Working papers economics - Uncertainty and the Power of Monetary Policy in Colombia

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Banco de la República has a highly effective instrument in the policy rate to achieve its objectives. However, uncertainty reduces that effectiveness; therefore, when uncertainty is higher, the Bank needs to act more forcefully to achieve the same objective.

Publication Date: Wednesday, 6 of May 2026 **Approach**
This Working Paper on Economics examines whether economic policy uncertainty has any impact on the effectiveness of monetary policy conducted by Banco de la República (the Central Bank of Colombia). In other words, the paper analyzes whether economic policy uncertainty affects the effectiveness of the policy rate as an instrument to influence economic activity.

To address this question, the paper follows a three-stage methodology. In the first stage, it compiles several data series on the policy interest rate set by Banco de la República (its main policy instrument), economic activity, and the degree of uncertainty, among other variables. In the second stage, the paper identifies those changes in the policy rate that are plausibly exogenous, that is, changes that do not respond to current economic conditions and can therefore be used for this type of analysis.

In the third and final stage, the paper applies a local projections methodology to estimate the effectiveness of exogenous policy rate changes in influencing aggregate demand, and to assess how uncertainty affects that effectiveness.

Contribution
In recent years, public debate has increasingly focused on the effects of uncertainty on economic performance. Much of this discussion has concentrated on the role of economic policy uncertainty, that is, uncertainty regarding decisions that authorities may take in areas such as taxation, public expenditure, and trade policy. For example, throughout 2025 there was substantial uncertainty regarding the direction of tariff policy in the United States. At the same time, in Colombia there were repeated references to uncertainty surrounding the size of the Government Budget, the fiscal deficit, and increases in key prices for the economy, such as the minimum wage. For policymakers, and particularly for Banco de la República, understanding the effects of this type of uncertainty on the economy is crucial for three reasons. First, in an environment of high uncertainty, authorities may choose to react differently to economic conditions, for instance by adopting a more cautious monetary policy stance. Second, higher uncertainty may serve as an early warning signal of future economic problems. Third, uncertainty may alter the effectiveness of the instruments used by authorities to stabilize the economy.

Results

The paper reports three main results. First, the policy interest rate is highly effective in influencing aggregate demand; that is, Banco de la República has a powerful instrument in the policy rate to achieve its objectives. However, and this is the second result, uncertainty significantly reduces that effectiveness. Therefore, when uncertainty is higher, Banco de la República needs to act more forcefully to achieve the same objective. Finally, this loss of effectiveness is the same regardless of whether Banco de la República is in an interest rate tightening cycle or an easing cycle.