



CPE Globalization Briefs

Center for Popular Economics • PO Box 785 • Amherst, MA 01004
413-545-0743 • www.PopularEconomics.org

Hot Money

Economists call the short-term investments that zip rapidly into and out of an economy “portfolio investment” and contrast them with more long-term flows, called “[foreign direct investment](#).” Most others call this footloose finance “hot money.” Movements of portfolio investment can destabilize entire regions of the world. A sudden outflow of portfolio investment can trigger a financial meltdown, requiring bailouts of billions of dollars to clean up the mess.

Portfolio investments reflect changes in how investors see their short-term prospects. When expectations begin to sour, an initial withdrawal of capital can cause the currency of a country to fall, reducing the value of other portfolio investments. As investments lose value, more investors will pull out, resulting in a cascading outflow of finance and rapidly falling [exchange rates](#).

Investors are not the only ones to lose during a currency crisis. Falling currency values directly affect the lives of ordinary people. As the currency loses value, imports of basic goods become much more expensive. In addition, economic activity slows down because of increasing costs of imported materials and equipment. The result is [stagflation](#) – higher

prices and slower growth that can reduce the living standards of a sizable portion of the population.

In the face of financial pressure, many countries raise their domestic interest rates in order to bribe investors to stay. Higher interest rates often mean higher rates of return. However, they also mean a slower economy and higher debt payments for many people – living standards suffer again.

In recent years, the expansion of portfolio investment and the reduction in regulatory controls have left countries around the world more suscep-

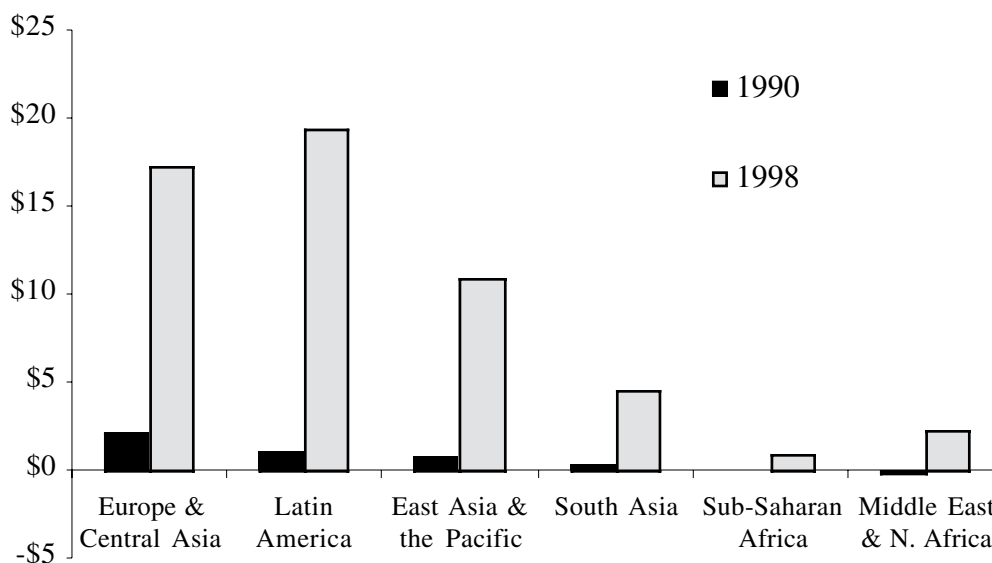
tible to financial crises. Although vulnerability varies from economy to economy, today any given country faces, on average, an estimated 10 percent chance of a financial crisis every year. Changing institutions also contribute to higher risks. For example, the expansion

of [stock markets](#) in many developing countries can encourage a higher volume of portfolio flows and increase uncertainty on domestic financial markets.

What can be done about the dangers associated with rapid inflows and outflows of short-term investment? One solution would be to implement a low-level tax (often called a “[Tobin tax](#)”) on every



**Total Portfolio Investment Flows to
Developing Countries by Region**
(billions U.S.\$)



Source: *World Development Indicators 2000*, Table 6.7.

cross-border foreign exchange transaction. The tax would penalize investors for playing speculative games in which finance is rapidly moved from one investment to another. However, for long-term investors, the total level of taxation would be negligible.

A second strategy would be to implement [capital controls](#) – policies that restrict the movement of short-term portfolio flows. For example, a country could require foreign investors to keep a fraction of capital inflows in a reserve account for a minimum length of time (for example, a year). The reserve account would act as a “speed bump,” slowing down short-term financial flows and lessening the risk of a financial crisis.

Sources:

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