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In a scenario of tighter financial conditions, when the government decides to adjust investment to comply with the fiscal rule, there is a short-term decline in domestic demand and inflation, which allows the central bank to lower the interest rate, leading to a faster recovery in private consumption and investment.

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Abstract

Fiscal policy and monetary policy are intricately connected, as government policies influence various macroeconomic variables, affecting prices and, consequently, Central Bank decisions. To elucidate this relationship, this document outlines the model employed by Banco de la República's technical staff to analyze and quantify the impact of fiscal policy on key macroeconomic variables, featuring a detailed fiscal structure that distinguishes it from other models. Furthermore, as an illustration of the analyses conducted with this model, the document presents a simulation that assumes an increase in the risk premium, examining two potential responses the government might consider under tighter financial conditions: adjusting public investment to comply with the fiscal rule, or not adjusting public expenses and incurring in additional debt, leading to non-compliance with the fiscal rule. When the adjustment involves reducing public investment, domestic demand, inflation, and the monetary policy rate decrease. Conversely, financing the revenue shortfall with public debt, thereby failing to comply with the fiscal rule, exacerbates negative effects on private demand.