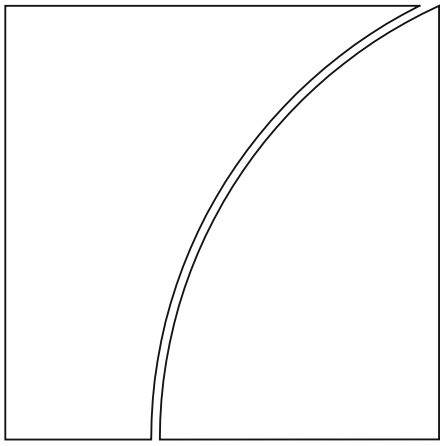

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by Ana Aguilar, Rafael Guerra, Carola Müller and Alexandre Tombini

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The macro-financial impact of economic policy uncertainty in Latin America

Ana Aguilar[*], Rafael Guerra[†], Carola Müller[‡] and Alexandre Tombini[†1]

Abstract

This paper investigates the impact of domestic economic policy uncertainty (EPU) on macroeconomic and financial variables in emerging market economies, focusing on Latin America. Using a panel dataset for Brazil, Chile, Colombia and Mexico from 2005 to early 2025, we find that domestic EPU shocks cause significant macroeconomic disruptions, leading to a contraction in output and a rise in inflation, akin to a supply shock. These effects are transmitted through a financial channel in the short term, via higher risk premia, increased equity market volatility and exchange rate depreciations, and through a real channel in the medium term, via declines in growth expectations and consumer and business confidence. Our analysis further reveals that EPU shocks are most damaging when the economy is weak or financial conditions are tight, while stronger economies are better able to absorb such shocks.

Keywords: macroeconomy; uncertainty, economic policy uncertainty, Latin America

JEL classification: C33, D80, E23, E31.

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1. Introduction

Emerging market economies (EMEs) generally exhibit higher levels of domestic uncertainty than advanced economies (AEs) (Bloom (2014); Choi and Shim (2019)), and heightened uncertainty can jeopardise macro-financial stability (Bloom (2009); Al-Thaqeb and Algharabali (2019)). More recently, geopolitical risks and trade tensions have increasingly contributed to uncertainty (IMF (2024)). These developments threaten to disrupt supply chains, affect trade flows, lead to sudden and unpredictable policy changes, increase the volatility of commodity prices, and lower investors' risk appetite. From a regional perspective, Latin America is no exception, as both global and domestic uncertainty pressures create a challenging environment (Tombini (2024)). The region is prone to high levels of domestic uncertainty and is highly sensitive to global financial conditions (Calvo, Leiderman and Reinhart (1993)). Distinguishing between domestic and foreign sources of uncertainty is particularly challenging for EMEs, as they are highly exposed to both.

This study evaluates the macroeconomic impact of domestic uncertainty in EMEs, using Latin America as a case study. In Latin America, policymakers and private investors face significant episodes of elevated uncertainty, particularly those related to domestic economic policy uncertainty (domestic EPU).[2] In order to isolate the effect of domestic sources of uncertainty given the high dependencies of the region on global developments, we clean the domestic EPU measure from global sources of EPU, especially coming from the United States (US) and China, Latin America's two biggest trading partners. We assess the average impact of domestic EPU shocks in four Latin American countries over the past 20 years. Our findings provide robust evidence that domestic EPU shocks result in a contraction in output and a rise in inflation. Finally, we go beyond the average effect and analyse the heterogeneous effects of domestic uncertainty in Latin America by examining downside and upside risks of tail events (ie in the 10th, 50th and 90th percentiles of the macroeconomic variables).[3] We find that the impact of uncertainty is greater in economies that are already weak (10th percentile) and that it can further increase inflation in economies with a higher probability of inflation becoming de-anchored (90th percentile).

We refine our findings by studying the transmission of EPU through two proposed channels: a real channel and a financial channel. First, we examine how uncertainty affects the real economy by using two forward-looking indicators of business cycles that are influenced by heightened uncertainty: expectations and confidence. Expectations about future revenue or income form the basis of investment (Gennaioli, Ma and Shleifer (2015)) and consumption decisions (Jappelli and Pistaferri (2000); Crump et al (2022)). When uncertainty is high, forecasters and investors tend to revise their growth expectations downwards. These shifts can lead to reductions in investment and consumption, as businesses and households delay economic decisions due to a lack of clarity about the future economic and political environment. We find that uncertainty leads to a sharp decline in GDP growth

[2] As we define our domestic EPU shock as one explicitly tied to internal, country-specific factors based on statistical techniques, it can also be understood as an idiosyncratic EPU shock, as it may be isolated to specific events or situations in each country.

[3] As pointed out by Adrian et al (2019) and López-Salido and Loria (2024), changes in financial conditions – such as those induced by risk-aversion shocks or financial uncertainty – might have a greater impact on the tails of growth and inflation than on the average. Jones and Enders (2016) also point out that uncertainty shocks can have asymmetric effects.

expectations and creates more volatile inflation expectations. Another important determinant of spending decisions is confidence (Acemoglu and Scott (1994); Nowzohour and Stracca (2020)). Elevated uncertainty can erode consumer confidence, leading to reduced consumption and increased precautionary savings. Similarly, businesses may become more cautious, scaling back investment and hiring plans. We find a drop in consumer confidence and heterogeneous but negative effects on business confidence as well.

Second, we study the effect of uncertainty on output through key financial markets. Investors demand higher returns to compensate for uncertainty, leading to tighter financial conditions (Bali et al (2017) and Amaral et al (2025)). Risk aversion may increase in response to uncertainty, implying higher risk premia. Sovereign debt and foreign exchange markets in EMEs are particularly sensitive to risk aversion and global factors (González-Rozada and Levy Yeyati (2008)). The impact on financial conditions may therefore also depend on international investors' reactions to domestic EPU. Capital outflows can lead to exchange rate depreciations, and uncertainty can also increase exchange rate volatility (Bush and López Noria (2021)). Sharp movements in the exchange rate can disrupt international trade and foreign direct investment decisions, amplifying economic instability. We find evidence of heightened equity market volatility and increased risk premia in reaction to domestic EPU in the short term, and these effects are more pronounced when financial conditions are already tight. Finally, we find strong evidence that EME currencies depreciate in response to higher uncertainty, a common feature of EMEs during stressful periods.

The literature on the economic effects of uncertainty is expanding (Cascaldi-Garcia et al (2023)), yet gaps remain in analysing how uncertainty may influence macroeconomic outcomes. Pioneer studies examining uncertainty beyond volatility in financial markets have identified a clear negative effect on output (Baker et al (2016) and Ahir et al (2022)).[4] While the measures of uncertainty vary across studies—ranging from financial markets to geopolitical risks or economic policy events—there is compelling evidence that uncertainty shocks can significantly harm EMEs.[5] Regarding the spillover effects of uncertainty shocks on EMEs, the literature consistently finds evidence of contractionary impacts.[6] Specifically, for Latin America,

[4] Baker et al (2016) introduced the widely used EPU index, showing that a one-standard-deviation increase in EPU leads to a 1% decline in industrial production and a 25 basis point rise in the unemployment rate across 12 advanced economies (AEs) from 1995 to 2014. Ahir et al (2022) expanded this work by developing a World Uncertainty Index (WUI) for 143 economies, finding that a one-standard-deviation increase in global uncertainty causes a 1.1% contraction in GDP, with stronger effects in countries with weaker rule of law and higher financial constraints. More recently, the IMF (2024) highlighted that a one-standard-deviation rise in macroeconomic uncertainty reduces real GDP growth (annualised, one quarter ahead) by 0.5 to 2 percentage points and proposed three transmission channels through which uncertainty impacts economic outcomes: the real, credit, and market channels, collectively dampening output growth and increasing market volatility.

[5] In comparison to AEs, EMEs experience much more severe declines in investment and private consumption following an exogenous uncertainty shock, with significantly longer recovery periods (Carrière-Swallow and Céspedes (2013)). Furthermore, Miescu (2023) found that uncertainty shocks had substantial contractionary effects on GDP, stock prices, and local currencies in EMEs. Also, Caldara and Icoviello (2022) found that threats of geopolitical risks also hurt the economies.

[6] Bonciani and Ricci (2020) provide evidence that global financial uncertainty has adverse effects on output, trade, and employment, with these impacts being more pronounced in EMEs characterised by weaker institutional quality. Similarly, Gupta et al (2020) find that rising US uncertainty negatively affects GDP, with the effects being particularly severe in EMEs that exhibit greater trade openness and weaker financial systems.

recent studies highlight how global uncertainty shocks influence macroeconomic performance[7]; however, there is limited evidence in the region from studies estimating the effects of domestic EPU shocks.

The contribution of this paper is threefold. First, we provide robust evidence of an adverse effect of domestic EPU shocks in Latin America, accounting for the potentially confounding influence of global uncertainty. Second, while the adverse effects of uncertainty shocks are well documented, the mechanisms driving these effects remain underexplored for EMEs. This paper addresses this gap by testing a real and a financial transmission channel using seven monthly indicators through which domestic uncertainty impacts the macroeconomy in EMEs. Third, we show that the effect of domestic EPU is heterogenous and depends on the initial state of the economy and financial conditions. To the best of our knowledge, there is no evidence so far on the tail effects of domestic EPU on the macroeconomy in Latin America.

Important policy implications emerge from this paper. For monetary policy, domestic EPU shocks in Latin America appear to operate like supply shocks, putting central banks in the difficult position of trading off between growth and inflation. Also, we show that the domestic EPU shocks can increase the volatility of inflation expectations. When inflation is low, EPU can decrease inflation expectations and have only minor or insignificant effects on inflation. However, when inflation is well above target, domestic EPU can add upward pressure by raising inflation expectations. In inflationary episodes, higher EPU could therefore contribute to the un-anchoring of inflation expectations.

The remainder of the paper is organised as follows. Section 2 outlines the data and variables used to measure the transmission channels of EPU. Section 3 details the empirical strategy employed in the analysis. Section 4 presents the main findings. The final section offers concluding remarks and discusses policy implications.

2. Data and measurement

This section outlines the data implemented in this study and the way we measure key variables and transmission channels. The analysis focuses on four key Latin American countries with available economic policy uncertainty data: Brazil, Chile, Colombia and Mexico. The dataset spans the period from January 2005 to January 2025, during which all four countries operated under inflation-targeting regimes.

2.1 Measure of economic policy uncertainty

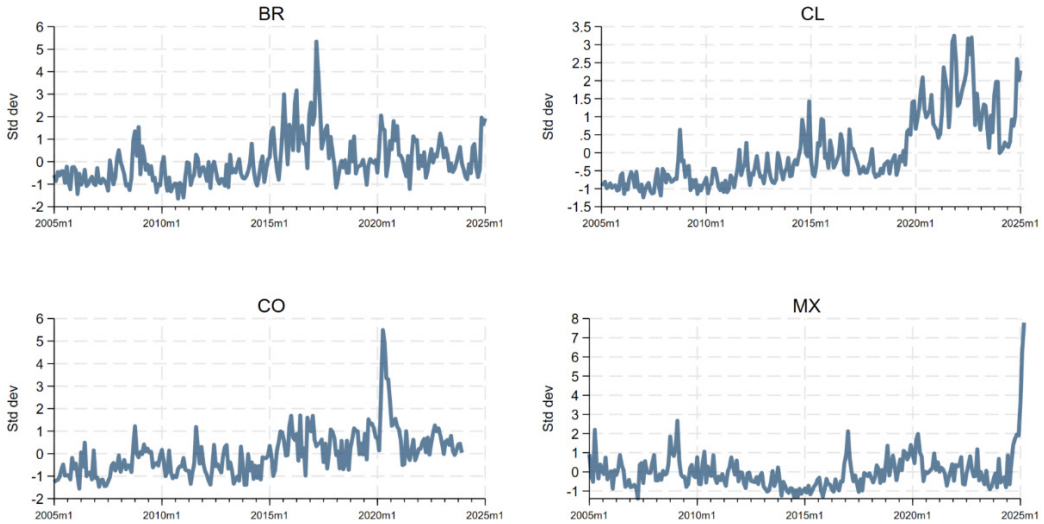
We use the EPU series developed by Baker et al (2016), which relies on text analysis of local newspapers.[8] Their methodology identifies and counts keywords associated

[7] The literature examining the effects of foreign uncertainty on Latin America indicates significant impacts on GDP growth, consumption, private investment, exchange rate depreciation and financial conditions (Ojeda-Joya and Romero-Chamorro (2023), Attílio (2024), Coronado et al (2020), Llosa et al (2022) and IMF (2025)). Table A1 provides a detailed overview of the available papers on individual countries in the region.

[8] We use the country series developed by Baker, Bloom and Davies (available on their website) for Brazil and Mexico, the EPUC series from Cerda, Silva and Valente (2016) for Chile and the series developed in Gil and Silva-Pinzón (2020) for Colombia.

with (i) uncertainty, (ii) the economy and (iii) policies. EPU increases if more articles appear in which keywords in all three categories are used in close vicinity within a phrase or paragraph together. In Latin America, the EPU index has captured significant moments, both historically and in recent times (Graph 1). Across these countries, EPU levels have also risen notably in the post-pandemic period, driven by ongoing political scandals, reforms and shifts in government.

Graph 1. Economic policy uncertainty in Brazil, Chile, Colombia and Mexico.



Note: For Colombia, the series ends in M12 2023. Sources: Bloom et al (2016); Cerda, Silva and Valente (2016); Gil and Silva-Pinzón (2020); authors' calculation.

2.2 Measures for transmission channels on macro-financial outcomes

Our main concern is to understand the effect of EPU on growth and inflation. To do so, we employ national data on monthly GDP levels (in per cent) and monthly year-on-year headline inflation (in percentage point). To further study a real and a financial channel through which EPU can ultimately harm the economy, we use a set of seven proxies, four for the real channel and three for the financial channel.

First, in the **real channel**, we study how uncertainty can lower output by dampening two forward-looking indicators of consumption and investment decisions: expectations and confidence. Uncertainty in economic policy can alter the expectations of economic agents regarding GDP and inflation. We use survey-based GDP growth and inflation expectations from Consensus Economics, focusing on a one-year-ahead horizon for both variables.[9] To study uncertainty-driven changes in

[9] Since these forecasts are based on a fixed event date, we transform them into a one-year-ahead forecast by taking a weighted average between current and next-year inflation expectations as done in past work on these topics (eg Dovern et al (2012), Siklos (2013) and Aguilar et al (2024)). This is computed based on the following equation:

$$\pi^{e}_{t+12|t} = \frac{12-h+1}{12}\pi^{e}_{t+h|t} + \frac{h-1}{12}\pi^{e}_{t+12+h|t}$$

where $\frac{12-h+1}{12}$ and $\frac{h-1}{12}$ are the respective weights for current and next year forecasts. We follow this approach for both GDP growth and inflation expectations.

confidence, we use business and consumer confidence indicators from national sources, which reflect current sentiments.

Second, the **financial channel** captures the effects of EPU on exchange rates, stock market volatility, and risk premia. EPU can heighten financial market volatility, increase risk premia and reduce the availability of credit. Investors may demand higher returns to compensate for the additional risks, making financing more expensive for businesses and governments. We proxy for these effects using the volatility of the domestic equity market indices and five-year credit default swap (CDS) spreads on US dollar-denominated government bonds from Bloomberg. Furthermore, exchange rate depreciation against the US dollar can disrupt international trade and foreign direct investment decisions, amplifying economic instability.

Summary statistics

Table 1

	Source:	Observations	Mean	Std dev	Min	Max
Economic policy uncertainty (std)	Bloom et al (2016)	953	0.0	1.0	–1.6	7.8
Monthly GDP (Index, Jan 2005 = 100)	National data.	944	134.0	23.11	98.7	192.6
Headline inflation (pp)	National data.	972	4.7	2.4	-3.3	14.0
One-year ahead GDP growth (pp)	Consensus Forecasts; authors' calculations.	976	2.8	1.7	–4.1	6.0
One-year ahead inflation expectations (pp)	Consensus Forecasts; authors' calculations.	976	4.1	1.0	1.5	7.8
Consumer confidence index (index)	National data.	964	45.6	14.9	8.1	88.8
Business confidence index (index)	National data.	936	52.6	6.7	14.2	70.4
Exchange rate deprecation (%)	National data.	976	0.2	3.1	-8.9	20.0
Five-year CDS spreads (bp)	Bloomberg.	976	138.1	78.3	12.8	480.1
Domestic equity volatility (std)[1]	Bloomberg.	952	1.1	0.7	0.3	7.7

[1] Monthly average of a 30-day daily moving standard deviation.

Source: Authors' calculations.

Table 1 provides a detailed overview of the data applied in the analysis. Overall, we have about 950 country-month observations. The EPU index is standardised to make it comparable across countries. The 20-year sample period covers several business cycles, including the Great Financial Crisis and the Covid-19 crisis, and several monetary cycles, but excludes hyperinflation episodes observed prior to the 2000s.

3. Empirical strategy

To investigate our central question of how domestic uncertainty in Latin America affects the macroeconomy through the real and financial transmission channels, we use a panel local projections approach (Jordà, 2005). We begin by analysing the effects of a one-standard-deviation change in EPU, followed by a deeper exploration of the impact of an orthogonal shock to domestic EPU. Finally, we extend the analysis by introducing quantile regressions to assess the asymmetric effects of domestic EPU in Latin American economies.

3.1 Impact of one-standard-deviation-increase of domestic EPU

We first propose a standard framework as follow:

$$Y_{i,t+h} = \alpha_i + \theta_t + \sum_{j=2}^{12} \gamma_j^h y_{i,t-j} + \beta^h EPU_{i,t} + \omega^h Controls_{i,t-1} + \varepsilon_{i,t+h} \quad (1)$$

where *Y* is the cumulative response of the dependent variable between month t-*1* and month *t+h* for country *i*, *y* is the lagged dependent variable from *t-2* to *t-12*, *EPU* is the standardised EPU index for country *i* in month *t*, and the vector *Controls* includes all the independent variables within the real and financial channels that are not tested on the right-hand side of the equation, lagged by one month. This approach controls for any interrelated effects among the variables of interest by holding the other variables constant when examining the impact of one of them. Fixed effects for country and months are also included in the model.

In this and subsequent approaches, we argue that endogeneity issues are not a primary concern, given the nature of the construction of the EPU index. As outlined by Baker et al (2016), an increase in the index requires the simultaneous presence of three types of words from the sets "Economic", "Policy", and "Uncertainty". This makes it unlikely – though not impossible – that changes in a single macroeconomic variable could directly influence the inclusion of new articles in the index related to economic policy uncertainty. To address concerns about spurious correlations, we implement a second estimation approach in which domestic EPU shocks are constructed to be orthogonal to the main sources of external EPU and to their own past. Additionally, the inclusion of time fixed effects helps control for other sources of global uncertainty (eg global financial volatility or episodes of global risk aversion). Country-constant characteristics are further absorbed through country fixed effects. Finally, consistent with the spirit of the panel local projections approach à la Jordà (2005), endogeneity concerns are further mitigated by estimating the impact of EPU at time *t* on subsequent periods *t+h* for different macro-financial variables, where *h* = 1, 2, …, 12.

3.2 Impact of one-standard-deviation-change of orthogonal domestic EPU shocks

The literature on EPU highlights significant spillovers from major economies to small open economies, making it challenging to obtain a purely domestic EPU time series that is distinct from foreign EPU influences. To address this issue, we orthogonalise domestic EPU with respect to US and China EPU in equation (2), which are the main trade and financial partners of Latin American region, broadly influencing the region. This approach allows us to isolate and accurately estimate the impact of domestic EPU, excluding spillovers from major economies and other global sources of uncertainty.

To recover domestic EPU shocks, we fit the data into regressions that include contemporaneous and lagged variables of the primary global sources of uncertainty, as well as lagged variables of the domestic EPU. This approach mimics structural VAR models with a Cholesky decomposition, following established methodologies (see

Diercks et al (2024) for further discussion on this strategy). The regression equation is as follows:

$$EPU_{i,t} = \alpha_i + \sum_{j=0}^{12} \beta_j US\ EPU_{t-j} + \sum_{j=0}^{12} \beta_j CN\ EPU_{t-j} + \sum_{j=1}^{12} \beta_j EPU_{i,t-j} + \varepsilon_{i,t} \quad (2)$$

where $\varepsilon_{i,t}$ is the domestic EPU shock orthogonal to the contemporaneous and past US and China (CN) EPUs as well as its own past series. In other words, these residual series remove all global news that comove with domestic EPU news (see the matrix of correlations in Table 2, first column). Furthermore, even when examining the correlation between these domestic EPU shocks and the global EPU time series, the correlation remains close to zero.

Graph 2 illustrates the presence of domestic sources of EPU that are orthogonal to global sources of uncertainty. Notably, for many of these, there are periods during which major events drive temporary upward trends in our series.

Matrix of pairwise correlations between the orthogonal domestic EPU shocks with other EPU variables

Table 2

	Domestic EPU shock	Domestic EPU	US EPU	China EPU	Global EPU
Domestic EPU shock	1.0				
Domestic EPU	0.51	1.0			
US EPU	0.00	0.51	1.0		
China EPU	0.00	0.53	0.64	1.0	
Global EPU	0.03	0.59	0.77	0.95	1.0

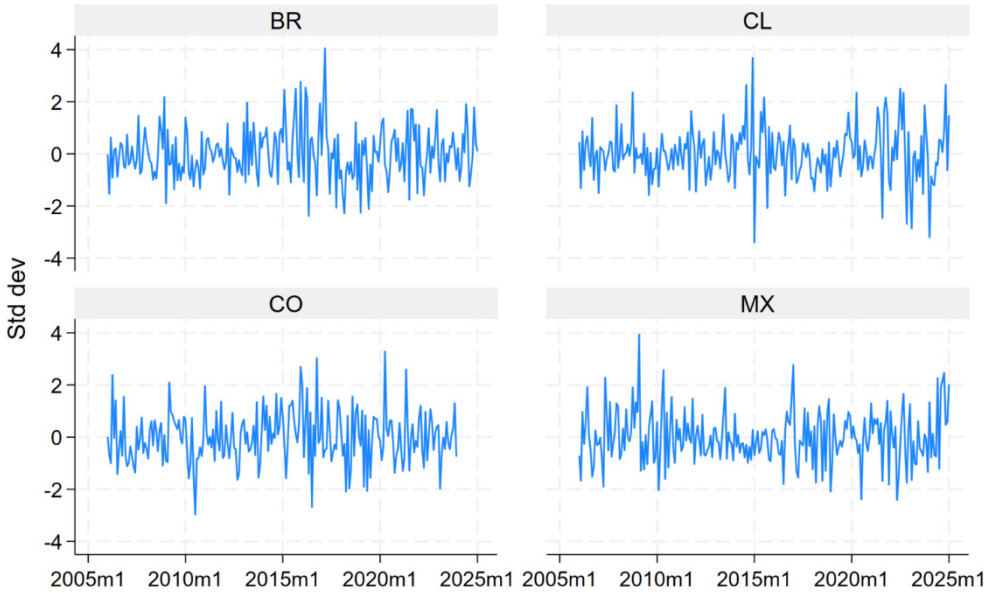
Source: Authors' calculations.

In this case, we estimate a second approach by following the next equation:

$$Y_{i,t+h} = \alpha_i + \theta_t + \sum_{j=2}^{12} \gamma_j^h y_{i,t-j} + \beta^h EPU\ shock_{i,t} + \varepsilon_{i,t+h} \quad (3)$$

In contrast to equation (1), in equation (3) we regress our dependent variable on the current level of the orthogonal EPU shock, including only the 12 lags of the dependent variable to account for potential serial correlation. In this specification, we omit the vector of control variables due to the uncorrelated nature of the orthogonal EPU shocks.

Graph 2. Domestic EPU shocks in Latin America.



Note: Authors' calculation.

3.3 Heterogenous effects one-standard-deviation-change of orthogonal domestic EPU shocks

Finally, to assess heterogeneity in the effect of EPU on macroeconomic outcomes along the distribution of the outcome, we employ a panel quantile regression approach using the estimator from Machado and Santos Silva (2019). This strategy allows us to study how EPU affects growth and inflation under the initial conditions of the economy and follows the spirit of the "growth-at-risk" approach proposed by Adrian et al (2019) and the "inflation-at-risk" approach studied by Banerjee et al (2020). To do this, we estimate the following equation:

$$Q(Y_{i,t+h},\tau) = \alpha_i(\tau) + \theta_t(\tau) + \gamma_j^h y_{i,t-1} + \beta^h(\tau) EPU\ shock_{i,t} + \varepsilon_{i,t+h}(\tau) \quad (4)$$

Here, τ represents the quantiles, while we regress the dependent variable on current levels of the orthogonal EPU shock as in equation 3 including time and country fixed effects as well as a lag of the outcome variable. We use three quantiles: the lowest and highest percentile (10th and 90th) as well as the median (50th) of the distribution of the outcome variables. In essence, we get one regression for each horizon-quantile pair. We bootstrap standard errors using 500 iterations and estimate 90% and 95% confidence intervals.

Endogeneity might still be a concern. While we study how EPU affects different quartiles of the distribution of macro-financial outcomes, different economic and financial conditions might imply more or less EPU. For example, recessions or financial crisis might raise the need for drastic or more debated policy measures, increasing EPU. Our methodology tries to account for endogeneity by including lagged outcomes as well as country and time fixed effects, thus relying on cross-country variation in EPU in Latin America.

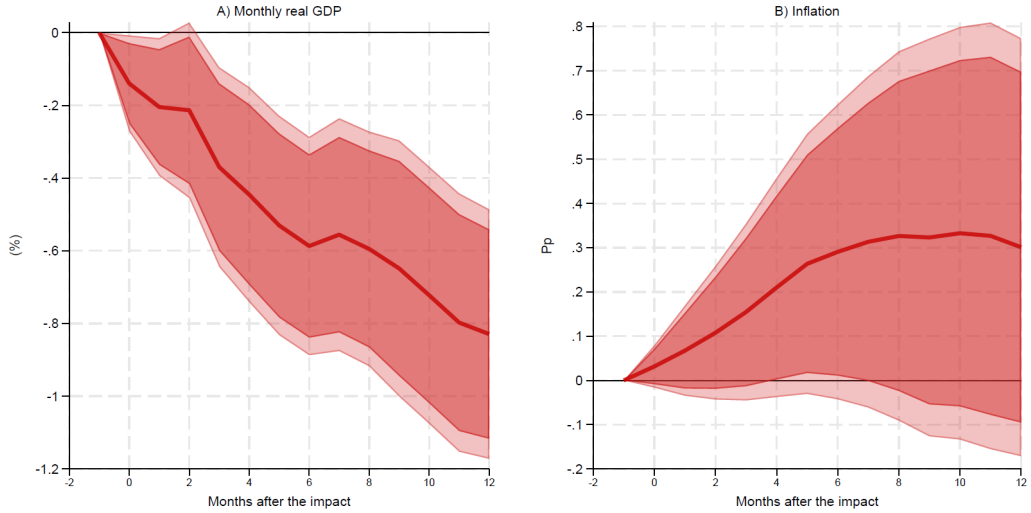
4. Empirical results

This section begins by reviewing the baseline results obtained from the estimation of equation (1), followed by an analysis of the results when orthogonal shocks are introduced (by using equation (3)). Finally, it examines whether EPU has non-linear effects on macroeconomic outcomes (as stated in equation (4)).

4.1 Impact of one-standard-deviation-change of domestic EPU

First, we present our baseline results, estimating the effects of a one standard deviation change in domestic EPU on monthly output and inflation without considering any control variables. Before analysing the transmission channels, we use equation (1) without the vector of domestic controls to report the direct impact of EPU on output and inflation. Graph 3, panel A illustrates the impulse-response functions (IRFs), showing that the cumulative effect on GDP could result in a decline of up to 0.8 per cent after one year. This indicates a consistent and lasting impact on output over a 12-month horizon following an increase in uncertainty (panel A). In contrast, while the effect on inflation is positive, approximately 0.3 percentage points, it is not statistically significant at the 95% confidence level (panel B). These preliminary results suggest that domestic EPU primarily affects output, with no clear or significant impact on inflation.

Graph 3. Impact of a one-standard-deviation increase in domestic EPU.

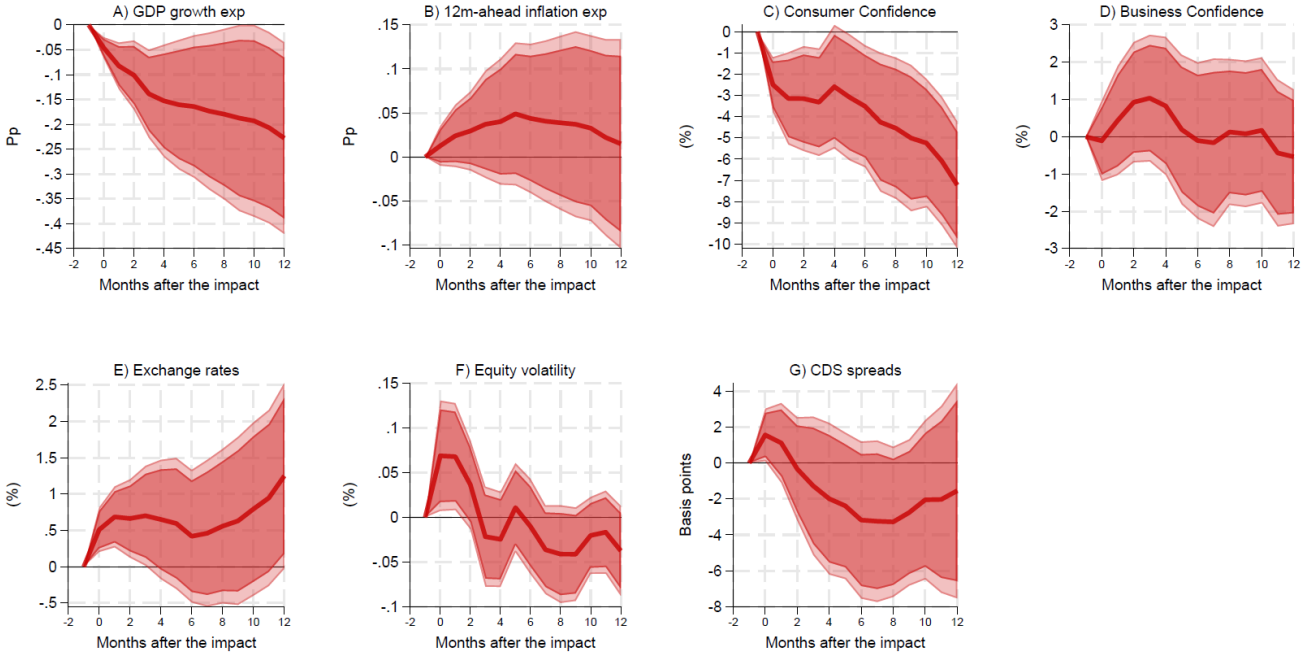


Note: Confidence intervals at 90% and 95%. Driscoll and Kraay standard errors account for interdependence across countries in the region. Country and time fixed effects are included.

When analysing the mechanisms (Graph 4), we observe that, through the real channel, uncertainty is associated with a decline in one-year-ahead GDP growth expectations, with a cumulative drop of nearly 0.25 percentage points over the next 12 months (Panel A). Regarding confidence, the key variable driving the negative response is an eight-per cent decline in consumer confidence which corresponds to a change of about 18 per cent of the standard deviation of the variable (Panel C). These results indicate that the uncertainty regarding the future economic and policy environment causes households to become more cautious. The decline in consumer confidence reflects growing concerns about job security, income stability, and overall

economic conditions. Consequently, households may postpone consumption and increase precautionary savings, weakening aggregate demand and exacerbating the slowdown in economic growth across the region.

Graph 4. Impact of a one-standard-deviation increase in domestic EPU through the transmission channels.



Note: Confidence intervals at 90% and 95%. Driscoll and Kraay standard errors, accounting for interdependence across countries in the region. Country and time fixed effects included.

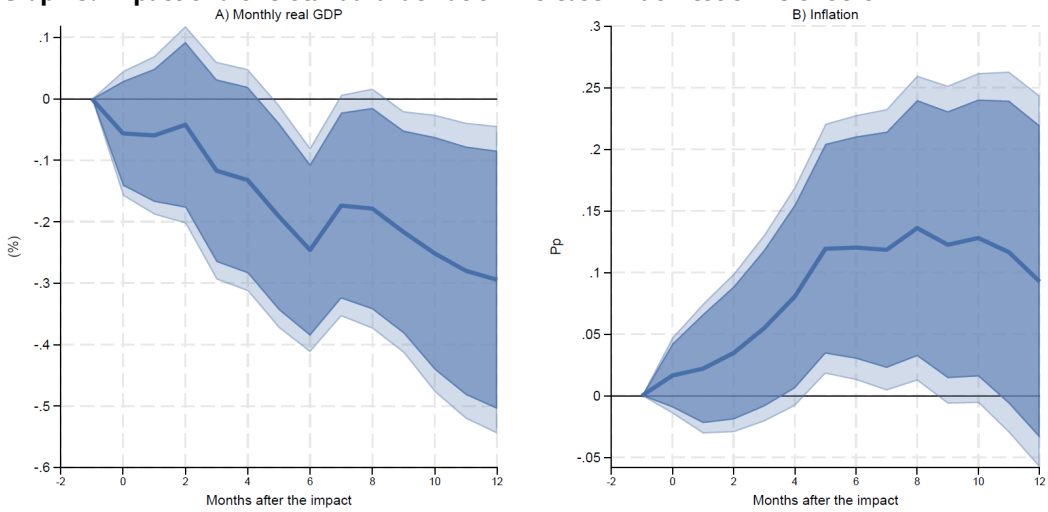
For the financial channel, we observe an exchange rate depreciation of approximately 0.7 per cent and a rise in equity volatility by 0.5 per cent in the same month when the domestic EPU index increases by one standard deviation (panel E and F). Both variables exhibit significant and sizeable increases in the short run, lasting up to two months, amounting to nearly a quarter of a standard deviation for the exchange rate and almost one standard deviation for equity volatility. Five-year CDS spreads, however, show an increase of only 2 basis points, representing an economically small effect (panel G). These responses within the financial channel suggest a short-lived reaction that subsides quickly following a rise in EPU levels. The economic intuition behind these results lies in the heightened risk and uncertainty perceived by investors following a domestic EPU shock. The depreciation of bilateral exchange rates reflects a shift in investor sentiment, as uncertainty drives capital outflows and a preference for safer assets such as the US dollar, thereby weakening domestic currencies. Simultaneously, the increase in sovereign risk premia indicates that investors demand higher compensation for holding assets in an environment of elevated uncertainty, reflecting greater perceived risks in financial markets. Together, these dynamics underscore how uncertainty can disrupt financial stability, increase the cost of financing (via CDS spreads, which measure the cost of long-term borrowing in USD, and exchange rate depreciation, which affects corporates with revenues in local currency), and strain external balances in Latin America.

At this stage, we find evidence supporting the presence of both proposed transmission channels, with differences in the horizon of the effects. As expected, financial variables react in the short run, while indicators of real variables show a continuous contraction over the medium term. However, we do not find any evidence of an impact on inflation expectations or business confidence. The general results remain consistent with country studies explored in Table A1. In the following subsection, we present results based on domestic EPU shocks, which enhance causal inference and clarify the direction of the effects.

4.2 Impact of one-standard-deviation-change of orthogonal domestic EPU shocks

Once we estimate the impact of domestic EPU shocks on monthly GDP and inflation following equation (3), we confirm a negative effect on output, though with a lower magnitude of approximately 0.3 per cent (Graph 5, panel A). Additionally, we now observe that increased EPU shocks can raise inflation by around 0.15 percentage points, with a 95% confidence level (panel B). These findings reinforce our initial results, demonstrating that EPU shocks can reduce output and increase inflation, resembling the dynamics of a perceived supply shock or stagflationary shock. With the following estimations on the transmission channels, we can now identify the primary mechanisms driving these effects.

Graph 5. Impact of a one-standard-deviation increase in domestic EPU shocks



Note: Confidence intervals at 90% and 95%. Driscoll and Kraay standard errors account for interdependence across countries in the region. Country and time fixed effects are included.

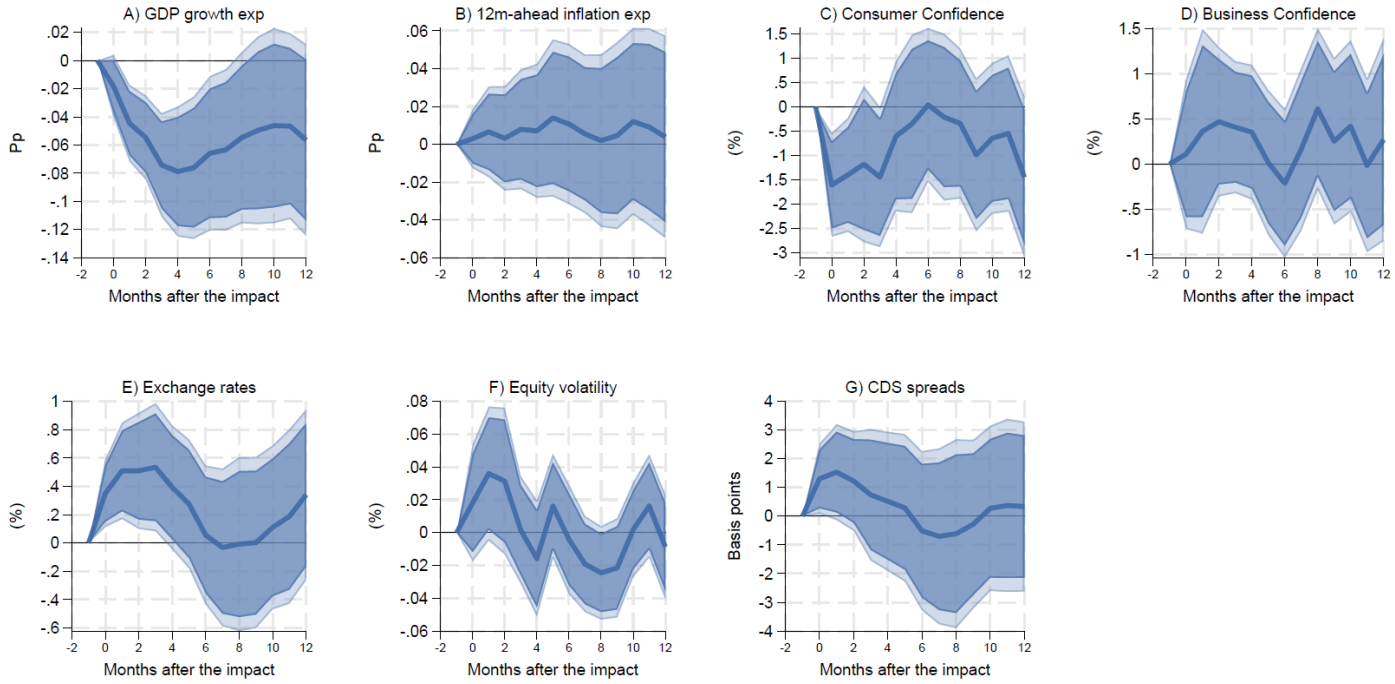
Graph 6 confirms the presence of the real and financial transmission channels. In terms of expectations, uncertainty shocks lead to a decline in one-year-ahead GDP growth expectations of approximately 1 percentage point (panel A). We do not find evidence of an average impact from uncertainty shocks on one-year-ahead inflation expectations yet. These effects indicate that private forecasters adjust their GDP growth expectations in response to domestic EPU shocks in at least within one-year-ahead horizon. On the proposed transmission through confidence, we observe in Graph 6, panel C, that a domestic EPU shock leads to a decline in consumer confidence in Latin America, though less persistent than the reaction based on the original EPU series. It may be an indication that consumer sentiment is not only

moved by domestic uncertainty but could be acerbated by globally uncertain environments.

In the financial channel, we find that two of the three proposed variables are affected by a domestic EPU shock: bilateral exchange rates and risk premia. Graph 6, panel E, provides clear evidence that an uncertainty shock leads to a depreciation of domestic currencies against the USD. Additionally, Graph 6, panel G, shows that the same shock increases risk premia, aligning with findings in the existing literature, at least when considering 90% confidence intervals. Both reactions are short-lived and similar in magnitude to previous findings using the original EPU series. These results align with IMF (2024), which highlights the risks of various types of uncertainty to financial stability for both AEs and EMEs.

Our findings confirm that the propagation of domestic EPU shocks in Latin America operates through the real and financial transmission channels by affecting expectations, confidence and risk premia. Uncertainty shocks lead to downward revisions in GDP growth expectations, worsened financial conditions in the form of exchange rate depreciation and increased risk premia, and a significant decline in consumer confidence. Together, these channels illustrate how domestic EPU shocks disrupt economic stability by dampening growth, increasing financing costs, and weakening aggregate demand, underscoring the critical role of uncertainty in shaping macroeconomic outcomes in the region.

Graph 6. Impact of a one-standard-deviation increase in domestic EPU shocks through the transmission channels.



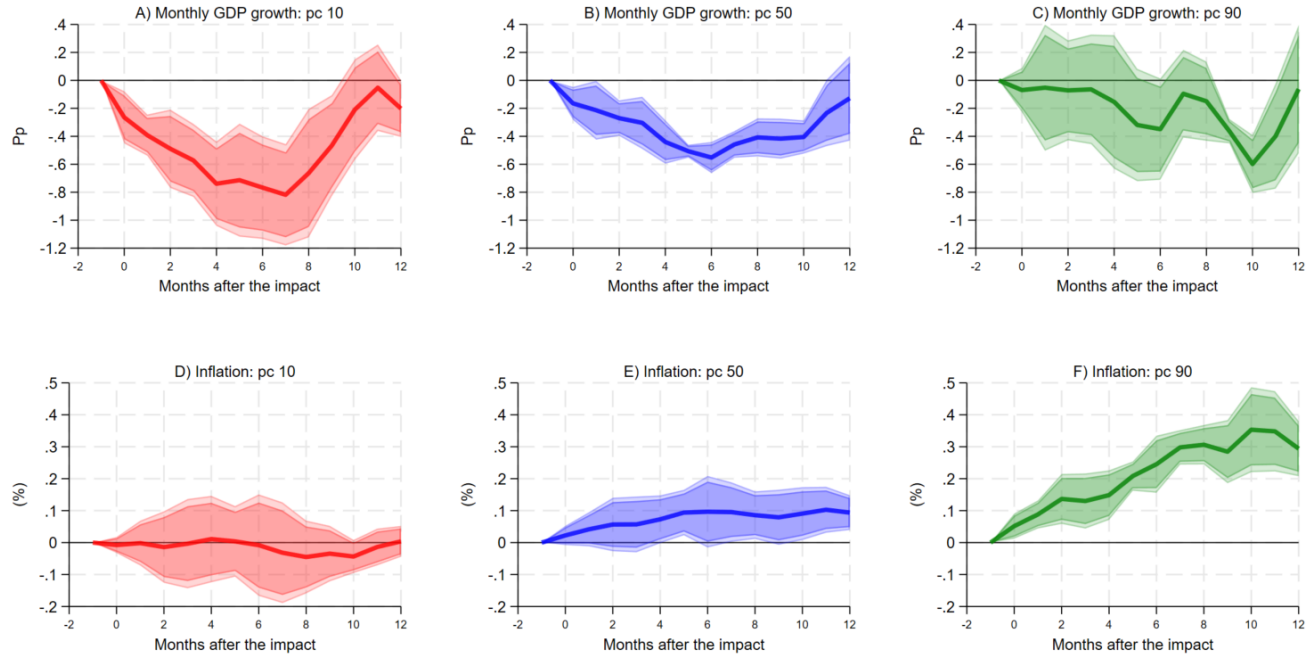
Note: Confidence intervals at 90% and 95%. Driscoll and Kraay standard errors, accounting for interdependence across countries in the region. Country and time fixed effects included.

4.3 Heterogeneous effects of EPU shocks beyond the mean

Finally, in this subsection, we study the heterogeneous effects of domestic EPU shocks on the economy using a quantile regression approach.[10] We find evidence that uncertainty has a more harmful impact on output growth at the lower end of its distribution (ie when the economy is relatively week and shows stronger signs of being in recession). We also find that high levels of inflation in economies with a greater probability of inflation becoming de-anchored are more affected by uncertainty shocks. This highlights the prevalence of heterogeneous effects of uncertainty shocks in EMEs. To the best of our knowledge, this is the first paper in predicting downside risks for the Latin American region.

We find that EPU shocks are most harmful to growth when the economy is weak (ie in the left tail of the distribution of GDP growth rates). In Graph 7, we show the impact of a one-standard-deviation change in EPU shocks on the 10th, 50th and 90th percentiles of GDP growth rates (upper panel) and inflation (lower panel) based on the estimation of equation (4). The lowest percentile of the growth distribution suggests recessionary periods in all four considered countries (Table 3). In this percentile, EPU shocks significantly reduce growth by 0.3% in the first month after the shock and up to 0.8% seven months after the shock (upper panel, in red). In contrast, the impact in the middle and upper percentiles is relatively lower (in blue and in red) compared with the impact on the lower percentile.

Graph 7. Impact of a one-standard-deviation increase in domestic EPU shocks on the 10th, 50th and 90th percentiles.



Note: Confidence intervals at 90% and 95% computed using bootstrapping with 500 iterations. Country fixed effects are included, along with a lag of the dependent variable.

[10] It is important to note that, for this approach, we estimate the impact on GDP growth along its distribution effects instead of the output level, as it provides more economic intuition in the analysis of risk tails (ie at the left-hand side of the distribution growth rate instead of the left-hand side of the distribution of output levels).

The effect of EPU shocks on output growth also shows different dynamics depending on the state of the economy. When growth is weak or moderate, ie in the 10th or 50th percentile of the distribution, EPU shocks have an immediate impact that intensifies over a period of about six months and recovers thereafter. In contrast, when GDP growth is in the upper percentile, the results indicate that EPU shocks do not have a significant impact in the short or medium term. Instead, uncertainty might depress growth nine or more months after the shock by up to 0.3% (upper panels, in green).

Regarding the impact on inflation, EPU shocks can potentially add inflationary pressures when inflation is already well above target. Focussing on the lower panel of Graph 7, we show that EPU shocks have no significant impact on inflation in its lower percentiles (in red) and only a limited impact of less than 10 basis points at its median percentiles (in blue), ie when inflation is within the target ranges or moderately above. However, EPU shocks can add substantial inflationary pressures when inflation is already high. Note that the 90th percentile of inflation in all four countries is well outside of their target ranges (Table 3). Upon impact, the shock can add 5 basis points to current inflation, which accumulates to around 25 basis points after six months and 30 basis points after a year. Using the quantile approach, we can uncover an important heterogeneous response of inflation to EPU shocks, which is hidden in the insignificance of the effect on the mean estimated in the previous analysis.

Descriptive statistics of percentiles of GDP growth (in %) and headline inflation (in pp) Table 3

	GDP growth (yoy, %)			Inflation (yoy, pp)		
	P10	P50	P90	P10	P50	P90
BR	-1.0	0.2	1.5	3.3	5.9	9.6
CL	-1.2	0.4	2.0	1.5	3.3	7.4
CO	-1.9	0.5	2.8	2.3	5.0	8.9
MX	-0.8	0.1	1.0	3.1	4.4	7.1

Source: Authors' calculations.

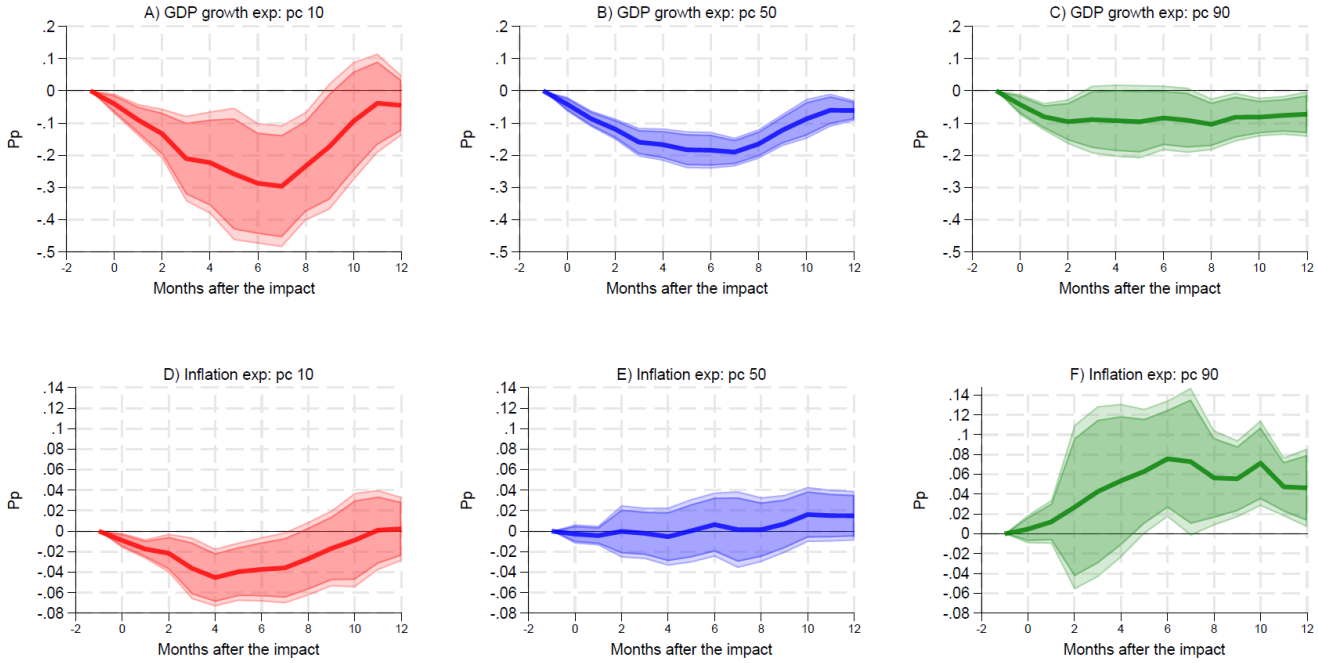
The heterogeneity in the transmission of EPU underlines the importance of both the real and financial channels. Regarding the real channel, we find patterns similar to the effect on growth when studying growth expectations (Graph 8, panels A, B and C), consumer confidence (Graph 9, panels A, B and C) and business confidence (Graph 9, panels D, E and F). The effect is strongest in the lower percentiles of their respective distributions and recovers over a one-year horizon. When the economy is strong (ie GDP expectations and confidence levels are high), growth expectations and consumer confidence are lowered but do not recover as much over a 12-month period. Moreover, business confidence shows a significant decline only nine months after the shock.

The heterogeneous response of inflation expectations explains why inflation did not show significant responses at the mean. The results in Graph 8, panels D, E and F show that the effect of EPU changes direction depending on the level of expectations

for one-year-ahead inflation. In response to a one-standard-deviation increase in domestic EPU shocks, expectations ease by up to 4 basis points if inflation expectations are in the 10th percentile of their distribution (in red), but they can rise by over 7 basis points if inflation expectations are in the 90th percentile (in green). The effect on the median (in blue), as well as the mean (Graph 6, previous section), is insignificant over the entire horizon. All told, domestic EPU shocks increase the volatility of inflation expectations after the shock, reflecting the uncertain decisions in the macroeconomy caused by EPU (ie it widens the distribution curve of inflation expectations).

The transmission through the financial channel is particularly strong when financial conditions are weak. The short-term effect, one month after the shock, of EPU on equity volatility and CDS spreads is twice as large in the 90th percentile (Graph 10, panels in green) as in the 50th percentile (panels in blue). Equity volatility increases on average by 16 basis points and CDS spreads by 10 basis points when financial conditions are already tight (panels F and I). The exchange rate depreciates by around 1.5% in the 90th percentile compared to 1% in the 50th percentile (panels B and C). The effect of EPU is economically smaller or insignificant when financial conditions are relatively loose (panels in red). In line with the previous findings, the results confirm that the financial channel operates mainly in the short term, up to six months after an EPU shock.

Graph 8. Impact of a one-standard-deviation increase in domestic EPU shocks on the 10th, 50th and 90th percentiles of GDP growth expectations and inflation expectations.

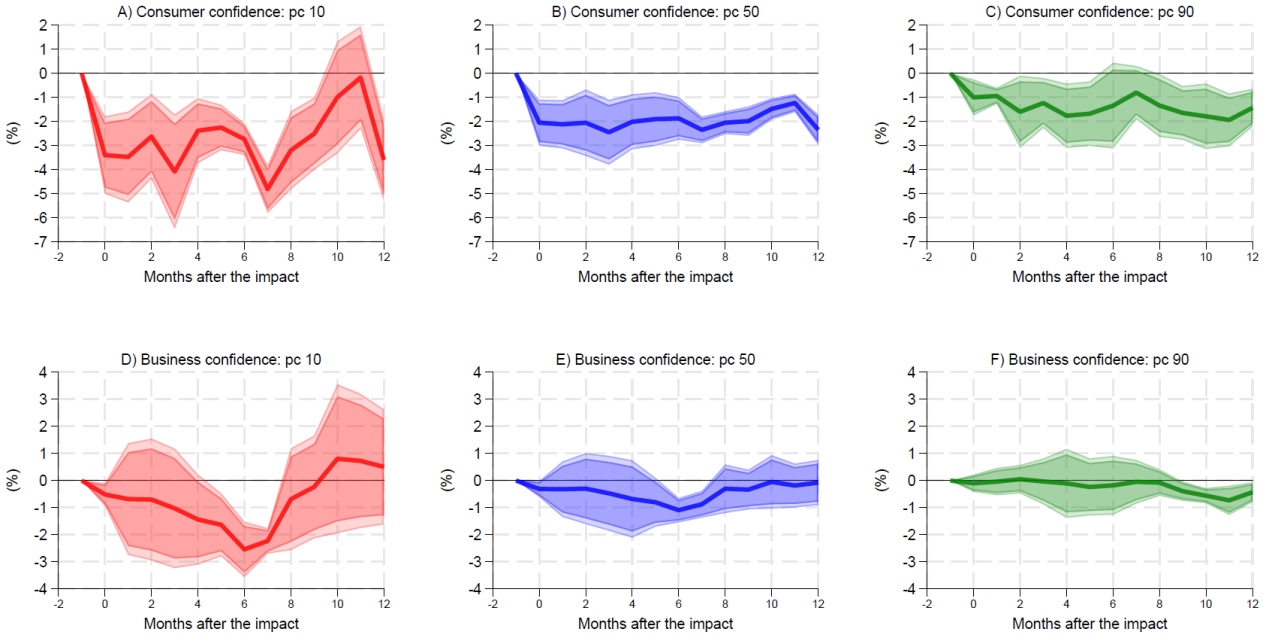


Note: Confidence intervals at 90% and 95% computed using bootstrapping with 500 iterations. Country fixed effects are included, along with a lag of the dependent variable and other channel variables.

Overall, in this work, we report the heterogeneous effects of domestic EPU in Latin America. The results from the quantile regression approach underline that EPU can be most harmful when the economy is already in a weak state and financial conditions are tight. Conversely, healthy economies can absorb EPU shocks without

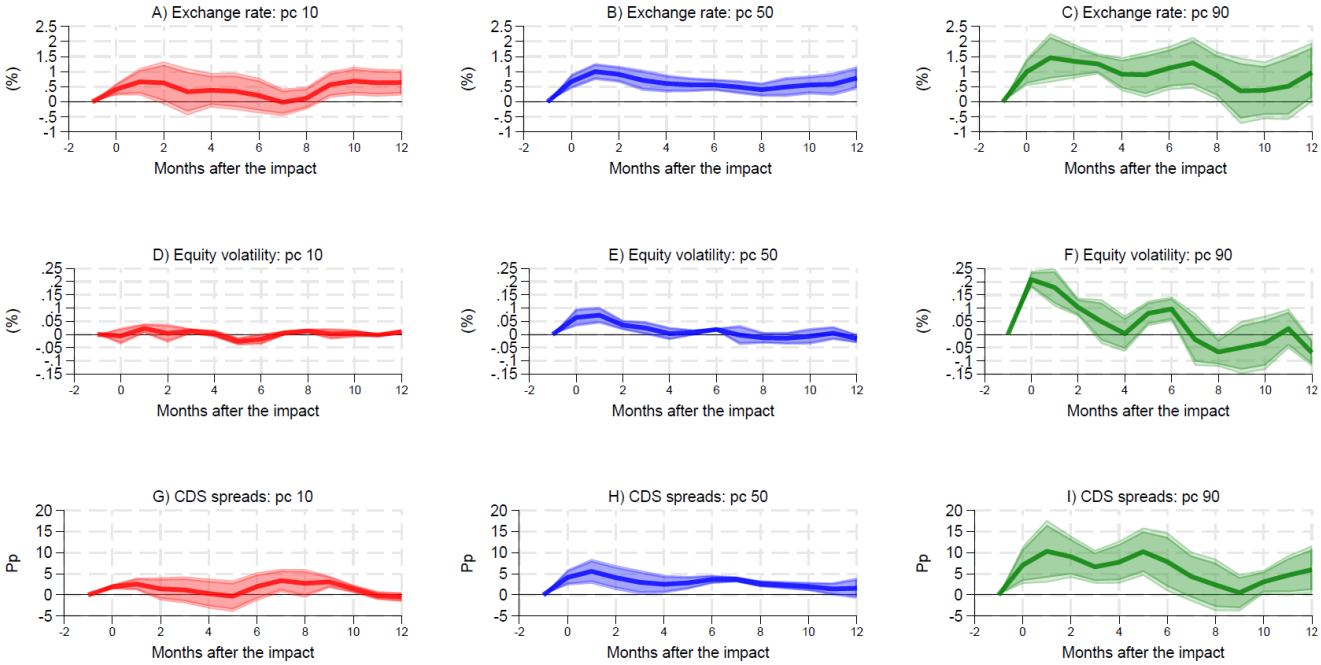
severe repercussions on macro-financial outcomes. These findings complement those of Jones and Enders (2016) who show that the effect of uncertainty is considerably stronger when the shock occurs before or during a crisis. They also align with the findings in Banerjee et al (2020) that tighter financial conditions can exert upward pressure on inflation volatility in emerging economies.

Graph 9. Impact of a one-standard-deviation increase in domestic EPU shocks on the 10th, 50th and 90th percentiles of variables capturing macro transmission channels.



Note: Confidence intervals at 90% and 95% computed using bootstrapping with 500 iterations. Country fixed effects are included, along with a lag of the dependent variable and other channel variables.

Graph 10. Impact of a one-standard-deviation increase in domestic EPU shocks on the 10th, 50th and 90th percentiles of variables capturing financial transmission channels.



Note: Confidence intervals at 90% and 95% computed using bootstrapping with 500 iterations. Country fixed effects are included, along with a lag of the dependent variable and other channel variables.

5. Conclusion and policy implications

This paper provides a comprehensive analysis of the impact of domestic EPU on the macro-financial variables in Latin America, offering new insights into its transmission channels and the heterogeneity of these effects. Using a panel dataset at a monthly frequency for Brazil, Chile, Colombia and Mexico, spanning from 2005 to early 2025, we find that domestic EPU shocks lead to significant macroeconomic disruptions, including a contraction in GDP growth and an increase in inflation. These effects operate through two key transmission channels that we empirically test: the real channel, which reflects adjustments in GDP growth and inflation expectations as well as a decline in consumer confidence; and the financial channel, evidenced by exchange rate depreciation and higher risk premia.

Importantly, our analysis highlights that the initial state of the economy and financial conditions define how domestic EPU shocks are absorbed (by using the quantile regression approach). In recessions or during periods of tight financial conditions, EPU shocks can be more harmful. Conversely, during economic upswings, Latin American economies are better able to absorb EPU shocks without severe repercussions.

Our findings show that EPU in EMEs, particularly in Latin America, exerts significant macroeconomic and financial pressures. These pressures lead to contractions in output, increased inflation and worsened financial conditions, all of which pose challenges to effective economic management.

Important policy implications follow from these results. For monetary policy, the results highlight the need for central banks to remain vigilant in the face of uncertainty shocks. Domestic EPU shocks not only depress output but also exert upward pressure on inflation, with short-term inflation expectations rising significantly. This dynamic resembles a cost-push or stagflationary shock, complicating the trade-offs faced by monetary policymakers. EPU shocks can push inflation expectations and inflation even higher when inflation is already above target. In light of the two-regime view of inflation (Borio et al (2023)), these results indicate that EPU shocks could raise the risk of transitioning into a high-inflation regime. Clear and consistent communication of monetary policy intentions can help anchor inflation expectations and mitigate the adverse effects of uncertainty on private sector behaviour (Tombini (2025) and BIS (2025)). Additionally, central banks should consider enhancing their analytical frameworks to incorporate uncertainty measures, enabling more precise assessments of its impact on inflation and growth dynamics.

For fiscal policy, the results highlight the importance of maintaining robust fiscal frameworks to mitigate the adverse effects of EPU shocks. Elevated uncertainty, particularly through the financial channel, is associated with increased risk premia and exchange rate depreciation, which can raise borrowing costs and strain public finances. Governments in Latin America would benefit from prioritising institutional reforms that enhance fiscal credibility, reduce policy unpredictability and strengthen investor confidence.

Overall, this study underscores the critical importance for policymakers in Latin America to account for domestic sources of uncertainty in their policy frameworks. By addressing both domestic vulnerabilities and external dependencies, policymakers can better safeguard macroeconomic stability and promote sustainable growth in the region.

Further research can be done on reporting the transmission channels and the heterogeneous effects of foreign EPU shocks, as well as the role of policies in mitigating them.

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Annex A: Summary of country studies

Selected literature of country cases — Table A1

	Author (s)	Main findings
Brazil	Ferreira et al (2018)	• By proposing a Brazilian Economic Uncertainty indicator, the authors estimate that an increase in this index is associated with an economic downturn in subsequent periods.
	Hillier and Loncan (2019)	• Domestic political uncertainty shocks cause a decrease in stock returns, with a stronger effect on firms that are highly connected to the public sector.
Chile	Cerda et al (2018)	• By proposing an economic uncertainty index for Chile, the authors find that an increase in this index is associated with declines in GDP, investment, and employment in both the short and long term.
Colombia	Gil-León and Silva Pinzón (2020)	• Using an EPU index based on the methodology of Baker et al. (2016), the authors find that an increase in this index negatively affects consumer and investor confidence.
Mexico	Alam and Istiak (2020)	• An increase in the US EPU leads to a decline in Mexican industrial production, price levels, and the policy rate. The authors also find that the effects of US EPU are stronger than those of domestic EPU.
	Cebreros et al (2020)	• The authors developed a trade policy uncertainty index and found that an increase in this index is associated with negative effects on FDI inflows.
	Hernández (2021)	• An increase of one standard deviation in uncertainty is associated with lower bond and equity portfolio flows.
	López and Bush (2019)	• Greater uncertainty leads to higher exchange rate volatility.
	López and Zamudio (2018)	• Uncertainty discourages FDI flows into the Mexican manufacturing sector. The authors also find that idiosyncratic uncertainty measures are more significant in explaining FDI flows than aggregate uncertainty measures.
	Salgado and Trujillo (2023)	• An increase in macroeconomic uncertainty has a negative and statistically significant effect on future GDP growth, particularly on the left tail of the distribution (under a Growth-at-Risk framework).

Source: Authors elaboration.

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