

THE MACRO-FINANCIAL IMPACT
OF ECONOMIC POLICY UNCERTAINTY
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THE MACRO-FINANCIAL IMPACT OF ECONOMIC POLICY UNCERTAINTY IN LATIN AMERICA ^(*)

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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 panel data for Brazil, Chile, Colombia, Mexico and Peru 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 aggravate episodes of weak economic conditions and tighter financial conditions, while stronger economies are better able to absorb such shocks.

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

JEL classification: C33, D80, E23, E31.

Resumen

En este documento se analiza cómo la incertidumbre de la política económica doméstica (EPU, por sus siglas en inglés) afecta a las variables macroeconómicas y financieras en las economías emergentes, con un enfoque en América Latina. A partir de un panel para Brasil, Chile, Colombia, México y Perú entre 2005 y comienzos de 2025, mostramos que los choques de la EPU generan perturbaciones macroeconómicas relevantes, como la reducción de la actividad económica y el aumento de la inflación, efectos similares a los de un *shock* de la oferta. A corto plazo, estos efectos se transmiten a través de un canal financiero —mayores primas de riesgo, mayor volatilidad bursátil y depreciaciones cambiarias—, mientras que en el medio plazo operan mediante un canal real, reflejado en la caída de las expectativas de crecimiento y de la confianza de los hogares y las empresas. Asimismo, encontramos que los choques de la EPU intensifican los episodios de debilidad económica y las condiciones financieras restrictivas, mientras que las economías más sólidas muestran una mayor capacidad de amortiguar este tipo de choques.

Palabras clave: macroeconomía, incertidumbre, incertidumbre de la política económica, América Latina.

Códigos JEL: C33, D80, E23, E31.

1 Introduction

Emerging market economies (EMEs) generally exhibit higher levels of domestic uncertainty than advanced economies (AEs), and heightened uncertainty can jeopardise macro-financial stability (Bloom, 2009, 2014; Al-Thaqeb and Algharabali, 2019; Choi and Shim, 2019). More recently, geopolitical risks and trade tensions have increasingly contributed to uncertainty (International Monetary Fund, 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; Andres-Escayola, Molina, Pérez, and Vidal, 2025). 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). 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 (CN), Latin America's two biggest trading partners.¹ We assess the average impact of domestic EPU shocks in five 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 shifts of tail events (ie in the 10th, 50th and 90th percentiles of the macroeconomic variables).² We find that uncertainty aggravates downturns by lowering the 10th percentile of the GDP growth distribution and that it worsens inflationary pressures by increasing the 90th percentile of the inflation and inflation ex-

¹As 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.

²As pointed out by Adrian, Boyarchenko, and Giannone (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 distributions more than lower percentiles of the distribution curve. The latter could spur the risk of inflation expectations becoming de-anchored as the 90th percentile consists of inflation rates above the desired target ranges.

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, Eusepi, Tambalotti, and Topa, 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 expectations and creates more volatile inflation expectations. The latter results from an asymmetric impact on the distribution of inflation expectations which is not discernible in the average effect: Domestic EPU lowers the 10th percentile and increases the 90th percentile. 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 negative effects on business confidence as well although less pronounced.

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, Brown, and Tang, 2017; Amaral, Guerra, Shim, and Tombini, 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. Again, measuring the heterogeneity of the effect matters. While the average effect

on equity volatility and risk premia is significant but small, the effects on the 90th percentiles are economically sizeable. 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, Sarisoy, Londono, Sun, Datta, Ferreira, Grishchenko, Jahan-Parvar, Loria, Ma, Rodriguez, Zer, and Rogers, 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, Bloom, and Davis, 2016; Ahir, Bloom, and Furceri, 2022).³ 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 (Caldara and Iacoviello, 2022; Miescu, 2023). 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). Additionally, EMEs experience negative spillovers from global or US-related uncertainty shocks which can be amplified through weak institutional quality (Bonciani and Ricci, 2020) or high trade openness and weak financial systems (Gupta, Olasehinde-Williams, and Wohar, 2020). Specifically, for Latin America, recent studies highlight how global uncertainty shocks influence macroeconomic performance (Ojeda-Joya and Romero-Chamorro, 2023; Attílio, 2024; Coronado, Martinez, and Venegas-Martinez, 2020; Llosa, Pérez Forero, and Tuesta, 2025; International Monetary Fund, 2025); however, there is limited cross-country evidence in the region from studies estimating the effects of domestic EPU shocks, except Andres-Escayola et al. (2025).⁴

The contribution of this paper is threefold. First, we provide robust evidence of an adverse effect of domestic EPU shocks in Latin America, proposing a methodology to account for the potentially confounding influence of global uncertainty. Second, while

³Baker 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 points rise in the unemployment rate across twelve 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, International Monetary Fund (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.

⁴Table A1 provides a detailed overview of the available papers on individual countries in the region.

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 heterogeneous and aggravates tail events related to growth and financial conditions. To the best of our knowledge, there is no evidence so far on the heterogeneous 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.

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 five key Latin American countries: Brazil, Chile, Colombia, Mexico and Peru. The dataset spans the period from January 2005 to January 2025, during which all five countries operated under inflation-targeting regimes.

2.1 Measure of economic policy uncertainty

We use the EPU series developed by Andres-Escayola et al. (2025) for Latin American countries, which relies on text analysis of local newspapers.⁵ Their methodology identifies and counts keywords associated 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

⁵We use the country series developed by Andres-Escayola et al. (2025) (available on their website), whose methodology builds on Baker et al. (2016), Ghirelli, Pérez, and Urtasun (2021) and Andres-Escayola, Ghirelli, Molina, Pérez, and Vidal (2024).

these countries, EPU levels have also risen notably in the post-pandemic period, driven by ongoing political scandals, reforms and shifts in government.

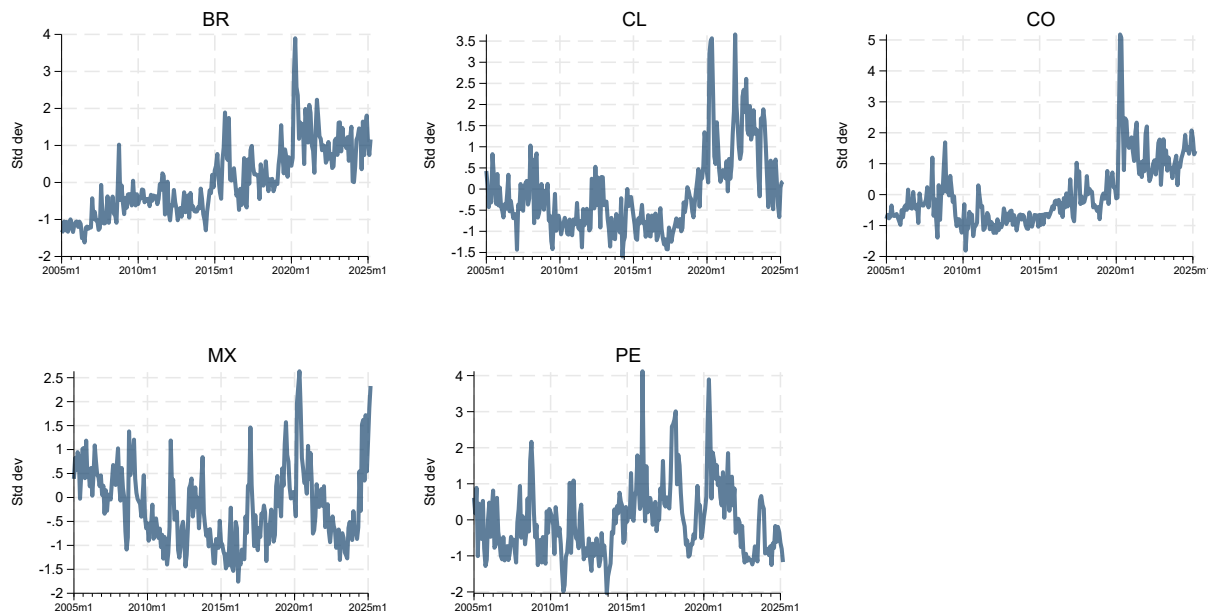


Figure 1: Economic policy uncertainty in Latin America.

Each graph shows the original EPU series as provided by Andres-Escayola et al. (2025) from January 2005 to January 2025 with monthly frequency. In the upper panel from left to right, we show EPU of Brazil (BR), Chile (CL), and Colombia (CO). In the lower panel, we show EPU of Mexico (MX) on the left and Peru (PE) on the right.

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.⁶ To study uncertainty-driven changes in 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.

Table 1 provides a detailed overview of the data applied in the analysis. Overall, we have 1,205 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.

⁶Since 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, Fritsche, and Slacalek (2012); Siklos (2013); Aguilar, Guerra, and Martinez (2024)). This is computed based on the following equation:

$$\pi_{t+12|t}^e = \frac{12-h+1}{12} \pi_{t+h|t}^e + \frac{h-1}{12} \pi_{t+12+h|t}^e \quad (1)$$

where $(12-h+1)/12$ and $(h-1)/12$ are the respective weights for current and next year forecasts. We follow this approach for both GDP growth and inflation expectations.

Table 1: Summary Statistics

Economic policy uncertainty is sourced from Andres-Escayola et al. (2025). Monthly GDP, headline inflation, consumer confidence, business confidence, and exchange rate depreciation are taken from national data sources. One-year-ahead GDP growth and one-year-ahead inflation expectations are based on Consensus Forecasts and authors' calculations. Five-year CDS spreads and domestic equity volatility are from Bloomberg. Domestic equity volatility is measured as the monthly average of a 30-day daily moving standard deviation.

Variable	Obs.	Mean	SD	Min	Max
Economic policy uncertainty (std)	1,205	0.0	1.0	-1.8	4.3
Monthly GDP (Index, Jan 2005 = 100)	1,205	141.1	30.2	98.7	225.4
Headline inflation (pp)	1,205	4.5	2.4	-2.3	14.1
<i>Real channel</i>					
One-year-ahead GDP growth (pp)	1,205	2.8	1.7	-4.1	6.0
One-year-ahead inflation expectations (pp)	1,205	4.1	1.0	1.5	7.8
Consumer confidence index	956	44.3	13.8	8.1	88.8
Business confidence index	1,205	52.8	6.8	14.2	76.6
<i>Financial channel</i>					
Exchange rate depreciation (%)	1,205	0.3	3.0	-8.6	22.3
Five-year CDS spreads (bp)	1,205	134.7	75.1	12.8	480.1
Domestic equity volatility (std)	1,205	1.1	0.7	0.2	7.7

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

We first propose a standard framework as follows:

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

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 $\mathbf{X}$ includes all the independent control variables within the real and financial channels that are not tested on the left-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 $h = 1, 2, \dots, 12$.

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, Hsu, and Tamoni (2024) for further discussion on this strategy). The regression equation is as follows:

$$EPU_{i,t} = \alpha_i + \sum_{j=0}^{12} \lambda_j US \ EPU_{t-j} + \sum_{j=0}^{12} \mu_j CN \ EPU_{t-j} + \sum_{j=1}^{12} \nu_j EPU_{i,t-j} + \varepsilon_{i,t}. \quad (3)$$

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.

Table 2: Matrix of pairwise correlations between the orthogonal domestic EPU shocks with other EPU variables.

	Domestic EPU shock	Domestic EPU	US EPU	China EPU	Global EPU
Domestic EPU shock	1.00				
Domestic EPU	0.51	1.00			
US EPU	0.00	0.51	1.00		
China EPU	0.00	0.53	0.64	1.00	
Global EPU	0.03	0.59	0.77	0.95	1.00

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.

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

$$Y_{i,t+h} = \alpha_i + \theta_t + \sum_{j=2}^{12} \gamma_j^h y_{i,t-j} + \beta^h EPU\ shock_{i,t} + \varepsilon_{i,t+h}, \quad (4)$$

In contrast to equation 4, here we regress our dependent variable on the current level of the orthogonal EPU shock, including only the twelve 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.

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

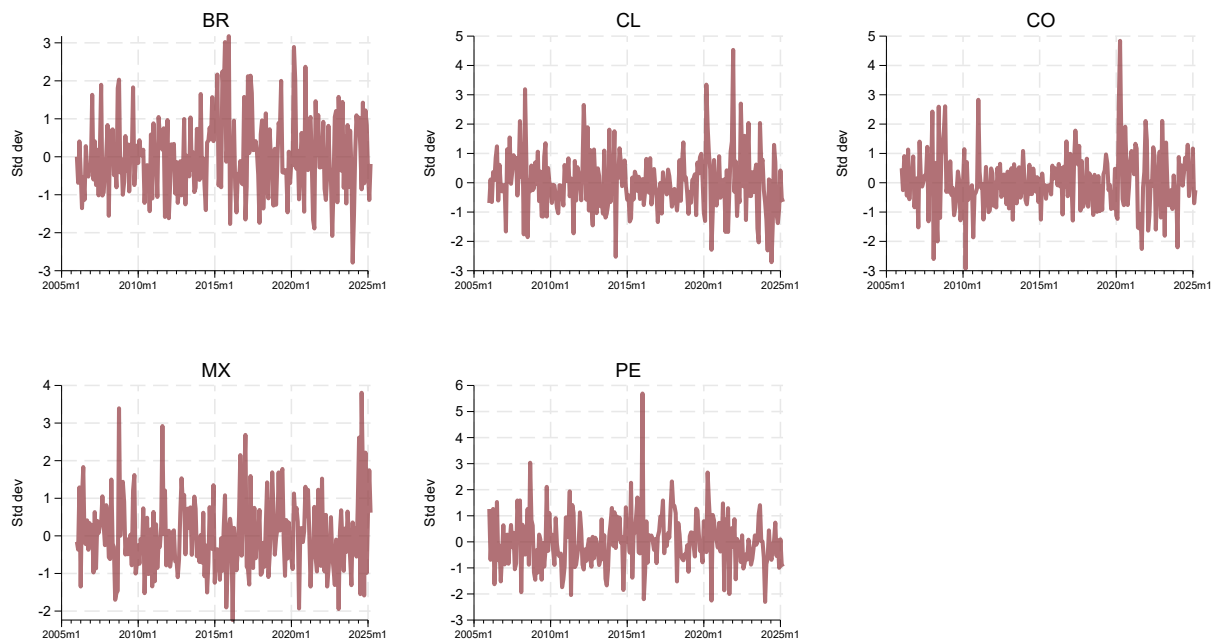


Figure 2: Domestic EPU shocks in Latin America.

Each graph shows the residual from estimating equation 3 from January 2005 to January 2025 with monthly frequency. In the upper panel from left to right, we show EPU shock of Brazil (BR), Chile (CL), and Colombia (CO). In the lower panel, we show EPU shock of Mexico (MX) on the left and Peru (PE) on the right.

the “inflation-at-risk” approach studied by Banerjee, Contreras, Mehrotra, and Zampolli (2020). To do this, we estimate the following equation:

$$Q(Y_{i,t+h}, \tau) = \alpha_i(\tau) + \theta_t(\tau) + \sum_{j=2}^{12} \gamma_j^h(\tau) y_{i,t-j} + \beta^h(\tau) EPU \text{ shock}_{i,t} + \varepsilon_{i,t+h}(\tau), \quad (5)$$

Here, τ represents the quantiles, while we regress the dependent variable on current levels of the orthogonal EPU shock as in equation 4 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 2, followed by an analysis of the results when orthogonal shocks are introduced (by using equation 4). Finally, it examines whether EPU has non-linear effects on macroeconomic outcomes (as stated in equation 5).

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 2 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 0.4% after eight months of the shock. This indicates a consistent and lasting impact on output over a 12-month horizon following an increase in uncertainty (panel A). In addition, we observe an increase in inflation of approximately 0.3 percentage points, statistically significant at the 95% confidence level (panel B). These preliminary results suggest that domestic EPU negatively affects output while positively affecting inflation.

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 0.22 percentage points over the next 12 months (panel A) and with a cumulative increase on inflation expectations of 0.11 percentage points (panel B). Regarding confidence, the key variable driving the negative response is a six-per cent decline in consumer confidence which corresponds to a large change of about 43 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

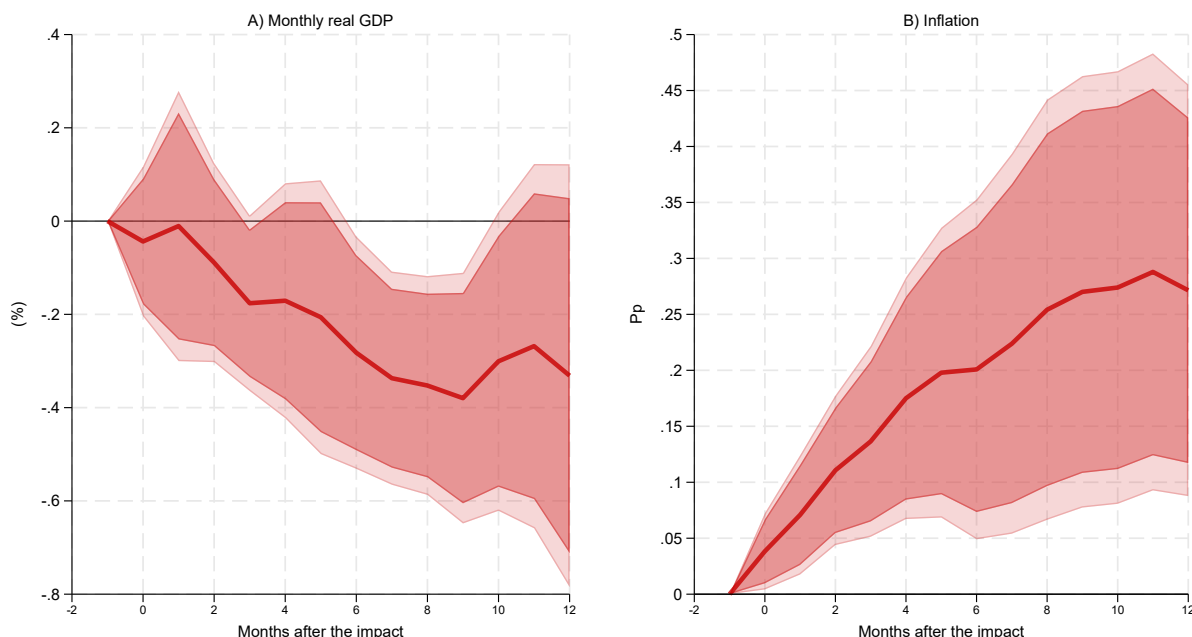


Figure 3: Impact of a one-standard-deviation increase in domestic EPU.

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.

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. Finally, there is weak evidence of business confidence being affected by domestic EPU at this stage of the analysis (panel D). We measure a negative effect amounting to approximately 15 per cent of the standard deviation of business confidence but which is significantly different from zero only after two or five months at the 90th percent confidence interval.

For the financial channel, we observe an exchange rate depreciation of approximately 1 per cent (panel E), a rise in equity volatility by 0.05 per cent (panel F) and an increase of 4 basis points in five-year CDS spreads (panel G) in the same month when the domestic EPU index increases by one standard deviation. The exchange rate depreciation worsens over time, reaching a cumulative impact of 3 per cent after 12 months. This is an economically large effect corresponding to a change of one standard deviation in the variable. Both, equity volatility and risk premia, exhibit significant increases only in the short run, lasting up to two months, representing an economically small effect amounting to less than 10 per cent of a standard deviation in the variables. These responses within

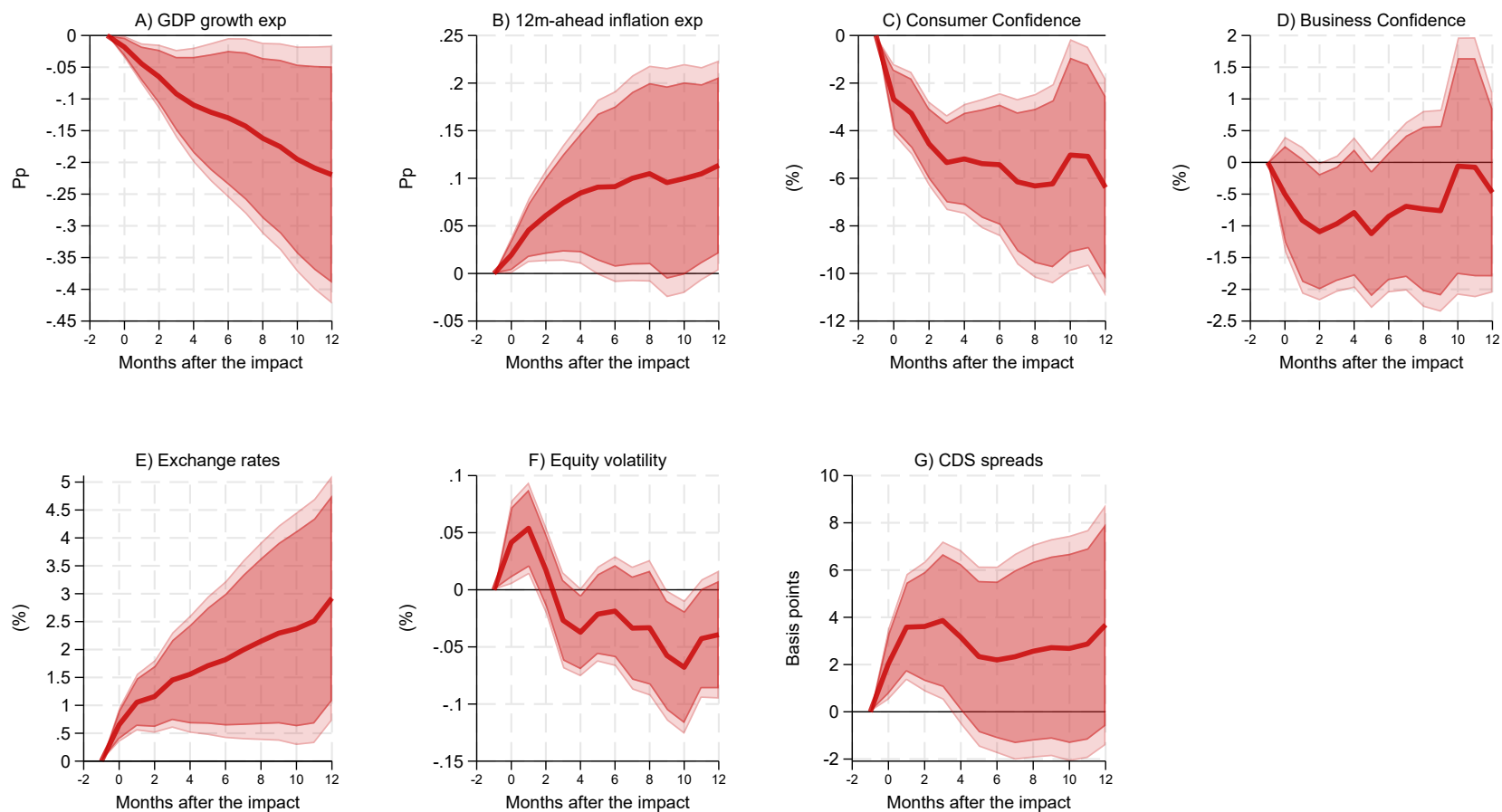


Figure 4: Impact of a one-standard-deviation increase in domestic EPU through the transmission channels. Confidence intervals at 90% and 95%. Driscoll and Kraay standard errors account for interdependence across countries in the region. Country and time fixed effects are included.

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 reliable evidence of an impact on inflation expectations or business confidence. The general results remain consistent with country studies explored in Table A1 and the cross-country evidence in Andres-Escayola et al. (2025). 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 4, 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 0.13 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 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 0.05 percentage point (panel A). We find an average positive

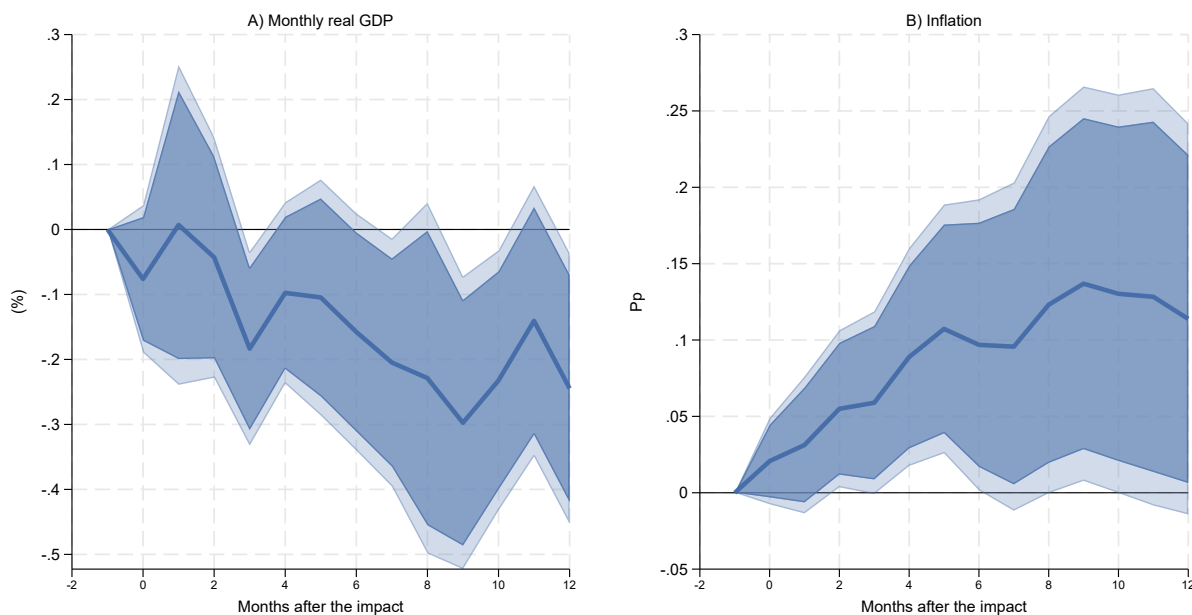


Figure 5: Impact of a one-standard-deviation increase in domestic EPU shocks.

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.

impact from uncertainty shocks on one-year-ahead inflation expectations in the second month after the shock. However, both results are sensitive to the confidence level. 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 smaller 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 exacerbated by globally uncertain environments.

In the financial channel, we find that the three proposed variables are affected by a domestic EPU shock. 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 F, shows that equity volatility is also affected by domestic EPU shocks. Furthermore, Graph 6, panel G, indicates that the same shock increases risk premia, aligning with findings in the existing literature. Both reactions are short-lived and similar in magnitude to previous findings using the original EPU series. These results align with International

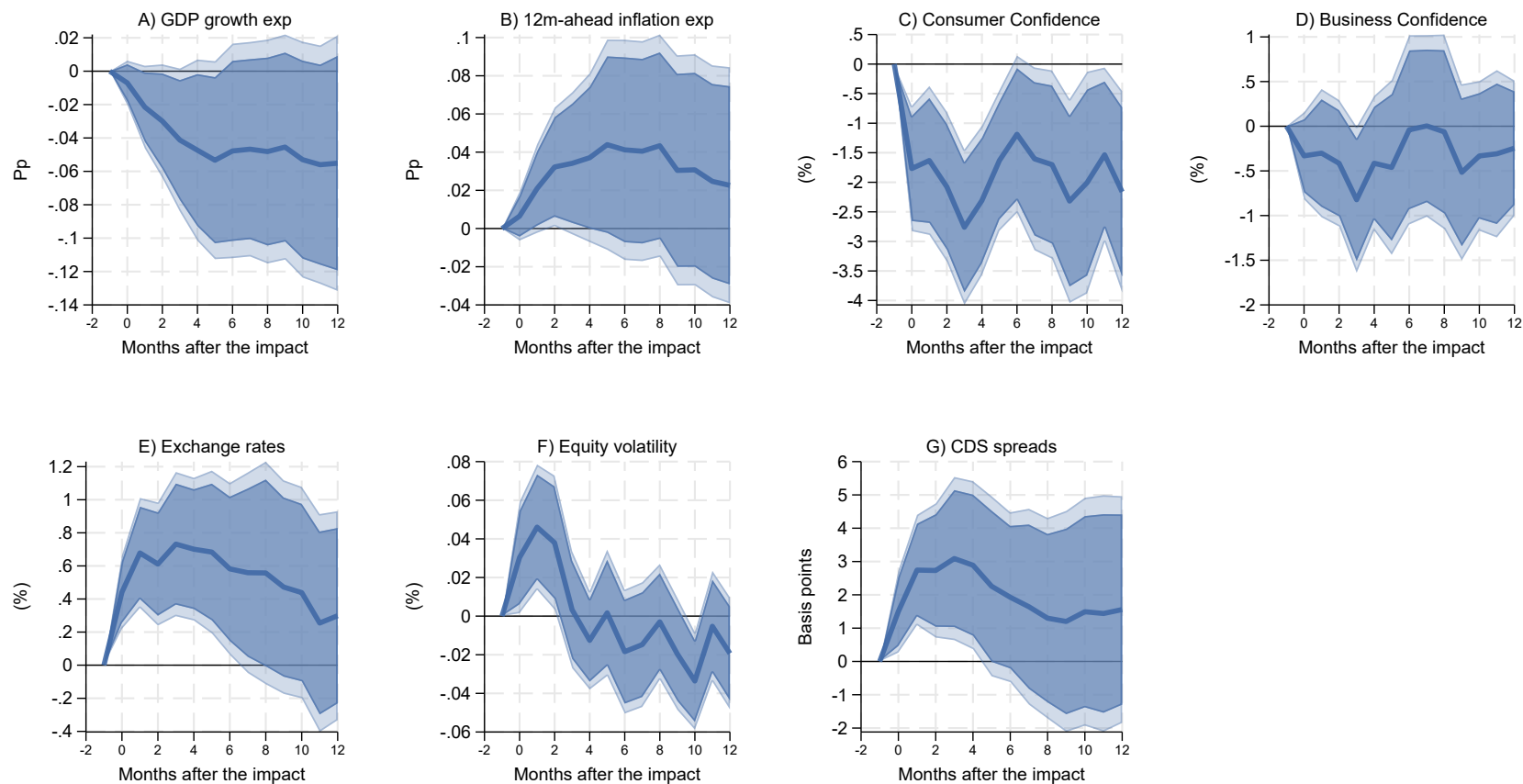


Figure 6: Impact of a one-standard-deviation increase in domestic EPU shocks through the transmission channels. Confidence intervals at 90% and 95%. Driscoll and Kraay standard errors account for interdependence across countries in the region. Country and time fixed effects are included.

Monetary Fund (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, consumer confidence, exchange rates, equity volatility and risk premia. 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.

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. 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 weak and shows stronger signs of being in recession). We also find that uncertainty shocks disproportionately affect the right tail of the distribution of inflation, thereby aggravating situations in which the inflation expectations of the country are more likely to become de-anchored. This highlights the prevalence of heterogeneous effects of uncertainty shocks in EMEs. To the best of our knowledge, this is the first paper to predict downside risks after uncertainty shocks for the Latin American region.

We find that EPU shocks pose more risk when economies are in recessions, ie they shift the left tail of the distribution of GDP growth further left. 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 (upper panel) and inflation (lower panel) based on the estimation of equation 5. The lowest percentile of the growth distribution consists only of negative growth quarters in all five considered countries (Table 3). The lower tail responses can therefore be interpreted as capturing recessionary conditions. In this percentile, a one standard deviation EPU shock shifts the conditional quantile of GDP growth downward by about 0.8 percentage points after one month (upper panel, in red). While EPU shocks also affect the median of the GDP growth distribution, the effect is more muted: the shift in the 50th percentile one month after the shock is less than half the size of the shift in the lower tail (upper panel, in blue). This indicates that uncertainty shocks disproportionately worsen economic conditions during downturns.

The effect of EPU on the growth distribution also shows different dynamics depending on the quantile. In the 10th or 50th percentile of the distribution, EPU shocks have an

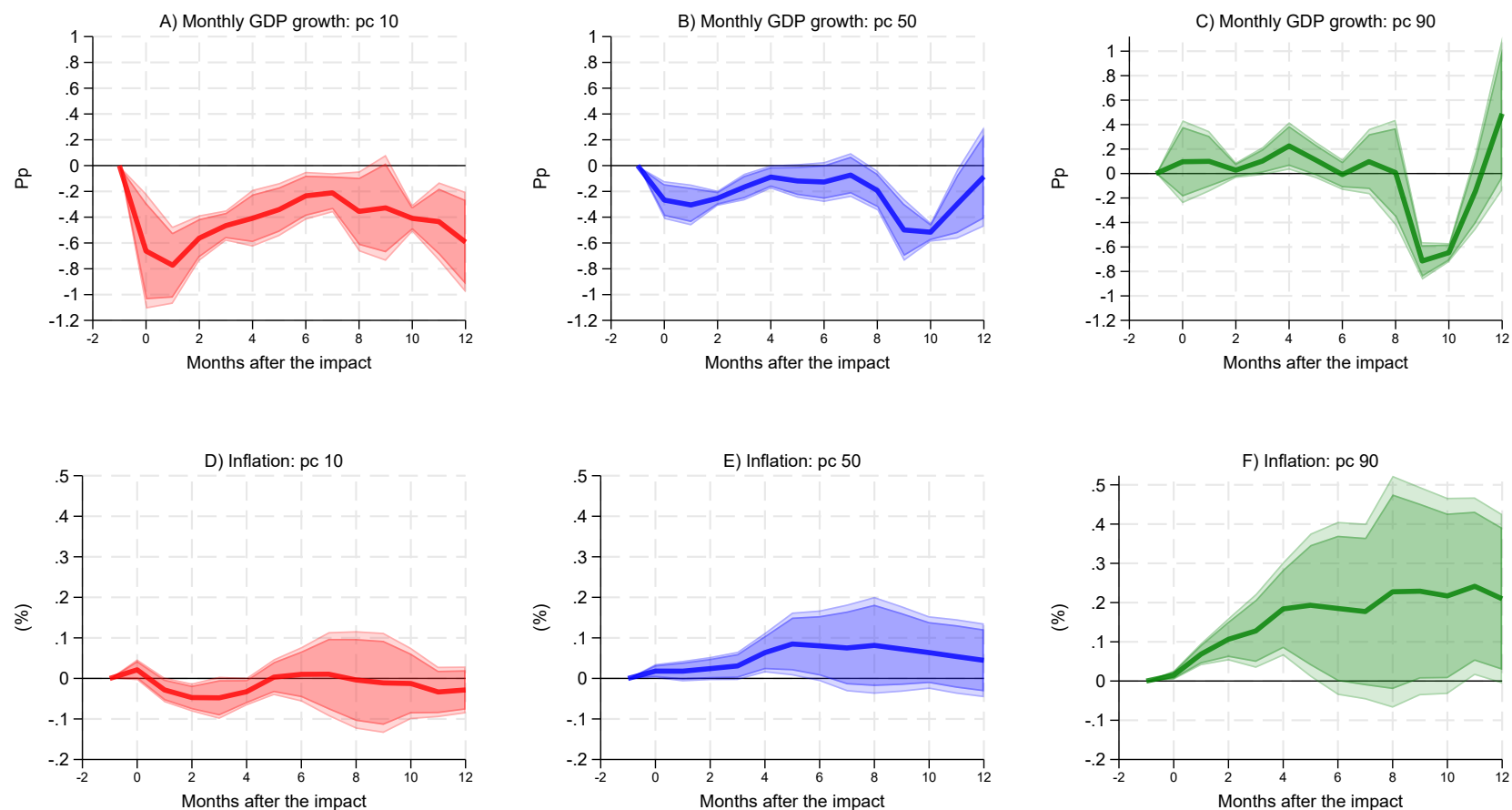


Figure 7: Impact of a one-standard-deviation increase in domestic EPU shocks on the 10th, 50th and 90th percentiles of GDP growth (upper panel) and inflation (lower panel).

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.

Table 3: Descriptive statistics of percentiles of GDP growth and headline inflation.

Country	GDP Growth (yoy, %)			Headline Inflation (yoy, pp)		
	P10	P50	P90	P10	P50	P90
BR	-0.8	0.2	1.2	3.1	5.3	9.0
CL	-1.3	0.4	2.0	1.8	3.4	8.2
CO	-1.2	0.4	1.8	2.1	4.1	8.4
MX	-0.8	0.2	0.9	3.0	4.2	6.3
PE	-1.0	0.5	1.8	1.3	2.9	6.0

immediate impact that intensifies over a period of about four to six months and recovers thereafter. In contrast, at the 90th percentile of the GDP growth distribution, EPU shocks produce positive shifts in the short or medium term. Only at longer horizons (after nine months), we observe a significant downward shift of the upper tail, with the 90th percentile falling by around 0.7 percentage points (upper panel, in green). Further, while the negative shift of the 10th percentile is persistent over the one-year horizon, the impact on the median and 90th percentile vanishes over the horizon.

Regarding the impact on inflation, EPU shocks can potentially aggravate inflationary pressures when inflation is already well above target. Focussing on the lower panel of Graph 7, we show that EPU shocks have a small negative impact on the lower percentiles of inflation (in red) and only a limited positive impact of less than 10 basis points on its median percentile (in blue), where inflation is within the target ranges or moderately above. However, EPU shocks can worsen inflationary episodes. Note that the 90th percentiles of inflation in all five countries are well outside of their target ranges (Table 3). Upon impact, the shock can shift the 90th percentile of inflation up by 5 basis points, accumulating to almost 20 basis points after four months and around 25 basis points after eleven months (the latter being significant only at the 90% level). 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.

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 on the lower percentiles of their respective distributions and only moderate on the upper percentiles. However, the shifts on the 10th,

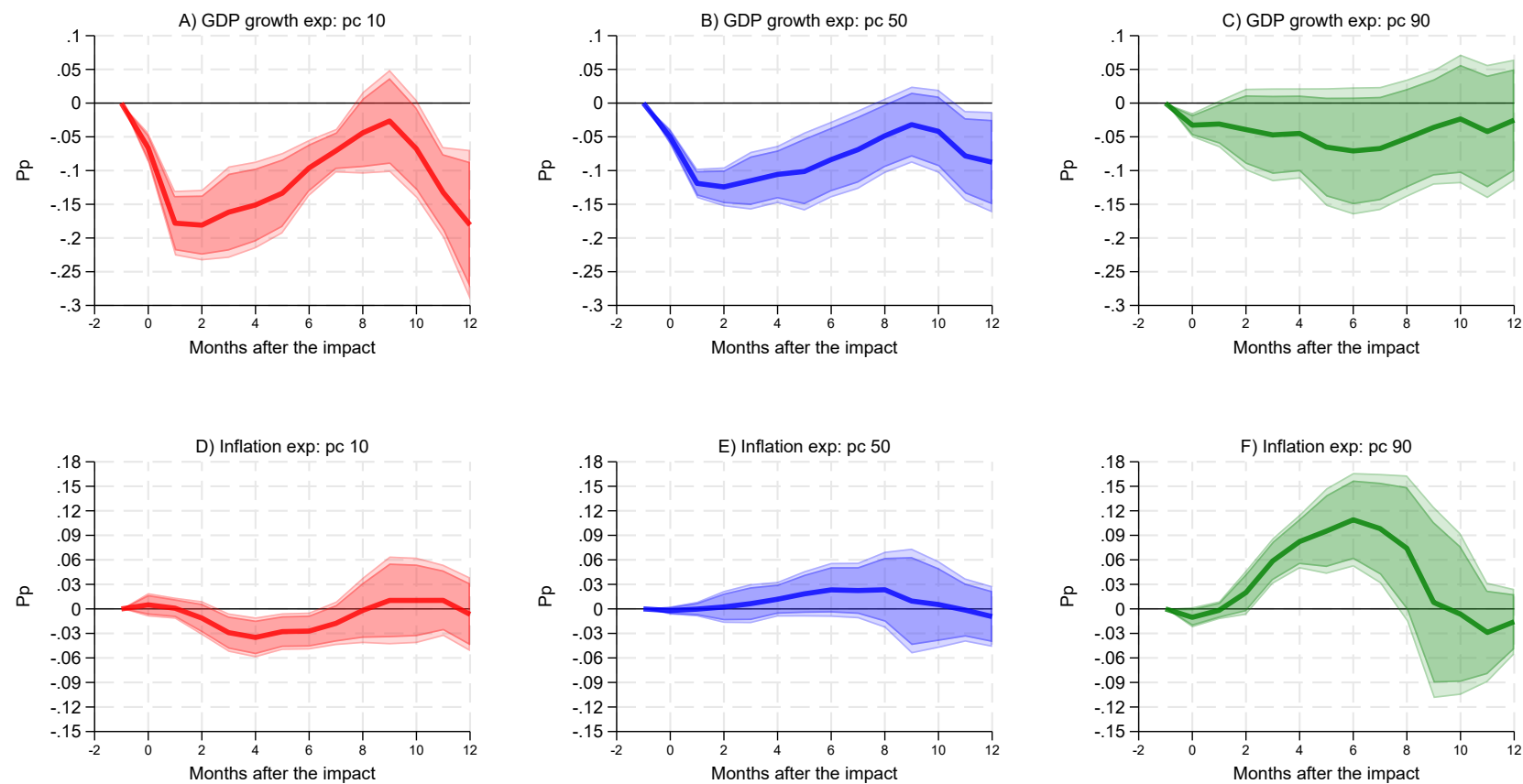


Figure 8: Impact of a one-standard-deviation increase in domestic EPU shocks on the 10th, 50th and 90th percentiles of GDP growth expectations (upper) and inflation expectations (lower).

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.

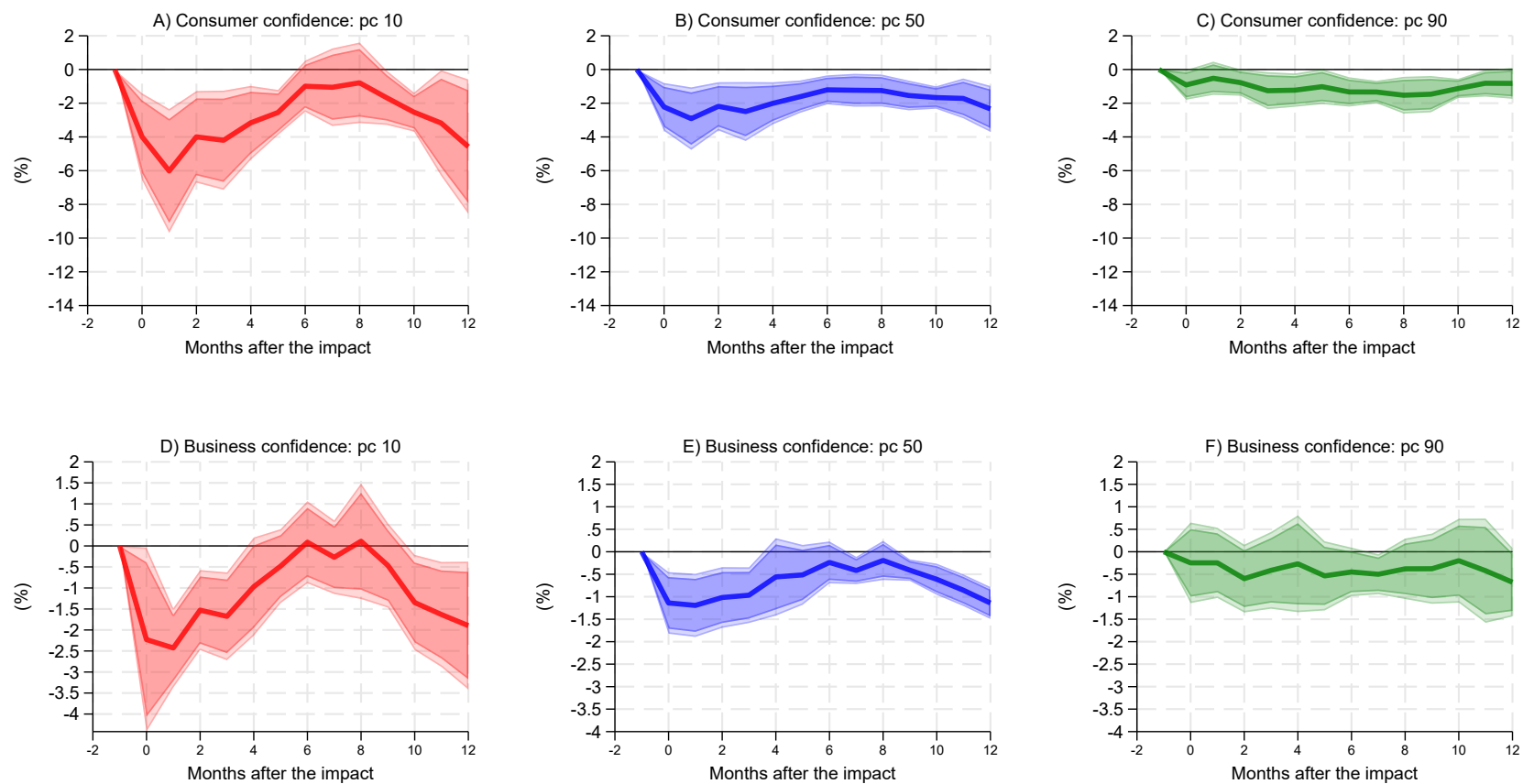


Figure 9: Impact of a one-standard-deviation increase in domestic EPU shocks on the 10th, 50th and 90th percentiles of consumer (upper) and business (lower) confidence.

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.

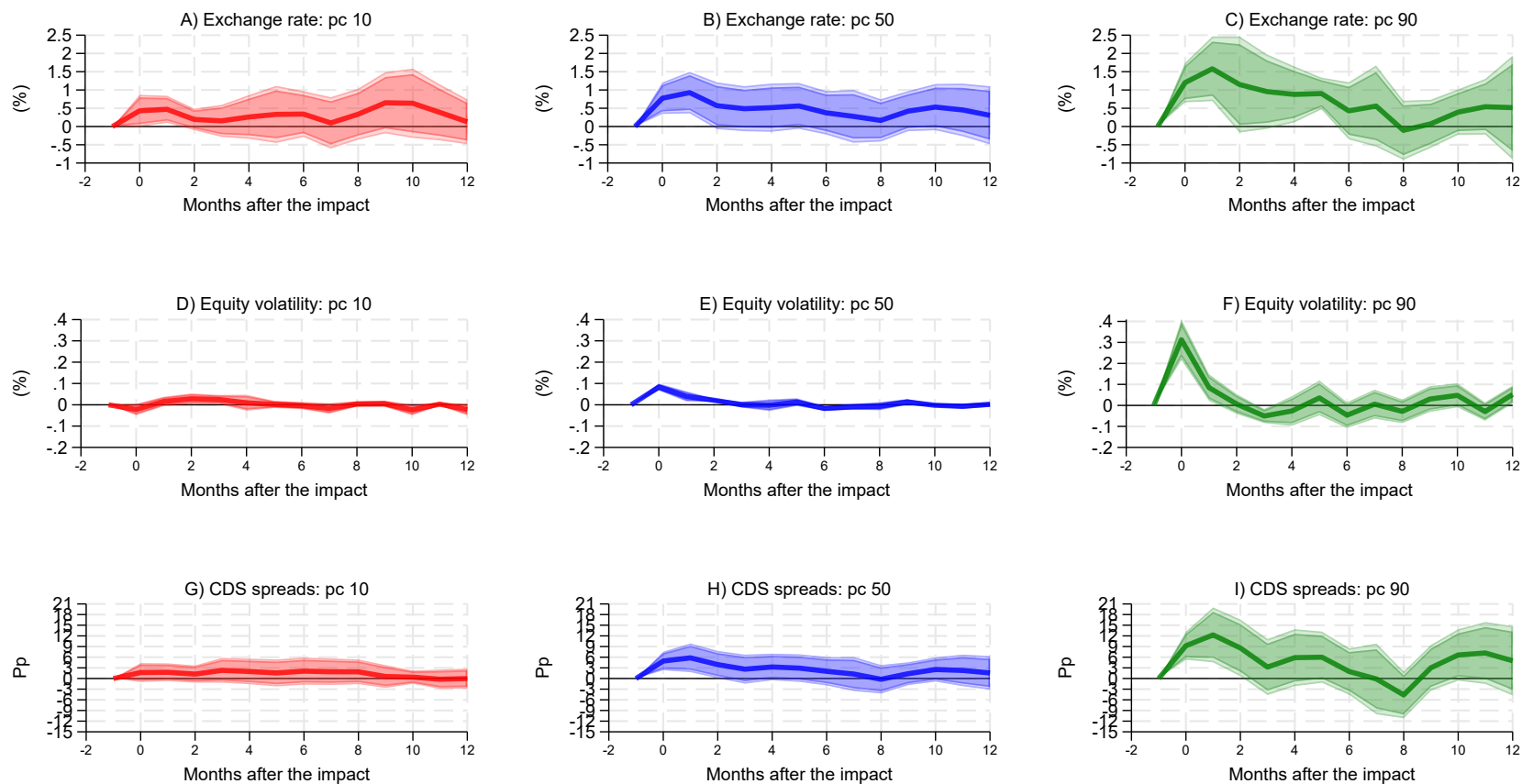


Figure 10: Impact of a one-standard-deviation increase in domestic EPU shocks on the 10th, 50th and 90th percentiles of the exchange rate (upper), equity volatility (middle) and CDS spreads (lower).

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.

50th and 90th percentiles of growth expectations do not differ markedly in magnitudes. Interestingly, the downward shift of the 10th and 50th percentile of the distribution of business confidence shows significance at the 95th percentile while the mean effect was mostly insignificant in our previous analysis. The median of growth expectations, consumer and business confidence are lowered for up to 12 months after the shock. Further, none of the variables shows a recovery towards the end of the horizon nor positive effects. This could imply that uncertainty has a more lasting and uniformly negative impact on expectations and confidence.

The heterogeneous response of inflation and inflation expectations highlights the importance of accounting for asymmetries in the relationship between uncertainty and expectations formation. The results in Graph 8, panel B show that the effect of EPU differs markedly across the distribution. In response to a one-standard-deviation increase in domestic EPU shocks, the lower tail of expectations shifts downward by up to 3 basis points (in red), but the upper tail can rise by over 10 basis points (in green). The effect on the median percentile (in blue), as well as the mean (Graph 6, previous section), is insignificant over the entire horizon. All told, domestic EPU shocks increase the cross sectional dispersion of inflation expectations after the shock, reflecting greater disagreement among agents about the macroeconomy caused by EPU (ie it widens the distribution curve of inflation expectations).

The financial channel's transmission intensifies when financial conditions are weak. One month after an EPU shock, the short-term effects on the 90th percentile of equity volatility and CDS spreads are significant and sizeable (Graph 10, panels in green). The upper percentile of equity volatility shifts on average by 30 basis points, that of CDS spreads by 12 basis points to the right, and that of the exchange rate shows a depreciation of 1.8% (panels C, F and I, in green). The 50th percentiles also shift upwards, though less than the 90th percentiles (panels in blue). The effect on the 10th percentiles is smaller or insignificant, ie when financial conditions are relatively loose (panels in red). Consistent with previous findings, the results confirm that the financial channel operates mainly in the short term (up to six months after an EPU shock) and that EPU shocks worsen adverse outcomes.

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 downward and upward pressure on inflation in emerging economies.

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, Mexico and Peru, 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 and business confidence; and the financial channel, evidenced by exchange rate depreciation and higher equity volatility and risk premia.

Importantly, our analysis highlights that EPU shocks pose greater risks when the economy is weak and/or experiencing high financial stress. They push lower GDP growth quantiles further into negative territory and raise upper quantiles of financial stress indicators. As the lower tail of GDP growth reflects recessions and the upper tail of volatility and spreads reflects tight financial conditions, the findings suggest that EPU shocks worsen downturns and heighten financial stress. Conversely, the opposite tails are less affected. During economic upswings, Latin American economies absorb EPU shocks more effectively. For inflation and inflation expectations, policy uncertainty shocks exacerbate upside risks to prices, with increased volatility in inflation expectations following domestic EPU shocks.

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 resem-

bles 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, Lombardi, Yetman, and Zakrajsek, 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); Bank for International Settlements (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.

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A Summary of country studies

Table A1: Selected literature on country cases.

Author(s)	Main Findings
<i>Brazil</i>	
Ferreira et al. (2019)	An increase in a domestic EPU 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.
<i>Chile</i>	
Cerda et al. (2018)	Higher economic uncertainty is associated with declines in GDP, investment, and employment in both the short and long term.
<i>Colombia</i>	
Gil-León and Silva-Pinzón (2020)	An increase in a domestic EPU index negatively affects consumer and investor confidence.
<i>Mexico</i>	
Alam and Istiak (2020)	Higher US EPU leads to a decline in Mexican industrial production, price levels and the policy rate. The effects are stronger than those of domestic EPU.
Cebreros et al. (2020)	An increase of a trade policy uncertainty index is associated with negative effects on FDI inflows.
Hernández Vega (2021)	Uncertainty lowers bond and equity portfolio flows.
Bush and López Noria (2021)	Uncertainty increases exchange rate volatility.
López and Zamudio (2018)	Uncertainty discourages FDI flows into the Mexican manufacturing sector. Idiosyncratic uncertainty measures are more significant in explaining FDI flows than aggregate uncertainty measures.
Salgado and Trujillo (2023)	Higher macroeconomic uncertainty lowers GDP growth, particularly on the left tail of the distribution.
<i>Peru</i>	
Flores et al. (2026)	Based a local EPU index, uncertainty reduces growth, induces exchange rate depreciations and an increase of short-term interest rates.

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