Explaining Macroeconomic Fluctuations in Ethiopia

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Abstract

The aim of this paper is to examine the role of monetary and fiscal policies in explaining macroeconomic fluctuations in Ethiopia using structural VAR and Factor Augmented VAR approaches. In order to identify monetary policy shocks, synthetic monetary policy indicator is estimated by factor analysis based on 13 variables reflecting monetary conditions in Ethiopia. Then the estimated factors along with the fiscal policy shocks are identified using non-recursive frameworks. Its main results can be presented as follows: first, an increase in government spending has an expansionary effect on output, while an increase in tax revenue is contractionary, with spending multipliers larger than net tax revenue multipliers; second, contractionary monetary policy is associated with fall in output, but statistically insignificant; third, the contributions of fiscal policy shocks are larger than that of monetary policy shocks in explaining movements in output, with roughly equivalent contributions coming from shocks in fiscal policy components. Furthermore, the effects of fiscal and monetary policy shocks on output and inflation has improved qualitatively and quantitatively when both policy variables are jointed examined than estimating separate model; suggesting role of joint analysis of fiscal and monetary policy shocks.

Key Words: Fiscal Policy, Monetary Policy, Fluctuations, SVAR, Dynamic Factors.