Box 3

## THE PASS-THROUGH OF FISCAL POLICY SURPRISES TO THE EXCHANGE RATE AND TO SOVEREIGN RISK IN BRAZIL AND COLOMBIA

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This box analyses the effects of fiscal surprises on key financial variables in Colombia and Brazil, two Latin American economies where public finances have performed less favourably.

These unexpected fiscal policy developments or shocks are identified using high-frequency data and statistical techniques for dataset simplification, estimating the principal components of changes in financial variables around major fiscal policy announcements, which may influence expectations regarding the sustainability of public finances. These announcements are sourced from the financial news service EmergingMarketWatch.[2] A fiscal surprise can be defined as the first principal component of changes in the sovereign risk premium (credit default swap or CDSs), in response to a significant event.[3]

Exchange rate and sovereign CDS responses to such fiscal shocks are estimated using a local projections model,[4] based on daily data from January 2010 to February 2026. In addition to the fiscal surprise, the model includes domestic monetary policy shocks[5] – which capture potential monetary policy surprises[6] – and global factors.[7]

### Following a negative fiscal shock, sovereign risk rises and the currency depreciates

What happens after a negative fiscal surprise? In Colombia, a negative fiscal shock triggers an immediate and sustained rise in five-year sovereign CDSs (Chart 1). Over the following two weeks, the Colombian peso depreciates by close to 0.7% (Chart 2), with no reversal in the subsequent ten business days, indicating the pass-through of fiscal risk to the exchange rate.

A similar, albeit less persistent, pattern is observed in Brazil. As the fiscal outlook worsens, sovereign CDSs increase, peaking at a level similar to that observed in Colombia, but begin to reverse three days after the shock. The Brazilian real also depreciates, peaking around day two, before correcting somewhat and settling at a cumulative depreciation of around 0.8% after ten days.

### Impact of fiscal policies on exchange rates and sovereign risk premia

In Brazil, the adoption of the new fiscal rule in May 2023 marked a major shift in the country's macroeconomic management framework, along with the approval, in late 2023, of the tax reform introducing a value added tax that will gradually replace other indirect taxes. As a result of these measures, the country's sovereign rating was upgraded for the first time since 2018. However, in 2024 markets began to question the attainability of the ambitious primary surplus targets. While the authorities were initially reluctant to revise them, these concerns triggered a market response that led the Government to announce spending cuts of nearly 2.5% of GDP in late 2024. In Colombia, fiscal balances have deteriorated in recent years, and its fiscal framework has undergone a series of changes. In 2024 compliance with the fiscal rule was partly achieved through one-off transactions, which were not endorsed by the Fiscal Council. In 2025 against a backdrop of pressures from lower-than-expected tax revenues and growing expenditure rigidity, the authorities activated the fiscal rule's escape clause and temporarily suspended its application until 2027. These changes in the implementation of the fiscal framework and successive revisions to targets have eroded the rule's credibility and

1 The findings are based on Paula Garda and Michael Koelle. (2026). "Policy Shocks and Exchange Rate Dynamics in Colombia". OECD. Mimeo.

2 Excluding any news items related solely to the release of fiscal data or to fiscal policy statements or reforms not yet discussed or approved.

3 Specifically, the first principal component of the change in sovereign CDSs at three-, five- and ten-year maturities measured between the business day preceding a major fiscal policy announcement and the following business day.

4 Òscar Jordà. (2005). "Estimation and Inference of Impulse Responses by Local Projections". *American Economic Review,* 95(1), pp. 161-182.

5 Monetary policy shocks are identified using the Emi Nakamura and Jón Steinsson approach. (2018). "High-Frequency Identification of Monetary Non-Neutrality: The Information Effect". *The Quarterly Journal of Economics,* 133(3), pp. 1283-1330, and the methodology of Chunya Bu, John Rogers and Wenbin Wu. (2021). "A unified measure of Fed monetary policy shocks". *Journal of Monetary Economics,* 118, pp. 331-349, which corrects for the "information effect" (Michael D. Bauer and Eric T. Swanson. (2023). "An Alternative Explanation for the 'Fed Information Effect'". *American Economic Review,* 113(3), pp. 664-700).

6 These surprises are identified on the basis of unexpected changes in sovereign yields around monetary policy decisions announced by central banks, which reflect revisions to expectations about the future path of interest rates.

7 Global factors include the dollar exchange rate against a basket of currencies (DXY), US stock market volatility (VIX) and soybean (Brazil) or West Texas Intermediate oil (Colombia) prices. Calendar fixed effects are also included.

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heightened uncertainty about the medium-term fiscal consolidation path.

Given the findings in this box, which indicate that negative fiscal policy announcements exert significant depreciation pressures and increase sovereign CDSs, counterfactual scenarios were developed to gauge the contribution of fiscal surprises to changes in sovereign risk and the exchange rate. To this end, 2025 was chosen for Colombia and 2024 for Brazil, because, as discussed above, this is when negative fiscal surprises were most prevalent in those countries. Chart 3 shows, over a ten-day window, the changes observed in the sovereign CDSs for Colombia and Brazil (black line), alongside the effects of negative fiscal shocks on the CDSs in the selected years (green line). According to these estimates, overall, the negative fiscal

Chart 1
Impulse response function of five-year sovereign CDSs to negative fiscal shocks (a)

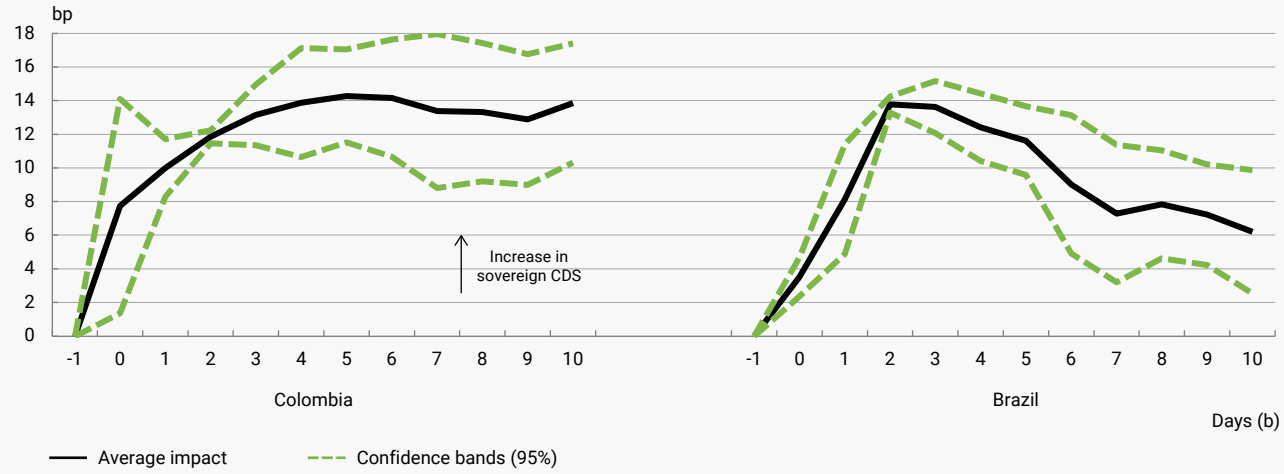
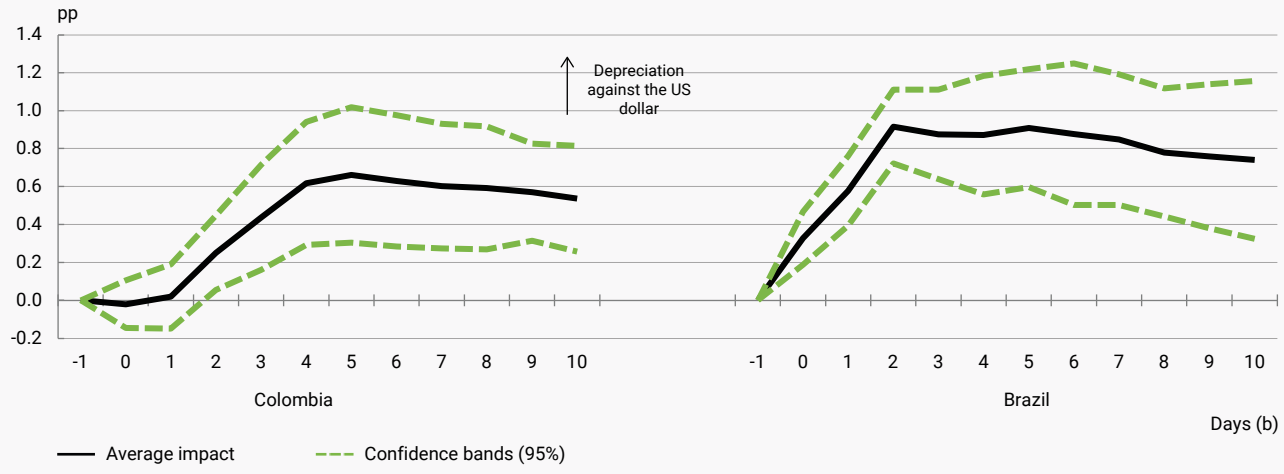



Chart 2
Impulse response function of exchange rate against the US dollar to negative fiscal shocks (a)




**SOURCE:** Paula Garda and Michael Koelle. (2026). "Policy Shocks and Exchange Rate Dynamics in Colombia". OECD. Mimeo.

**a** The model-based line shows the implied cumulative movements in five-year sovereign CDSs and the exchange rate against the dollar following a negative fiscal shock, calculated on the basis of the impulse-response functions estimated in Charts 1 and 2. The contribution is obtained by applying the estimated coefficients to the average negative fiscal shocks observed in 2025 (Colombia) and 2024 (Brazil) and including the sum of their dynamic effects. The observed line relates to the average exchange rate and five-year sovereign CDS movement following a fiscal shock.
**b** Number of days since the fiscal shock (0 on the horizontal axis).

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shocks increased the CDSs by 92 basis points (bp) in Colombia in 2025 and 69 bp in Brazil in 2024.[8]

As regards the exchange rate, Chart 4 shows the average movements and those resulting from negative fiscal

Chart 3
Implied pressure on five-year sovereign CDSs of negative fiscal shocks (a)

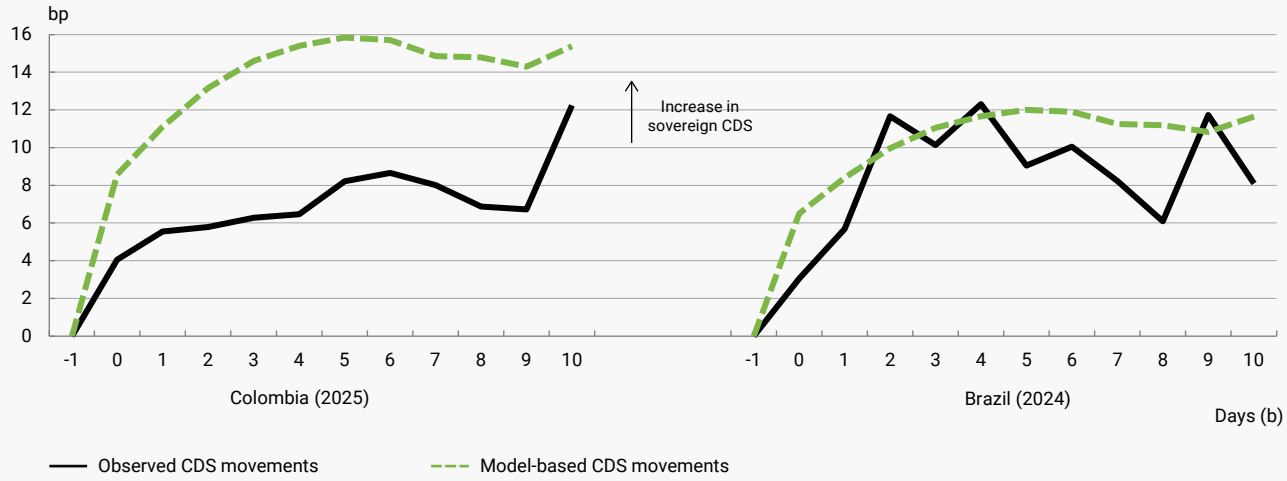
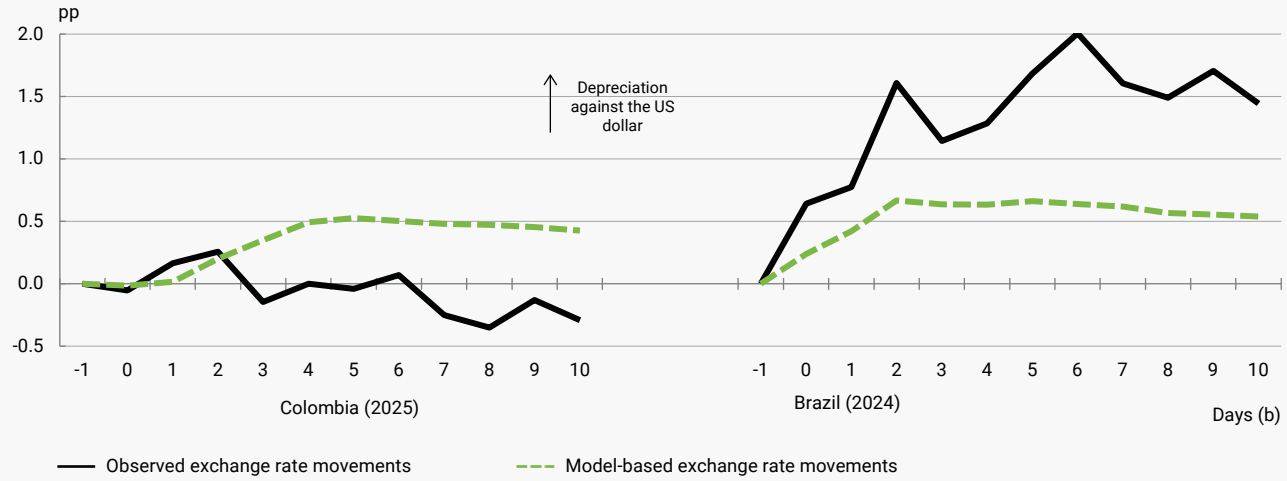



Chart 4
Implied depreciation pressure of negative fiscal shocks (a)




**SOURCE:** Paula Garda and Michael Koelle. (2026). "Policy Shocks and Exchange Rate Dynamics in Colombia". OECD. Mimeo.

**a** The model-based line shows the implied cumulative movements in five-year sovereign CDSs and the exchange rate against the dollar following a negative fiscal shock, calculated on the basis of the impulse-response functions estimated in Charts 1 and 2. The contribution is obtained by applying the estimated coefficients to the average negative fiscal shocks observed in 2025 (Colombia) and 2024 (Brazil) and including the sum of their dynamic effects. The observed line relates to the average exchange rate and five-year sovereign CDS movement following a fiscal shock.
**b** Number of days since the fiscal shock (0 on the horizontal axis).

8 When positive fiscal shocks, i.e. those that strengthen fiscal credibility, are also taken into account, these effects are reduced to 49 bp and 53 bp for Colombia and Brazil, respectively.

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shocks for both countries in the selected years. In this case, negative fiscal shocks are estimated to have depreciated the Colombian peso by 4.3 percentage points (pp) over 2025; when positive fiscal shocks are considered, the net effect amounts to a depreciation of 2.6 pp. In short, in the absence of fiscal pressures, the Colombian peso would have appreciated by almost 3% more than it did in 2025, in line with the patterns observed in other Latin American economies that benefited from the favourable external environment.

Brazil displayed a somewhat different pattern in 2024, as the Brazilian real followed a depreciating trend throughout the year. Model estimates indicate that negative fiscal shocks exerted sustained depreciation pressures on the Brazilian real, accounting for roughly one-third of the total depreciation over the ten business days following a fiscal shock (Chart 4). Cumulatively, negative fiscal shocks are estimated to have contributed 3.8 pp to the depreciation of the Brazilian real in 2024, or 1.8 pp when both positive and negative shocks are included.

### Conclusions

The findings presented in this box show that negative fiscal surprises quickly translate into higher sovereign risk, as measured by CDSs, and exert depreciation pressures on the exchange rate. They also underline the importance of a sustained and credible fiscal consolidation strategy, and the need to clearly communicate any deviation from the announced path, comply with existing fiscal frameworks and strengthen institutions. These measures are essential for anchoring expectations, limiting sovereign risk premia, ensuring a more stable and sustainable growth path and easing monetary policy pressures stemming from financial stability risks.