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The Impact of Remittances on Economic Insecurity

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Abstract

This paper illustrates that cross-country generalizations about the impact of remittances on economic security are useful only up to a certain point; beyond that their effect can be influenced by the interplay of various factors relating to the motivations and characteristics of migrants, economic/social/political conditions in the country of origin, immigration policies and conditions in the host country, and the size and concentrations of the remittances. The policy implications outlined in the paper include the need for caution and retrospection in certain instances as well as action and international collaboration in other areas.

JEL Classification: F24 (Remittances), F22 (International Migration), F30 (International Finance: General), D31 (Distribution: Personal Income, Wealth, and Their Distributions)

Keywords: remittances, macroeconomic insecurity, consumption, poverty, income distribution, savings, investment, incentives

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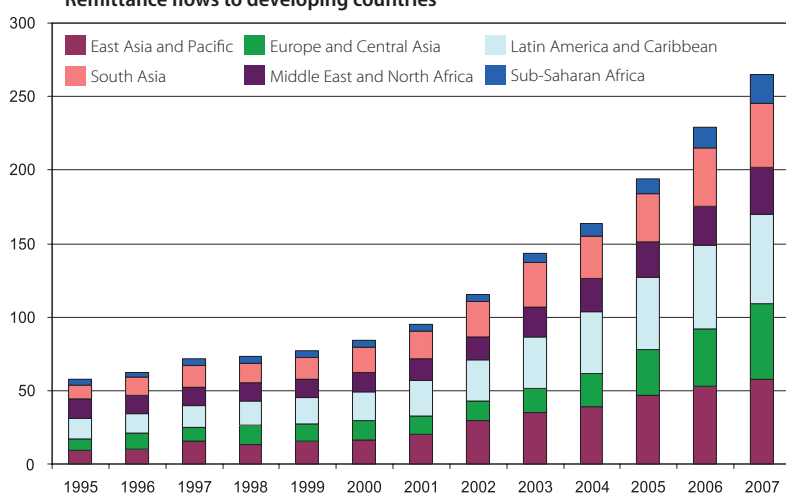
The Impact of Remittances on Economic Insecurity

Krishnan Sharma¹

Introduction and trends

The sheer size of international remittances renders their effect important at country, regional and household levels. International remittances are personal flows of money by migrant workers to family and friends in their country of origin. In 2007, recorded remittances by migrants from developing countries totaled \$265 billion, in comparison with \$229 billion in 2002 and more than double the level recorded in 2001 (World Bank, 2008). International remittances are almost as large as foreign direct investment (FDI) and more than twice as large as the official aid received by developing countries; yet their true size, including unrecorded flows through formal and informal channels, is much larger. Furthermore, the growth in recorded international remittances to developing countries has outpaced that of private capital flows and official development assistance over the last decade. During 2007, the top three recipients of remittances were India, China and Mexico, accounting for a total of more than US\$77 billion in migrant transfers (worth almost a third of the remittances received by developing countries as a whole). Having said this, remittances are more evenly distributed across developing countries than private capital flows. For instance, smaller and poorer countries tend to receive relatively larger remittances in proportion to the sizes of their economies. As a share of GDP, the top recipients in 2007 included Tajikistan (46 per cent), Moldova (38 per cent), Tonga (35 per cent), and Lesotho (29 per cent) (World Bank, 2008). In addition, South-South remittance flows have been estimated to make up 30-45 per cent of total remittances received by developing countries, reflecting the fact that over half of migrants from developing countries migrate to other developing countries (World Bank, 2006).

Chart 1
Remittance flows to developing countries



Source: Adapted from World Bank, 2008.

Given this rapid growth in international remittances, recent years have seen an emerging body of research devoted to analyzing their impact on recipient countries. The focus of this paper would be to provide an overview of issues regarding the ability of migrant remittances to address economic insecurity in developing countries. Economic insecurity relates to the vulnerability of countries, communities and individuals to adverse economic shocks, natural disasters, ill-health or conflict and the consequent impact on incomes, employment and assets. It also relates to insecurity

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brought about by poverty, which brings greater uncertainty and unpredictability into people's lives and makes them more vulnerable to shocks and volatile economic circumstances. Various studies have suggested that international remittances can address the problems relating to economic insecurity at different levels. At a macroeconomic level, they can provide a relatively stable and countercyclical source of capital, alleviate problems relating to conflict and natural disasters and, moreover, improve a country's access to external financing. In addition, evidence has been cited regarding their ability to impact on problems relating to income volatility and poverty.

While there is evidence suggesting a positive impact of international remittances on these facets of economic insecurity, there are many complexities and nuances here. The relationship between remittances and aspects of economic insecurity is not always clear and often a function of specific characteristics of the recipient countries and migrant communities. These nuances will be illustrated in this paper which will be organized as follows: the next section will assess the impact of migrant remittances on macroeconomic insecurity, followed by a discussion of their effect in smoothing household consumption and on reducing poverty. The paper will conclude with some broad policy implications.

Impact on macroeconomic insecurity

The large size of remittances relative to other external flows and to GDP in many countries suggests that their macroeconomic effects may be of critical importance in some economies. In particular, it has been argued that an important beneficial feature of these flows is that they tend to be more stable than private capital flows, which exhibit considerable volatility and herd-like behavior, and may also be countercyclical to economic conditions in the recipient country. In a broader sense, they can therefore be viewed as a self-insurance mechanism for developing countries through enabling them to diversify their sources of external finance. This is especially true where the economic cycles of the host country and country of origin are relatively decoupled and the levels of economic and political risk have a low correlation.

Thus, in the late 1990s, when Ecuador experienced a severe economic crisis, combined with political chaos and social upheaval, its remittances leaped from \$643 million in 1997 to more than \$1.4 billion in 2001 to become the second largest source of foreign exchange after petroleum exports (Kapur, 2003). Similarly, remittances to developing countries continued to rise steadily in 1998-2001, when private capital flows declined in the wake of the Asian financial crisis, and also rose during the financial crises in Mexico in 1995 and in Argentina in 2001. Through their econometric analysis, Bugamelli and Paterno point out that a high level of remittances as a ratio of GDP reduces the probability of sharp current account reversals triggered by an increase in external debt or a decrease in the stock of international reserves. This effect becomes stronger when remittances are above 3 per cent of GDP, signaling an increased ability to repay liabilities (Bugamelli and Paterno, 2006).

Having said this, the counter-cyclicity of remittances has not been evident in all instances. Indeed, there is evidence to suggest that the flow of remittances may be acyclical or even procyclical to output in some recipient countries. The dangers of generalizing across countries is illustrated by Sayan, who looks at

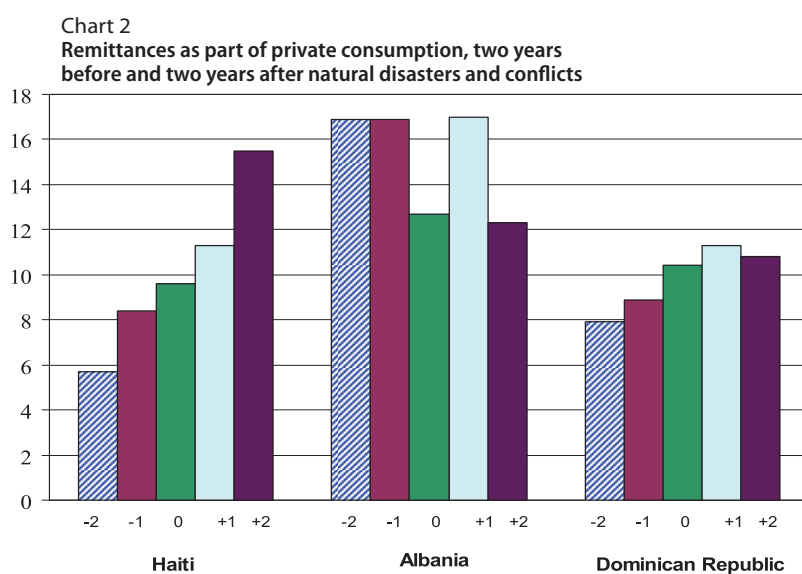
Table 1: Top recipients of remittances, 2007

<i>Country</i>	<i>Percentage of GDP</i>
Tajikistan	45.5
Moldova	38.3
Tonga	35.1
Lesotho	28.7
Honduras	24.5
Lebanon	24.4
Guyana	23.5
Jordan	22.7
Haiti	20.0
Jamaica	19.4

Source: World Bank, 2008.

the flow of remittances to 12 low-income/lower middle-income countries (Sayan, 2006). The econometric analysis finds remittances are procyclical/acyclical with the output of some countries within the group, even though remittances received by the group as a whole are countercyclical—thus there are important country specific factors that are not captured by cross-country models. To elaborate, the countries whose output showed strong counter-cyclicality to remittance flows included India and Bangladesh; those that do not display significant cyclicality included Lesotho, Dominican Republic and Senegal; and, in the case of Jordan and Morocco, a procyclical relationship was demonstrated between output and remittance flows.

The exact relationship between remittances and the economic cycle of the recipient country is likely to depend upon the motivations behind the transfers and the circumstances of the migrant communities. Where they are used primarily for investment purposes by recipients (as opposed to being used for consumption), there is a greater likelihood of a procyclical relationship of remittances with domestic economic conditions². As developing countries lifted exchange restrictions and liberalized their current and capital accounts in the 1990s, the volatility of remittances rose along with their level, presumably because an increasing amount of these remittances were being used for investment purposes (Ratha, 2003). In fact, the relationship between remittances and the economic cycle in the recipient economy can evolve over time, in line with changes in the circumstances of migrants and their perceptions of conditions in the home country. In Turkey, it has been argued that a variety of factors (including reunification of workers with immediate family members in host country, weakening ties back home over time, changing decisions by migrants about length of stay in host country and a changing investment atmosphere in home country) may have made migrant remittances from workers based in Germany more procyclical over time (Sayan, 2006). Having said this, the evidence does in most instances point to remittances being more stable than other components of private capital flows. Even in countries such as Turkey and Philippines, where remittances were more volatile and procyclical in the 1990s than in the 1980s, their decline and fluctuations during the later decade were smaller than those of other private capital flows (Ratha, 2003).



Remittances have often also risen in the event of natural disaster or conflict, again because migrants may send more funds during hard times. Remittance flows (as a share of personal consumption) continued to rise after natural disasters in Bangladesh, Dominican Republic, Haiti and Honduras. In both Sierra Leone and Albania, they rose during periods of conflict and also increased following hurricanes in Central America. In Somalia, following the collapse of the government in the early 1990s, remittances became a critical means for survival for many families and, by the end of the

² In the case of Jordan, it is also possible that output drops may have been caused by drops in remittances since, with remittances taking up close to 20 per cent of GDP in 1990-2003, the country suffered a severe drop in migrant financial inflows during the 1991 Gulf War as many workers in Kuwait and Saudi Arabia lost their jobs.

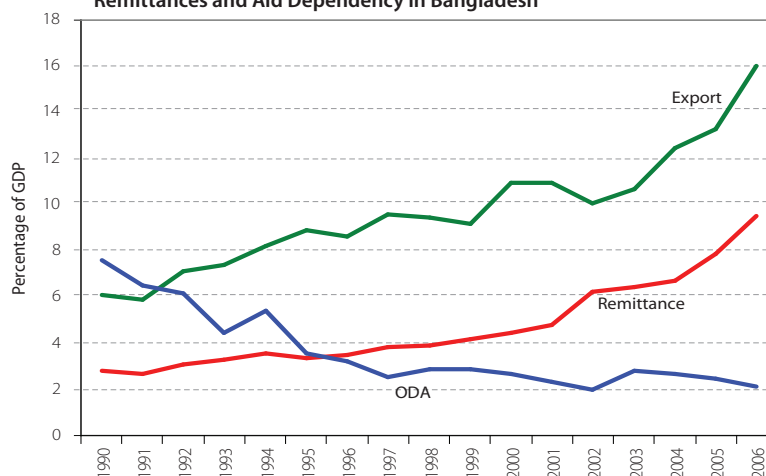
decade, began to be invested in some areas in construction and commerce. They have been an important lifeline in other areas where the state has 'broken down' such as Haiti, where they average around 20 per cent of GDP. Having said this, there have also been cases where remittances may have been employed to perpetuate conflict. They should also not be seen as a substitute for effective remedial action by the governments or the international community to respond to natural disasters or to resolve conflicts.

Remittances can also be said to impact on macroeconomic insecurity through enhancing countries' access to external finance. By generating a steady stream of foreign exchange earnings, they can improve a country's creditworthiness for external borrowing. For a number of countries, the ratio of debt to exports of goods and services would increase, in some cases significantly, if remittances were excluded from the denominator. However, country credit ratings by the major rating agencies often fail to incorporate remittances in their assessments. Calculations, undertaken by staff from World Bank, suggest that including remittances in assessments of creditworthiness may improve ratings and reduce sovereign spreads for some countries, including Lebanon, Haiti and Uganda (World Bank, 2006).

Moreover, future flows of remittances can be used as collateral to improve the rating of sub-sovereign borrowers (i.e. private firms and banks) in developing countries. In recent years, a number of developing country issuers have employed the securitization of future flows of foreign exchange to avoid a credit squeeze in the face of deteriorating sovereign risk ratings. These have for the large part been banks that receive large amounts of wire transfers from workers and companies abroad and the bonds that they have issued on the international capital markets have been backed by foreign exchange from remittance flows. For example, in 2001, Banco du Brasil issued US\$300 million in bonds using the future yen remittances of Brazilian workers in Japan. Similar bonds have also been used in Mexico, El Salvador, Panama and Turkey and, through this technique, banks in all these countries have been able to raise cheaper and longer-term financing from international capital markets (Johnson and Sedaca, 2004). However, the strategy is not without its risks. In addition to the usual hazards associated with accumulating foreign currency debt, its adoption needs to be viewed with caution in cases where remittance flows are volatile and procyclical. At the same time, the high costs of investment banking, credit rating and legal services have made it difficult for many sub-sovereign borrowers in developing countries to undertake securitization. In fact, it has mainly been the highest-rated financial institutions from developing countries that have in practice been able to issue future remittance-backed bonds (World Bank, 2006).

To a degree, international remittances may also in some cases enable a country to move away from aid dependency. This point has recently been made with reference to Bangladesh, where official development assistance as a percentage of GDP has declined steadily over the past couple of decades at the same time as exports and remittance flows have increased. It could be argued that the parallel rises in remittances and exports

Chart 3
Remittances and Aid Dependency in Bangladesh



Sources: IMF database 2007; OECD International Data Statistics Online 2007; adapted from Bhattacharya 2007.

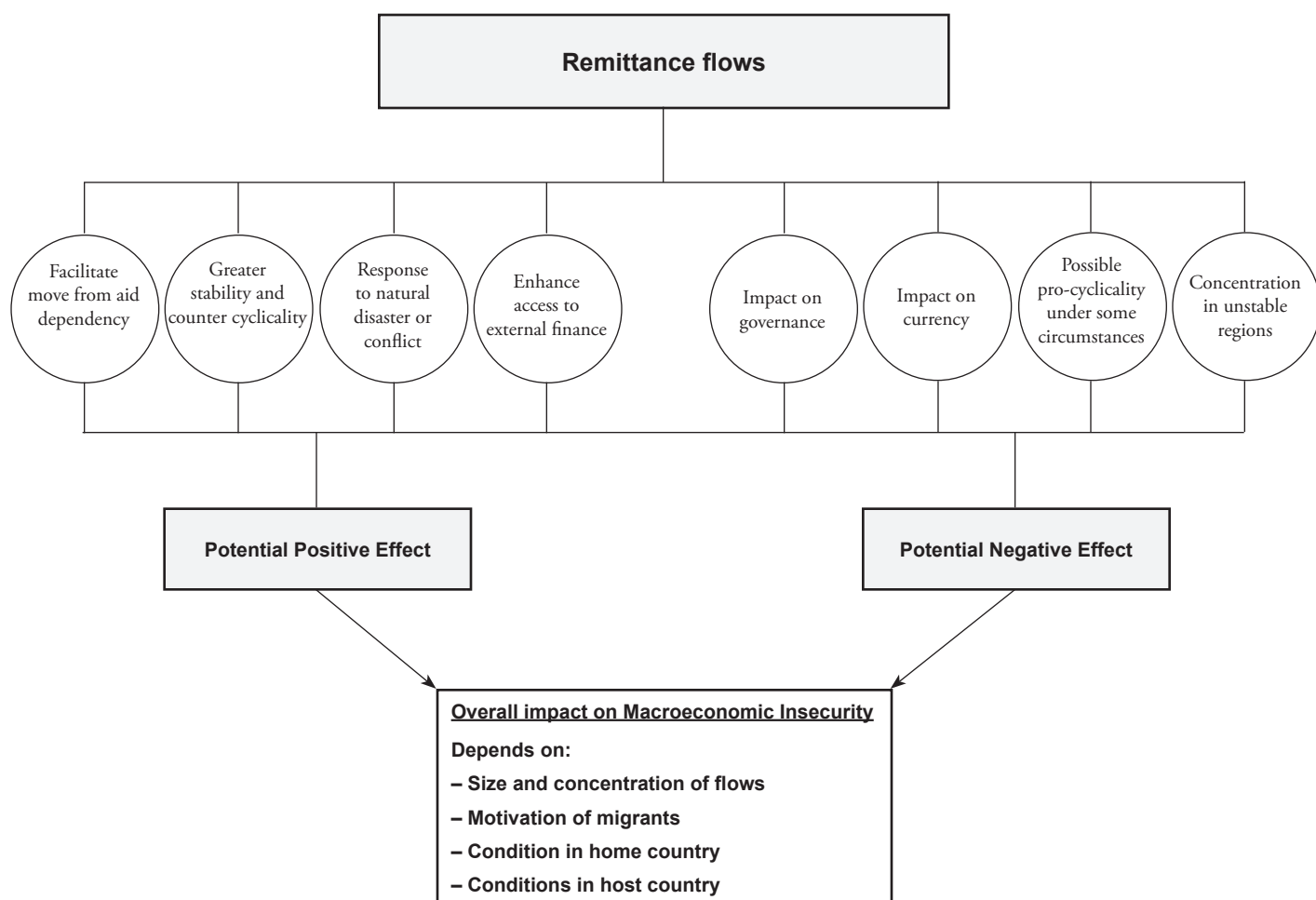
may have enabled the economy to better withstand the impact of the decline in aid flows. This nevertheless should not be interpreted as a justification for remittances to be viewed as a substitute for aid. For a start, they are private flows and cannot be expected to fund public projects; in Bangladesh, and other countries, there are critical sectors that are dependent on aid for the implementation of development programs. Moreover, as will be explained later, remittances often do not go to the poorest households and official development assistance remains necessary to address the needs of large numbers of people who live in poverty.

Albeit with some significant caveats, the preceding paragraphs illustrate the conditions under which international remittances can address macroeconomic insecurity through enhancing stability and access to finance. Yet in certain circumstances they can also generate insecurity through contributing to currency appreciation and eroding competitiveness. The empirical research of such ‘dutch disease’ effects is limited and the findings are somewhat mixed. Lopez-Cordova and Olmedo, using a worldwide database, show that a 10 per cent increase in remittance inflows as a percent of GDP can reduce exports by anywhere between 2 per cent and 4 per cent (Lopez-Cordova and Olmedo, 2005). However, Rajan and Subramanian did not find any evidence that remittance flows slow down growth by affecting competitiveness (Rajan and Subramanian, 2005; World Bank, 2006). On balance, it can be said that the impact on the real exchange rate is likely to be greater where remittances are large relative to the size of the economy and countries such as Kenya, Moldova and El Salvador have been concerned about the effects of large remittance flows on the currency (Ratha, 2007). Moreover, trying to ‘sterilize’ the impact of remittance flows to prevent currency appreciation can be costly since they tend to persist over long periods of time.

The effects of large flows of remittances on the real exchange rate may be mitigated through policies to improve productive capacity and competitiveness through, among other things, investing in infrastructure and creating an enabling environment for exporters. At the same time, a related concern is whether large amounts of migrant income from abroad can affect the quality of economic policies and governance. In particular, it has been argued that the dual effect of remittances in generating foreign exchange receipts while harming the competitiveness of exports may deter countries from undertaking structural reforms to promote export-led growth. According to Hossain, the increase in the relative demand for non-tradeables in Bangladesh, due in part to remittances, brought about a change in both output and employment in favor of the non-tradeables goods sector, which encouraged the government to adopt protectionist measures that slowed down structural reforms (Hossain, 1997; Lopez-Cordova and Olmedo, 2006). Despite this, and in contrast to the well-documented effects of windfall gains from natural resources such as oil, the evidence on the effect of remittances on governance is not conclusive. Moreover, unlike natural resource windfalls, remittances tend to be widely dispersed, are not intermediated through the government and hence are less likely to create incentives for mismanagement and corruption.

Remittances can also contribute to vulnerability at the macroeconomic level where they are concentrated in unstable regions and countries. For example, during the 1991 Gulf War, Jordan and Yemen suffered severe drops in migrant financial inflows as their workers lost jobs in the countries directly affected by the conflict. Similarly, a civil war in the Ivory Coast badly affected economic conditions in Burkina Faso through curbing remittances from migrants in the former country (that accounted for up to a quarter of the GDP of Burkina Faso). In this respect, it has also been argued that the expulsion of a number of Indonesian workers from Malaysia and Thailand during the Asian crises exacerbated the already severe economic problems in the former country. Kapur goes further and argues that the concentration of the sources of remittances creates “source-destination dyads” that can not only transmit economic shocks but can also become a coercive instrument on the part of the host country of the migrant (Kapur, 2003). Yet the degree to which economic and political

Figure 1. Impact of Remittances on Macroeconomic Insecurity



shocks get transmitted may also be a function of factors relating to institutional conditions in the host country and the circumstances of migrant workers. Migrants residing in more developed countries tend to benefit from a greater degree of income (i.e. social security schemes) and political protections (i.e. less likelihood of forced repatriations) during economic downturns that may soften the impact of remittance flows to the home country. Similarly, unlike in Jordan and Yemen, remittances to India did not decline during the 1991 Gulf War, probably due to migrant workers bringing back their entire savings when they returned (Ratha, 2002).

On balance, the impact of remittances on macroeconomic insecurity depends on the complex interplay of various factors relating to their size and concentration, the circumstances and motivations of the migrant, and the political, economic and institutional conditions in both source and destination countries. While there is compelling evidence of remittances being of considerable assistance during economic downturns in the home country and of its potential to enhance the access to finance of both sovereign and sub-sovereign entities, they may under certain circumstances contribute to macroeconomic vulnerability. Cross-country generalizations are useful only up to a certain point and policies need to focus on the specificities at a national level that influence the potential benefits and vulnerabilities generated by remittances.

Impact on households and poverty

Smoothing household consumption

Where they respond positively to adverse shocks relating to natural disasters, crop failure, job loss, and health crisis, remittances play an important role in smoothing household consumption. In this sense, they can be said to provide a degree of social insurance to poorer households that lack access to insurance and credit markets and are therefore vulnerable to severe declines in income from negative shocks. Thus remittances to Botswana increased in line with the severity of the drought in the migrant's home region while migrant income transfers are estimated to have replaced about 60 per cent of income loss due to weather-related shocks in a sample of households in the Philippines in 2005 (World Bank, 2006; Yang and Choi, 2005). Given this, the sending of family members to other regions and countries can in some instances be viewed as part of a strategy to manage risks facing households—namely the correlation of income shocks with the home region will be smaller, thereby facilitating consumption-smoothing income transfers.

The effect of remittances in diversifying risk and smoothing consumption is greater where their motive is to primarily support consumption by relatives back home (implying they are likely to be predominantly countercyclical or acyclical rather than procyclical). As mentioned in the preceding section, the motivation behind remittances can vary or even evolve among and within migrant communities. However, there is international evidence suggesting that a predominant part of remittances in a number of countries tend to go towards supporting consumption, including education and health care expenses. For example, surveys in a number of Latin American countries show that daily household expenses range from 46 per cent (in Brazil) to 84 per cent (El Salvador) of remittances; education expenses take between 2 per cent (Ecuador) and 17 per cent (Dominican Republic); while investment in a business ranges from 1 per cent (Mexico) to 10 per cent (Guatemala, Brazil) of remittance income. Moreover, as high as 11 per cent of remittances can be saved (Guatemala) and up to 7 per cent used for acquiring property (Brazil) (Lopez-Cordova and Olmedo, 2006). In another study, by Amuedo-Dorantes and Pozo, 46 per cent of Mexican migrants say that the main reason for sending money back home is to cover health expenses, 30 per cent cite food and maintenance, while 8 per cent and 6 per cent respectively indicate property construction/repair and debt payments as the main reason for their remittances (Amuedo-Dorantes and Pozo, 2004).

Impact on poverty

Economic insecurity also relates to insecurity brought about by poverty, which brings greater uncertainty and unpredictability into people's lives and also makes them more vulnerable to volatile economic circumstances. Remittances can reduce poverty through augmenting the income of recipient households, through indirect multiplier effects and through their macroeconomic effects. The Keynesian multiplier story suggests that even if the remittances are totally spent on consumption, there will still be a benefit to the receiving economy, to the extent that at least some of the funds are spent on local goods and services. Disparate studies have estimated remittances multipliers, operating primarily through the consumption effect, in a number of countries and found their values to be significant (Chami et al, 2003)³.

Estimating the effect of remittances on poverty is nevertheless complex due to the need to account for the counterfactual loss of income from migration and for the likelihood that the level of poverty also affects the volume of remittances. Nevertheless, a combination of evidence from econometric analysis and household

3 The studies cited include those by Stahl and Habib (1989) referring to Bangladesh, Nishat and Bilgrami (1991), referring to Pakistan and Adelman and Taylor (1990) focusing on Mexico.

surveys suggest that remittances have reduced poverty in many countries, though the magnitude has varied. For example, according to household surveys, remittances may explain a significant proportion of the 11 percentage-point reduction in the poverty headcount rate⁴ in Nepal over the last decade. Household survey data also show them to have reduced the percentage of the population below the national poverty line by 11 percentage points in Uganda, 6 percentage points in Bangladesh and 5 in Ghana (Ratha, 2007). The magnitude of the reduction in poverty, as a result of international remittances, can often depend on how it is measured. In addition to the poverty headcount index, poverty can also be measured in terms of how far households are from the poverty line (i.e. the depth of poverty). Studies by Adams and Adams and Page use both these measures to assess the impact of remittances on poverty in respectively Guatemala and a panel of 74 low and middle-income countries. In both instances they found that international remittances had a larger impact in reducing the depth of poverty than on the poverty headcount (Adams, 2004; Adams and Page, 2005).

The above studies look at the more immediate impact of remittances on poverty. In this respect, some authors have argued that the more direct effect of remittances on poverty can be greater than traditional foreign aid, depending on the income characteristics of the household—the transaction costs may be lower and there are fewer governance/corruption issues (Kapur, 2003). However, analyzing the less direct and longer-term impact of remittances on poverty is less straightforward due to need to account for varying and sometimes conflicting effects on a number of variables including income distribution, savings and investment, access to credit and incentives to work.

Impact on income distribution

In order to better understand the longer-term broader impact of remittances on poverty, it is important to begin by trying to assess how it can affect the distribution of income and/or assets in the receiving country. For instance, studies have suggested that poverty in Latin America would be significantly lower if the distribution of income was less unequal. According to Lopez-Cordova and Olmedo, the theoretical relationship between remittances and inequality should be viewed as a dynamic process, with an early increase in inequality followed by decreases over time (Lopez-Cordova and Olmedo, 2006). During the initial stages of migration to a new destination, the cost of emigrating is usually relatively high, with mainly higher-income migrants being able to afford to move. However, as the number of migrants in the destination increases, the cost of emigration declines allowing individuals in lower-income households the possibility to migrate. This is because established and growing networks reduce information costs about the specific destination, accommodation, the search for a job and so on. Thus, over time, remittances should increasingly accrue to low-income households and reduce income inequality in the country of origin.

This model is nevertheless simplistic since, in practice, other factors are important in determining the composition of migrants in a country (e.g., the receiving country's immigration policy, which may favor certain occupations). Indeed, empirical investigations into the effect of remittances on inequality are unclear, with studies citing different results based on varying social, geographic and historical circumstances⁵. While the effect of migration on equity will depend upon the income levels of those who migrate, migrants in many instances tend not to be drawn representatively from the population pool, but from specific communities and educational and income groups—often, they tend not to be drawn from the poorest households (Kapur, 2003). Thus, a large proportion of Indian emigrants to the United States during the 1990s tended

⁴ The share of the population whose income or consumption is below the poverty line.

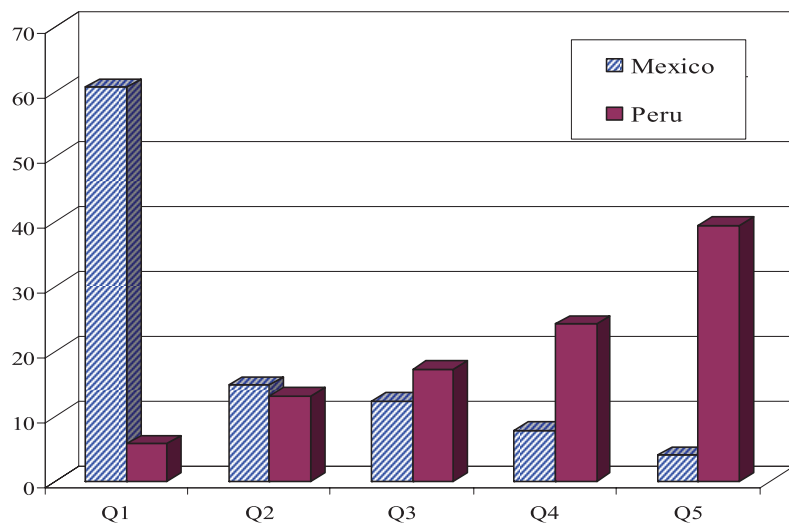
⁵ It has been argued that a possible reason for the unclear empirical evidence on the impact of remittances on inequality is because the Gini coefficient does not adequately capture the effect of mobility between the income categories—thus it remains unchanged if a household moves up a level while another moves down.

to be information technology professionals whose emigration was facilitated by the immigration policies and economic needs of the receiving country. On the other hand, proximity to more developed economies and established networks may make migration more affordable for poorer households. Thus, in Mexico, the overall impact of migration and remittances is estimated to have reduced inequality for communities with relatively high levels of past migration (World Bank, 2006). Geographical proximity may moreover encourage illegal immigration, which is likelier to emanate from poorer households.

Some writers have suggested that the beneficial impact of remittances on poverty and inequality may increase where migrants tend largely to be low skilled or unskilled workers. This could imply that the ensuing remittances are directed at less-well-off households and, moreover, the supply of low or unskilled wages is reduced in the home country thereby increasing the wages of poorer workers. The share of remittances recipient households belonging to the lowest quintiles of the income distribution can vary sharply across countries as illustrated by chart 4. Recent evidence from Latin American household surveys indicate that while in some countries the recipients of remittances are predominantly poor (for instance, over 60 per cent and 40 per cent, respectively, of Mexican and Paraguayan recipient households fall in the lowest quintile of the income distribution), this is not the case everywhere. In the other extreme, in Peru, less than 6 per cent of the recipient households belong to the lowest quintile while 40 per cent belong to the top quintile; similarly, in Nicaragua, around 12 percent of recipients belong to the lowest quintile while over 30 per cent belong to the top quintile (Acosta et al, 2007). These differences are most likely due to the migration, and subsequent remittances, by large numbers of people from better-off households in Peru and Nicaragua⁶. Having said this, in most of the countries that were surveyed, remittances tended to flow either to households in the lower quintiles or were more homogenously distributed across the income categories.

Yet, even where they tend to flow predominantly to poorer households, the impact of remittances in addressing poverty among the lowest income classes should not be overestimated. Perspective is provided by evidence from the Latin American household surveys which indicate that, even in Mexico where the recipients tend to be concentrated among the poorest segments of the populace, the number of households that both receive remittances *and* belong to the lowest quintile constitute only 3 per cent of the population. In terms of the countries surveyed, only in El Salvador and Haiti did more than 5 per cent of households both receive remittances and belong to the lowest quintile of the population (Acosta et al, 2007). On balance, what can be said is that while remittances may often have limited impact on the

Chart 4
Remittances to households by quintile of income distribution, 2002



Source: ACOSTA et. al.

⁶ According to experts from the World Bank, this exodus happened in Nicaragua when the Sandinistas took power, while in Peru this took place in the wake of economic problems, such as hyper-inflation, during the first Alan Garcia administration during the 1980s. By contrast, in Mexico, a larger proportion of migrants are from poorer households (and come from the border areas with the United States).

poorest households, or on measures of inequality, they do in most instances flow to people who are relatively poor (by the standards of industrialized countries) or at least not rich. By contrast, richer and better educated migrants often tend to make investments or non-financial contributions in their homeland (i.e. direct investment, transfer of knowledge, facilitation of trade, business development) (United Nations, 2006). While their activities are unlikely to benefit the poorest sections of the populace in the short-term, they have in a number of instances improved employment, incomes and economic security for a wider range of people who, though relatively educated, are unlikely to be viewed as well-off in an industrial-country context.

Impact on savings and investment in human, social and physical capital

The survey results cited earlier indicate high propensities to consume remittance income in a number of Latin American countries, indicating their important role in smoothing household consumption and moving countercyclically. This however does not obviate the fact that remittances may at the same time also boost households' savings, thereby reducing their economic vulnerability and increasing their ability to invest in their future. In particular, remittances may free up resources for greater savings from other sources of household income—i.e. the fungibility issue—providing the basis for studies indicating a higher propensity to save among remittance-receiving households than in others (Kapur 2003; Orozco, 2003). Thus, in a number of cases, remittances have been shown to both smooth consumption and provide funds for investment—notably in education, health, housing and, also, in business⁷.

Remittances can particularly impact on longer-term poverty where investments are made in human capital. Human capital not only affects today's well-being but also allows future generations to break the cycle of poverty and improves growth prospects—thereby providing longer-term economic security. Remittance transfers may improve education and health as they relax income constraints that limit optimal human capital investment. It should nevertheless be noted that it is empirically difficult to measure the effects of remittances on human capital formation, which may occur over a very long period of time.

- With respect to education, studies based on household surveys in El Salvador and Sri Lanka find that children of remittance-receiving households have a lower school dropout ratio and that these households spend more on private tuition for their children. In the Philippines, an increase in remittances equal to 10 per cent of initial household income has been measured to lead to a proportional increase in enrollment rates for children aged 17-21 (Lopez-Cordova and Olmeda, 2006). Having said this, analyzing the impact of remittances on schooling can be complex since the impact and possibility of migration can respectively alter the actual and perceived returns to education in the country of origin. Lopez-Cordova finds that, as the fraction of remittance-receiving households in a given Mexican municipality increases, the impact on school attendance is positive among children aged 5, neutral on children aged 16 to 14, but negative among teenagers aged 15 to 17 (i.e. they face a disincentive to stay in school) (Lopez-Cordova, 2006). Overall, while the balance of evidence seems to indicate a positive impact of remittance on education, it is dangerous to make generalized conclusions since the actual effect is likely to be related to specific conditions relating to the country and the migrant populations⁸.

⁷ In fact, the increased flow of remittances in the face of adverse shocks may allow households to sustain funding for key investments in areas relating to business working capital, education and health.

⁸ These conditions, together with other factors such as skilled migration rates, also influence the broader issue of whether remittances can compensate for the 'brain drain' created by the departure of skilled workers. Without going into the intricacies of this issue, which deals with the broader impact of migration, it suffices to say here that this would vary by country (Docquier and Marfouk, 2005).

- Remittances can also play an important role in promoting health, particularly in countries where the public healthcare system is not able to provide adequate treatment or preventive care. In Sri Lanka, the children in remittance-receiving households have a higher birth weight, while migrant surveys in Latin America show that an important motivation for remittances is to cover health expenditures (World Bank, 2006). There is also evidence to suggest that the better housing conditions enabled as a result of remittances may have a positive impact in reducing infant mortality through improving access to public services or by allowing mothers to stay at home and care for their children. Notwithstanding these encouraging outcomes, it should be noted that the impact of migration on the health of children left behind is often not straightforward. The health impact of absenteeism of one of the parents can be negative and migration has been linked with a lower measure of preventive healthcare such as vaccinations. In such cases, remittances serve to ameliorate or offset this disruptive effect of migration. Hence, recent research shows that infant mortality across a number of Mexican municipalities falls in line with an increase in the percent of remittances-receiving households (Lopez-Cordova, 2006). From another angle, the exports of doctors and nurses may also affect the availability and quality of medical services in migrant source countries. This has been particularly acute in the Philippines where the large levels of migration of nurses have been argued to have led to the closure or scaling down of a number of hospitals (Conde, 2006). While these effects may not be as severe in all cases, there is nevertheless a need to take into account these factors when assessing the overall impact on health of migration.

On a related note, an increasing number of emigrants have also used collective remittances to address shortcomings in social and economic infrastructure in their community or country of origin. The most renowned medium for channeling collective remittances have been hometown associations or HTAs, composed of emigrants from Mexico and Central America. The concentration of these groups has been on social and infrastructure projects, involving health, education, recreation and other public services. Moreover, by often involving local residents in the identification, design and implementation of activities, HTAs can help local individuals and households gain capabilities that facilitate further development and enhance their human capital. Both donors and governments have tried to encourage and enhance capacity in HTAs. An example of such a program is Mexico's 'Three-for-One' matching program where the authorities match dollars donated by diasporas with funds from federal and state coffers. While the mobilization of collective remittances has benefited a number of communities and countries, their real value added will be greater where they are not seen as a substitute for the provision of public services by local and national authorities (Johnson and Sedaca, 2004). It is also not clear in many cases whether communities have the resources to maintain what has been built through these contributions.

While still on the issue of collective remittances, a relevant consideration is their effectiveness vis-à-vis other non-financial forms of mobilized action by diaspora groups, especially in the field of knowledge and skills transfer. In particular, the activities undertaken by expatriate knowledge networks have in some areas been as or more valuable than financial transfers in addressing shortcomings in human, social and physical capital. An example is the role played by the Indian-American community in the improvement of Indian hospitals through sabbatical residencies (Seguin et al, 2006). Similarly, in India, Africa and Latin America, 'digital' diaspora networks have transferred ICT technologies and skills to local entrepreneurs through 'virtual' training (Johnson and Sedaca, 2004). However, despite the existence of many such networks, there is a shortage of studies examining their impact, longevity and viability.

Investments in physical capital, including business ventures, can impact positively on poverty where they generate strong multiplier effects. There are empirical studies showing that remittances are invested in productive activities when profitable⁹. For instance, a recent survey of self-employed workers and small firm owners located in over 40 urban areas of Mexico found remittances to be a significant source of capital for micro-enterprises (Lopez-Cordova and Olmedo, 2006). In recent years, a number of governments and donors have looked at ways that they can incorporate remittances into wider SME development programs. For example, the Multilateral Investment Fund (MIF) of the Inter-American Development Bank (IADB) has led development efforts to link remittances to SME development in a number of countries. For example, in Brazil, it has collaborated with a local bank to set up a remittance fund for entrepreneurs. Having said this, it is important that initiatives to channel remittances into productive enterprises do not overreach themselves and be unduly interventionist. They should exist only to attract those migrants who have entrepreneurial qualities and intentions and not serve to divert other funds (which may be directed into building equally important human/social capital). Ultimately the degree of remittances that flow into productive business investment will be a function of both the condition/aspirations of the migrant and investment opportunities/business environment in the country of origin.

Several studies also indicate that remittances may facilitate investment in both human and physical capital through easing credit constraints. To elaborate, a steady stream of remittance income may make households more credit worthy in the eyes of formal financial sector institutions. Furthermore, remittance receipts that increase when the household receives an adverse shock may be even more important in relaxing credit constraints, since they increase the lender's confidence they will be repaid even when things go bad. More empirical research is nevertheless required on this issue.

Effect on incentives

Earlier in this paper, mention was made regarding concerns that international remittances may affect the quality of economic policies and governance at the macroeconomic level. There are parallel concerns that they could also generate a moral hazard problem at a more localized level, encouraging recipients to decrease their labor force participation, limit job searches, reduce labor effort or invest in riskier projects—all of which could adversely affect the longer-term economic prospects of households and the wider economy and render them vulnerable to adverse shocks. However, empirical work on this issue has not been definitive as to the exact impact of remittances on the supply of labor. For instance, a study on Pakistan found remittances to have had a significant negative impact on the labor force participation of males, but does not indicate the other activities the recipients may have been pursuing—remittances could have made it possible for them to pursue education, which should enhance long-term growth (Chami et al, 2003). Indeed, a rise in remittances is shown to have reduced labor force participation in Managua, Nicaragua, but increased self-employment (Funkhouser, 1992; World Bank, 2006). By contrast, other research has indicated more positive effects of remittances on labor force participation, showing them to reduce the supply of child labor but increase that of adult labor (Yang, 2005; World Bank, 2006).

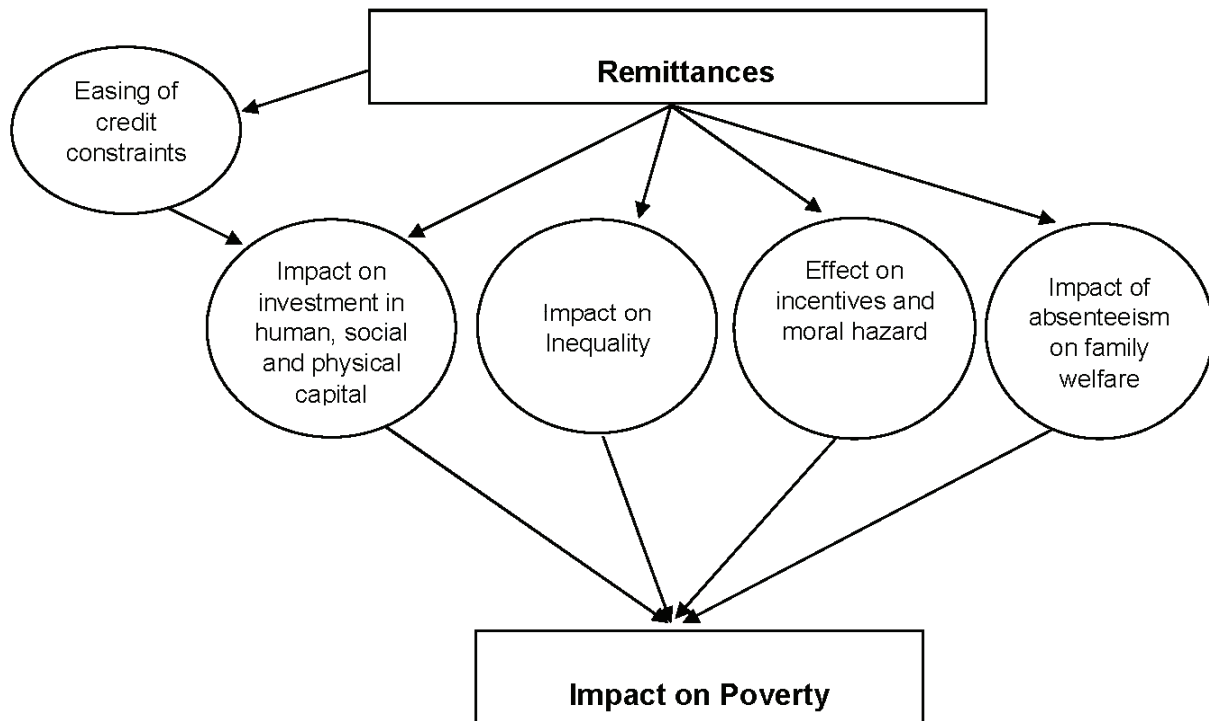
While research by Chami, Fullenkamp and Jahjah find remittances to be negatively associated with economic growth, due to the moral hazard problems cited above, the empirical evidence on this issue is mixed (Chami et al, 2003). This is partly due to the difficulties in assessing the direction of causality, given the fact that in many cases remittances respond countercyclically to economic growth. Moreover, to the extent that they encourage investments in human and physical capital, remittances should have a positive effect on growth. However, these effects are difficult to measure since they are realized over a long period of time.

9 The likelihood of remittances triggering business development is greater for low to middle-income households that have the requisite skills to operate a business but are likely to face credit constraints.

Summary

On balance, there is evidence of remittances smoothening household consumption and reducing poverty. Yet, the impact of remittances on poverty is complex and nuanced. While a combination of evidence from econometric analysis and household surveys suggest that remittances have reduced poverty in many countries, the magnitude has varied and often depended upon how poverty is measured. Moreover, analyses of the longer-term impact of remittances on poverty needs to account for varying and sometimes conflicting effects on a number of variables including income distribution, savings and investment, access to credit and incentives to work. The balance of evidence appears positive in most cases but, in the final analysis, specificities relating to the characteristics of migrants and conditions in the home country are often important in determining the impact of remittances on the longer-term economic prospects of recipient households.

Figure 2. Channels through which remittances may impact on poverty



Policy Implications

A theme that has been prevalent throughout this paper has been that cross-country generalizations about the impact of remittances on economic security are useful only up to a certain point. Beyond that their effect can be influenced by the interplay of various factors relating to the motivations and characteristics of migrants, economic/social/political conditions in the country of origin, immigration policies and conditions in the host country, and the size and concentrations of the remittances. Given the independent dynamics driving some of these factors, there are clearly limitations to the extent to which policy can determine and shape the economic impact of remittances. It may therefore make sense to begin by outlining the areas where governments should exhibit caution in their actions and, in some cases, limit their interventions.

- For a start, some current policy practices pose pitfalls. Efforts to channel remittances to business investment should not overreach themselves and be unduly interventionist. They should exist only to attract those migrants who have entrepreneurial qualities and intentions, otherwise they are unlikely to succeed. Even matching-fund programs such as Mexico's three-for-one initiative, that can effectively leverage small volumes of collective remittances, have on occasions been criticized for not being scalable and diverting funds from other local priorities. Similarly active government attempts to encourage remittances could be counterproductive in instances where they are contributing to macroeconomic vulnerability. Even in cases where they are countercyclical and contribute to economic security, certain measures to increase them have come under critical scrutiny. For instance, almost all developing countries offer tax incentives to attract remittances. However, such exemptions may only serve to encourage tax evasion.
- In recent years, a number of developing country issuers have employed the securitization of future flows of foreign exchange to avoid a credit squeeze in the face of deteriorating sovereign risk ratings. However, the strategy is not without its risks. In addition to the usual hazards associated with accumulating foreign currency debt, its adoption needs to be viewed with caution in cases where remittance flows are volatile and procyclical, which in such cases may serve to increase macroeconomic vulnerabilities.
- The potential positive impact of remittances on economic security should not be seen as a substitute for effective action by governments or the international community to respond to natural disasters, to provide public services and in general to implement effective development-oriented policies. Neither should remittances be viewed as a substitute for official development aid—they are after all private sources of finance that should not be expected to fund public projects. Moreover, as mentioned earlier, they often do not go to the poorest households (nor in any case to all lower-income households) and official assistance remains necessary to address the needs of these people.

Like other forms of international capital flows, remittances are likely to be more effective in an enabling domestic economic and financial environment. In particular, an enabling investment climate may be more effective in encouraging remittances to flow into productive business investments than other forms of policy intervention. In addition, well-developed financial systems and sound institutions may encourage a higher share of remittances to be better invested in areas that may contribute to strengthening economic security at all levels in the longer-term. For instance, remittances received through a bank account are more likely to be saved and get invested in both physical and human capital; they may, moreover, also be channeled into microfinance ventures.

In this respect, it has been argued that increasing the penetration of formal financial intermediaries—including microfinance institutions, credit unions and savings banks—may be an effective way of increasing the long-term productive impact of remittances. Besides encouraging saving out of remittances, these financial intermediaries can enhance the development and economic security impact of remittances through introducing senders and recipients to other financial services such as savings accounts, insurance, small business and housing credit. This may entail the creation of financial services with linkages to remittances such as remittance-linked consumer loans and services and the usage of remittance receipt for evaluation of a recipient's credit worthiness, all of which would serve to enhance households' access to capital and also promote financial deepening (Ratha, 2007). However, for these possibilities to materialize, existing

laws and regulations may need to be amended to encourage the participation of a wide range of financial intermediaries in the remittance market, ensure a level competitive playing field between them, and facilitate their operations in the most relevant regions.

Moreover, national efforts to encourage remittances to flow through official financial channels may need to be complemented by cooperation at the international level. In this respect, there are concerns relating to countries suffering from conflict/state collapse that have experienced instability in remittance flows due to emerging international security concerns (related to terrorism). A classic example is Somalia where, in the absence of a functioning state apparatus, remittances became a lifeline to its inhabitants during the 1990s. In the absence of a formal banking system, remittances flows to the country were dominated by a firm that was shut down by the United States in 2001 due to suspicions of links with terrorism. Such cases may highlight the need for the international community to create a transparent and acceptable international money transfer system for countries in conflict/state collapse that rely heavily on remittances. One proposal has been for the international community to underwrite the development and maintenance of a common electronic platform that would facilitate remittance transfers—ensuring greater transparency, reduced security risks and lower transactions costs (Kapur, 2003).

There are also a range of additional measures related to attracting and strengthening the broader economic impact of remittances that could also, depending on the characteristics of these flows, have a positive impact on economic security. These include actions, suggested elsewhere in the literature, to reduce the costs of remittances and overcome the relevant policy, regulatory and market barriers that impede their potential utilization for development. Where the flows are shown to be stable, these also include actions to leverage remittances to strengthen the capital market access of financial institutions and countries.

Overall, though, the most obvious starting point for policy action would be to strengthen the availability and quality of data, information and analyses relating to international remittances. As a result, policy making is running ahead of knowledge. Greater research is required on a number of issues mentioned above, including on the size, channels and cyclical behavior of remittances as well as the conditions determining its impact on poverty-related variables such as inequality, health and education. More empirical analysis is also needed on the degree to which remittances ease credit constraints, especially during periods of adverse shocks, and impact on microeconomic incentives facing recipients. Above all, there is a need to better document and account for the size and impact of the large amount of remittances that flows through unrecorded channels.

In this regard, it may be particularly useful to have more analysis on possible differences in female and male migrants' remitting behavior, including their relationship with economic cycles, natural disasters and conflicts. While there has been relatively little research on gender-based differences in remittances, work undertaken by Orozco et al of remittance senders originating from Latin America, Caribbean and Africa appears to indicate that women migrants are more altruistic in their remitting behavior than men. While, on the authors' admission, the tests conducted were incomplete due to a lack of data about characteristics of receiving households, they nevertheless point to the possibility of important gender differences that may have policy implications. If, as these preliminary findings suggest, women are more committed to sending money over the longer-term and are more willing to remit to more distant, as opposed to immediate, family members, their remittances may possibly be more counter-cyclical and more forthcoming after natural and man-made calamities (Orozco, 2006). This is clearly an area in which further research would be useful.

In closing, the huge levels of remittance flows to developing countries indicate their potential to significantly impact on economic security at all levels. Moreover, these may grow further over the medium term owing to increasing migration pressures. While there is some evidence of a positive effect of international remittances on various facets of economic insecurity, this paper has attempted to illustrate the many complexities and nuances here. These in turn have implications, suggesting policy caution in some areas in addition to action in others. At the same time, there is a growing need to enhance our understanding about the size, concentration and impact of remittance flows through improving their documentation, and the quality of available data, information and analyses.

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