag structure for the model is strictly constrained to two ($p \leq 2$), given the sample size constraint of 32 annual observations. Within this parsimonious bound, the optimal lag length selection is determined endogenously using the Akaike Information Criterion (AIC**)** to balance model fit against parameter proliferation. The empirical model takes ARDL (1,1,0) with one lag for each variable.

To see the long-run relationship between inflation, exchange rate and money supply, we employed the ARDL estimation model. The test result is presented in the following Table. The adjustment coefficient of Error Correction Term (ECT) (-0.972) with statistical significance indicates that this is the strongest evidence that a long-run equilibrium relationship exists between the variables included in the specification. The data provides sufficient statistical evidence that the real exchange rate and money supply has a long-run effect on inflation. A short run increase in money supply will significantly increase inflation in Ethiopia. More specifically, one percent increase in money supply will increase inflation by 1.55 percentage points in Ethiopia. This finding aligns closely with empirical literature on Ethiopia. Specifically, utilizing a vector error correction model (VECM), Durevall et al. (2013) documented a 1.2 to 1.5 percentage point inflation response to money growth. Similarly, Minyahil et al. (2016) estimated a long-run elasticity of 1.45 to 1.60 percentage points using an Autoregressive Distributed Lag (ARDL) bounds testing framework for Ethiopia. Beyond country-specific studies, Barnichon and Peiris (2008) reported comparable panel evidence across Sub-Saharan Africa. In developing African economies, monetized fiscal deficits and structural supply constraints amplify the standard monetary pass-through, causing price growth to outpace broad money expansion (Nwokoma, 2006; Ofori et al., 2017).

[5]Our initial plan was to use a real effective exchange rate to see how it affects the performance and competitiveness of the export sector of Ethiopia . However, export is not stationary at first difference. Thus, we switched to nominal effective exchange rate to see how it interacts with money supply and inflation.

Table 2. 2: ARDL Estimation Result

Variables	(1) ADJ	(2) LR	(3) SR	(4) Inf
Log of money supply		3.417		155.6*
		(8.222)		(84.96)
Log of NEER		21.15		20.56
		(29.19)		(28.56)
L.inflation	-0.972***			0.0277
	(0.208)			(0.208)
D.log of money supply			152.3*	
			(81.02)	
Reg4			13.52	13.52
			(10.67)	(10.67)
L.log of money supply				-152.3*
				(81.02)
Constant			-140.7	-140.7
			(215.0)	(215.0)
Observations	25	25	25	25
R-squared	0.563	0.563	0.563	0.328

Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

2.17.1.2. Bounds testing for long run relationship

We applied the Pesaran, Shin, and Smith (2001) bounds test to check the long run cointegration between the variables included in the analysis. The null hypothesis is no level relationship between inflation, exchange rate and money supply, and the test result is presented in the following Table 2.3. The computed F- value and t-value are 17.668 and -6.343, respectively. Accordingly, we reject the null hypothesis that there is no long run relationship between inflation, exchange rate and money supply. Since the computed F-statistics and t-statistics are higher than the Kripfganz and Schneider (2020), critical values F and t statistics of the upper bound at 1% significant level, which are 8.5699 and -4.574, respectively. Therefore, both the F-test and the t-test provide very strong evidence of cointegration.

Table 2. 3: Test for Cointegration (Bounds Test)

Statistics	10%		5%		1%		p-value	
	I(0)	I(1)	I(0)	I(1)	I(0)	I(1)	I(0)	I(1)
F	3.498	4.667	4.407	5.778	6.708	8.569	0.005	0.015
T	2.581	-3.243	-2.962	-3.672	-3.766	-4.574	0.002	0.008

The empirical ARDL estimate result is given by:

$$inf_t = -140.7 + 0.0277\ (inf_{t-1}) + 20.56\ ln(NEER_t) + 155.64\ ln(M_t) - 152.32\ ln(M_{t-1}) + 13.52(Regime_t)$$

2.17.1.3. Postestimation test

Before moving to forecast, we need to check the validity of the estimation results. Some important validity tests were conducted. These tests include autocorrelation, normality and parameter stability. We employed Breusch-Godfrey LM test for autocorrelation, Jarque-Bera for normality and CUSUM &CUSUMSQ[6] for parameter stability. The autocorrelation test result is presented in the following Table 2.4. Accordingly, we do not reject the null hypothesis that there is no autocorrelation between the error terms at 5 percent of significance.

Table 2. 4: Breusch-Godfrey LM Autocorrelation Test Result

lags(p)	chi2	Df	Prob > chi2
1	3.374	1	0.0662
2	5.317	2	0.0701

The Jarque-Bera test result shows that the residual is not normally distributed, as indicated by the Jarque–Bera statistic of 46.23 ($p < 0.001$). However, normality is desirable but not a strict requirement for parameter consistency in the ARDL model. We introduced the structural break and excluded the year 2025 as outlier because the standard deviation of the error term is greater than 2. After these changes, the Jarque-Bera test result shows that the residual is not normally distributed. However, the results were interpreted in a cautious manner.

2.17.2. Forecasted inflation (2026-2030) using Scenario Analysis

The scenario analysis was conducted using the following variables:

1. Money supply
2. Exchange rate changes
3. Policy changes
4. Combination of changes

[6] Structural breaks were introduced before estimations and already included in the analysis.

Short term Forecasting Inflation

For instance, a 5% surge in broad money supply while holding all else constant, inflation will increase by 7.6 percentage points immediately, before accounting for lagged adjustment. This is in line with the classical quantity theory of money, which posits a fundamental direct relationship between money growth and price levels (Fisher, 1930; Friedman, 1956). In high-inflation developing economies, the magnified price response occurs because nominal liquidity shocks instantly elevate inflation expectations and accelerate money velocity, causing domestic prices to adjust faster than proportional money supply growth (Cagan, 1956; Sargent & Wallace, 1981; Agénor & Montiel, 2015). The short-term impact of money supply is estimated as follows:

Change inflation $= 155.64 * 0.04879 = 7.7$, Where 0.04879 is ln (1.05).

2.17.2.1. Medium term forecasting of inflation

Inflation was projected for the period 2026-2030 using scenario simulations that incorporated exogenous shocks to broad money growth, nominal exchange rates, and structural regime shifts. The baseline and simulation scenarios are presented in the following Table 2.5.

Table 2. 5: Simulation Scenario for Inflation for the Year (2026-2030)

Scenario	Money Supply	NEER	Regime
Baseline	No additional Shock	No Additional Shock	No Change
Scenario 1	+5%	0	No Change
Scenario 2	0	-5%	No Change
Scenario 3	+5%	+5%	Change

Baseline Analysis: An increase in M2 by 25% and A Decrease NEER by 5%

For the last three decades, on average, money has increased by 24.87% for the period (1993-2025) while NEER decreased by 5.07 percent for the same period. For this simulation, we used a 25% increase in money supply and a 5% decrease in NEER.

As demonstrated by the back-testing results in Table 2.6, the model exhibits high predictive power, generating tightly fitted in-sample forecasts for inflation in both 2023 and 2024. For the 2025 fiscal year, official government data reported an inflation rate of 13.9 %. Conversely, our baseline model estimated the actual structural inflation rate at 28.5%. Despite this divergence from official statistics, the model's estimates provide a more robust capture of underlying macroeconomic fundamentals.

Under the baseline policy scenario, assuming authorities maintain the historical long-run broad money supply expansion at a mean rate of 25% alongside a steady 5% nominal decrement of the Nominal Effective Exchange Rate (NEER), the inflation trajectory is projected to undergo only a marginal structural deceleration. The model forecasts inflation to soften from approximately 16.5% in 2026 to just under 15% by 2030. These policy simulation outputs deliver a clear imperative for macroeconomic managers: maintaining the current policy stance guarantees persistent, double-digit price pressures. Achieving a sustainable, single-digit inflation target within the medium-term horizon remains structurally impossible without an aggressive transition toward a contractionary monetary policy posture.

Table 2. 6: Baseline Forecast of Inflation of Ethiopia (2025-2030)

Year	Actual Inflation	Forecasted inflation	Money supply in logarithm	Nominal Effective exchange rate	Regime
2023	29.33	29.33	14.59063	3.408835	1
2024	19.91	17.13	14.72293	3.618993	1
2025	13.9 [7]	28.47	15.02443	2.884801	1
2026	-	16.54	15.24758	2.833507	1
2027	-	15.89	15.47072	2.782214	1
2028	-	15.56	15.69386	2.730921	1
2029	-	15.24	15.91701	2.679627	1
2030	-	14.91	16.14015	2.628334	1

Source: Author's Estimation

Scenario 1: M2 Shock with no change in NEER

This simulation introduces a scenario where broad money supply growth is restricted to a steady 5% expansion, while the Nominal Effective Exchange Rate (NEER) is held constant at its historical baseline trend, representing a continuous 5% nominal depreciation. The resulting deterministic inflation forecast for the 2026-2030 horizon is structured in Table 2.7. Under this policy configuration, the inflation rate is projected to be at 22.64% in 2026, subsequently embarking on a gradual disinflationary trajectory to contract by 0.93 percentage points, settling at 21.73 percent by the end of 2030.

This forecast dynamic is governed by the model's short-run lag structure and opposing coefficient sign dynamics. Specifically, the model reveals a strong, positive contemporaneous effect of monetary expansion on price levels, yielding a coefficient of 155.6%. However, this immediate demand-pull pressure is almost entirely neutralized in subsequent periods by a significant negative lag effect of 152.3%. Consequently, when these opposing forces are aggregated, the estimated net long-run impact of a money supply expansion is restricted to a marginal positive effect of 3.3%. The projected moderation in the forecast path over the 2026-2030 horizon reflects this low net long-run elasticity, as the initial contemporaneous price shock gradually unwinds and recalibrates to the more stable underlying monetary anchor.

[7] A substantial discrepancy of 14.57 percentage points was observed between the projected and official inflation rates for 2025. Specifically, the empirical model forecasted an inflation rate of 28.47% for 2025, whereas the Ethiopian Statistics Service (ESS) reported an actual figure of 13.9 percent. Due to structural noise and potential measurement distortions in the 2025 dataset. The year 2025 observation was treated as an outlier and excluded from the baseline empirical model. Given that 2025 represents the sole isolated forecast deviation across the entire sample horizon, the model's projected trajectory is maintained as a more reliable reflection of underlying macroeconomic dynamics than the reported figure.

Table 2. 7: Forecasted Inflation with Money Supply Shock (2026-2030)

Year	Actual Inflation	Forecasted inflation	Money supply in logarithm	Nominal Effective exchange rate	Regime
2023	29.33	29.33	14.59063	3.408835	1
2024	19.91	17.13	14.72293	3.618993	1
2025	13.9	28.47	15.02443	2.884801	1
2026	-	22.64	15.2868	2.833507	1
2027	-	22.29	15.54916	2.782214	1
2028	-	22.10	15.81153	2.730921	1
2029	-	21.91	16.07389	2.679627	1
2030	-	21.73	16.33625	2.628334	1

Source: Author's Estimation

Scenario 2: NEER Shock and No Change in M2

In this simulation, we assumed money supply grows by baseline while NEER decreases by 5% further. In other words, the depreciation of the domestic currency by 5% further. The simulation output is presented in the following Table 2.8. Under this scenario, projected headline inflation decelerates from 15.42% in 2026 to 9.23% by 2030, successfully attaining the single-digit policy target. Although this disinflationary path appears counterintuitive to standard exchange rate pass-through effect, which posits that nominal currency depreciation induces cost-push inflation. The possible explanations for the unexpected result are:

Table 2. 8: Forecasted Inflation with NEER Shock (2026-2030)

Year	Actual Inflation	Forecasted inflation	Money supply in logarithm	Nominal Effective exchange rate	Regime
2023	29.33	29.33	14.59063	3.408835	1
2024	19.91	17.13	14.72293	3.618993	1
2025	13.9	28.47	15.02443	2.884801	1
2026	-	15.42	15.24758	2.77944	1
2027	-	13.64	15.47072	2.67408	1
2028	-	12.16	15.69386	2.568719	1
2029	-	10.70	15.91701	2.463359	1
2030	-	9.23	16.14015	2.357998	1

Source: Author's Estimation

First, the estimated coefficient for the Nominal Effective Exchange Rate (NEER) is positive but statistically insignificant, implying a negligible empirical transmission from official NEER movements to domestic CPI over the sample period. Econometrically, this reflects Ethiopia's pre-2024 Forex

regime, where official exchange rate series were administratively managed and failed to capture marginal pricing, which was instead driven by parallel market premiums.

Second, the scenario assumes strict monetary discipline; the potential inflationary pressure emanating from currency adjustment is effectively counterbalanced by broad money supply restraint, enabling demand-pull disinflation to dominate medium-term price dynamics.

Scenario 3: Combined Shocks (Money supply, NEER and Policy Change)

As can be seen from Table 2.9, an increase in both money supply and NEER by 5 percent and a change in regime will result in an increase in inflation from 11.2 percent in 2026 to 18.338 percent, the inflation rate will increase by 21.27 percent. This provides an important policy implication that an increase in money supply and NEER will lead to an increased inflation rate in the country even with policy changes[8] in the country.

Table 2. 9: Forecasted Inflation Due to Combined Shocks

Year	Actual Inflation	Forecasted inflation	Money supply in logarithm	Nominal Effective exchange rate	Regime
2023	29.33	29.33	14.59063	3.408835	1
2024	19.91	17.13	14.72293	3.618993	1
2025	13.9	28.47	15.02443	2.884801	1
2026	-	11.17	15.2868	2.933591	0
2027	-	12.57	15.54916	2.982381	0
2028	-	14.48	15.81153	3.031171	0
2029	-	16.41	16.07389	3.079962	0
2030	-	18.34	16.33625	3.128752	0

Source: Author's Estimation

2.18. Conclusions and Recommendations

Empirical analysis of Ethiopia's monetary dynamics (1993–2025) reveals that persistent double-digit inflation is driven by excessive broad money expansion, agro-centric structural supply bottlenecks, and severe post-2020 fiscal dominance.

[8] To isolate the structural impact of the recent regulatory and policy landscape on macroeconomic stability, this study conducts a policy regime simulation. The results yield a striking empirical revelation: when holding broad money supply expansion and the Nominal Effective Exchange Rate (NEER) at their baseline growth paths while systematically reverting the regulatory policy framework to the pre-2017 regime, forecasted inflation experiences a dramatic deceleration plummeting from 28.5% in 2025 to a stable 1% by 2030.
This stark divergence provides compelling empirical evidence that recent institutional and policy shifts, rather than purely autonomous market forces, act as the primary structural drivers of contemporary inflationary pressures in Ethiopia. This finding strongly reflects the severe macroeconomic consequences of recent internal shocks: to finance unbudgeted public expenditures stemming from localized conflicts, the state engaged in heavy domestic debt monetization and expanded central bank credit advances. By simulating a return to the pre-2017 macro-fiscal discipline framework, the model effectively removes this structural fiscal dominance, allowing prices to return to an optimal, non-inflationary equilibrium path. *(The full output for this simulation is available upon request.)*

2.18.1. Key Macroeconomic Conclusions

- **Fiscal Dominance and Crowding Out:** Prior to 2021, public borrowing operated counter-cyclically to tame inflation. Post-2020, public credit growth surged toward 751%, while private credit was restricted to a 14% ceiling. This structural shift institutionalized fiscal dominance, making government borrowing the primary driver of domestic inflation**.**
- **Monetary Transmission and Inflation Elasticity:** Cointegration bounds testing confirms a long-run equilibrium between broad money supply exchange rates, and inflation. A 1 percent increase in money supply generates a 1.55 percentage point long-run increase in headline inflation.
- **Negative Real Interest Rates:** Persistent inflation exceeding rigid nominal rate ceilings created deeply negative real interest rates. This eroded domestic savings, transferred implicit credit subsidies exclusively to affluent collateralized borrowers, and discouraged foreign capital inflows**.**
- **Forex Reforms and Pass-Through**: The July 2024 exchange rate liberalization corrected decades of currency overvaluation, sending quarterly REER growth to -38%. While food inflation continues to anchor headline price movements, non-food inflation exhibits delayed forex pass-through from imported industrial inputs**.**
- **Medium-Term Inflation Outlook (2026–2030):** Maintaining the historical baseline trajectory (25% M_2 expansion and 5% nominal effective exchange rate depreciation) locks Ethiopia into persistent double-digit inflation, easing marginally from 16.5% in 2026 to 14.9% by 2030. Achieving single-digit inflation is impossible under current baseline policies.

2.18.2. Policy Recommendations

- **Transition to Contractionary Stance:** Systematically decelerate broad money supply expansion below the historical 25% to disrupt double-digit inflationary inertia.
- **Dismantle Asymmetric Credit Ceilings:** Phasing out rigid credit caps (such as the 14% commercial bank limit) and transitioning to price-based, interest-rate monetary instruments will restore credit flow to high-productivity private enterprises.
- **Restore Real Returns on Savings:** Allow nominal interest rates to adjust flexibly, establishing positive real interest rates to mobilize domestic savings and reduce wealth inequality.
- **End Central Bank Direct Monetization:** Enforce strict fiscal discipline by ending reliance on central bank direct credit advances to fund public deficits and shifting government borrowing to competitive domestic debt markets.
- **Target Agro-Supply Chains**: Allocate fiscal spending toward agricultural productivity, storage infrastructure, and domestic logistics to alleviate the structural food supply shocks anchoring overall CPI.
- **Mitigate Foreign Exchange Pass-Through:** Implement targeted, temporary social safety net buffers to protect vulnerable households from imported price surges caused by ongoing Forex market unification.

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CHAPTER THREE

FISCAL SECTOR PERFORMANCE AND PROSPECTS

3.1. Introduction

While Ethiopia recorded one of Africa's highest growth rates in the last two decades (IMF, 2025; AfDB, 2026a; AfDB, 2026b; IMF, 2026; WB, 2026), the country also experiences several fiscal challenges including fiscal deficits and high debt to GDP ratio that are associated with different factors including the pandemic and conflict (Note & Polic, 2022; AfDB, 2022). Moreover, despite robust expansion in terms of real GDP growth, Ethiopia's domestic revenue generation has lagged behind, severely constraining the government's ability to finance development priorities and maintain fiscal stability; the divergence between Ethiopia's economic growth and its weak tax performance highlights fundamental weaknesses in revenue mobilization (Hegab, 2025). Tulin (2025) posits the need for rebuilding fiscal space that is needed to support the macro-stabilization function of public finances and the essentiality of improving institutional coordination among others.

Ethiopia's fiscal challenges manifest themselves in terms of several indicators. The country has been experiencing low and declining government revenue to GDP ratio; the magnitude falls even short of other SSA countries, reflecting that the state capacity to mobilize government revenue has been dwindling in recent years (Hegab, 2025). The country's low revenue mobilization capacity has limited its ability to finance essential infrastructure, social programs, and development priorities unlike many other peer countries that have strengthened their tax capacity through policy and administrative reforms. The tax structure of the country also shows disproportionate reliance on indirect taxes posing risks related to regressive consumption taxation, thereby potentially adversely impacting income distribution. Given that low-income households disproportionately spend a higher percentage of their income on consumption expenditure compared to high-income households, disproportionate reliance on indirect taxation may lead to regressive consumption taxation that thereby increases inequality.

The government expenditure to GDP ratio has been also experiencing a downward trend reflecting that government size is falling. Government expenditure is recently dominated by recurrent expenses, forgoing long-term investments that could boost future government revenue mobilization, thereby enhancing fiscal sustainability. Capital expenditure decomposition shows that the percentage share of social development has been recently falling, reflecting that government priorities are shifting away from spending on social developments such as education and health, which poses risks such as slowing down long-term social progress.

The country experiences an overall government budget deficit and primary balance deficit. While overall budget deficit and fiscal deficit to GDP ratio have experienced a falling trend, the fact that the country experiences primary balance deficit reflects that the government cannot cover its day-to-day expenses let alone pay its previous debt. The government experiences a heavy debt burden and experiences debt distress when gauged against several indicators including debt to GDP ratio, debt to government revenue ratio, and debt to tax revenue ratio (AfDB, 2026b). Debt distress is most clearly revealed when observing the debt service to export ratio, which surpasses the threshold of even high-debt carrying capacity countries. Given that Ethiopia is among the low-debt carrying capacity countries,

debt service to export ratio reflects that it experiences debt distress. Moreover, decomposing government debt into domestic and foreign debts shows that while domestic debt to GDP, to total revenue, and to tax revenue showed a falling trend in recent years, the corresponding foreign debt indicators have shown rising trends posing potential risks such as exchange rate risk.

Fiscal outlook of Ethiopia shows that fiscal challenges of the country will by and large be persisting in the coming three years. To address prevailing fiscal challenges, enhancing revenue mobilization capacity through promoting tax mobilization and administration, transparency and compliance is essential. Moreover, enhancing fiscal policies that prioritize capital expenditure over recurrent expenses is vital to enhance long-term investments that in turn boost future government revenue mobilization that thereby enhances fiscal sustainability. Moreover, proportionate allocation of capital budget to social development is imperative to promote social progress through human capital formation thereby building an inclusive economy that in the long term increases the base for government revenue mobilization and hence fiscal sustainability.

3.2. Fiscal Stance: Revenue and Expenditure Dynamics

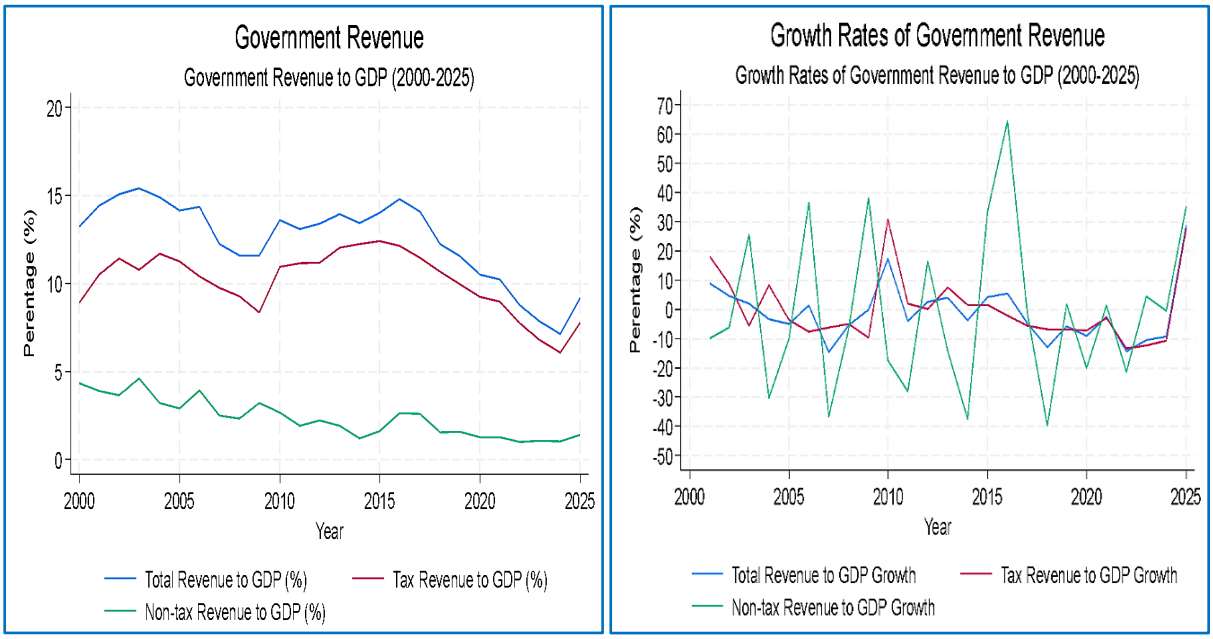
3.2.1. Overall Government Revenue Analysis

Figure 3.1 presents trends and growth rates of government revenue. Ethiopia's fiscal framework is primarily supported by domestic tax revenues, while external grants and overall non-tax revenue contribute only a marginal share. The total government revenue to GDP ratio shows that the government has been mobilizing between 10% to 20% of the total economy from 2000 to 2020. After 2020, total government revenue fell below 10% reaching its minimum of around 7.5% in 2024; it increased in 2025 while remaining less than 10%. The decomposition of government revenue shows that the tax to GDP ratio was less than 10% in the early 2000s and rose to above 10% after 2002 until around 2006 after which it again fell below 10% until around 2010. The lowest point was experienced around 2008/9, coinciding with the global financial crisis. After 2010, it has been consistently greater than 10% until around 2018. After 2018, the figure continued to fall reaching around 7% in 2024 while it increased in 2025. The years through 2017 to 2024 are characterized by overlapping local and global shocks such as political instability followed by the COVID-19 pandemic, civil war and conflicts; these shocks have been potential factors for reduction of government capacity to mobilize revenue through tax collection.

Ethiopia's tax revenue to GDP ratio is far less than the benchmarks that IMF widely states low-income countries (LICs) must achieve a minimum tax-to-GDP ratio of 15% to properly handle basic state functions and service public debt; 15% tax-to-GDP benchmark is a critical threshold for accelerating growth and development (Gaspar et al., 2016). Moreover, Ethiopia's tax collection is far below its potential; it is collecting only about half of its potential tax revenues, underscoring the importance of policy and administrative reforms to strengthen domestic revenue mobilization (Hegab, 2025).

Tax to GDP ratio that proxies a government's ability to mobilize domestic resources is low and declining particularly after around 2015 despite recent uptick, reflecting that Ethiopia's tax revenue mobilization remains among the weakest in SSA. It signals that the ability of the government to mobilize domestic resources is weak; it further indicates the country's weaker fiscal capacity. Moreover, its declining trend indicates that domestic resource mobilization ability and hence fiscal capacity of the country has been dwindling over time. Ethiopia's recent performance in terms of tax mobilization is in contrast to other peer countries; the country's tax to GDP has declined while many countries in SSA have made significant progress in enhancing tax collection (Hegab, 2025).

Figure 3. 1: Government Revenue Dynamics



Source: Ministry of Finance; and Own Computation

Moreover, the literature (Hegab, 2025) shows that the tax system of Ethiopia exhibits uneven responsiveness to economic fluctuations, with trade and consumption taxes displaying high cyclicality, while income taxes remain structurally constrained. Hegab notes that while income and profit taxes are procyclical—taxes increase as economic activity expands—in most countries, elasticity of tax revenues from income, profits, and capital gains in Ethiopia is negative, though not statistically significantly different from zero. According to the author, Ethiopia's tax responsiveness to economic fluctuations contrasts with country groups in SSA, where income tax elasticity is generally positive. For Ethiopia, this contrasting story of tax responsiveness to economic fluctuations particularly matters given that the country's recent strong economic growth has not translated into commensurate income tax revenue mobilization, reflecting missed fiscal dividends that a more responsive tax system could have captured without the need to raise rates.

There are several potential factors contributing to the low tax to GDP ratio of the country, including a growing informal sector that has been considered to be one of the areas where a significant amount of tax revenue is lost in SSA (Amare et al., 2023). The country's tax system is also characterized by a narrow tax base, lack of fiscal transparency, and tax administration inefficiencies; the country's low performance compared to peer countries highlights structural inefficiencies, compliance challenges, and policy gaps that constrain tax mobilization. Structural factors including large agricultural sector—as countries with higher share of agriculture in GDP experience lower tax collection due to the sector's informality, fragmented production, and difficulty in enforcement—and low trade openness are among the contributing factors to Ethiopia's low tax mobilization compared to its potential (Yimam et al., 2023; World Bank, 2020; Hegab, 2025).

Overall, the contribution of nontax revenue to total government revenue continued to decrease, albeit exhibiting some fluctuations, indicating nontax government revenue such as grants and aid have persistently fallen over time highlighting dwindling external budgetary supports. Growth rate of government revenue to GDP ratio shows that while tax revenue exhibits relative stability, despite some

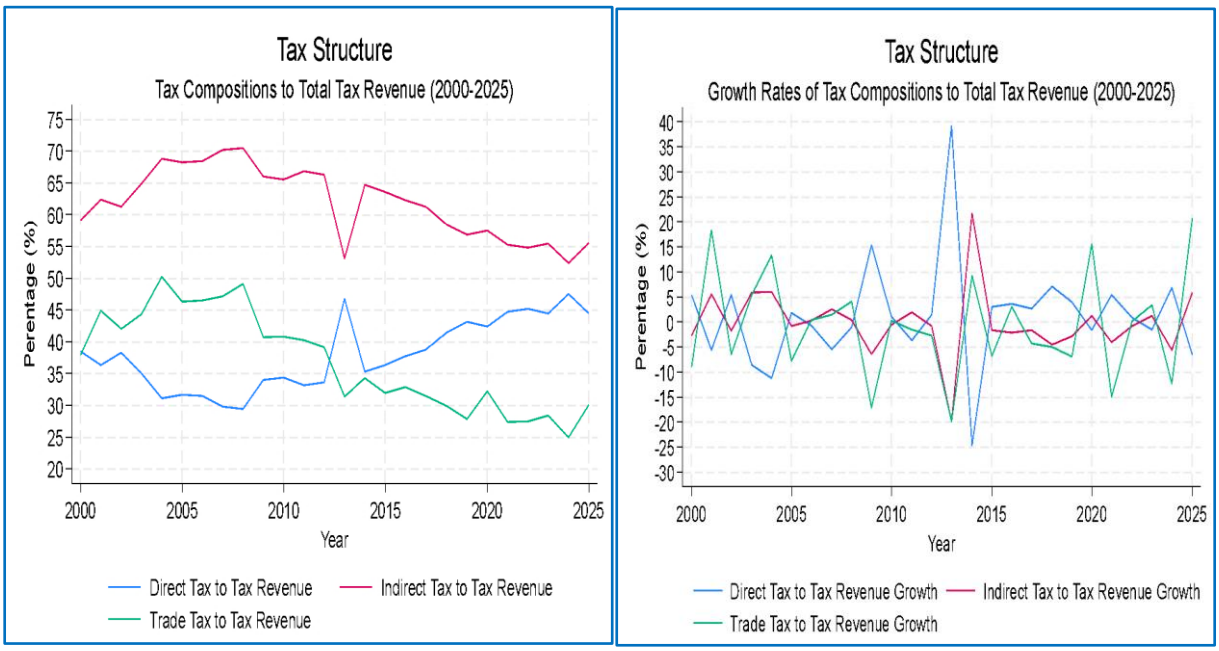
fluctuations, non-tax revenue shows volatility: while tax revenue is relatively predictable, non-tax revenue displays unpredictability.

3.2.2. Tax Structure

Figure 3.2 presents Ethiopia's tax structure dynamics from 2000 to 2025. While there have been positive developments related to direct tax share over time, indirect tax share has been consistently more than 50% of tax revenue throughout the time under consideration. While trade tax was the second contributor to tax mobilization, direct tax has taken the second role after 2013. As such, despite an increasing trend in the role of direct tax recently, the country is characterized by heavy reliance on indirect taxes for revenue mobilization. Such strong and disproportionate reliance on indirect taxes, while possibly viable from fiscal perspectives, poses potential risks of dominance of regressive consumption taxation that may increase inequality.

Accordingly, indirect taxes such as VAT, sales taxes, and excise taxes are the largest revenue sources indicating that Ethiopia collects much of its revenues from consumption expenditure rather than from personal or corporate income taxes. Such disproportionate reliance on indirect taxes poses risk of being regressive because, compared to higher income households, lower income households spend a large share of their income on consumption; and hence heavy reliance on indirect taxes may adversely affect income distribution by negatively impacting low-income households. One of the major reasons for heavy reliance on indirect tax is associated with the prevalence of the informal sector in the country that inhibits tax mobilization from direct tax sources (Asmare et al., 2023).

Figure 3. 2: Tax Structure Dynamics



Source: Ministry of Finance; and Own Computation

Ethiopia's heavy reliance on indirect tax is similar to tax structures of other SSA. According to Kararach et al. (2022), domestic resource mobilization in Africa often relies on consumption taxes, which are generally regressive; the authors note that while mobilizing indirect taxes is viable from a debt sustainability perspective, it has important distributional consequences. Protracted fiscal deficit and fiscal adjustment through indirect taxes increase inequality as low-income households spend a larger

share of income on consumption goods compared with better-off households; consequently, increase in indirect taxes tends to widen consumption inequality. Although Ethiopia disproportionately relies on indirect taxes for its revenue mobilization, it experiences weaknesses in consumption tax collection that further constrain revenue potential of the country (Hegab, 2025).

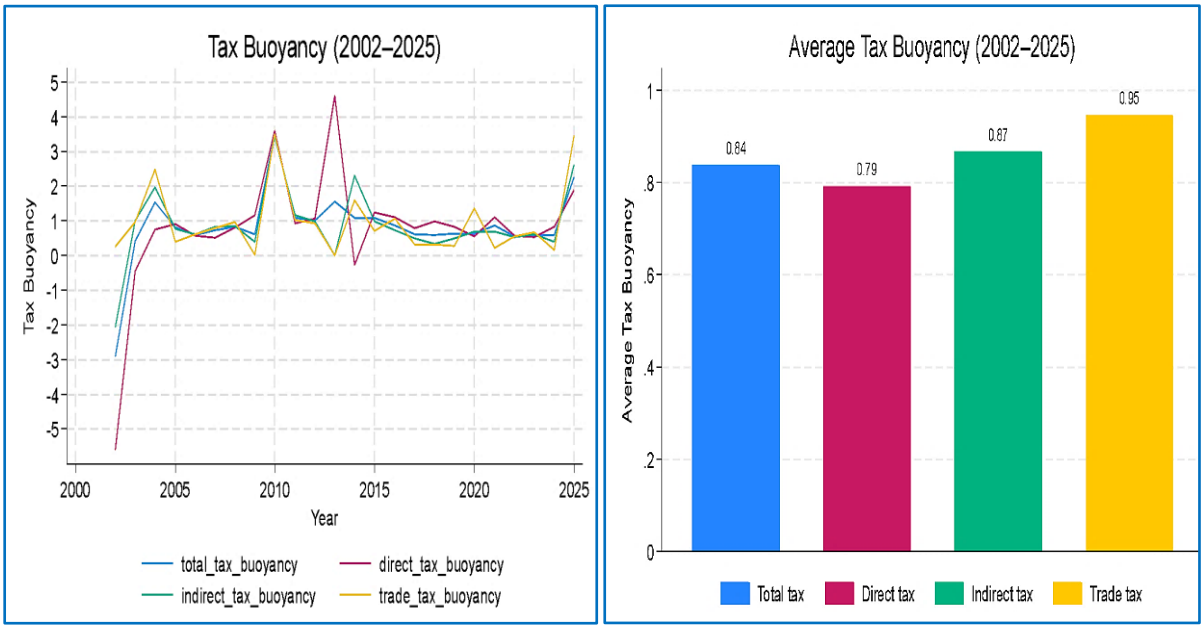
Trade tax was the second most important source for tax revenue until 2013. After 2013, however, there appeared to be a structural break in the country's tax mobilization as the share of direct taxes suddenly and sharply increased surpassing that of trade. According to Hegab (2025), the sharp and sustained decline of the share of taxes on international trade and transactions mirrors the country's shrinking trade openness rather than changes in tax policy or enforcement efficiency. While there appear to be some fluctuations, the share of direct tax continued to increase gradually narrowing the gap with the share of indirect tax over time. During this period, while the share of direct tax consistently showed an increasing trend, the shares of indirect tax and trade taxes continued to fall. The trend shows that heavy reliance on regressive taxation through indirect tax is falling while progressive taxation through direct tax is expanding. Ethiopia's personal income tax and corporate income tax contributions, although increasing over time, are low compared to regional standards (Hegab, 2025).

The tax structure dynamics observed after 2013/14 reflect potential interrelated developments indicating that Ethiopia shifted toward a more direct tax-oriented revenue mobilization due to several possible factors including improved income-tax collection and taxpayer registration, expansion of formal-sector employment, profitable business, and corporate activity, and rising personal incomes. The dynamics of tax structure also reflect that the government is continuously reducing its reliance on trade taxes that potentially distort economic activities and expanding its dependence on domestic taxes in the form of direct and indirect taxes. The dynamics signal an expanding trend of increasing tax diversification, declining dependence on trade taxes, and strengthening direct tax mobilization. In general, after 2013, the fact that direct tax share continued to rise and became the second largest source of tax revenue, and that trade and indirect taxes' share continued to fall highlight structural shifts that potentially reflect improvements of reliance on direct tax.

3.2.3. Tax Buoyancy

Figure 3.3 presents the tax buoyancy of Ethiopia. The results show that, despite fluctuations, the total tax buoyancy is low and by and large less than one, indicating that tax revenue grows more slowly than the overall economy due to growth and new tax rules. The literature (AfDB, 2026c) shows that Ethiopia's tax buoyancy is weak and falls below Africa's average. Disaggregation by tax components shows that trade tax buoyancy is the highest followed by indirect tax buoyancy while the country's direct tax buoyancy is the weakest.

Figure 3. 3: Tax Buoyancy



Source: Ministry of Finance; and Own Computation

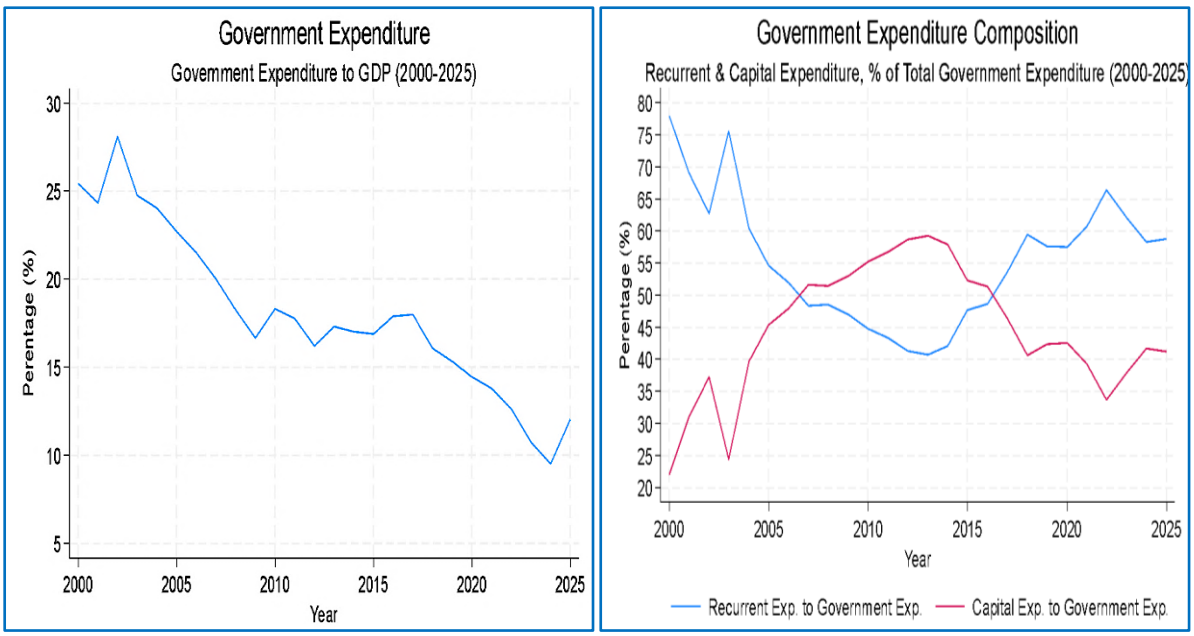
3.3. Government Expenditure Analysis

The government expenditure to GDP ratio, which is a proxy of government size, of Ethiopia shows a persistent declining trend falling from more than 25% in early 2000s to around 10% in 2024, as presented in Figure 3.4, reflecting that government size has been dwindling. The decline in tax revenue of the country has led to proportional expenditure reductions, particularly in capital spending and poverty-related programs, as the government seeks to contain fiscal deficits (Hegab, 2025).

Government expenditure decomposition into recurrent and capital expenses shows the period between 1993 and 2006 experienced recurrent expenditure dominance, the gap between recurrent and capital expenditures as shares of total government expenditure being huge. During this time, recurrent budget shares ranged from 50% to 79% of total expenditure, reflecting that the government has been disproportionately allocating its budget to recurrent expenses at the expense of long-term investments. The period was characterized by a budget structure that reflected consumption oriented fiscal policy where the government primarily focused on financing current operations and public services. Specifically, capital budget share was at its lowest around 1999 and 2000 reflecting the Ethio-Eritrea war period where the largest share of government budget went to recurrent expenditure.

Despite observed fluctuations, composition of government expenditure exhibited increasing share of capital budget and hence decreasing share of recurrent expenses until around 2013. Capital expenditure surpassed recurrent expenditure in 2007 representing a major structural shift in public spending; capital exhibited dominant share until 2016 reflecting that the period was characterized by development oriented fiscal strategy.

Figure 3. 4: Government Expenditure and Composition



Source: Ministry of Finance; and Own Computation

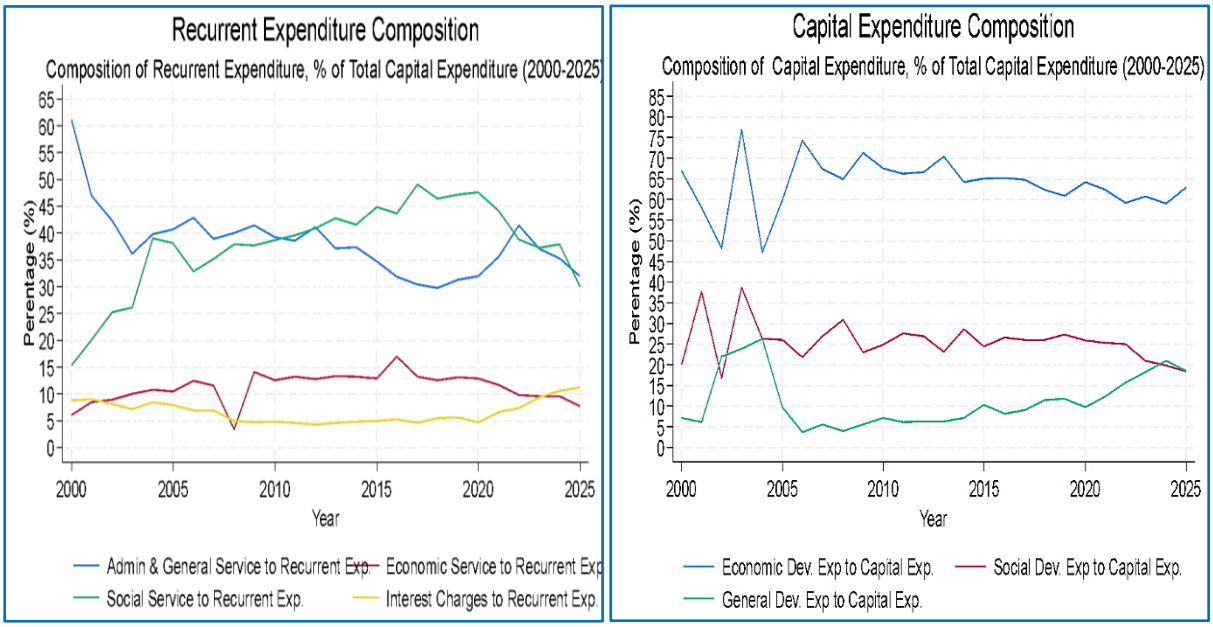
The post 2017 period observed a reversal in expenditure strategy as recurrent expenses dominated total government expenditure. Several overlapping potential factors may have contributed to the dominance of recurrent spending during this time; the 2017 and 2018 years were characterized by political instability and security related problems that have possibly constrained the government's budget to spend on long-term investments. These challenges were later exacerbated by the COVID-19 pandemic, civil war, and conflicts. These domestic and global shocks resulted in public health emergencies, political instability and security challenges, thereby ultimately shifting the expenditure structure of the government whereby recurrent expenses rose as high as more than 60% of total government expenditure.

Overall, the huge difference between the shares of recurrent and capital expenditure out of overall government budgetary expenditure shows that spending is dominated by recurrent costs rather than supporting long-term growth and development. Moreover, the higher relative share of recurrent expenses, compared to capital expenditure may weaken future growth of the economy and fiscal sustainability. In summary, government expenditure is dominated by rigid recurrent spending such as wages and interest payments while capital investment is cut in the last decade indicating that the country is sacrificing future growth for present consumption.

Decomposition of recurrent expenditure reveals that expenses related to administration and general expenses, and social services dominate recurrent expenditure compared to expenses related to economic services, and interest and charges. While the share of interest and charges has shown a decreasing trajectory throughout the years until 2020, it has recently shown an increasing trend, signaling a rising allocation of government budget to debt servicing posing concerns related to debt and fiscal sustainability. Decomposition of capital expenditure on average reveals that, despite fluctuations, expenditure on economic development including roads and transport, agriculture and irrigation, and energy and power cover more than 60% of capital expenditure. Expenditure on social development including education and health care, despite fluctuations, accounted for the second highest capital budget allocation followed by expenditure on general developments. Recently, however, social

development share exhibits a decreasing trend posing risks given that the shrinking budget allocation on social development may hamper long-term social progress.

Figure 3. 5: Recurrent and Capital Expenditure Compositions

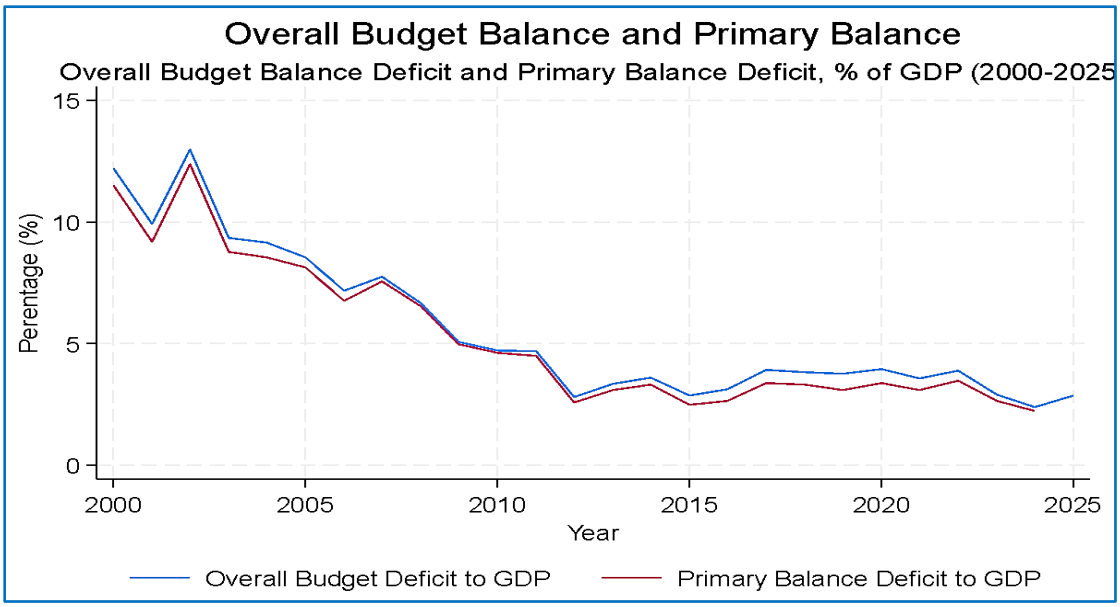


Source: Ministry of Finance; and Own Computation

3.4. Fiscal Balance and Stance

As can be seen from Figure 3.1 and 3.4, total government expenditure was greater than 25% of nominal GDP in early 2000s while total revenue that the government could mobilize during the same time period was around 15%, indicating that the gap between the two figures was the budget deficit to GDP. Government budget deficit to GDP steadily continued to fall from more than 10% in early 2000s until about 2012; it showed relative stability after 2012, now hovering around 2.5% of GDP.

Figure 3. 6: Budget Balance and Primary Balance Deficits to GDP Ratio



Source: Ministry of Finance

Overall, the primary balance deficit to GDP ratio of the country follows similar trends as that of overall budget deficit. The primary balance as a critical indicator of current fiscal effort reveals important information because it shows whether a government's current revenues can cover its day-to-day policies and services. The fact that Ethiopia experiences a primary balance deficit indicates that the government cannot even cover its operational costs without borrowing more, let alone paying interest rate. From fiscal sustainability point of view, to stabilize or reduce a high debt-to-GDP ratio, which will be discussed in the next section, a country usually needs to run a primary balance surplus; if a country is running a primary deficit, it is borrowing just to pay for today's public services, posing concerns about fiscal sustainability in the long run.

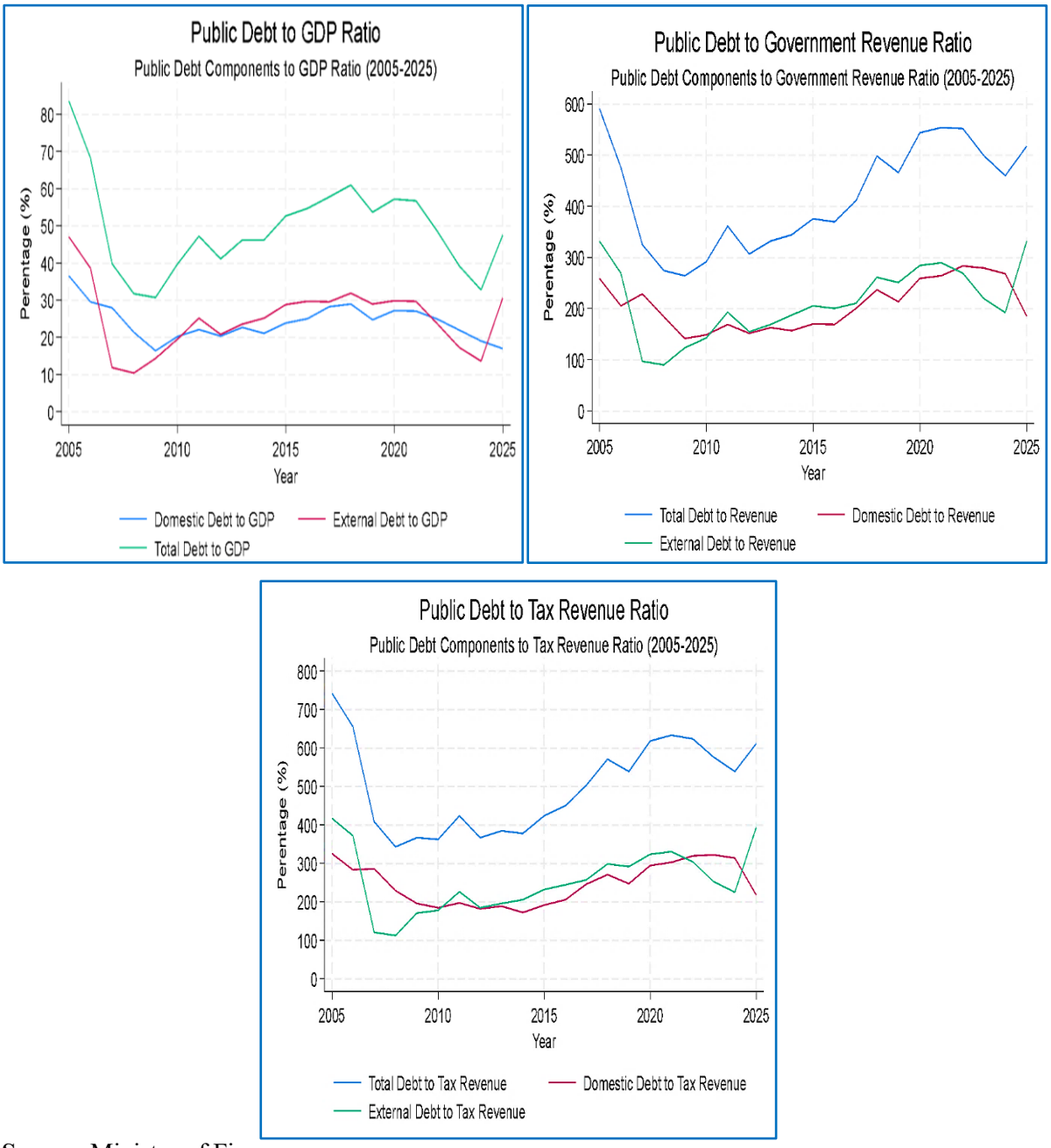
3.5. Public Debt and Sustainability Analysis

Historical contexts of debt sustainability are associated with several shocks such as: (i) the 1980s Latin American debt crisis, (ii) widening fiscal deficits in the United States in the 1980s, (iii) sharply higher debts, starting with the global financial crisis of 2008 and intensified by the COVID-19 pandemic (Willems & Zettelmeyer, 2022). Willems and Zettelmeyer (2022) contend that sovereign debt is unsustainable if it cannot be repaid without altering the contractual terms of the debt or rendering them irrelevant via default, restructuring, or hyperinflation. Kararach (2022) posits that, following the recent fall in commodity prices and associated decline in fiscal revenues, fiscal sustainability concerns are rising in Africa; and rapid rise in public debt accumulation in some African countries is fueling concerns about the possibility of a new debt crisis which has been worsened by the onset of COVID-19 pandemic since March 2020. Growing debt service obligations are creating liquidity problems and crowding out development investments in Africa. According to World Bank (2024), more than half of African governments grappled with external liquidity problems, faced unsustainable debt burdens, or actively sought to restructure their debts while external borrowing has become more expensive than it was prior to the COVID-19 pandemic.

Figure 3.7 presents public debt to GDP, to government revenue, and to tax revenue ratios. The debt to GDP ratio, which is a traditional metric of overall debt burden, exhibited fluctuations over time: after 2021, debt to GDP ratio exhibited a falling trend, reaching about 35% in 2024, while a sharp rise was observed in 2025. The sharp increase in overall debt in 2025 is entirely contributed by rising external debt while domestic debt continues to fall, potentially posing greater vulnerability to shocks in general and to exchange shocks in particular. Accordingly, the rising external public debt to GDP ratio that measures foreign debt exposure may pose shocks such as exchange rate risk and external financing risk. In other words, the currency composition of debt shows that external debt share has recently surpassed domestic debt share and is rising, potentially increasing shocks such as exchange rate vulnerability.

Debt to total government revenue ratio shows similar trends to the debt to GDP ratio; domestic and external debt to total government revenue ratio also show similar trends. While debt to GDP ratio shows the overall capacity of the economy of a country relative to debt-paying capacity, debt to total revenue specifically indicates government’s revenue mobilization capacity relative to its capacity of paying its debt. Debt to revenue ratio, as a measure of debt stock against actual resources available to repay it, is a crucial debt indicator particularly for developing countries with low tax collection. As a proxy of actual payment power, public debt to government revenue ratio is important because it shows whether a government can cover its debt obligations using money it successfully collects rather than relying on broader economic output.

Figure 3. 7: Public Debt To GDP, Government Revenue, and Tax Revenue Ratios



Source. Ministry of Finance

Public debt to tax ratio shows by and large a similar pattern to debt to overall government revenue. Public debt to tax ratio specifically indicates solvency risk, collection efficiency, and structural imbalances of a government. As a measure of solvency risk, the figure indicates the government's ability to service its obligations because an indebted state can remain financially stable if it has robust and reliable tax collection. As an indicator of collection efficiency, by taking the ratio of the stock variable of accumulated debt to the flow variable of annual tax revenue, it reveals how heavy the debt burden is relative to the government's bankable revenue. Moreover, it shows institutional efficiency of a country by revealing the difference between a country's economic size and its actual tax administration. Furthermore, as an indicator of structural imbalances, the high ratio of public debt to tax indicates that a country's obligations are disproportionately large compared to the government's revenue generating

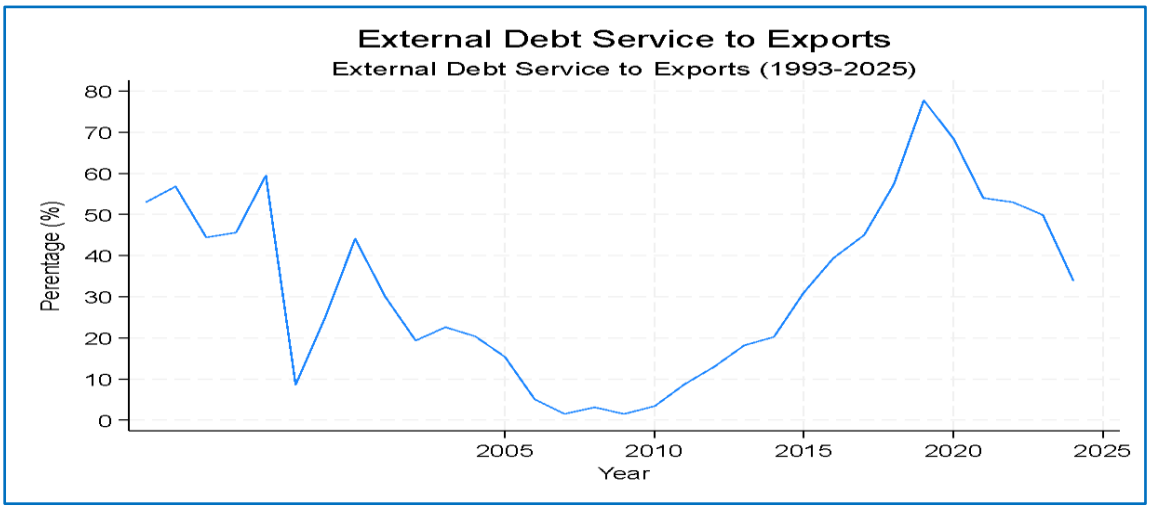
powers, highlighting a need to either cut spending, increase tax rates, or broaden tax bases. The recent increase in external debt to tax ratio poses additional potential risks; besides financial stability, accounting for exchange rate risks is essential.

Figure 3.8 presents the external public debt service to export ratio. The figure shows that external public debt service to export ratio exhibits fluctuations over time. Although it has fallen recently, the figure is still higher than even the threshold for strong debt-carrying capacity. The figure shows that Ethiopia is still experiencing an external debt service-to-exports ratio exceeding 30%, indicating a critical liquidity risk. The figure reflects that the country is spending around a third of its total export earnings just to make principal and interest payments on foreign loans, highly increasing the likelihood of debt distress. This likely poses liquidity risks and debt distress when accounting for the recent sharp increase in external debt to GDP ratio.

Large debt buildup, according to Yared (2019), can ultimately lead to diminished economic activity, either by crowding out private capital investment or by forcing an increase in distortive taxes and reduction in public investment to facilitate repayment. Public debt build-up adversely impacts economic progress through several channels such as higher long-term interest rates, greater uncertainty, and vulnerability to crises especially when their level exceeds a certain threshold (Baharumshah et al., 2017). The authors posit that maintaining fiscal sustainability is important to obtain enough fiscal space for orderly adjustments to mitigate the impacts associated with adverse effects of debt-buildup.

Kararach et al. (2022) argue that current heightened fiscal vulnerabilities in Africa can be attributed to external and internal factors. The external factors include volatile commodity prices particularly for commodity-exporting countries and health challenges like the COVID-19 pandemic that weakened fiscal revenues and growth. The domestic factors include elevated government spending on big-push investment expenditures to close infrastructure gaps and increased security expenditures in response to conflict and social unrest in some countries. To entrench fiscal sustainability, according to the authors, African countries need to strengthen domestic resource mobilization and improve public investment management for greater efficiency. According to the authors, promoting tax revenue collections, savings mobilization and efficiency of public spending are therefore critical; moreover, it is prudent for development partners to support debt reporting, data harmonization, tax compliance, combating illicit financial flows and developing effective debt resolution frameworks.

Figure 3. 8: External Public Debt Service to Export Ratio



Source: Ministry of Finance

Moreover, studies (Guerguil, 2013; Brändle & Elsener, 2024) show that fiscal rules are considered one of the key institutional instruments for the conduct of sound and sustainable fiscal policies and eventually for the resilience of public finances. Fiscal rules are argued to discipline politicians' public spending behavior, create confidence for economic agents and allow them to build up fiscal buffers for economic shocks. Yared (2019) contends that countries with more rent-seeking, political fragmentation, or political risk will incur larger government deficits, resulting in faster government debt accumulation. According to the author, every political explanation for rising debt is based on time-inconsistency in government preferences: current governments want to be fiscally irresponsible, while simultaneously hoping that future governments be fiscally responsible; therefore, governments across the world have sought to adopt fiscal rules (at subnational, national, and supranational levels)—such as mandated deficit, spending, or revenue limits—to restrict future fiscal policy and curtail the increase in government debt.

Kararach et al. (2022) posit the importance of public sector efficiency in public debt management. They claim that the nexus between efficiency and public investment is decisive in the context of poor governance and rudimentary public investment systems. Public sector corruption puts unnecessary strain on resources and efficiencies given that corruption alters decision making processes connected with public investment projects. They contend that corruption can affect investment in several ways including through impacting the size of public investment and quality of investment decisions and investment projects. Hence, unsustainable debt burdens are of great concern to developing countries and debt crises due to fiscal inefficiencies are a recurrent phenomenon. According to the authors, while good public debt management can reduce borrowing costs and curb financial risks, increased corruption leads to an increase in public debt by speeding up misallocation of resources and enhancing other leakages such as illicit financial flows that force the government to increase its spending, divert resources, and create or widen the deficit.

In summary, for Ethiopia, to ensure debt sustainability, promoting tax revenue collections, savings mobilization and efficiency of public spending are essential. Moreover, public sector efficiency and allocative transparency are crucial in fiscal management and thereby reducing public debt buildup and enhancing fiscal sustainability. Furthermore, enhancing institutional quality and hence combating corruption are essential to promote revenue mobilization (by increasing transparency and compliance) and good public debt management thereby undercutting borrowing costs, curbing financial risks, and reducing misallocation of public resources.

3.6. Fiscal Outlook

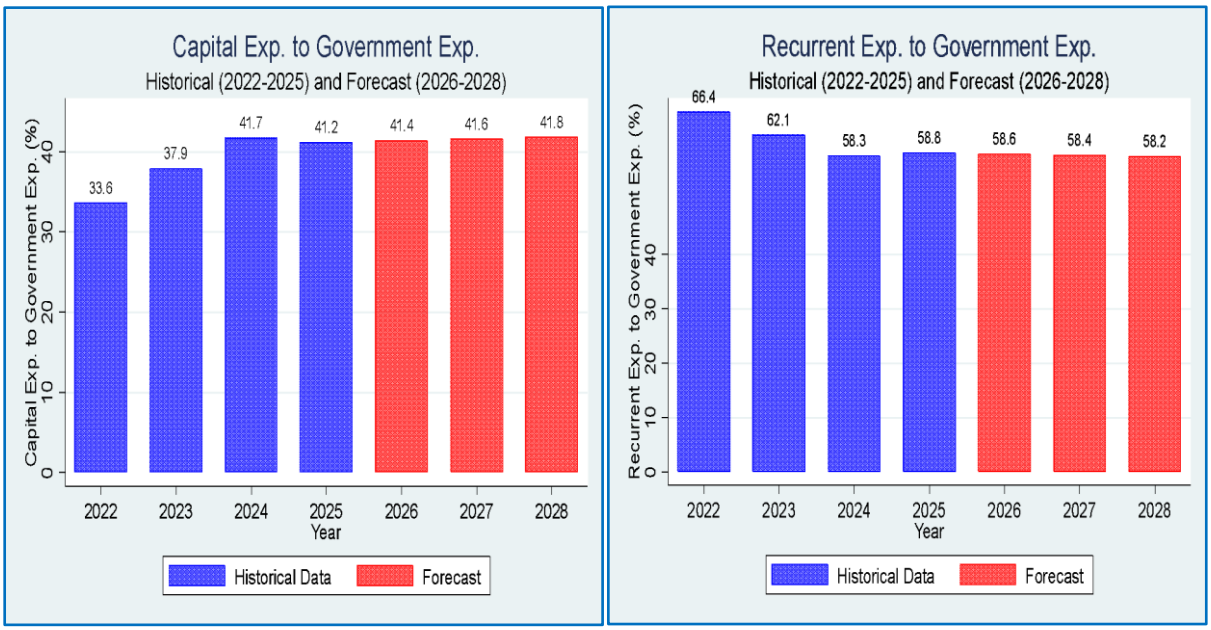
3.6.1. The Outlook

In this section, we present the fiscal outlook by focusing on the main fiscal variables of interest[9]. Ethiopia's fiscal outlook in the coming three years shows mixed results, as presented in Figure 3.9, Figure 3.10, and Figure 3.11. The share of recurrent expenditure continues to dominate the overall government expenditure signaling that the country will continue to disproportionately spend on recurrent expenses, forgoing investment on long term investments. Forgoing long term investment by disproportionately allocating public expenditure on recurrent spending may adversely impact Ethiopia's

[9] We undertook the forecast using ARIMA. Given the short time horizon of the sample, though attempts were made, alternative forecasting strategies such as VAR and ARDL do not yield better forecasts. In undertaking the forecast using ARIMA, we controlled for the Ethio-Eritrea war of 1998 to 2000, the 2003 drought, the 2008 global financial crisis, the 2018 political change, the 2020 COVID-19 pandemic, and the 2020 to 2022 civil war.

fiscal sustainability. On the other hand, the country will enjoy falling overall budget deficit and primary budget deficit to GDP that may signal good fiscal stance as government expenditure and revenue gap is expected to keep falling.

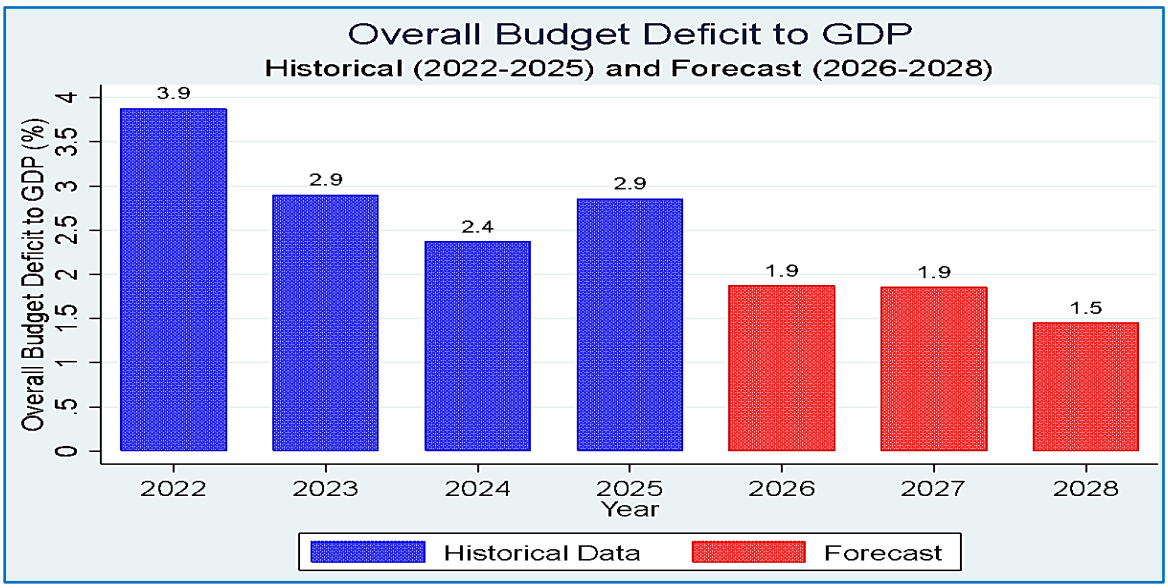
Figure 3. 9: Outlook of Capital and Recurrent Expenditure Shares in Overall Public Expenditure



Source: Own Estimation

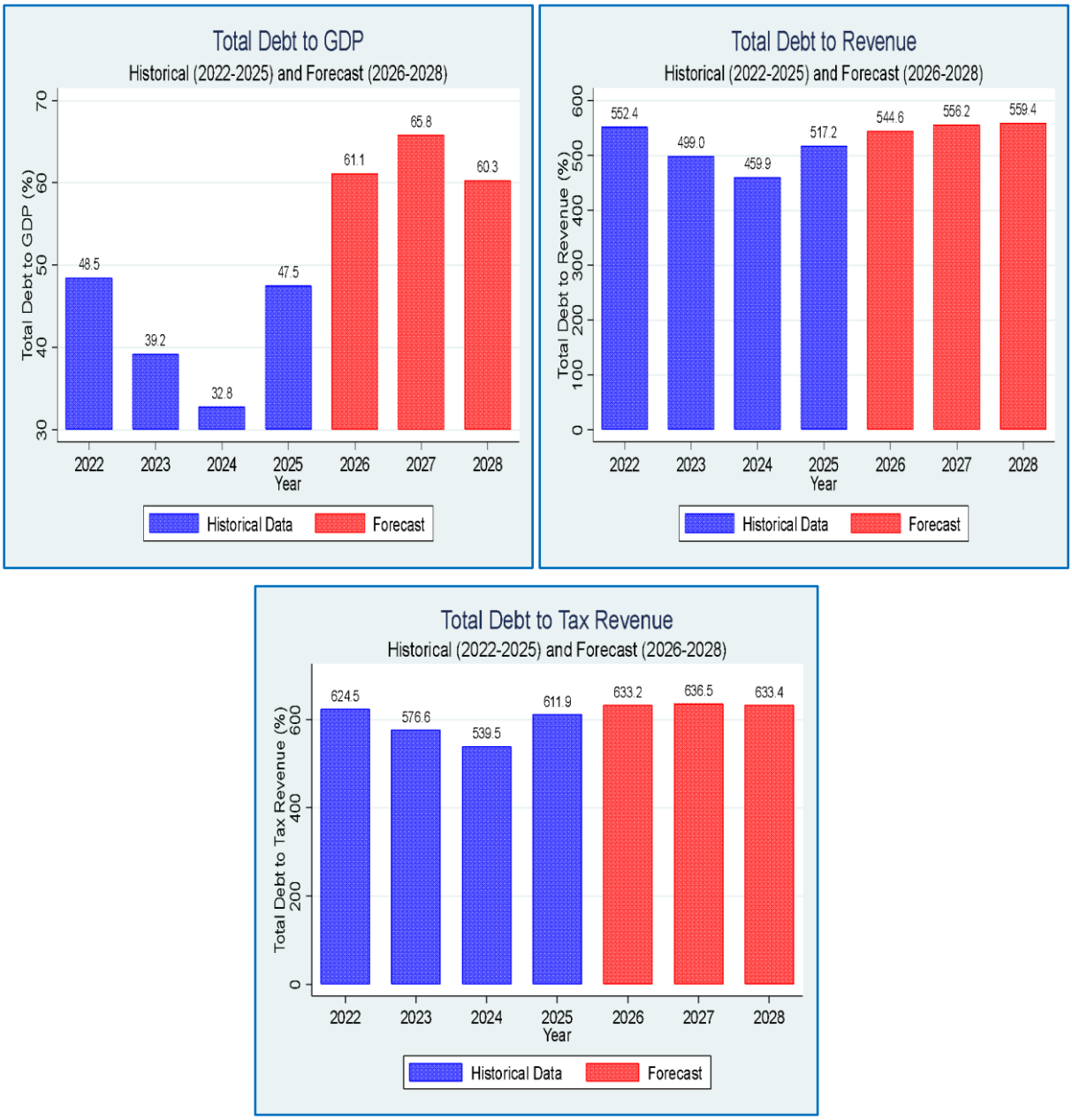
However, the outlooks related to public debt show that Ethiopia will continue to experience debt distress given that overall debt to GDP ratio, overall debt to government revenue, and overall debt to tax revenue will continue to rise. Specifically, the overall public debt to GDP will surpass 60% (a magnitude above the threshold of debt sustainability for low-income countries) signaling that the country will continue facing debt distress in the coming three years.

Figure 3. 10: Outlook of Budget Deficit to GDP



Source. Own Estimation

Figure 3. 11: Outlook of Public Debt to GDP, Total Revenue, and Tax Revenue Ratios



Source. Own Estimation

3.6.2. Risks to the Outlook

3.6.2.1. Downside risks

The major downside risks to the outlook emanate from domestic and international factors. The domestic downside risks include security and political uncertainties that may lead to (i) shrinking the government's ability to mobilize domestic resources including taxation and (ii) disproportionate government budget allocation to recurrent expenses by forgoing long-term investment. Moreover, the disproportionate government expenditure share of recurrent expenses may pose challenges related to forgoing long-term development investments thereby undermining future sources of revenue mobilization and fiscal sustainability.

Shrinking external sources of finance including concessional loans, increasing costs of external borrowing, and increasing debt distress are among the major downside risks to the fiscal outlook. Moreover, increasing import costs of Ethiopia's strategic inputs such as fuel and fertilizer that are subsidized by the government are headwinds to the fiscal outlook, potentially posing increased fiscal pressures and reduced policy flexibility.

To mitigate the downside risks, the government can take a number of potential interrelated measures: (i) accelerating domestic revenue mobilization through addressing security uncertainty and enhancing institutional quality; (ii) scaling up public-private partnerships to mobilize resources for investment; (iii) prioritizing capital expenditure over recurrent spending; (iv) enhancing efficiency in public expenditure utilization; and (v) promoting institutional quality to enhance transparency, accountability, compliance and efficiency related to revenue mobilization and public resource allocation.

3.6.2.2. Upside risks

While risks to the outlook tilt toward the downward risk, there are also upward risks to the outlook that mainly depend on several factors. One of the major upward risks is related to increasing domestic finance mobilization. Moreover, the increasing public-private-partnership (PPP) and blended financing roles in resource mobilization are among the upward risks to the fiscal outlook.

3.7. Conclusion

The fiscal sector of Ethiopia is characterized by low revenue mobilization in terms of many indicators including the tax revenue to GDP ratio; the country's tax to GDP ratio is lower even compared to other SSA countries. Tax structure shows excessive reliance of the government on indirect tax that may disproportionately impact low-income households as they spend larger portions of their income on consumption compared to high-income households; thus, such a heavy reliance on indirect tax for government revenue mobilization may adversely affect income distribution.

Government expenditure to GDP is falling, signaling that the size of government is shrinking. The composition of government expenditure shows that the government is disproportionately spending on recurrent expenditure forgoing long-term investments, posing risks related to fiscal sustainability. The fiscal stance analysis shows that the country is experiencing a public budget deficit although the overall budget deficit to GDP is falling. Although primary balance deficit to GDP ratio is falling, the fact that Ethiopia experiences primary balance deficit indicates that the government cannot finance its current day to day expenditure let alone pay previous debt.

Public debt indicators gauged in terms of debt to GDP ratio, debt to government revenue ratio, and debt to tax ratio show that the country experiences a debt burden. Disaggregating total debt into domestic and external debt shows that external debt to GDP ratio, external debt to overall government revenue, and external debt to tax revenue ratio show sharp increase signaling that the country faces risks such as exchange risks emanating from high external debt. Moreover, the debt service to export shows that the country's debt service exceeds the threshold of even high-debt carrying capacity countries. Given that Ethiopia is among the low-debt carrying capacity countries, its debt service to export ratio that even surpasses the threshold for high-debt carrying capacity countries reflects that the country is experiencing debt distress.

Fiscal outlook of the country shows that recurrent expenses will dominate government expenditure in the coming years, posing fiscal sustainability risks given that the government will be forgoing long-

term investment (that could raise future public revenue) in favor of recurrent expenditure. Public debt is projected to increase in the coming three years, putting the country at risk of debt distress. Particularly, the public debt to GDP ratio is expected to surpass 60% posing debt distress.

In the era of shrinking external (concessional) finance sources, strengthening domestic revenue mobilization is essential to achieve and sustain macroeconomic stability and long-term development. Given that Ethiopia's tax-to-GDP ratio remains far below the critical threshold level (that constrains government's capacity to finance essential services), increasing tax mobilization capacity of the government by improving institutional quality thereby enhancing transparency, compliance and accountability is essential. Such measures help the government to close revenue-expenditure gap and reduce debt distress, thereby enhancing fiscal sustainability and supporting long-term economic progress that will ultimately enable the country to achieve SDGs.

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CHAPTER FOUR

THE EXTERNAL SECTOR PERFORMANCE

4.1. Introduction

This chapter evaluates the performance, trajectory, and structural dynamics of Ethiopia's external sector over a 32-year period from 1993 to 2025.

The first part of the chapter analyzes the export sector's performance across four distinct structural regimes: the Post-Command Transition Period (1993-2002), the State-Led Growth Period (2003-2009), the Devaluation Period (2010-2017), and the Market Liberalization Period (2018-2025). It evaluates disaggregated trends across seven major export commodities: coffee, oilseeds, gold, pulses, leather and leather products, meat and meat products, fruits and vegetables alongside major export destinations. Furthermore, this section examines the transmission channels of the Nominal Effective Exchange Rate (NEER), Real Effective Exchange Rate (REER), and the parallel market exchange rate premium on export growth.

The second part of the chapter focuses on the trends of Ethiopia's import sector, disaggregating imports by major product categories and key geographic trade partners. It assesses the one-quarter lagged sensitivity of import growth to exchange rate adjustments and examines bilateral trade balances to highlight structural deficits with major capital- and energy-supplying nations.

Finally, the chapter reviews the historical growth trajectory of Ethiopia's trade deficit over the past three decades and concludes with key findings and strategic policy recommendations to rebuild export competitiveness, address supply-side rigidities, and reduce systemic balance-of-payments constraints.

4.2. Export Performance (1993-2025)

The long-run trend of Ethiopia's export sector over the past 32 years reveals an average nominal value of 82.307 billion ETB, expanding at a long-term average growth rate of 33.25 %. However, this aggregate figure masks profound structural volatility and regime-specific performance variations over time. The following subsections present the performance of the export sector of Ethiopia by structural window of breaks.

4.2.1. Post Command Transition Period (1993-2002)

The immediate post-command period was characterized by severe export growth volatility. The economy suffered multi-year contractions, with negative growth rates recorded in 1996(-11.24%), 1999 (-4.99%), 2001(-1.49%), and 2002 (-1.29%). Conversely, temporary trade openings and initial liberalization triggered sharp, short-lived spikes in 1995 and 1997, where export growth reached cyclical maximums of 90.04% and 52.01%, respectively. Overall, the post command period average growth rate was 18.44%, with a mean export volume of 3.121 billion ETB[10], significantly underperforming relative to the long-term average growth rate.

[10] Data from the National Bank of Ethiopia (NBE) reports annual export values in domestic currency (ETB). Consequently, it is difficult to distinguish real export growth from nominal increases driven by the depreciation of the ETB. This study focuses on growth rates rather than absolute values. However, because export growth reflects changes

4.2.2. State-Led Growth Period (2003-2009)

During the state-led growth period, the export sector stabilized, generating a higher mean value of 9.502 billion ETB and an accelerated average growth rate of 23.27%. As illustrated in the second panel of Figure 4.1, export growth remained consistently in positive territory throughout this period. Strong performances were anchored in 2005 (41.58%) and 2008 (31.6%), reflecting favorable global commodity prices and structured state support mechanisms.

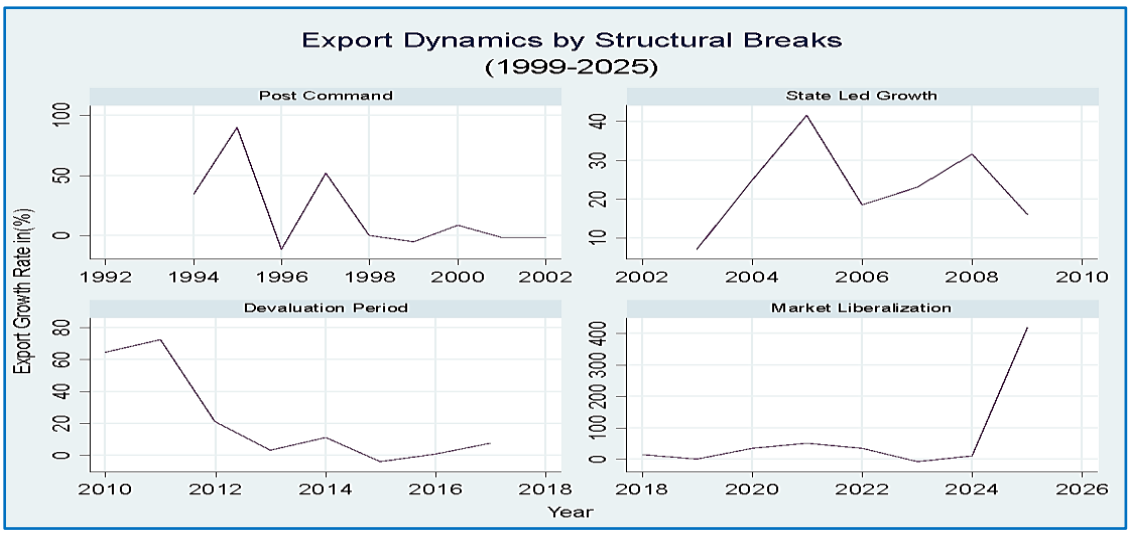
4.2.3. Devaluation Period (2010–2017)

The 2010 currency adjustment triggered an immediate nominal export expansion. As visualized in the third panel of Figure 4.1, the rate peaked in 2010 (64.7%), and the upward momentum carried through into 2011 (72.5%), establishing a cyclical regime peak before entering a prolonged deceleration phase that lasted until 2016. Despite this deceleration, the period achieved a high nominal average value of 55.532 billion ETB, though the average growth rate (22.12%) was marginally lower than the preceding state-led growth phase.

4.2.4. Market Liberalization Period (2018–2025)

The market liberalization period post-2018 registers the highest nominal metrics, yielding an average export value of 271.776 billion ETB and an average growth rate of 69.73%. This data is heavily skewed by an unprecedented and massive export growth spike of 418.6% in 2025. This historic outlier is attributed to positive exogenous supply shocks specifically, a severe disease-driven supply contraction in Brazil that drove international coffee prices and Ethiopian volumes upward alongside expanded output in the domestic gold and mining sector. Crucially, dropping this single outlier causes the period's average growth rate to plunge to 19.89%, which is mathematically consistent with the low, flat baseline visible from 2018 to 2024 in the fourth panel of Figure 4.1.

Figure 4. 1: Export Performance by Structural Breaks



Source: National Bank of Ethiopia; Own Computation

in both price and volume, disaggregating these two components is beyond the scope of this study and needs further detailed analysis.

The nominal export figures exhibit an upward trajectory, and the values are denominated in local currency (ETB) and do not account for exchange rate valuation effects**.** The apparent surge across historical phases is largely a reflection of a depreciating domestic currency rather than an expansion of real and trade competitiveness.

When factoring out the anomalous 2025 coffee shock, the true underlying structural growth rate of Ethiopia's export sector consistently clusters around a modest 18% to 23%. This performance is inadequate given the country's mounting foreign exchange constraint which is driven by systemic import growth over time.

4.3. Trends of Exports Disaggregated by Major Exporting Items

Seven major exporting items of Ethiopia were considered for the analysis. These are coffee, oilseeds gold, pulses, leather and leather products, and fruits and vegetables. The value of export for each item was measured in million USD unlike the unit of measurement used for total value of export where the data is available in local currency units.

4.3.1. Export values of Major Items in Post Transition Period (1993-2002)

As can be seen from Table 4.1 below, the average export value of coffee was close to 238 million USD with high variation compared to other major commodities. Leather and leather products followed coffee exports with an average exports value of 46.9 million USD in this period. Gold and oilseeds exports value during the post transition period were 30.44 and 20.4 million USD, respectively.

Table 4. 1: Export Value for Major Commodities in Post Transition Period

Commodity	Obs	Mean	Std. Dev.	Min	Max
Coffee Export	10	237.93	87.228	121.7	380.4
Oilseeds Export	10	20.4	15.134	0.2	41.9
Gold Export	9	30.444	15.152	10.8	64
Leather and Leather Product Export	10	46.86	14.913	29.7	75.9
Pulses Export	10	12.44	8.525	0.8	32.9
Meat and Meat Product Export	10	2.12	1.58	0.1	4
Fruit and Vegetables Export	10	4.4	2.6	0.6	9.4

Source: NBE (2026); Own Computation

4.3.2. Export values of Major Items in State Led Growth Period (2003-2009)

During this period, the average export value for all commodities increased substantially compared to the post-transitional period. The average value of coffee exports was 343.2 million USD, which is higher than the average value of the post-transition period, which was 238 million USD. The increment in the value of oil seed export was very remarkable, which outpaced the gold contribution to the overall export values.

Table 4. 2: Export values of Major Items in State Led Growth Period (2003-2009)

Commodity	Obs	Mean	Std. Dev.	Min	Max
Coffee Export	7	343.243	120.224	165.2	524.5
Oilseeds Export	7	175.357	103.141	46.1	356.1
Gold Export	7	69.786	22.179	42.1	97.8
Leather and Leather Products Export	7	71.786	19.524	43.6	99.2
Pulses Export	7	59.943	45.038	20	143.6
Meat and Meat Products Export	7	15.171	8.102	2.4	26.6
Fruit and Vegetables Export	7	13.243	2.309	9.6	16.2

Source: NBE (2026); Own Computation

4.3.3. Export values of Major Items in Devaluation Period (2010-2017)

Throughout the devaluation window, the aggregate value of Ethiopian exports recorded a robust expansion relative to the historical state-led growth period. For instance, the average export value of coffee is more than doubled its previous regime average, solidifying its role as a traditional pillar of foreign exchange generation. However, the most profound structural shift occurred within the mining sector, specifically concerning gold dynamics. Interestingly, during this period, Ethiopia has exported close to 400 million worth of gold each year for 8 years which is 3.2 billion USD.

Table 4. 3: Export values of Major Items in Devaluation Period (2010-2017)

Commodity	Obs	Mean	Std. Dev.	Min	Max
Coffee Export	8	756.325	110.104	528.3	883.2
Oilseeds Export	8	448.888	106.265	326.6	651.9
Gold Export	8	399.837	145.935	208.8	602.4
Leather and Leather Products Export	8	110.238	23.715	56.4	131.6
Pulses Export	8	205.487	55.594	130.1	279.9
Meat and Meat Products Export	8	76.613	21.209	34	98.7
Fruit and Vegetables Export	8	44.388	9.017	31.5	56.1

Source: NBE (2026); Own Computation

4.3.4. Export values of Major Items in Liberalization Period (2018-2025)

As shown in Table 4.4, on average, the liberalization period recorded a notable value expansion in primary commodities including coffee, gold, pulses, meat and meat products, fruits and vegetables relative to the preceding devaluation period. On the other hand, the average export values for oilseeds and leather and leather products exhibited a sharp contraction. Analyzing the underlying drivers of this sector-specific underperformance reveals distinct localized and systemic challenges. In the agricultural sector, protracted domestic security instabilities and territorial rivalries directly fractured the supply

lines of core oilseeds clusters, and a sharp fall the global price causing Ethiopia's flagship sesame export volumes to plummet from an estimated 359,000 tons five years ago to 210,000 tons in 2025 (Addis Fortune, 2025)[11].

Table 4. 4: Export values of Major Items in Market Liberalization Period (2018-2025)

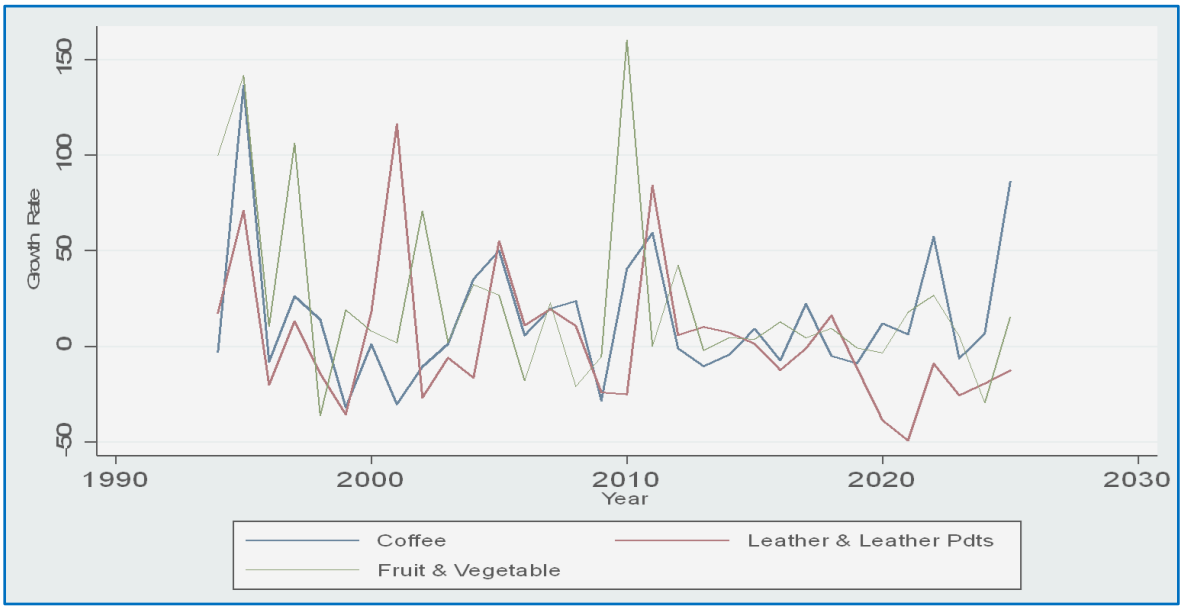
Commodity	Obs	Mean	Std. Dev.	Min	Max
Coffee Export	8	1279.4	626.26	764.1	2665.1
Oilseed Export	8	335.175	55.369	258	423.5
Gold Export	8	701.138	1144.068	27.9	3480.9
Leather and Leather Products Export	8	56.687	45.563	17.4	132.4
Pulses Export	8	271.412	44.046	218.9	343.8
Meat and Meat Products Export	8	88.05	17.157	67.4	109.7
Fruit and Vegetable Export	8	71.375	12.771	58.8	92.5

Source: NBE (2026); Own Computation

Similar vulnerabilities are also observed in the manufacturing sector as well. Despite targeted government interventions such as the *'Ethiopia Tamirt' (Let Ethiopia Produce)* national industrial movement, the leather and leather product sector suffered a catastrophic structural downturn. The data highlights a stark contraction, with annual leather and leather products export revenues collapsing from an earlier baseline of $132.4 million in 2018 to approximately $17.4 million in 2025. This deceleration could be triggered externally by the revocation of Ethiopia's duty-free access under the African Growth and Opportunity Act (AGOA) in January 2022. Locally, a shortage of raw leather and the subsequent operational closure or downsizing of major domestic tanneries could have contributed to the low export performance of the leather industry (Addis Fortune, 2025)[12] . The number of tanneries shrank from 35 to seven due to shortage of raw leather.

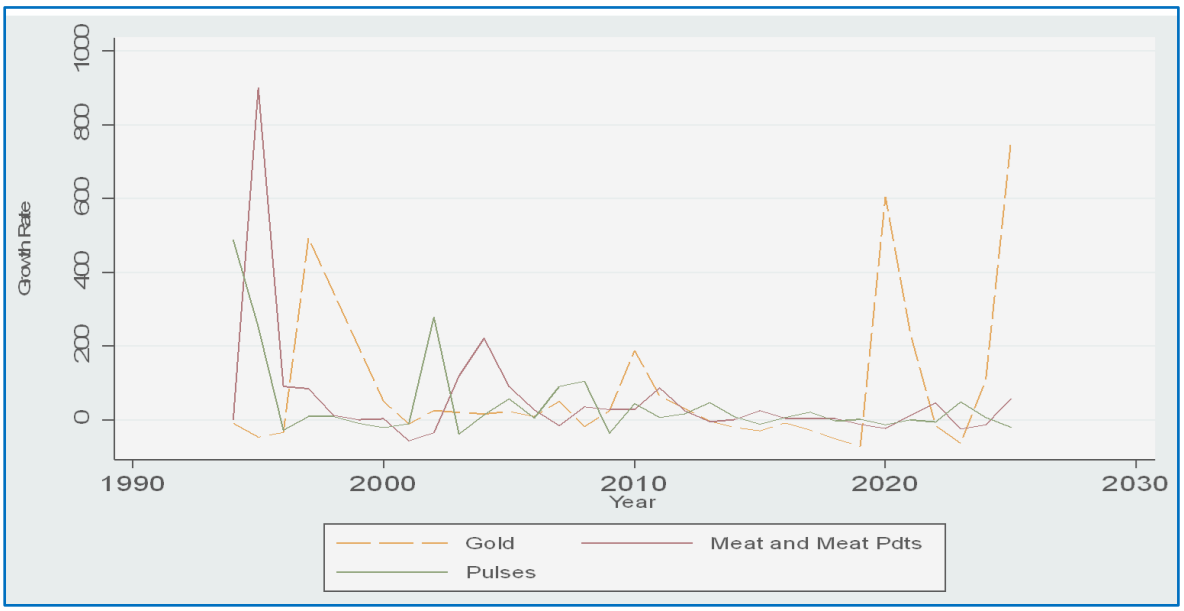
[11] https://addisfortune.news/sesame-export-faces-bitter-harvest#:~:text=Today%2C%20Chinese%20imports%20are%20a,had%20dropped%20to%20210%2C000tns.
[12] https://addisfortune.news/minister-melaku-to-suspend-raw-leather-exports-amid-industry-crisis#:~:text=The%20sector%2C%20once%20seen%20as,dollars%20recorded%20five%20years%20earlier.

Figure 4. 2A: Trends of Export growth for Three Major Commodities



Source: NBE (2026); Own Computation

Figure 4.2B: Trends of Export growth for Three Major Commodities



Source: NBE (2026); Own Computation

4.4. Exports and Exchange Rate

Figure 4.3 illustrates the relationship between nominal exchange rate movements and Ethiopia's export[13] performance from 1993 to 2025. Theoretically, nominal depreciation of the local currency provides a short-run competitive stimulus for the external sector through the expenditure-switching channel

[13] To clearly visualize the trends and relationship between exchange rate growth and export growth, the analysis excludes the export growth rate for 2025. Export growth reached 418.5 percent in 2025, which is an outlier that may distort the overall trend.

(Engel, 2002). Depreciation makes the price of domestic goods relatively competitive on international markets, which expands export volumes if the depreciation of local currency does not instantly fuel domestic inflation and inflate local factor-input costs (Dornbusch, 1987). Concurrently, a depreciating currency should compress the external deficit by raising the domestic-currency price of imported goods, thereby discouraging import demand. This mechanism represents the primary transmission channel through which monetary and exchange rate adjustments influence the real and external sectors in the short run. However, for currency depreciation to improve the net trade balance, the Marshall-Lerner (M-L) condition must hold, that is, the absolute sum of the price elasticities of demand for exports and imports must exceed unity.

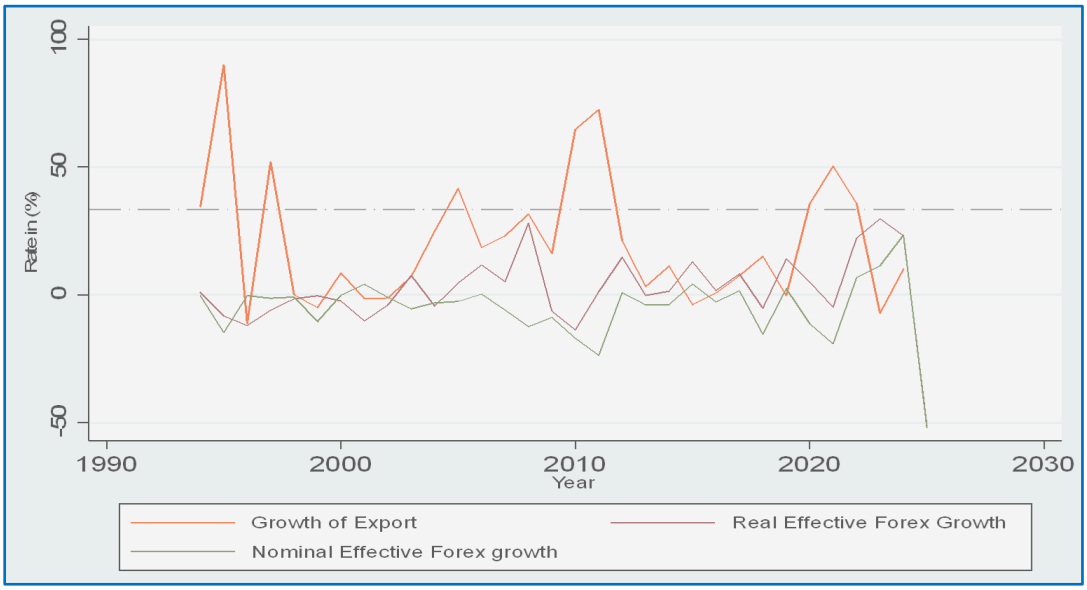
However, in a real-world scenario, currency depreciation exerts simultaneous, opposing pressures on both importing and exporting cost structures. For an economy like Ethiopia, this relationship is profoundly non-linear due to a severe import dependency of the country economy. Trade data shows that intermediate and capital goods systematically comprise over 50 percent of Ethiopia's aggregate import and over 52 percent of domestic manufacturing establishments entirely or partially depend on imported raw materials and intermediate inputs. Thus, nominal exchange adjustment immediately inflates the cost of essential production inputs, machinery, and logistics. This upward cost pressure effectively neutralizes the intended price competitiveness gained in international markets. Ultimately, the transmission channel between the exchange rate and export performance is also constrained by the deep-seated structural rigidities such as supply-side capacity constraints.

For the period (1993-2025) Ethiopia's exports grew by approximately 20.2 percent on average. This could be considered as a long-term growth rate of the export sector of Ethiopia. This threshold rate of export growth is expected in the coming years. The real and nominal effective exchange rates grew by 1.9 percent and -5.9 percent for the same period. The average nominal effective exchange rate growth is negative indicating that Ethiopia's currency value has been depreciating over time relative to the major trading partners of the country. On the other hand, a positive real effective exchange rate suggests that Ethiopia's inflation growth rate is higher than the trading partners inflation growth rate. Thus, a growth in the real effective exchange rate indicates Ethiopia's competitiveness relative the trading partners has been improved over time. Thus, Ethiopia's goods became relatively price competitive compared to the trading partners. Both nominal and real effective exchange rate indexes are published by the National bank of Ethiopia. Let us examine the association between exchange rate and export growth of Ethiopia disaggregated by the structural breaks.

4.4.1. Post-Command Period (1993-2002)

During this period, the Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate growth (REER) were -2.8 percent and -4.9 percent, respectively. Both NEER and REER were depreciating the value of currency compared to trading partners within this period. This suggests that domestic currency was overvalued and needed devaluation. The relationship between NEER and REER during this period is not clearly observed from Figure 4.3 below while technically they should have some forms of relationship. REER growth rate indicates that the domestic inflation was higher than the trading partner inflation rate in this period. On the other hand, the average export growth rate was 18.44 percent. Moreover, during this period, the relationship between exchange rate growth and export growth is clear.

Figure 4. 3: Trend of Export and Exchange Rates Growth (1993-2025)



Source: NBE (2026); Own Computation

4.4.2. State-Led Growth Period (2003-2009)

During this structural window, the Nominal Effective Exchange Rate (NEER) depreciated sharply, contracting by an average of 5.47 percent. Concurrently, export performance exhibited robust expansion, accelerating at an average growth rate of 23.27 percent, which represents the most substantial average growth rate observed across all designated structural break periods. This inverse relationship between nominal currency depreciation and export acceleration aligns precisely with standard trade theory.

Conversely, the Real Effective Exchange Rate (REER) was appreciated by approximately 6.6 percent. Technically speaking, a real appreciation indicates that the international-domestic inflation differential was positive, meaning domestic inflation outpaced foreign price levels, thereby eroding a portion of the nominal competitive advantage. As REER appreciation intensified, export growth faced structural headwinds. In general, the REER and NEER demonstrate a theoretically sound relationship with export dynamics of Ethiopia.

4.4.3. Devaluation Period (2010-2017)

During this structural break, more robust co-movement of exchange rate and export performance of Ethiopia was observed. The value of exports grew by 22.12 percent annually on average while NEER and REER grew by -5.9 percent and 3.3 percent respectively. In this period, both NEER and REER growth trends co-moved with export growth trends. Therefore, depreciation of domestic currency could contribute to the positive performance of the export sector of Ethiopia.

4.4.4. Market Liberalization Period (2018-2025)

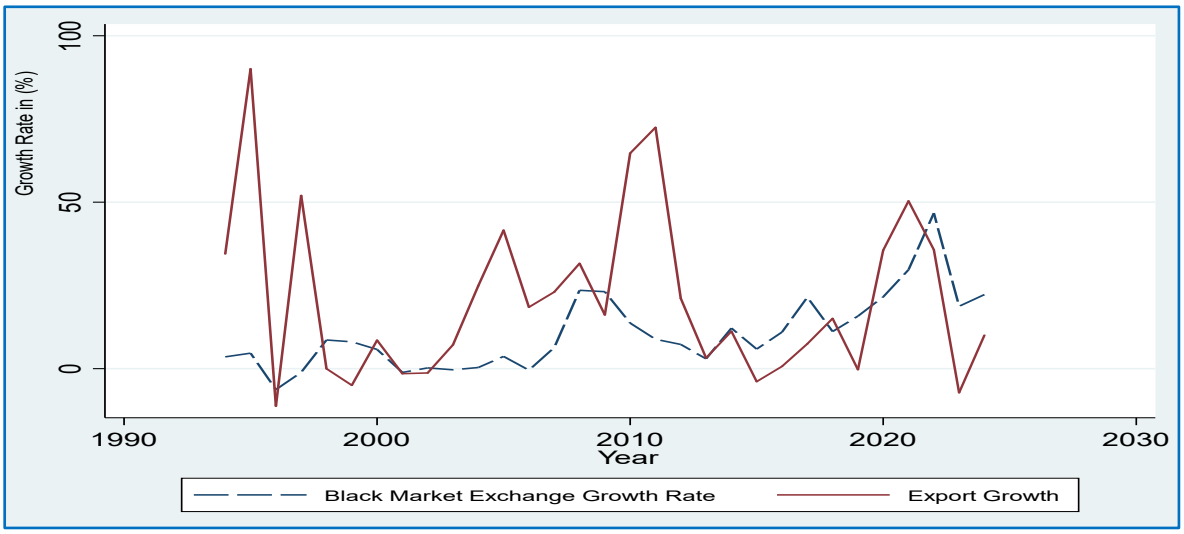
Ethiopia's exports grew by 17.41 percent excluding the windfall growth in 2025 whereas the NEER and REER grew by close to -6.8 percent and 4.1 percent annually, respectively. Similarly, a clear relationship has been observed between exchange rates and export performance. As NEER and REER growth rate declined export growth rate also declined. Thus, the export sector of Ethiopia responded more to the REER growth rate than the NEER. Theoretically, we expect an inverse relationship between

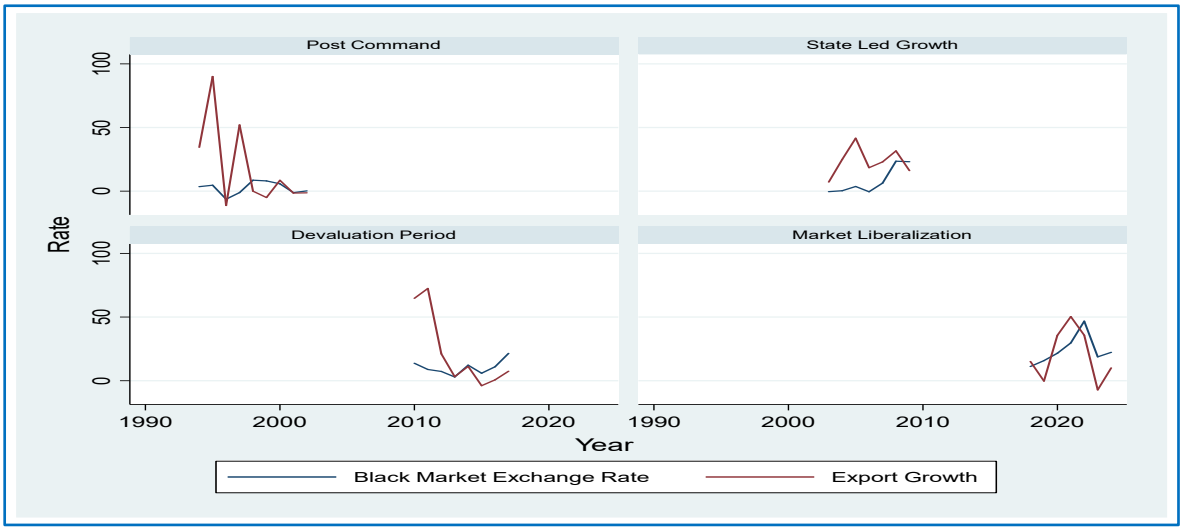
NEER and export performance. Thus, the effectiveness of REER on export performance hugely depends on the price differential between domestic and international

4.5. Black Market Exchange Rate and Export Growth

The empirical dynamics reveal a strong and positive co-movement between official export growth and parallel foreign exchange market fluctuations. An increase in the growth rate in the parallel market exchange rate premium consistently coincides with accelerated export growth rates, and vice versa. The notable historical exception to this co-movement occurred between 2008 and 2011, a period during which the parallel market premium growth rate decelerated while official export growth surged, a phenomenon primarily driven by the structural impact of the major 2010 nominal devaluation and heightened administrative enforcement against informal trade. While standard trade theory assumes exporters respond exclusively to official exchange rate incentives, this unconventional responsiveness to informal market signals is explained by the microeconomic behavior of multi-activity trading firms under foreign exchange rationing context.

Figure 4. 4: Trends of Black-Market Exchange Rate and Export Growth Rate





Source: NBE (2026); Own Computation

Across almost all breaks with the notable exception of the post-command transition period, a persistent co-movement is evident between the parallel (black-market) exchange rate and the export growth rate of Ethiopia. This association suggest that Ethiopia's export sector responds primarily to the shadow price of foreign exchange rather than to official exchange rate adjustments. The parallel market rate reflects the true, unconstrained market value of the domestic currency under conditions of foreign exchange scarcity. Consequently, when the parallel market premium widens, the effective economic incentives for exporters increase. This finding indicates that administrative trade measures and rigid official exchange rate management have historically lacked the traction needed to guide export sector of Ethiopia.

In a severely foreign exchange-constrained economy, exporters have operating dual import-export business models to execute an internal cross-subsidization strategy. Exporters utilize their retained foreign currency allocations to import high-demand intermediate inputs, capital equipment, and consumer goods. Domestic retail prices for these imported items are priced at the cost determined by the parallel market exchange rate, then firms are effectively internalizing the parallel market premium into substantial profit margins. Consequently, a widening parallel market premium amplifies the implicit shadow value of foreign exchange retentions, providing a potent incentive to expand official export volumes despite underlying official exchange rate distortion. In Sub-Saharan Africa, central banks have rationed foreign exchange and maintained overvalued official rates, then the parallel market rate functions as the effective shadow price for resource allocation (Kiguel & O'Connell, 1995; Elbadawi, 1999).

Moreover, empirical evidence from Ethiopia demonstrates that exporters in key sectors, such as coffee and oilseeds, frequently accept slim or negative margins on their primary export sales treating export operations as a "loss-leader" in order to access foreign currency retention accounts (Minten et al., 2014; Gebreeyesus et al., 2018; World Bank, 2018). Similar dual-model behaviors and retention-driven export dynamics have been documented in other forex constrained African economies.

4.6. Trends of Export by Destination Country

National trade accounting records disaggregate bilateral commodity export values only when a destination country falls within the top ten annual ranking threshold. Consequently, historical panel data displays variable observation lengths across primary trade partners, as certain destinations temporarily dropped off the top ten list in specific fiscal years.

Despite being historically one of Ethiopia's primary trade partners, China was notably absent from the top ten destination list for five consecutive years between 2019 and 2023, re-entering the ranking in 2024.

On a long-term historical average basis, China leads as Ethiopia's largest export destination with a 15-year average of $232.4 million USD, followed closely by the Netherlands with a 20-year average of $212.2 million USD, and Germany with a 20-year average of $201.8 million USD. Saudi Arabia represents the fourth largest market over two decades at $198.9 million USD, followed by the United States at $182.2 million USD. Rounding out the primary corridors, the United Arab Emirates averages $149.2 million USD over a 13-year window, Djibouti averages $123.0 million USD over 15 years, and Japan averages $105.0 million USD over a 9-year observed period.

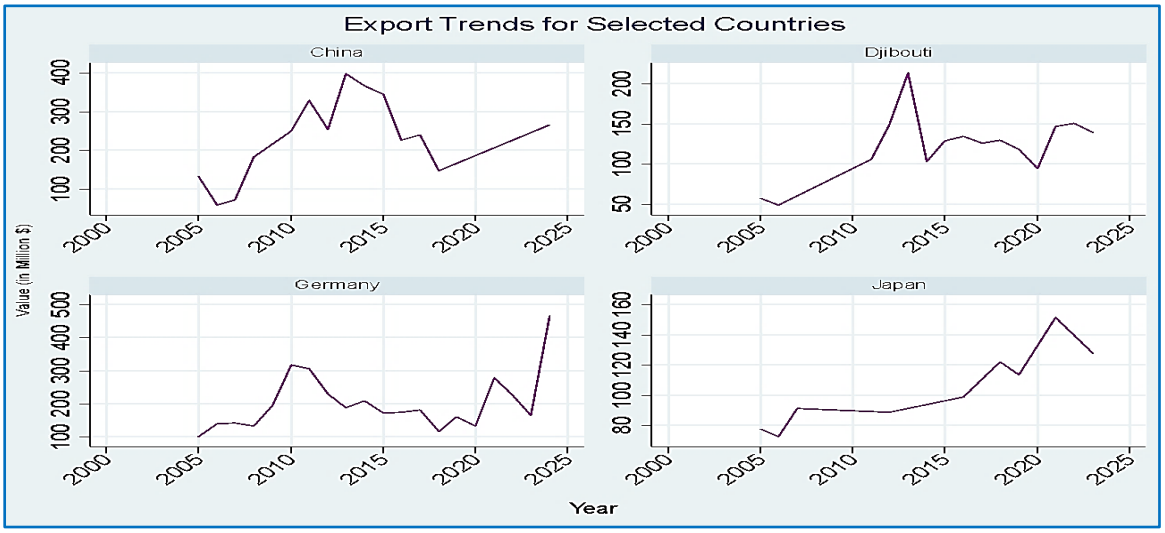
4.6.1. High-Growth Expansion Corridors: The GCC and the Netherlands

The United Arab Emirates: Demonstrating the most rapid relative expansion over a decade horizon, export values to the UAE expanded more than threefold, climbing from $98.0 million USD in 2014 to $332.7 million USD in 2024. This growth highlights the UAE's role as a major regional trading hub for Ethiopian gold, live animals, meat products, and agricultural commodities**.**

Saudi Arabia: Bilateral export earnings to Saudi Arabia have accelerated significantly since 2020. Export revenues more than doubled in five years, rising from $209.0 million USD in 2020 to $491.0 million USD in 2025. Growth in this market is driven by expanding air-freight logistics and strong Middle Eastern demand for live animals, chilled meat, and specialty coffee**.**

The Netherlands: Anchored by strong foreign direct investment (FDI) in the floriculture sector, exports to the Netherlands have achieved sustained, structural growth over the past eight years. Integrated supply chains linking Ethiopian farms to European flower auctions have protected this trade corridor from broader primary commodity price swings.

Figure 4. 5A: Exported Value Trends by Destination Country



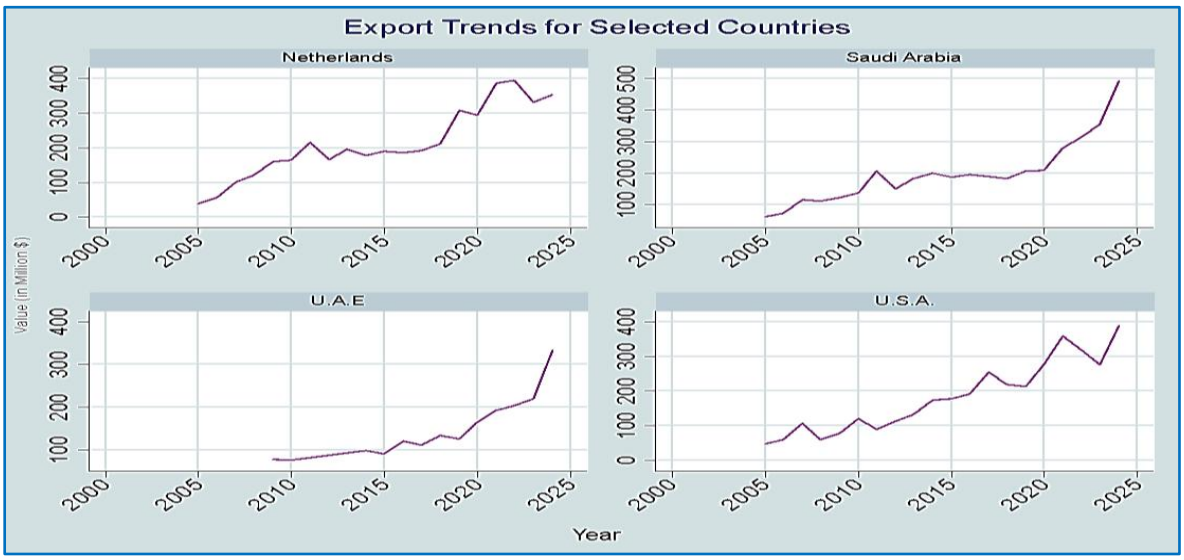
4.6.2. Structural Contraction and Cyclical Volatility: China, Germany, and Djibouti

China: Despite holding the highest long-term average export value, China's trade volume has followed a downward trajectory since peaking around 2013. Shifting domestic demand patterns and increased global market competition in agricultural bulk goods (such as sesame seeds and oilseeds) caused China to fall out of Ethiopia's top ten destination list from 2019 through 2023.

Germany: Trade performance with Germany reflects high sensitivity to international primary commodity cycles, particularly Arabica coffee and oilseeds. Exports rose steadily during the 2000s, reaching a peak of $317.0 million USD in 2010, before contracting sharply to $116.2 million USD in 2018. The corridor has shown a steady recovery since 2020, despite minor pandemic-related freight disruptions in 2020.

Djibouti: Cross-border trade to Djibouti has moderated over time, shifting from historical highs toward lower-margin perishable foodstuffs, livestock, and utility exports, reflecting broader regional transit and supply chain adjustments.

Figure 4.5B: Exported Value Trends by Destination Country



Export trajectory to the United States illustrates the vulnerability of policy-dependent industrial manufacturing. Supported by tariff-free access under the African Growth and Opportunity Act (AGOA), export values to the U.S. grew steadily from 2005 onward, reaching a peak of $358.6 million USD in 2021.

However, following political instability and armed conflict in Northern Ethiopia, the U.S. government suspended Ethiopia's AGOA eligibility effective January 1, 2022[14]. By 2023, export receipts to the U.S. fell to $275.6 million USD, a net direct contraction of approximately $83.0 million USD (or 23.1%) compared to pre-suspension levels.

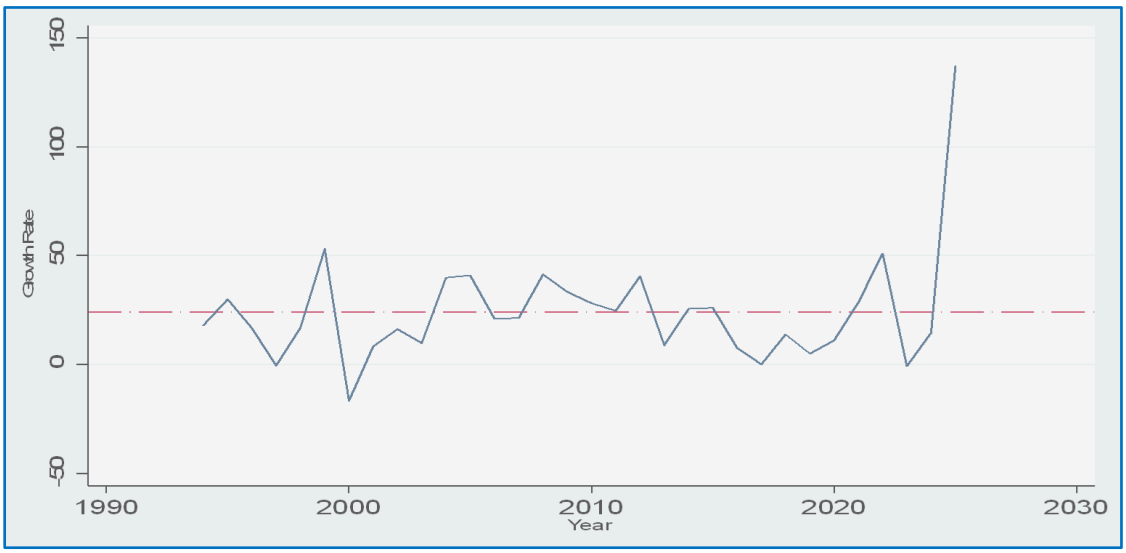
This institutional shock severely impacted light manufacturing firms operating within national industrial parks, particularly in textiles, apparel, and leather goods, leading to reduced factory capacity utilization and job losses.

4.7. Dynamics of Imports

As can be seen from Figure 4.6, significant volatility in import growth rates, with values fluctuating between approximately -16.6% in 2000 and 137% in 2025. A horizontal red dashed line represents the average growth rate of the entire period, which is positioned just above the 24.2 % mark on the Y-axis. There are distinct peaks and troughs, notably a significant decline below 0% around the year 2000 and several periods where growth spikes toward 50%. The graph exhibits a dramatic and sharp upward trend beginning around 2024, culminating in a peak near 140% by 2025.

[14] Ethiopia was officially suspended from duty-free trade benefits under the U.S. African Growth and Opportunity Act (AGOA) on January 1, 2022, following political instability and armed conflict between federal forces and the Tigray People's Liberation Front (TPLF) in Northern Ethiopia.

Figure 4. 6: Trend of Import Growth Rate



Source: NBE (2026); Own Computation

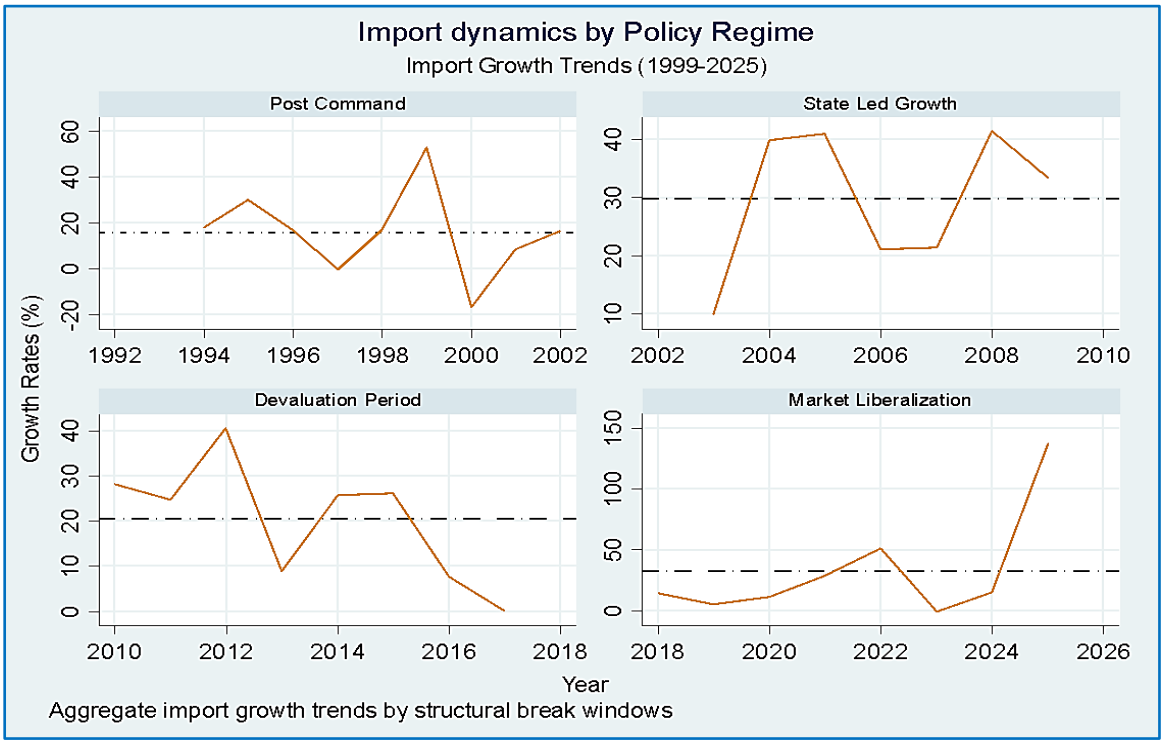
During the post-command transition period, the average growth rate of imports stood at a modest 15.8%. This baseline increased sharply to 29.7% during the state-led growth phase, a period characterized by aggressive public investment and state-driven capital accumulation. This heavily managed economic model systematically expanded the state's footprint in industrial sectors, dramatically amplifying aggregate demand for foreign-sourced raw materials, capital equipment, and intermediate industrial goods.

Conversely, during the devaluation period (2010–2017), import growth experienced notable compression, with the average growth rate decelerating to 20.5 %. This deceleration aligns precisely with international trade theory. A significant devaluation raises the domestic-currency price of foreign goods, thereby compressing real import demand.

Remarkably, the market liberalization period registers the highest average import growth rate at 32.6%. However, a disaggregated look at the annual series reveals that this figure is highly skewed; import growth fell consistently below this average in all years except for 2022 and 2025. Mirroring export analysis, if the anomalous 2025 growth spike of 137% is isolated and omitted, the period's structural average import growth drops precipitously to 17.7%.

Consequently, when adjusting for temporary liberalization shocks, the highest sustained structural import growth rate was recorded during the state-led growth epoch. This confirms that while intensive state intervention and public infrastructure spending can successfully stimulate short-run domestic production, they simultaneously induce systemic macro-fiscal strains by severely exacerbating the country's structural balance-of-payments (BoP) constraints.

Figure 4. 7: Trend of Import by Structural Breaks



Source: NBE (2026); Own Computation

4.8. Import Trends by Country

To evaluate Ethiopia's trade integration with major global counterparties, this analysis examines import values (goods and services) from key trading partners over the past 26 years.

4.8.1. China

Over the 26-year sample period, China served as Ethiopia's primary import origin, averaging $2.62 billion annually. Imports from China expanded nearly fivefold between 2011 and 2015, surging from $1.3 billion to a peak of $6.3 billion. This capital-goods influx was driven by aggressive infrastructure spending under the Growth and Transformation Plan I (GTP I), funded via Chinese sovereign and commercial credit lines (financing the Addis-Djibouti railway, industrial parks, and energy grid expansions).

Conversely, between 2016 and 2021, imports from China decelerated to $3.8 billion, constrained by acute domestic foreign exchange shortages, Chinese debt-sustainability adjustments, and COVID-19 supply chain disruptions. Post-2022, Chinese imports rebounded sharply, reaching a new peak of over $6.3 billion by 2025. This recovery reflects post-conflict reconstruction alongside a structural demand surge for Chinese electric vehicles (EVs) and renewable energy technology following Ethiopia's 2024 policy pivot.

4.8.2. Djibouti

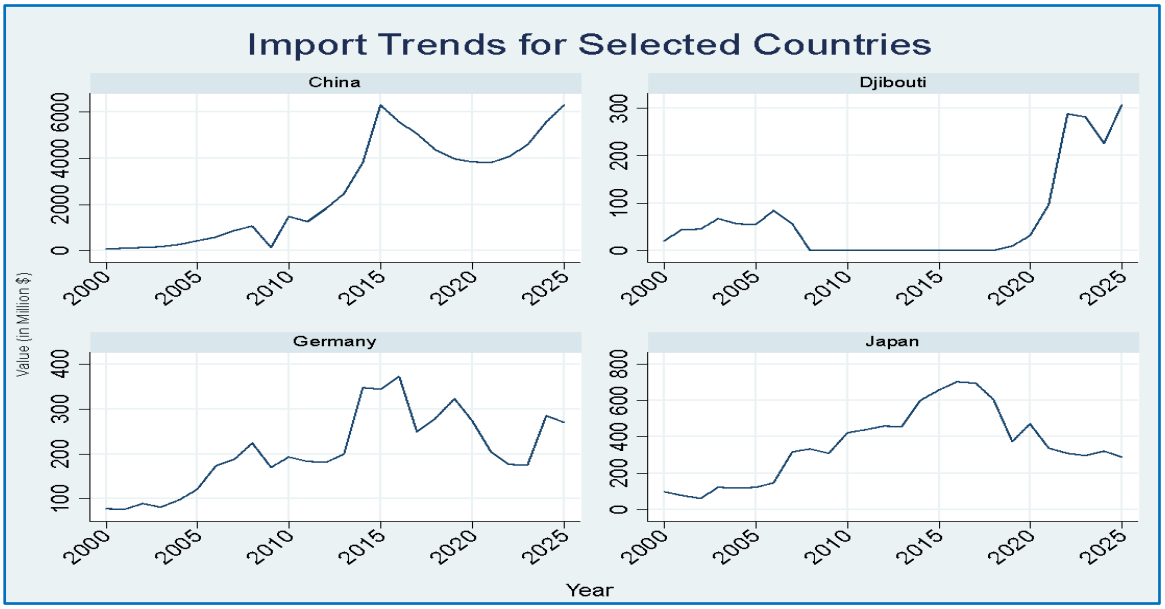
Imports from Djibouti historically remained nominal (below $1 million annually between 2008 and 2018). However, import values rose sharply from $9.6 million in 2019 to $306.6 million in 2025. Because Djibouti lacks a large domestic manufacturing base, this jump reflects structural shifts in

customs reporting, specifically the capture of port logistics services, Djibouti International Free Zone (DIFTZ) re-exports.

4.8.3. Germany and Netherlands

Imports from Germany averaged $205.7 million with a standard deviation of $87.2 million, fluctuating between a minimum of $75.9 million (2001) and a peak of $371.2 million (2016), reflecting capital machinery and specialized industrial equipment acquisitions. Meanwhile, imports from the Netherlands increased from $33.5 million in 2000 to $94.1 million in 2013, primarily comprising agricultural and floriculture capital inputs. Due to reporting gaps of NBE after 2014, recent post-2014 trends for the Netherlands cannot be empirically verified in this series.

Figure 4. 8A: Import Trends by Country

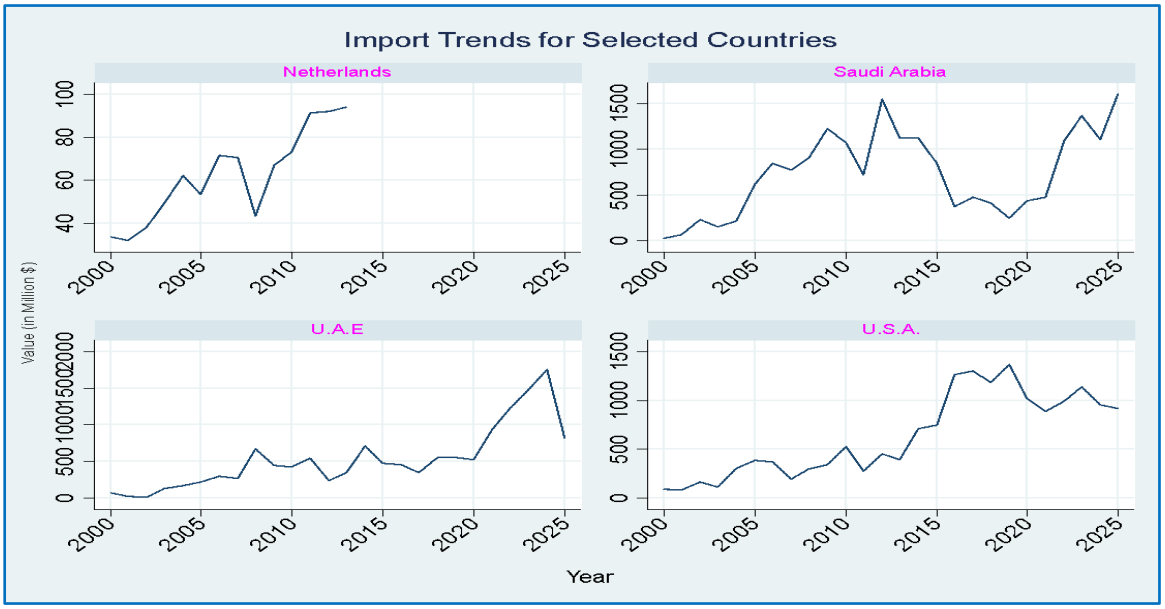


Source: NBE (2026); Own Computation

4.8.4. Japan

Imports from Japan grew steadily until 2017 before contracting continuously from 2018 through 2025. This structural downward shift resulted from strict foreign currency rationing by commercial banks which prioritized fuel, pharmaceuticals, and fertilizer over Japanese motor vehicles and was further reinforced by Ethiopia's January 2024 ban on Internal Combustion Engine (ICE) passenger vehicle imports.

Figure 4.8B: Import Trends by Country



Source: NBE (2026); Own Computation

4.8.5. Saudi Arabia and UAE

Imports from Saudi Arabia and the United Arab Emirates (UAE) averaged $733.2 million and $525.5 million annually, respectively. Post-2020, trade volumes from the Gulf region surged dramatically. Imports from Saudi Arabia grew from $436.6 million in 2020 to $1.1 billion by 2024, while imports from the UAE tripled from $523.7 million to $1.8 billion, placing the UAE as Ethiopia's second-largest import source after China. This acceleration is explained by long-term refined petroleum and fertilizer supply contracts with Saudi Arabia, alongside the UAE's role as a primary trade-re-invoicing, logistics, and commercial credit hub for Ethiopian trade.

4.8.6. USA

Ethiopia's annual imports from the United States averaged $632.1 million. Import values expanded steadily between 2013 and 2018 before experiencing a sustained contraction post-2018. This decline is attributable to two main factors:

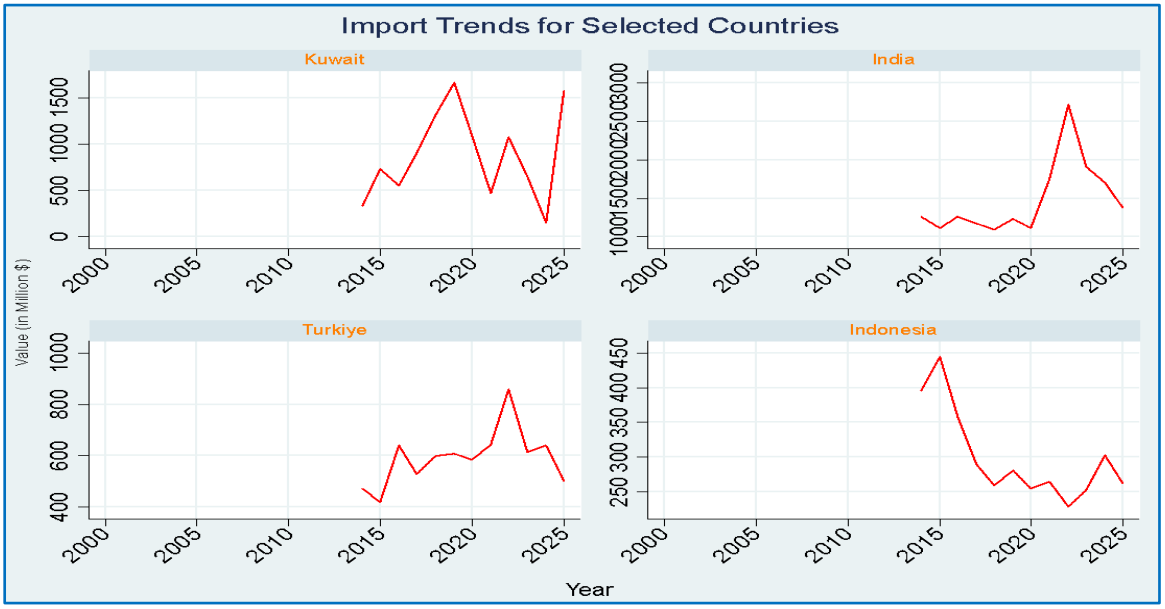
1) **Commercial Aviation Delivery Cycles**: The pre-2018 expansion coincided with multi-billion-dollar aircraft procurements by Ethiopian Airlines from Boeing. Post-2018 orders slowed due to the global grounding of the Boeing 737 MAX and capital expenditure deferrals.

2) **Policy and Trade Constraints:** Bilateral trade friction surrounding the 2020–2022 Tigray conflict culminated in Ethiopia's suspension from the African Growth and Opportunity Act (AGOA) in January 2022, restricting commercial credit guarantees and official import financing channels**.**

Beyond its top primary trading partners, Ethiopia maintains substantial commercial import ties with several key global economies, including India, Kuwait, Türkiye, and Indonesia. Over the 2014–2025 observation period, these nations accounted for critical inflows of essential fuels, strategic food reserves, pharmaceuticals, and capital goods. Notably, several of these origins exhibit a severe bilateral trade asymmetry, supplying massive import volumes despite absorbing relatively negligible shares of Ethiopian exports.

Imports from India averaged $1.5 billion annually between 2014 and 2025. This exceptionally high volume highlights a pronounced bilateral trade deficit, as India ranks among Ethiopia's largest import sources while absorbing minimal Ethiopian export volume. Import values experienced a dramatic spike in 2020 before contracting toward 2022. This temporary expansion was driven by emergency public health procurement (pharmaceuticals, active chemical ingredients, and medical equipment) during the COVID-19 pandemic, alongside state-backed bulk import contracts for essential commodities including refined sugar, cereals, and structural steel.

Figure 4.8C: Import Trends by Country



Source: NBE (2026); Own Computation

Imports from Kuwait averaged $873.7 million annually over the sample period, predominantly comprising refined mineral fuels and petroleum derivatives. Fuel imports constitute a major structural share of Ethiopia's overall national import bill. This trade flow is governed by long-term Government-to-Government (G2G) term contracts between the Ethiopian Petroleum Supply Enterprise (EPSE) and the Kuwait Petroleum Corporation (KPC), securing stable supplies of refined diesel and jet fuel for domestic transport and aviation operations.

Annual imports from Türkiye averaged $591.6 million, exhibiting a sustained upward trajectory from 2018 through 2024 and reaching a peak of $857.7 million in 2022. This surge reflects expanding bilateral economic integration, underpinned by substantial Turkish FDI in local manufacturing (textiles and industrial parks). The peak in 2022 was further propelled by public and private procurement of construction inputs (iron, steel, cement), agricultural machinery, and defense-related security equipment

Imports from Indonesia averaged $299.3 million annually, driven almost entirely by refined palm oil. Indonesia's market share contracted steadily from 2015 to 2022, resulting from a combination of factor dynamics:

- Trade Deflection: A competitive shift toward Malaysian palm oil suppliers under state allocation tenders.
- Macroeconomic Forex Rationing: Severe foreign exchange constraints limiting government-subsidized edible oil imports.

- Supply Shock & Rebound: Indonesia's global palm oil export restrictions in 2022, followed by a post-2022 import recovery as regulatory bans eased and bilateral trade channels resumed.

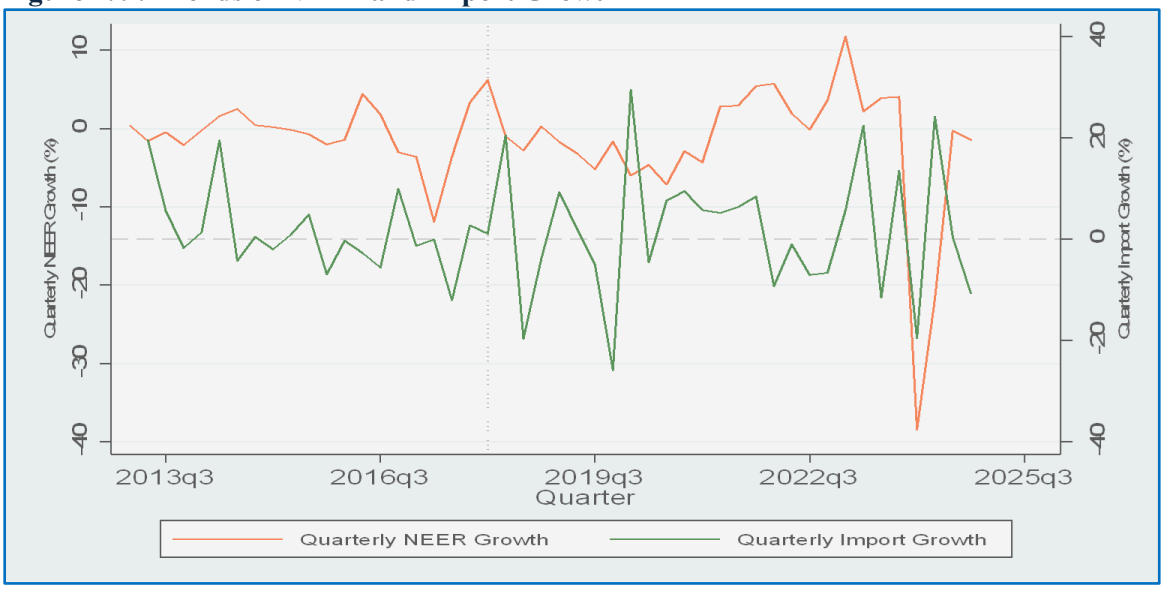
4.9. Trends of Quarterly Import and NEER

In standard open-economy macroeconomic theory, a nominal currency depreciation increases the relative domestic price of foreign goods, inducing an immediate price-effect compression on import demand before broad domestic prices fully adjust due to nominal rigidities. Evaluating this transmission mechanism within a structural foreign exchange-constrained economy like Ethiopia yields critical empirical insights.

As illustrated in Figure 4.9, import growth demonstrates a persistent, one-quarter lagged sensitivity to adjustments in the Nominal Effective Exchange Rate (NEER). This single-quarter transmission lag reflects the operational timeframe required to open letters of credit (LCs), finalize international procurement contracts, and process shipping logistics. In line with theoretical expectations, periods of nominal exchange rate depreciation (a negative trajectory in the NBE's NEER index) trigger a subsequent deceleration in import growth, likely one quarter later.

From a policy perspective, this lagged contraction is driven less by structural shifts in domestic consumer behavior and more by severe working-capital constraints and foreign exchange rationing. Following a nominal currency depreciation, importers require substantially larger volumes of local currency (ETB) to clear equivalent physical units of foreign goods. In an environment restricted by tight domestic credit ceilings and scarce foreign exchange allocations, importers face severe liquidity bottlenecks, forcing an immediate mechanical reduction in overall import volumes.

Figure 4. 9: Trends of NEER and Import Growth



Source: NBE (2026); Own Computation

Figure 4.9 illustrates the quarterly co-movement between quarterly NEER growth and quarterly import growth from 2013-Q1 through 2024-Q4. The quarterly data for imports has been available starting from 2013 while quarterly data for exchange rate has been available since 1992.

The NEER growth rate for most quarters is below the zero-baseline threshold with the exception of a few years. This clearly indicates the persistent nominal depreciation of the Ethiopian Birr across the sample horizon. Major policy-driven adjustments are clearly visible, notably the sharp negative plunge in the second quarter of 2017(-11.9%) corresponding to the October 15% nominal devaluation and the unprecedented depreciation was observed in the 1st quarter of 2024 reaching nearly -38.5%, capturing the structural foreign exchange market reform conducted in July 2024.

Figure 4.9 highlights that the two series (import growth and NEER growth) have a positive association. More specifically, import growth responds to NEER adjustments with a distinct one-quarter lag.

Depreciation Transmission (Downward Spikes): Following sharp downward contractions in NEER growth (accelerated depreciation in 2017-Q2 and 2024-Q1**),** quarterly import growth experiences a steep downward shock in the subsequent quarter (t+1). The import growth in 2017-Q3 was close to -12%. However, the 2024 nominal exchange rate devaluation shock was not responded to by the importers immediately maybe due to huge speculation and expectation of the foreign exchange reform that will be in effect.

Stabilization Transmission (Upward Peaks): When NEER growth briefly stabilizes or approaches positive territory (such as the 2022-2023 window where NEER growth peaked above +11% in 2023-Q1), import growth exhibits a lagged expansion. The imports grew by 22.4% in 2023-Q2.

This single-quarter transmission lag reflects the operational lead time required for central bank foreign exchange queue allocations, opening Letters of Credit (LCs), and processing international shipments. In line with open-economy macroeconomic theory, exchange rate depreciation makes foreign goods more expensive in local currency terms. In Ethiopia's institutional setting, however, this contraction is primarily driven by working-capital constraints and foreign exchange rationing. Following a devaluation, importers require significantly higher domestic currency (ETB) reserves to clear the same physical volume of goods. Bound by tight bank credit ceilings, importers face an immediate liquidity wall, resulting in a mechanical compression of aggregate import volumes one quarter after the exchange rate shock.

4.10. Trade Balance

Beyond evaluating export and import flows independently, analyzing bilateral trade balances is critical for identifying structural external vulnerabilities, and foreign exchange leakages. Between 2005 and 2025, Ethiopia’s trade balances with major global counterparties exhibited sharp structural divergence, alongside with deep expanding deficits with capital and energy supplying nations.

4.10.1. Surplus Partners: Netherlands and Djibouti (Pre-2021)

Ethiopia maintained an uninterrupted net trade surplus in trading with the Netherlands averaging $62.6 million annually across the entire 2005–2025 period. This surplus is anchored by Ethiopia’s floriculture and horticulture export corridor, where high-value cut flower shipments to Dutch auction hubs consistently exceed agricultural and pharmaceutical imports.

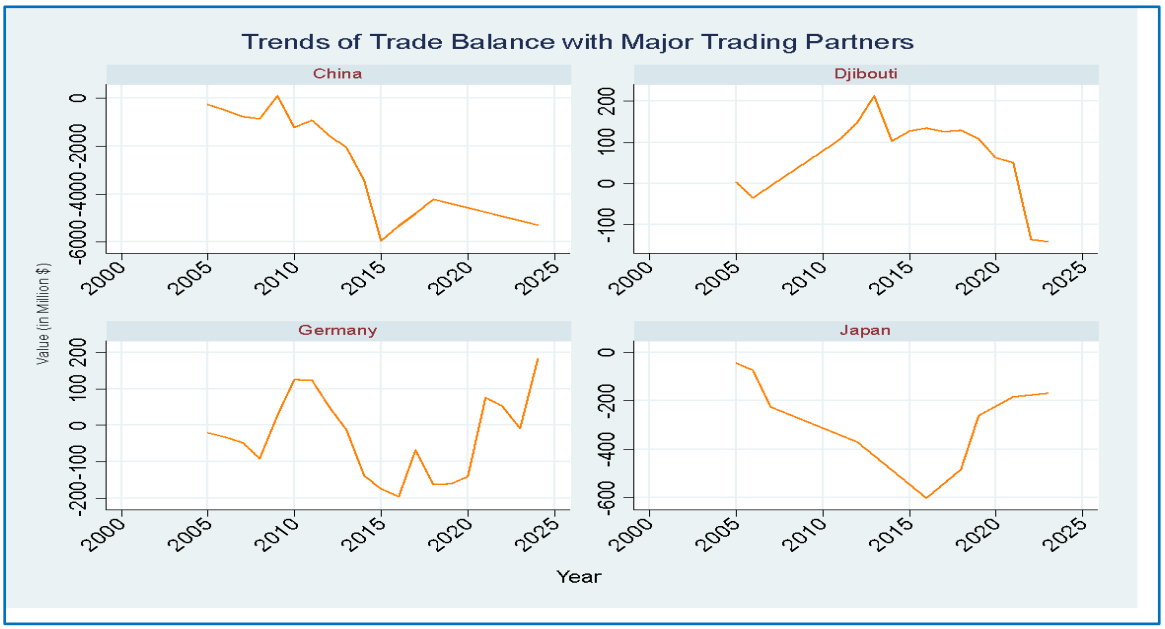
Ethiopia recorded a net trade surplus with Djibouti averaging $66.5 million annually between 2005 and 2020, driven by cross-border sales of hydroelectricity, potable water, and livestock. However, post-2021, the bilateral balance turned negative. This reversal reflects the rapid escalation of port usage fees, logistics services, and transit infrastructure charges associated with Ethiopia’s heavy reliance on Djiboutian port corridors.

4.10.2. Deep Deficit Partners: China, Gulf States, and the USA

China represents Ethiopia's largest bilateral trade deficit, averaging approximately -$2.5 billion annually. The deficit deteriorated continuously over the sample period, except for a brief stabilization between 2015 and 2017 following the completion of GTP I capital procurement cycles. This imbalance reflects massive capital machinery and manufactured goods imports unmatched by Ethiopian primary commodity exports to China

Trade deficits with both Gulf nations (Saudi Arabia and UAE) broadened dramatically post-2020, averaging -$639.7 million (Saudi Arabia) and -$609.8 million (UAE). This rapid deterioration stems from rising national demand for refined petroleum products, fertilizer, and petrochemical inputs, coupled with expanding UAE-based trade re-invoicing.

Figure 4. 10A: Trends of Trade Balance by Country



Source: NBE (2026); Own Computation

4.10.3. Germany, Japan, and the USA

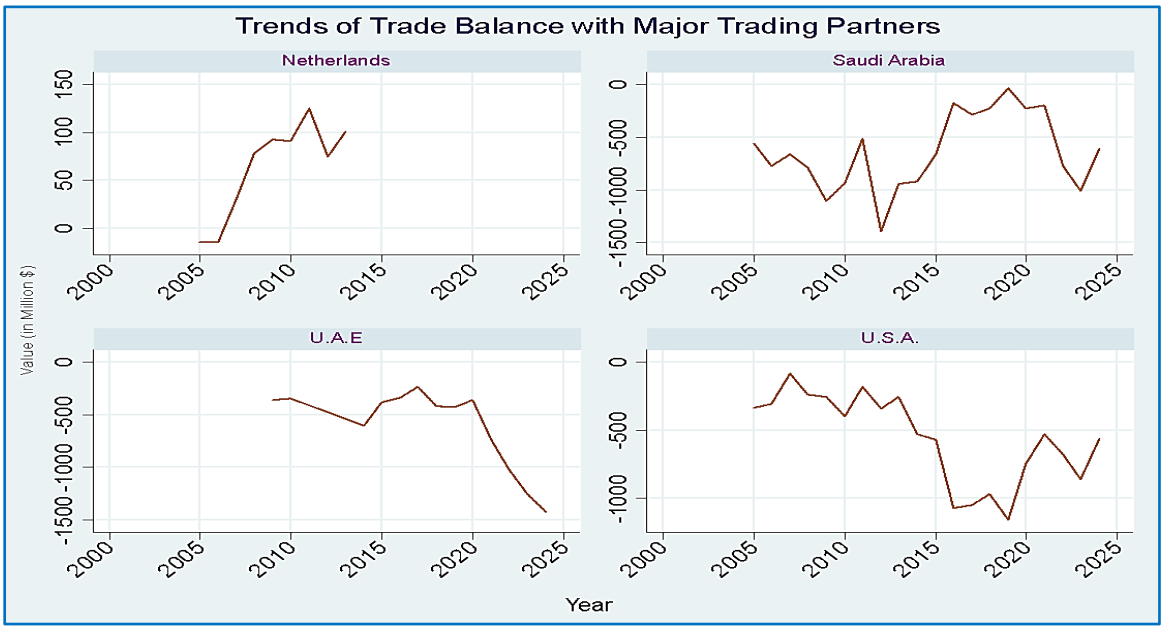
Across the entire sample period, Ethiopia maintained a net average deficit of -$31.1 million with Germany due to historical imports of heavy machinery and vehicles. However, since 2021, the trade balance transitioned into a net surplus. This shift was propelled by elevated European demand for specialty Arabica coffee alongside Forex constraints that restricted Ethiopian capital goods orders from German suppliers.

The bilateral trade deficit with Japan averaged -$268.6 million but showed steady narrowing post-2016. Crucially, this improvement does not reflect export expansion, but rather policy-induced import compression, specifically Forex allocation restrictions by commercial banks on non-essential motor vehicle imports, culminating in the 2024 ban on internal combustion engine vehicles.

The average deficit with the USA stood at -$556.6 million. Following a sharp widening prior to 2018 (driven by commercial aircraft deliveries to Ethiopian Airlines), the deficit contracted post-2018. Like Japan, this adjustment resulted primarily from reduced fleet delivery cycles and broader Forex

constraints, rather than gains in export performance particularly given the 2022 revocation of AGOA trade preferences.

Figure 4.10B: Trends of Trade Balance by Country



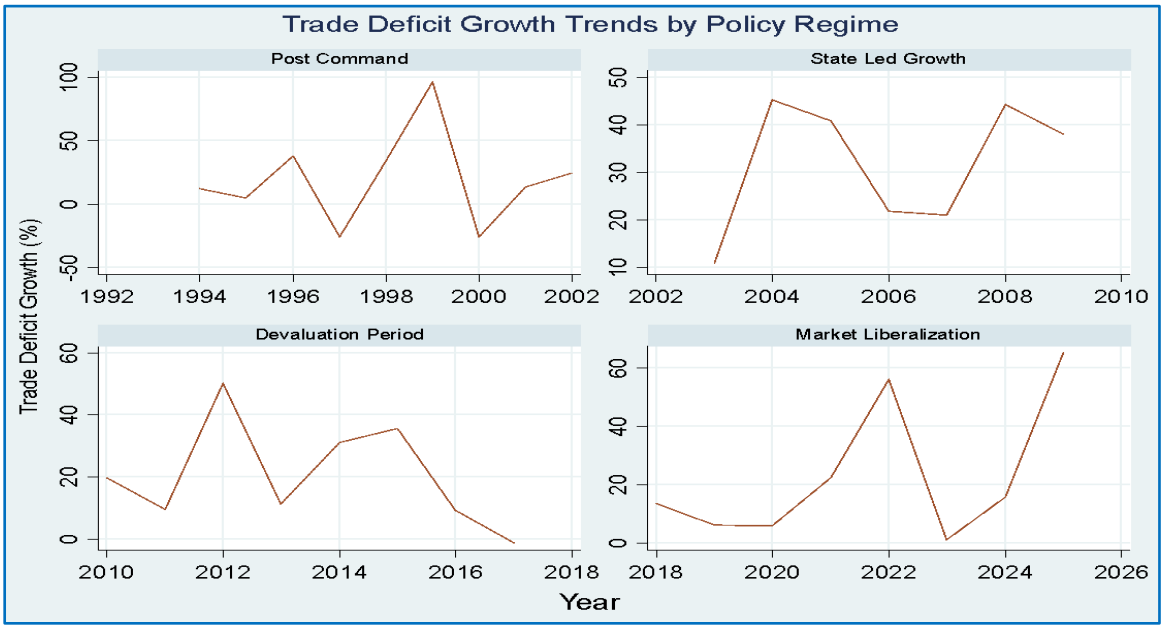
Source: NBE (2026); Own Computation

4.11. Trade Deficit Growth (1993-2025)

Across the empirical analysis period, Ethiopia's trade deficit exhibited persistent growth, punctuated only by brief contractionary anomalies (notably in 1997, 2000, and 2017). The long run average annual growth rate of the trade deficit stood at 23.32%, reflecting a rapid compounding of net external imbalances. Regime-specific decomposition reveals pronounced structural variation across the structural breaks:

- **Post-Transition Period:** The trade deficit expanded at an average annual rate of 19.2%.
- **State-Led Growth Period:** Deficit expansion accelerated sharply to 31.7% per annum, driven primarily by high public sector capital-import intensity and infrastructure investments.
- **Devaluation Period:** Strategic currency adjustments dampened deficit expansion, decelerating the growth rate to 20.7%. This slowdown aligns with standard open-economy trade theory, as real exchange rate depreciations activate expenditure-switching mechanisms by raising relative import prices.
- **Recent Period (Eight-Year Horizon):** Deficit growth rebounded to an average of 24.7% per year. Surges during this window particularly across 2020–2022 coincided with the Northern Ethiopia conflict-related fiscal pressures.

Figure 4. 11: Trends of Trade Deficit growth



Source: NBE (2026); Own Computation

4.12. Ethiopia's Export and Import Outlook

We employed the Autoregressive Integrated Moving Average (ARIMA) framework to generate short-term out-of-sample forecasts (2026-2028) for Ethiopia's export and import growth rates. Prior to model estimation, standard unit root testing was performed to establish time-series stationarity. The empirical tests confirmed that import growth is stationary at level, $I(0)$, at the 5% significance level, whereas export growth is non-stationary at level but achieves stationarity after first differencing, $I(1)$.

Consequently, the specification directly models the actual annual growth rate for imports, while for exports, the model estimates the first-differenced transformation. Economically, this implies that the import forecast projects the level trajectory of import expansion, whereas the export forecast models the rate of growth acceleration or deceleration.

Table 4.5 reports the projected change in the export growth rate over the 2026-2028 horizon. The results indicate that export growth will accelerate by 1.93 percentage points in 2026 compared to 2025. However, this momentum tapers off in subsequent years, experiencing a deceleration of 2.96 percentage points in 2027 and 2.93 percentage points in 2028. This deceleration suggests that while export volume may continue expanding, the pace of growth will slow following an initial peak in 2026.

Table 4. 5: Projected Export Growth for Ethiopia (2026–2028)

Year	Change in Growth Rate of Export
2026	1.93
2027	-2.96
2028	-2.93

Table 4.6 below presents the three-year out-of-sample point forecasts for Ethiopia's import growth rate from 2026 to 2028, generated using the stationary AR (1) specification. The empirical results project a stable import growth trajectory, stabilizing at approximately 20.52% annually across the forecast horizon (20.5027 in 2026, and 20.5027 in both 2027 and 2028). Economically, these projections indicate that while import demand will continue to expand at a robust pace of over 20% per year, the rate of acceleration in import growth is virtually zero.

This growth path suggests structural import dependency driven primarily by persistent demand for capital goods, industrial inputs, and essential commodities, without immediate signs of rapid surge or contraction over the 2026-2028 period.

Table 4. 6: Projected Import Growth for Ethiopia (2026–2028)

Year	Growth Rate
2026	20.52
2027	20.52
2028	20.52

The combination of a high, persistent import growth rate close to 20.52 % annually and decelerating export growth momentum holds significant implications for Ethiopia's external sector stability over the 2026-2028 forecasting horizon. Because Ethiopia operates under a substantial structural trade deficit where the absolute baseline value of imports far exceeds exports a high, constant import growth trajectory rapidly enlarges the total nominal trade gap in dollar terms. Although export growth experiences a temporary acceleration of 1.93 percentage points in 2026, the subsequent decelerations in 2027 (-2.96 percentage points) and 2028 (-2.96 percentage points) indicate that export revenue expansion will not keep pace with the compounding surge in import expenditures.

Consequently, the trade deficit is projected to widen in both absolute terms and as a proportion of total trade turnover relative to the baseline period. This widening trajectory underscores persistent foreign exchange liquidity pressures and reinforces the structural necessity for targeted export diversification, import-substitution strategies, and foreign exchange management over the medium term.

4.13. Conclusions and Recommendations

Over the past 32 years (1993–2025), Ethiopia’s external sector has been defined by persistent structural imbalances, severe foreign exchange constraints, and an expanding trade deficit. While nominal export earnings expanded at a long-term average growth rate of 33.25% (averaging ETB 82.31 billion), this growth is heavily distorted by domestic currency depreciation and exogenous shocks. When adjusting for the anomalous 2025 coffee price boom (418.6% growth spike), Ethiopia's underlying structural export growth remains stagnant at 18%-23%. Concurrently, imports expanded at a sustained average of 24.2%, driven by heavy capital goods and fuel dependency. This chapter provides policy makers with a rigorous diagnostic of the structural break regimes, evaluates exchange rate transmission failures, and outlines targeted policy interventions to rebuild trade competitiveness and resolve balance-of-payments (BoP) constraints.

4.10.4. Conclusions

Primary Commodity Dependence and Structural Constraints: Exports remain heavily reliant on primary commodities (coffee, gold, oilseeds, pulses). Coffee revenues surged to $2.67B in 2025 due to a severe global supply shock in Brazil, masking structural contractions elsewhere. Flagship sectors suffered major downturns: oilseed exports fell from 359k to 210k tons due to security conflicts in core agricultural clusters, while leather exports collapsed from $132.4M (2018) to $17.4M (2025) with active tanneries dropping from 35 to 7 following raw leather shortages and U.S. AGOA revocation.

Nominal Devaluation and the Import-Dependency Paradox: Persistent Birr depreciation (NEER growth averaging -5.9%) has failed to sustainably boost export competitiveness. Over 50% of Ethiopia's imports are intermediate and capital goods, and 52% of domestic manufacturing relies on imported inputs. Consequently, nominal devaluations immediately inflate the production, machinery, and logistics costs, eventually neutralizing price gains.

Parallel Market Dynamics and Cross-Subsidization Mechanics: A strong positive co-movement exists between the black-market exchange rate premium and official export growth. Under severe forex rationing, multi-activity trading firms utilize retained forex from low-margin primary exports to import high-demand goods priced at parallel market rates. Exporters internalize this parallel premium into high domestic margins, using import profits to cross-subsidize official export operations.

Import Rigidity, Transmission Lags and Bilateral Deficits: Imports exhibit a distinct one-quarter lagged contraction following sharp NEER devaluations (e.g., 2017-Q2 and 2024-Q1 shocks), driven by letter-of-credit (LC) lead times and severe working-capital liquidity walls. Ethiopia faces deep structural trade deficits with major capital and energy suppliers such as China (-$2.5B annual average), Saudi Arabia (-$639.7M), UAE (-$609.8M), India (-$1.5B), and Kuwait (-$873.7M). Uninterrupted surpluses are maintained only with the Netherlands (+$62.6M, floriculture), while Djibouti turned negative post-2021 due to port logistics fees.

Policy Sensitivity and Vulnerability to External Trade Shocks: Ethiopia's external sector is acutely exposed to foreign trade policy. The January 2022 U.S. AGOA suspension caused an $83.0M (23.1%) export contraction to the U.S. by 2023, depressing industrial park manufacturing. Conversely, policy pivots such as the 2024 ban on Internal Combustion Engine (ICE) passenger vehicles and NBE formal gold channel incentives ($3.48B in 2025) demonstrate that targeted institutional realignments can rapidly alter trade flows.

4.10.5. Policy Recommendations

1. **Agricultural Supply Security and Tannery Industry Rescue Package:** Ending armed conflicts and resolving political differences through peaceful means, with the support of regional actors. For the short term, secure agricultural supply corridors in core oilseed and coffee producing regions to restore sesame export capacity above 350,000 tons. Execute an urgent rescue plan for the leather sector providing targeted raw hide collection incentives, duty drawbacks, and priority Forex allocations to rebuild active tanneries back to baseline capacity.
2. **Shift from Devaluation to Structural Competitiveness:** Avoid relying solely on nominal currency devaluations to correct trade deficits since intermediate cost push inflation neutralizes export gains. The exchange rate policy needs to focus on REER stability and domestic inflation control.

3. **Import Rationalization and Bilateral Deficit Management:** Address deep bilateral trade deficits with China, India, and Gulf countries by negotiating counter-trade agreements, local-currency settlement frameworks, and supplier credit lines. Expand targeted import-substitution in domestic construction inputs, while enforcing strict project-financing discipline on capital procurements.
4. **Strategic Market Diversification:** Prioritize diplomatic engagements to restore U.S. AGOA trade eligibility while expanding bilateral trade agreements across GCC nations (UAE, Saudi Arabia) and AfCFTA corridors. Capitalize on growing Middle Eastern demand for specialty coffee, chilled meat, and livestock through enhanced air-freight logistics.
5. **Forex Market Unification and Retention Scheme Reform:** Accelerate market-clearing Forex rate unification to eliminate distortionary parallel market cross-subsidization incentives. Further reform exporter forex retention schemes to prioritize market-driven allocation for high-productivity intermediate and capital inputs rather than consumer goods re-invoicing.

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CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.1. Conclusions

Ethiopia experienced rapid and sustained economic growth during the last more than two decades, positioning itself among the fastest growing economies globally, despite facing structural challenges. Although the share of agricultural sector exhibited falling trend while that of industrial and service sectors experienced increasing trends for around two decades, only modest dynamics have been observed in the last one decade posing challenges related to achieving structural transformations because shifting the economy away from low-productive agriculture to high-productive industry and service sectors seems to have been very modest. Similarly, dynamics of sectoral contributions to national employment have been very modest in the last close to a decade: agriculture's share in national employment creation has been shrinking for close to two decades and that of service sector has been rising, and industry's share showing no notable changes. The sectoral dynamics regarding relative contribution to national employment further reflect structural transformation challenges that the country is facing because labor reallocation from low-productive to high-productive sectors is modest.

The dynamics of relative sectoral contributions to GDP and national employment further reflect structural challenges. Agriculture contribution to GDP is falling at a higher rate than its contribution to national employment, indicating that workers are trapped in the low-productive agriculture sector; on the contrary, while overall contribution of industry to GDP has exhibited positive growth rate, its share in national job-creation growth rate has by and large been negative indicating that the country is experiencing job-less industrial growth. Unlike agriculture and industry, the growth rates of service sector contribution to both GDP and national employment have been positive while the growth rate of contribution to job creation is higher than that of contribution to GDP reflecting that the sector is on average experiencing low labor productivity. The overall relative growth rates of sectoral share in GDP and national employment in Ethiopia indicate that labor in the country experiences horizontal shift, from low-productive agriculture to low-productive service.

Moreover, the structural challenge of the country's economy is observed from shift share analysis of employment: overall employment growth in Ethiopia is by and large associated with within-sector effect while the contribution of structural effect is very modest. The results reflect that the country has struggled related to achieving the highly sought structural transformation. Furthermore, strong economic growth that the country experienced during the last two decades has not translated into commensurate employment creation. Ethiopia's employment elasticity of economic growth shows that the country's robust economic growth was translated into modest job creation: employment elasticity of economic growth is 0.27 over the period of 2000 to 2025, indicating that 1% economic growth translates into only 0.27% employment creation albeit heterogeneity across sectors. Compared to industry and agriculture, service sector experiences better employment elasticity of economic growth. The structural challenges including modest performance regarding structural transformation and employment elasticity of growth potentially pose risks related to achieving inclusive and sustainable development because the challenges adversely affect income distribution thereby increasing inequalities. The macroeconomic outlook of the country shows that while the country is expected to experience robust economic growth, the structural challenges seem to persist in the coming years.

Empirical analysis of Ethiopia's monetary dynamics (1993–2025) reveals that persistent double-digit inflation is driven by excessive broad money expansion, and agro-centric structural supply bottlenecks, and severe post-2020 fiscal dominance. Prior to 2021, public borrowing operated counter-cyclically to tame inflation. Post-2020, public credit growth surged toward 751%, while private credit was restricted to a 14% ceiling. This structural shift institutionalized fiscal dominance, making government borrowing the primary driver of domestic inflation**.**

Cointegration bounds testing confirms a long-run equilibrium between broad money supply, exchange rates, and inflation. A 1% increase in money supply generates a 1.55 percentage point long-run increase in headline inflation. Persistent inflation exceeding rigid nominal rate ceilings created deeply negative real interest rates. This eroded domestic savings, transferred implicit credit subsidies exclusively to affluent collateralized borrowers, and discouraged foreign capital inflows**.**

Maintaining the historical baseline trajectory (25% money supply expansion and 5% nominal effective exchange rate depreciation) locks Ethiopia into persistent double-digit inflation, easing marginally from 16.5% in 2026 to 14.9% by 2030. Achieving single-digit inflation is impossible under current baseline policies.

July 2024 exchange rate liberalization corrected decades of currency overvaluation, sending quarterly REER growth to -38%. While food inflation continues to anchor headline price movements, non-food inflation exhibits delayed forex pass-through from imported industrial inputs**.**

Like the real sector, the country's fiscal sector is characterized by structural challenges including low tax mobilization; Ethiopia's tax to GDP ratio is lower even compared to that of other SSA countries. Tax structure of the country is characterized by excessive reliance of the government on indirect taxes that potentially impacts low-income households disproportionately because they spend larger portions of their income on consumption compared to high-income households; accordingly, such a heavy reliance on indirect taxes for government revenue mobilization may adversely affect income distribution. While the government expenditure to GDP ratio is falling, reflecting shrinking government size, expenditure composition shows government disproportionately spends on recurrent expenditure forgoing long-term investments thereby potentially posing risks related to fiscal sustainability. The fiscal stance shows that Ethiopia is experiencing public budget deficit although overall budget deficit to GDP ratio is on a falling trend. The country also experiences a primary balance deficit, albeit its size to GDP ratio is falling, indicating that the government cannot finance its current day to day expenditure let alone pay previous debt.

Public debt indicators show that Ethiopia experiences debt distress. Disaggregation of public debt into domestic and external debt shows that external debt to GDP, to government revenue, and to tax revenue ratios show sharp increase recently, signaling that the country faces risks such as exchange risks. Moreover, external debt service to export ratio shows that Ethiopia's debt service exceeds the threshold of even high-debt carrying capacity countries. Given that Ethiopia is one of a low-debt carrying capacity countries, its debt service to export ratio that even surpasses the threshold for high-debt carrying capacity countries reflects that the country experiences debt distress that potentially poses exchange risk. Ethiopia's fiscal outlook shows that recurrent expense will dominate government expenditure in the coming years, posing fiscal sustainability risks because the government will be forgoing long-term investment (that could raise future public revenue) in favor of recurrent expenses. Public debt is projected to increase in the coming years, putting the country in further debt distress; particularly, public

debt to GDP ratio of the country is expected to surpass 60% threshold posing debt distress in the coming years.

Over the past 32 years (1993–2025), Ethiopia's external sector has been defined by persistent structural imbalances, severe foreign exchange (Forex) constraints, and an expanding trade deficit. While nominal export earnings expanded at a long-term average growth rate of 33.25% (averaging ETB 82.31 billion), this growth is heavily distorted by domestic currency depreciation and exogenous shocks. When adjusting for the anomalous 2025 coffee price boom (418.6% growth spike), Ethiopia's underlying structural export growth remains stagnant at 18%–23%. Concurrently, imports expanded at a sustained average of 24.2%, driven by heavy capital goods and fuel dependency.

Exports remain heavily reliant on primary commodities (coffee, gold, oilseeds, pulses). Coffee revenues surged in 2025 due to a severe global supply shock in Brazil, masking structural contractions elsewhere. Flagship sectors suffered major downturns: oilseed exports fell due to security conflicts in core agricultural clusters, while leather exports collapsed in the last eight years because of active tannery closures following raw leather shortages and U.S. AGOA revocation.

Persistent Birr depreciation (NEER growth averaging -5.9%) has failed to sustainably boost export competitiveness. Over 50% of Ethiopia's imports are intermediate and capital goods, and 52% of domestic manufacturing relies on imported inputs. Consequently, nominal devaluations immediately inflate the production, machinery, and logistics costs, eventually neutralizing price gains.

A strong positive co-movement exists between the black-market exchange rate premium and official export growth. Under severe forex rationing, multi-activity trading firms utilize retained forex from low-margin primary exports to import high-demand goods priced at parallel market rates. Exporters internalize this parallel premium into high domestic margins, using import profits to cross-subsidize official export operations.

Imports exhibit a distinct one-quarter lagged contraction following sharp NEER devaluations (e.g., 2017-Q2 and 2024-Q1 shocks), driven by letter-of-credit (LC) lead times and severe working-capital liquidity walls. Ethiopia faces deep structural trade deficits with major capital and energy suppliers such as China (-$2.5B annual average), Saudi Arabia (-$639.7M), UAE (-$609.8M), India (-$1.5B), and Kuwait (-$873.7M). Uninterrupted surpluses are maintained only with the Netherlands (+$62.6M, floriculture), while Djibouti turned negative post-2021 due to port logistics fees.

Ethiopia's external sector is acutely exposed to foreign trade policy. The January 2022 U.S. AGOA suspension caused $83.0M (23.1%) export contraction to the U.S. by 2023, depressing industrial park manufacturing. Conversely, policy pivots such as the 2024 ban on Internal Combustion Engine (ICE) passenger vehicles and NBE formal gold channel incentives ($3.48B in 2025) demonstrate that targeted institutional realignments can rapidly alter trade flows.

5.2. Recommendations

To sustain strong economic growth and achieve macroeconomic stability and fiscal sustainability, designing and implementing policies that address Ethiopia's structural challenges are essential. To sustain robust economic growth along with achieving structural transformation and meeting inclusive and sustainable growth, economic policies that account for structural bottlenecks that the country is facing are vital. In the era of shrinking external (concessional) finance sources, strengthening domestic revenue mobilization is essential to achieve and sustain macroeconomic stability, fiscal sustainability,

and long-term development. Particularly, given that Ethiopia's tax-to-GDP ratio remains far below the critical threshold level, constraining the government's capacity to finance essential services, enhancing tax mobilization capacity by improving institutional quality that enhances transparency, compliance and accountability is essential. Such measures help the government to close the revenue-expenditure gap and mitigate risks associated with debt distress thereby enhancing fiscal sustainability and supporting long-term economic progress that will ultimately enable the country to achieve SDGs.

Based on an empirical analysis of Ethiopia's monetary policy, exchange rate dynamics, and inflation trends over the past three decades, the following targeted policy recommendations are proposed to restore macroeconomic stability and promote sustainable growth.

Transition to Contractionary Stance: Systematically decelerate broad money supply expansion below the historical 25% to disrupt double-digit inflationary inertia.

Dismantle Asymmetric Credit Ceilings: Phaseout rigid credit caps (such as the 14% commercial bank limit) and transitioning to price-based, interest-rate monetary instruments will restore credit flow to high-productivity private enterprises.

Restore Real Returns on Savings: Allow nominal interest rates to adjust flexibly, establishing positive real interest rates to mobilize domestic savings and reduce wealth inequality.

End Central Bank Direct Monetization: Enforce strict fiscal discipline by ending reliance on central bank direct credit advances to fund public deficits and shifting government borrowing to competitive domestic debt markets.

Target Agro-Supply Chains: Allocate fiscal spending toward agricultural productivity, storage infrastructure, and domestic logistics to alleviate the structural food supply shocks anchoring overall CPI.

Mitigate Foreign Exchange Pass-Through: Implement targeted, temporary social safety net buffers to protect vulnerable households from imported price surges caused by ongoing Forex market unification.

To reverse Ethiopia's protracted export stagnation and address its structural trade deficit, a comprehensive set of policy interventions is proposed. The recommendations are focused on improving export competitiveness and mitigating macro-financial barriers.

Agricultural Supply Security & Tannery Industry Rescue Package: Establish secure agricultural supply corridors in core oilseed and coffee producing regions to restore sesame export capacity above 350,000 tons. For manufacturing, execute an urgent rescue plan for the leather sector—providing targeted raw hide collection incentives, duty drawbacks, and priority Forex allocations to rebuild active tanneries back to baseline capacity.

Shift from Devaluation to Structural Competitiveness: Avoid relying solely on nominal currency devaluations to correct trade deficits, as intermediate input inflation neutralizes export gains. Focus exchange rate policy on REER stability and domestic inflation control. Pair currency reforms with targeted input-cost subsidies and logistics facilitation for export-oriented manufacturers.

Forex Market Unification & Retention Scheme Reform: Accelerate market-clearing Forex rate unification to eliminate distortionary parallel market cross-subsidization incentives. Reform exporter

Forex retention schemes to prioritize market-driven allocation for high-productivity intermediate and capital inputs rather than consumer goods re-invoicing.

Strategic Market Diversification & Preference Defense: Prioritize diplomatic engagements to restore U.S. AGOA trade eligibility while expanding bilateral trade agreements across GCC nations (UAE, Saudi Arabia) and AfCFTA corridors. Capitalize on growing Middle Eastern demand for specialty coffee, chilled meat, and livestock through enhanced air-freight logistics.

Import Rationalization & Bilateral Deficit Management: Address deep bilateral trade deficits with China, India, and Gulf countries by negotiating counter-trade agreements, local-currency settlement frameworks, and supplier credit lines. Expand targeted import-substitution in electric vehicles and domestic construction inputs, while enforcing strict project-financing discipline on capital procurements.