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Abstract

We study how capital controls and domestic macroprudential policy tame credit supply booms, respectively targeting foreign and domestic bank debt. For identification, we exploit the simultaneous introduction of capital controls on foreign exchange (FX) debt inflows and an increase of reserve requirements on domestic bank deposits in Colombia during a strong credit boom, as well as credit registry and bank balance sheet data. Our results suggest that first, an increase in the local monetary policy rate, raising the interest rate spread with the United States, allows more FX-indebted banks to carry trade cheap FX funds with more expensive peso lending, especially toward riskier, opaque firms. Capital controls tax FX debt and break the carry trade. Second, the increase in reserve requirements on domestic deposits directly reduces credit supply, and more so for riskier, opaque firms, rather than enhances the transmission of monetary rates on credit supply. Importantly, different banks finance credit in the boom with either domestic or foreign (FX) financing. Hence, capital controls and domestic macroprudential policy complementarily mitigate the boom and the associated risk-taking through two distinct channels.