ECB Macroeconometric Models for Forecasting and Policy Analysis

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Contributions to Boxes
Box 1: Simulating models against external models for a standard monetary policy shock (Santi Doni)

Box 2: Unconditional and conditional forecasting with NARMA (Iain Lemon, Gennaro and Anders Werner)

Box 3: A carbon tax transition scenario using our climate-augmented models (Romeo Priftis)

Annex 1: how do we get there? A short history of model development at the ECB (Matteo Ciccarelli and Gabriel Pagan)

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1

Suite-of-model approach

Rationale and flexibility
One or many models?

- No aspiration to build a model that includes everything
- Need for continuity in the assessment while keeping changing and including new channels and frictions
- Resonance or dissonance between academic research and modelling at policy institutions?

<table>
<thead>
<tr>
<th>Academic research</th>
<th>Policy modelling</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simple and stylised</td>
<td>Realistic and granular</td>
</tr>
<tr>
<td>Deep theoretical foundations</td>
<td>Robust to structural uncertainty</td>
</tr>
<tr>
<td>Original and strong policy prescriptions</td>
<td>Continuity and consistency with policy paradigm</td>
</tr>
</tbody>
</table>

- **ECB approach:** develop and maintain a suite of models and tools for complementary purposes
Ensure robustness across modelling approaches

- Exploit the trade-off between strong structural features and empirical performance

Aggregate and multi-country modelling of the EMU

- Bottom up and top down approaches

Interactions between MAIN and SATELLITE models

- Create a common institutional language through (few) MAIN models
- But articulate them with specialised SATELLITE tools

Evolutionary process

- Balance the need to learn from on-going research creativity while maintaining consistency in the model-based input to the policy process
Broad ECB macro-modelling portfolio

Structural
- NAWM II
- NAWM variants
- Other specialised DSGEs
- HANK

Semi-structural
- ECB-BASE
- ECB-MC
  - Country blocks
  - Linked version

Empirical
- Structural econometrics
- BVARs forecasting toolbox
- Quantitative risk metrics
- Other thematic studies

MAIN models
SATELLITE models
ECB staff rationale for investing in semi-structural models

<table>
<thead>
<tr>
<th>Need to account for country dimension</th>
<th>• Managing a multi-country/sector dimension is relatively easier (e.g. in terms of specification and estimation) than in a structural model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Need to account for <em>conceptual</em> flexibility regarding specification design</td>
<td>• Complementary to DSGE models also under different or hybrid expectations formation, and in combination with satellite financial models</td>
</tr>
<tr>
<td>Need to introduce <em>empirical</em> flexibility in a changing world for timely analyses</td>
<td>• Exploit a greater data flexibility and sectoral granularity within a consistent theoretical and accounting framework</td>
</tr>
<tr>
<td>Need to introduce <em>institutional</em> flexibility amenable to the policy process</td>
<td>• Forecasting with judgment, incorporating sectoral and/or country-specific expert views</td>
</tr>
</tbody>
</table>

*See also Bernanke’s Bank of England review*
Benchmarking our models against external models for a standard monetary policy shock

Annual inflation (left) and output gap (right)
(percentage point deviations from baseline; quarters)

Note: The responses of the models are based on publicly available material and may not reflect the most current version of each model. FRB/US: a large scale general equilibrium model of the US economy with flexible optimisation, developed by the Federal Reserve System; LENS: a large empirical and semi-structural model used by the Bank of Canada for forecasting and policy analysis; NAWM II: the New Area-Wide Model, a structural econometric model used by the ECB within a DSGE framework for the euro area; QUEST III: a macroeconomic model used by the European Commission for policy analysis and research in the EU; ECB-BASE: a semi-structural model used by the ECB for the euro area.
Policy use cases

Projections, policy scenarios, risks analysis, monetary policy
Policy use of the ECB macro-modelling portfolio

Economic projections
- Forecasting with judgment and model-based projection narratives for the euro area as well as for the largest euro area countries

Sensitivity, risk and scenario analysis
- Conditional predictive densities from forecasting models
- Sensitivity of baseline to key assumptions (Oil, FX, Fiscal, Financial)
- Risk balance for the (B)MPEs
- Scenario analysis of relevant macroeconomic contingencies

Policy analysis
- Impact study of monetary policy options
- Normative monetary policy analysis
- Strategic issues related to monetary-fiscal-financial policy mix in the euro area
NAWM: Structural shock decomposition of the June 2023 MPE baseline

Real GDP
(q-o-q growth rates, in pp, in deviations from steady state)

HICP inflation
(y-o-y growth rates, in pp, in deviations from 2%)

Source: ECB staff calculations using the NAWM II.
The category “Structural factor” includes the contributions of the initial state, the discount rate shock and the persistent component of the permanent technology shock. “Interest rate shocks” comprises the short-term interest rate shock and the shock to the retail bank’s markdown. “Domestic demand” includes the domestic risk-premium shocks and shocks to government spending. The category “Domestic supply” captures supply-shocks, namely: the transitory component of the permanent technology shock and the transitory and investment specific technology shocks as well as wage and price mark-ups. The category “Foreign and trade” captures shocks to foreign demand, foreign prices, US 3-month and 10-year interest rates, competitor’s export prices, oil prices, import demand , export preferences, mark-up shocks to export prices and import prices and a foreign risk-premium shock whereas “Other” includes measurement errors and residuals from bridge equations.
Forecasting with judgement: analytical roadmap

- **New assumptions**
- **New data and short-term outlook**
- **Changes in long-term trends**
- **Model-based projections**

- **Judgement on assumptions**
- **Judgement on ST outlook propagation**
- **Other judgement**
- **Projections with judgment**
Model-based projections: December 22 BMPE

Real GDP – Euro area
(q-o-q growth rates, in %)

HICP– Euro area
(y-o-y growth rates, in %)

Source: ECB/NCB projections database and ECB/NCB staff calculations based on ECB-BASE
December 2022 BMPE MPC assumptions and short-term outlook until 23Q1.

‘Projection updates’ correspond to model-based updates of the previous (B)MPE baseline on the basis of changes in assumptions as well as new data and changes in the short-term outlook up to 2023Q1. The dark grey areas represent the 90% confidence interval from the conditional ECB BASE forecast and light grey areas represent the 90% confidence interval from the unconditional ECB BASE forecast. They are both centred around the ECB BASE projection update. The conditional ECB-BASE forecast uses the values produced by the ECB staff for the Fiscal, Foreign, UIP, Transfers, Exchange rate, House prices, Financial, Wealth, Production, Inventories and Policy Rule blocks. In the ECB BASE model, the density forecast is computed using a bootstrap method that re-samples the in-sample residuals of the model. The forecasted value of an endogenous variable is calculated by adding the re-sampled residual to the value forecasted by the model and the distribution is obtained by repeating the process 500 times.
Risk analysis: Probabilities of high inflation under alternative scenarios

<table>
<thead>
<tr>
<th>Scenario Description</th>
<th>2024</th>
<th></th>
<th>2025</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>HICP between 1.75% and 2.25%</td>
<td>HICP &gt; 2.25%</td>
<td>HICP between 1.75% and 2.25%</td>
<td>HICP &gt; 2.25%</td>
</tr>
<tr>
<td>ECB-BASE</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Baseline</td>
<td>11%</td>
<td>85%</td>
<td>28%</td>
<td>42%</td>
</tr>
<tr>
<td>Unccentred</td>
<td>0%</td>
<td>100%</td>
<td>23%</td>
<td>61%</td>
</tr>
<tr>
<td>Higher wage indexation</td>
<td>6%</td>
<td>92%</td>
<td>24%</td>
<td>56%</td>
</tr>
<tr>
<td>Unanchoring of long-term inflation</td>
<td>10%</td>
<td>86%</td>
<td>26%</td>
<td>50%</td>
</tr>
<tr>
<td>Higher wage indexation and unanchoring</td>
<td>6%</td>
<td>93%</td>
<td>20%</td>
<td>65%</td>
</tr>
<tr>
<td>NAWM II</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Baseline</td>
<td>12%</td>
<td>69%</td>
<td>14%</td>
<td>48%</td>
</tr>
<tr>
<td>With supply risks</td>
<td>9%</td>
<td>80%</td>
<td>11%</td>
<td>57%</td>
</tr>
<tr>
<td>Higher wage indexation</td>
<td>9%</td>
<td>73%</td>
<td>13%</td>
<td>55%</td>
</tr>
<tr>
<td>Unanchoring of long-term inflation</td>
<td>10%</td>
<td>73%</td>
<td>15%</td>
<td>51%</td>
</tr>
<tr>
<td>Higher wage indexation and unanchoring</td>
<td>8%</td>
<td>84%</td>
<td>12%</td>
<td>60%</td>
</tr>
<tr>
<td>BVARs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Small VAR</td>
<td>11%</td>
<td>56%</td>
<td>11%</td>
<td>50%</td>
</tr>
<tr>
<td>Large VAR</td>
<td>10%</td>
<td>63%</td>
<td>9%</td>
<td>63%</td>
</tr>
<tr>
<td>Small VAR with time-varying coefficients</td>
<td>9%</td>
<td>60%</td>
<td>8%</td>
<td>54%</td>
</tr>
</tbody>
</table>

Sources: ECB calculations and June 2023 BMPE.
Notes: The table shows the probability of different inflation events under different risk scenarios. The probabilities are calculated using stochastic simulations around the baseline. For ECB-BASE, in the case of higher wage indexation the parameter capturing wage indexation in the wage Phillips curve of the model increases from 0.39 to 0.5. The case of unanchoring assumes that long-term inflation expectations are an autocorrelated process that depends on the ECB’s inflation target and past inflation outcomes, with the weights for target inflation (72%) and past inflation (28%) calibrated so that long-term inflation expectations in the baseline reach 2.5% at some point during the forecast horizon. For NAWM II, the case of higher wage indexation assumes that the wage indexation parameter in the model increases from 0.37 to 0.5. In the case of unanchoring, long-term inflation expectations are assumed to react to past inflation, such that $\pi_t^* = 0.75\pi_{t-1}^* + 0.25\delta\pi_{t-1}$, with $\delta = 0.32$. “Small VAR” refers to a VAR with GDP growth, headline HICP inflation and the short-term interest rate; “large VAR” includes 14 variables; “small VAR with time-varying coefficients” includes the same variables as “small VAR”.
Impact of monetary policy tightening from end-21 to spring-23 across models

Impact of monetary policy tightening on real GDP growth (year-on-year, percentage points)

Impact of monetary policy tightening on HICP inflation (year-on-year, percentage points)


Notes: This chart reports the results of a simulation involving changes to short-term rate expectations between December 2021 and March 2023 and changes to expectations regarding the ECB’s balance sheet between October 2021 and May 2023. The reported values refer to year-on-year growth rates. “Mean” denotes the average across the three models.
NAWM: Monetary policy decomposition of the June 2023 MPE baseline

Real GDP
(q-o-q growth rates, in pp, in deviations from steady state)

Private consumption deflator
(annual level)

Source: ECB calculations using NAWM II and June 2023 BMPE.
Notes: The chart shows a historical decomposition of the June 2023 BMPE baseline based on NAWM II that identifies the impact of monetary policy (MP) shocks and the impact of the systematic component of monetary policy since December 2021. The latter refers to the historical response in the short-term nominal interest rate to changes in inflation and output according to a policy rule, while the shocks account for deviations from that rule. The grey bars capture the impact of all other shocks in the model, without any monetary policy response.
3
Forecasting and policy analysis under high uncertainty
The effect of large and unexpected crises on the approach

- Point or density forecast becomes ‘problematic’
- IRF and conditional forecasts of time series models with extreme values can explode
- The forecast uncertainty (typically based on past performance) is not meaningful any longer

**Solution:** informed scenarios make more sense than a baseline forecast

For example:
- Alternative pandemic scenarios for the euro area economic outlook, September 2020.
- The impact of the conflict in Ukraine on the euro area economy in the baseline and two alternative scenarios, March 2022.
- Scenario analysis of a potential further slowdown and financial stresses in China and spillovers to the euro area, September 2023.
- Scenario analysis of a potential further escalation of the conflict in the Middle East, December 2023.
Alternative pandemic scenarios for the euro area: analytical roadmap

Unchanged technical assumptions across scenarios

- Estimated-loss approach to derive the first quarters for GDP growth in the pandemic scenarios
- Evaluation of the supply side implication of the pandemic scenarios
- Alignment with the international environment and global trade spillovers
- Assumptions on the scope for real-financial amplification in the scenarios
- Derivation of the full macroeconomic outcomes for the scenarios using ECB-BASE conditional projections
- Real-nominal consistency of the scenarios
- Labour market dynamics
- Other judgement

Real side
Potential output
Global factors
Financial
Model simulation
Cross-check
Final scenarios
ECB-BASE: Simulating alternative pandemic developments in 2020Q3

Real GDP
(index =100 2019q4)

HICP inflation
(y-o-y growth rates, in %)

Sources: ECB projections database and ECB calculations based on ECB-BASE for the scenarios.
Notes: The grey areas represent the 90% and 68% confidence intervals from the ECB-BASIR forecast. They are centred around the September 2021 MPE. The density forecast is computed using a bootstrap method that re-samples the in-sample residuals of the model and considers the uncertainty related to pandemic developments, like vaccination efficiency and virus fundamentals.
Scenario of a potential escalation of the conflict in the Middle East

Simulating a Middle East war escalation scenario in 2023Q4

Real GDP
(quarter-on-quarter growth rates)

HICP inflation
(year-on-year growth rates)

Source: ECB staff calculations.
EA macroeconomic results simulated with ECB-BASE. International spillovers effects consists of euro area foreign demand, competitor’s export prices and exchange rate changes. Energy consists of oil and gas price assumptions. The effect of uncertainty on GDP is derived from a satellite VAR analysis featuring the VIX index. The real GDP, business investment and consumption effects are then imposed in ECB-BASE to extract other endogenous variables including HICP inflation.
Risk assessment through counterfactual scenarios during the energy crisis

Real GDP
(index, 2021Q4 = 100)

HICP inflation
(year-on-year growth rates)

Source: ECB staff calculations.
Baseline refer to the respective baseline staff projections.
Scenario: March 2022 MPE: see box: ‘The impact of the conflict in Ukraine on the euro area economy in the baseline and two alternative scenarios’
Scenario: Sept. 2022 MPE: see box: ‘A downside scenario related to the war in Ukraine and energy supply cuts’
Scenario: Dec. 2022 BMPE: see box: ‘A downside scenario related to the war in Ukraine and energy supply cuts’
The “inflation surge” through the lens of Bernanke-Blanchard model for the euro area


Notes: The figure shows a decomposition of the sources of annual negotiated wage growth and HICP inflation between the first quarter of 2019 and the fourth quarter of 2023 based on the solution of the full model and the implied impulse response functions. The continuous line shows actual data, and the total net heights of the bars are the model’s forecast of inflation in each period, given initial conditions up to the fourth quarter of 2019. The contributions of the residuals are computed as the difference between actual and simulated data. The dark blue portion of each bar shows the contribution of pre-2020 data. The coloured segments of each bar show the general equilibrium, fully dynamic contribution of each exogenous variable to inflation in that period, as implied by the estimated model.
Monetary policy analysis

- Scenario analysis also considers the impact of monetary policy and its calibration
- Together with **counterfactual analysis** to evaluate its effectiveness
- Also, **normative analysis**: 
  \[ L_j = \frac{1}{2} \sum_{t=1}^{t+h} \beta^t \mathbb{E}_t (\lambda_\pi \hat{\pi}_{t,j}^2 + \lambda_y y_{t,j}^2 + \lambda_\Delta \Delta \hat{\pi}_{t,j}^2) \]

Actual monetary policy conduct against real-time optimal policy benchmarks

Optimal short-term interest rate
(annualised, percentages)

-1.0 -0.5 0.0 0.5 1.0 1.5 2.0 2.5 3.0 3.5 4.0 4.5
2021 2022 2023 2024 2025 2026

HICP inflation
(year-on-year growth rate)

-1.0  0.0  1.0  2.0  3.0  4.0  5.0  6.0  7.0  8.0  9.0  10.0  11.0
2021 2022 2023 2024 2025 2026


Note: This figure depicts policy under staggered real-time information about macroeconomic conditions between 2021Q4 and 2023Q4. Policy projections are updated every quarter with the vintage of the relevant projection baseline (December 2021, March 2022, June 2022, September 2022, December 2022, March 2023, June 2023, September 2023, December 2023). The optimal policy paths are computed by minimizing the central bank loss function. From 2023Q4 onwards, the optimal policy projections conditional on the December 2023 baseline are shown over the projection horizon.
Transparency on forecast errors

For forecast accuracy of BMPE projections and related material see these publications:


4. A full database of past Eurosystem/ECB staff macroeconomic projections is available to the public via the ECB Data Portal, which allows researchers to easily assess the performance of these projections. The processes and tools used to produce staff projections are described in a guide available on the ECB’s website.

4 Modelling infrastructure

The importance of investment
The importance of a good infrastructure: A projection platform

The ECB Projections Platform

User interface

Data repository and exchange

HPC

TOOLS

ECB-MC

MATLAB/DYNARE

NAWM

MATLAB

YADA

SCM

EViews

Matlab, R and various software

NCB country projections

EURO area projections

EURO countries projections

Small countries projections

(Ad-hoc) Scenario and risk analyses

Discuss & refine results

Present results

Archive results

Forecast evaluation

Publish report

Executive Board

Governing Council

NCBs

Public

Define model

Discuss model

Refine model

Publish model

COLLECT DATA

VALIDATE & PROCESS DATA

RUN THE MODEL

PRODUCE FORECAST

CROSS-CHECK & DISCUSS FORECAST

SYNTHESISE REPORTS

Data from BAs

NCB country data

Data consistency checks

Data plausibility checks

Set up technical, financial and fiscal assumptions

ECB system data
eurostat

DE, FR, IT, ES, NL

The importance of a good infrastructure

**Versioned and controlled**
- Preserve institutional knowledge
- Ease model development
- Maximize synergies (internals and with NCBs)

**Robust**
- Sustainable
- Fully supported
- Long-term solution that reduces risks and increases consensus

**Lean and efficient**
- Efficient use of resources with maximum time for analysis
5

Agenda

Current modelling plans and future agenda
Main ingredients for soundness

Humbleness

• Models fail and need to be constantly reviewed or complemented by judgment and other models

• Suite-of-model approach will continue to be a robust way of combining complementary alternative tools that can be flexibly adjusted to address unforeseen events and new challenges

Adaptability

• Inclusion of new economic theories and developments

• Keep abreast of technological advances for models and infrastructure

• Cooperate, cooperate, cooperate
The future of modelling

**Consolidate the current modelling capabilities**
- Examine alternative expectations formation
- Supply shocks and monetary policy
- Introduce heterogeneity and non-linearity

**Acquire new ideas and technology**
- New micro-finance-fiscal models
- Heterogeneous models (HANK, agent-based,…)
- Structural changes: climate, digitization, other secular drivers

**Think beyond**
- Machine learning and AI to handle new or big data
- Interdisciplinary teams
- Borderless organizations