

Leveraging Remittances for Development

Dilip Ratha*

Development Prospects Group
World Bank
1818 H Street N.W.
Washington D.C. 20433

Paper prepared for the Second Plenary Meeting of the **Leading Group on Solidarity Levies to Fund Development**, Oslo, February 6-7, 2007.

* Thanks to Uri Dadush and Sanket Mohapatra for extensive discussions, and Zhimei Xu for research assistance. The views expressed are the author's own, not those of the World Bank. The author can be reached at dratha@worldbank.org.

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1. Introduction

Migrant remittances have become a major source of external development finance. They can play an effective role in reducing poverty. And they provide a convenient angle for us to approach the complex migration agenda.

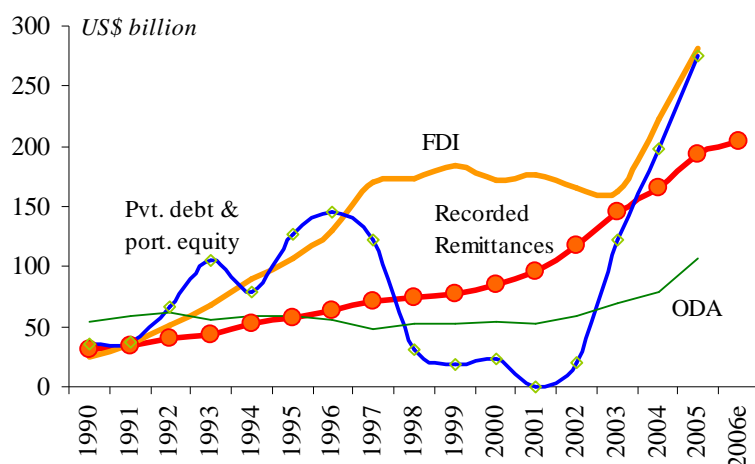
Remittances, however, are personal flows from migrants to their friends and families. They should not be taxed or directed to specific development uses. Instead, the development community should make remittance services cheaper and more convenient, and indirectly leverage these flows to improve financial access of migrants, their beneficiaries, and the financial intermediaries in the origin countries.

This note is organized as follows. The next section highlights the growing importance of remittances, and their development impact. Policy interventions to facilitate remittance flows and to leverage these flows for financial access of households and capital market access of financial intermediaries are discussed in section 3. The concluding section summarizes the international remittances agenda.

2. The growing importance of remittances, and their development impacts

Remittances received from migrants abroad are the largest source of external finance for the developing countries as a group. In 2006, recorded remittances sent home by migrants from developing countries exceeded \$200 billion, up from \$193 billion in 2005 and more than double the level in 2001 (annex table). The true size of remittances, including unrecorded flows through formal and informal channels, is believed to be even larger. They are larger than foreign direct investment and more than twice as large as official aid received by developing countries (figure 1).

Figure 1: Remittances and capital flows to developing countries

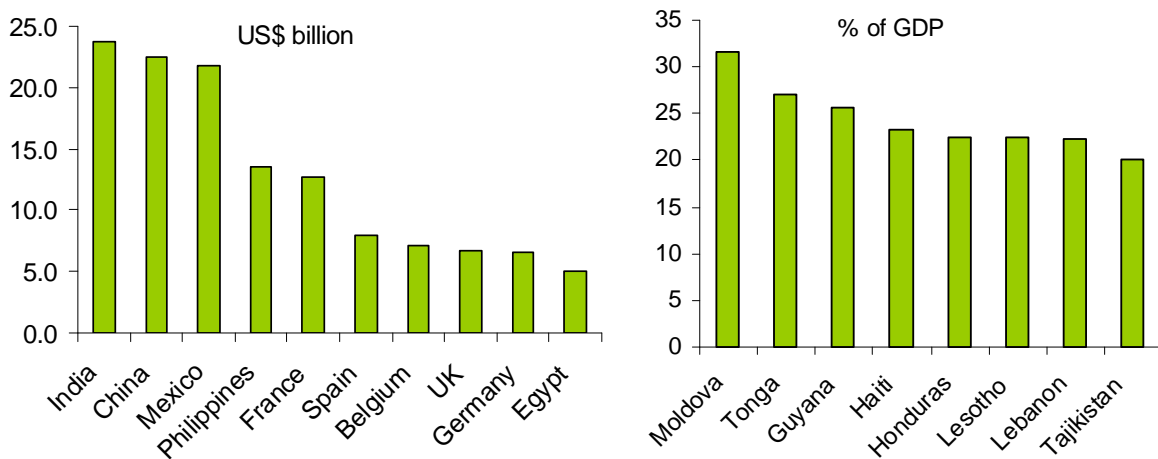


The doubling of recorded remittances over the last five years is a result of a combination of factors: better measurement of flows; increased scrutiny since the terrorist attacks of September 2001; reduction in remittance costs and expanding networks in the industry; depreciation of the dollar (raising the dollar value of remittances in other currencies); and growth in the migrant stock and incomes.

Poor countries receive relatively larger remittances

In 2006, the top three recipients of remittances—India, China, and Mexico—each received over \$23 billion. But smaller and poorer countries tend to receive relatively larger remittances when the size of the economy is taken into account. Expressing remittances as a share of GDP, the top recipients were Moldova (31.7%), Tonga (27.0%), Guyana (25.7%) and Haiti (23.2%). Remittances are thus more evenly distributed across developing countries than private capital flows.

Figure 2: Top recipients of remittances

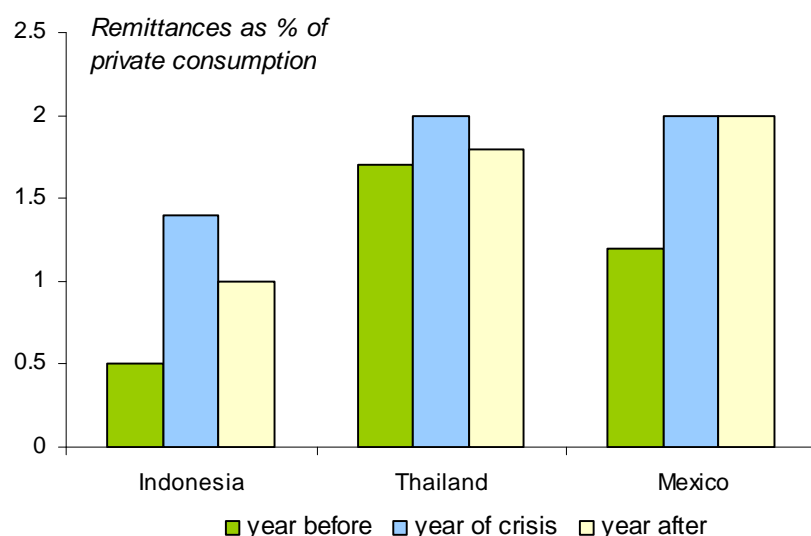


Remittances exceed 10% of GDP in 22 developing countries. They are larger than capital flows in 36 developing countries; merchandise exports in 12 countries; and the largest single commodity exports in 28 countries. They are larger than foreign direct investment in Mexico, tea exports in Sri Lanka; tourism revenue in Morocco; and the revenue from the Suez Canal in Egypt.

Remittances are stable or even counter-cyclical

Remittances tend to be more stable than private capital flows, and may even be counter-cyclical relative to the recipient economy. They tend to rise when the recipient economy suffers a downturn in activity, an economic crisis, natural disaster, or political conflict, as migrants may send more funds during hard times to help their families and friends. They rose during the financial crisis in 1995 in Mexico, and in 1998 in Indonesia and Thailand (figure 3). They also increased following hurricanes in Central America. In Somalia and Haiti, they have provided a lifeline for the poor. In addition to bringing the direct benefit of higher wages earned abroad, migration, therefore, helps households diversify their sources of income and thus reduce their vulnerability to risks.

Figure 3: Remittances rise during crisis, natural disaster, or conflict



Remittances reduce poverty

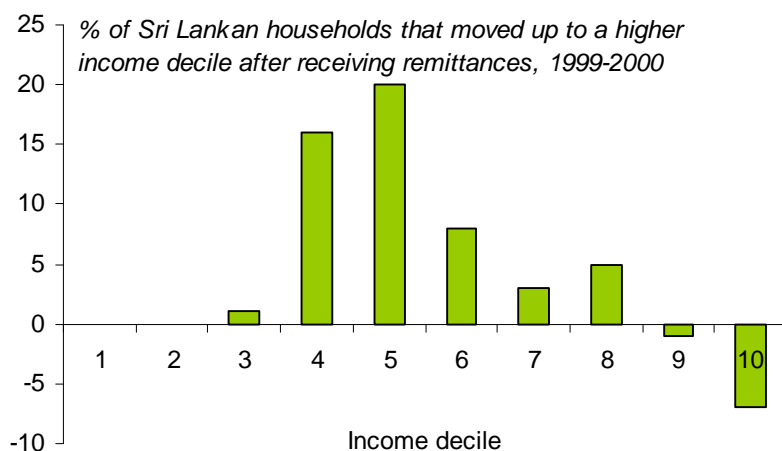
Remittances directly augment the income of the recipient households. In addition to providing financial resources for poor households, they also indirectly affect poverty and welfare through indirect multiplier effects and also macroeconomic effects. Cross-country regression analysis also show significant poverty reduction effects of remittances: a 10% increase in per capita official remittances may lead to a 3.5% decline in the share of poor people. Recent research indicates that remittances reduced poverty in Sub-Saharan Africa and Latin America, although with heterogeneous effects across countries.

Household survey data show that remittances have reduced the poverty headcount ratio significantly in several low-income countries—by 11 percentage points in Uganda, 6 percentage points in Bangladesh, and 5 in Ghana. In Nepal, remittances may explain a quarter-to-half of the 11 percentage point reduction in the poverty headcount rate over the last decade (in the face of a difficult political and economic situation).

The analysis of poverty impact of remittances must account for counter-factual loss of income that the migrant may experience due to migration (for example, if the migrant has to give up his or her job). Such losses are likely to be small for the poor and unemployed, but large for the middle- and the upper-income classes.

Very poor migrants may not be able to send remittances in the initial years after migration. Also the remittances of the very rich migrants may be smaller than the loss of income due to migration. But for the middle-income groups, they enable recipients to move up to a higher income group. In Sri Lanka, for example, households from the third through the eighth income decile moved up the income ladder thanks to remittances.

Figure 4: Remittances help reduce poverty



Source: Global Economic Prospects 2006

Remittances finance education, health and entrepreneurship

Remittances are associated with increased household investments in education, entrepreneurship, and health—all of which have a high social return in most circumstances. Studies based on household surveys in El Salvador and Sri Lanka find that children of remittance recipient households have a lower school drop-out ratio and that these households spend more on private tuition for their children. In Sri Lanka, the children in remittance receiving households have higher birth weight, reflecting that remittances enable households to afford better health care. Several studies also show that remittances provide capital to small entrepreneurs, reduce credit constraints and increase entrepreneurship.

Remittances may cause currency appreciation

Large remittance inflows, like any other foreign currency inflows, can cause an appreciation of the real exchange rate and raise the international price of traditional exports. Although empirical evidence of such “Dutch disease” effects of remittances is still lacking, they are likely to be large in small economies. Several countries including El Salvador, Kenya and Moldova are concerned about the effect of large remittance inflows on currency appreciation.

The traditional “sterilization” technique used to prevent currency appreciation due to natural resource windfalls, however, is not appropriate for addressing the currency appreciation due to remittances. Unlike oil windfalls, remittances persist over long periods. Trying to sterilize their impacts year after year which can be very costly. Countries have to learn to live with these persistent flows. Government spending on infrastructure and efforts to raise labor productivity can to some extent offset the currency appreciation effects of remittances.

The effect of remittances on growth is mixed

To the extent that remittances finance education and health and increase investment, remittances could have a positive effect on economic growth. In the economies where the financial system is

underdeveloped, remittances may alleviate credit constraints and act as a substitute for financial development. On the other hand, large outflow of workers (especially skilled workers) can reduce growth in countries of origin. Remittances may also induce recipient households to choose more leisure than labor, with adverse effects on growth.

Remittances may be more effective in a good policy environment. For instance, a good investment climate with well-developed financial systems and sound institutions is likely to imply that a higher share of remittances is invested in physical and human capital. Remittances may promote financial development, which in turn can enhance growth.

Empirical evidence on the growth effects of remittances, however, remains mixed. In part, this is due to the fact that the effects of remittances on human and physical capital are realized over a very long time period. In part, this is also due to the difficulty associated with disentangling their counter-cyclical response to growth which implies that the causality runs from growth to remittances, but the correlation between the two variables is negative. It has not been easy to find appropriate instruments for controlling such reverse causality. It would be easy to conclude that remittances have a negative effect on growth, but that would be erroneous. Also, to the extent that they increase consumption, remittances may increase individual income *levels* and reduce poverty, even if they do not directly impact growth.

3. Leveraging remittances for development

Governments in destination and origin countries can facilitate remittance flows and enhance their development impacts through the application of appropriate policies. It is worth noting from the outset, however, the pitfalls of some current policy practices. Almost all developing countries offer tax incentives to attract remittances; but such tax exemption on remittances may encourage tax evasion. Matching-fund programs (such as Mexico's 3-for-1) may effectively leverage small volumes of collective remittances from migrant associations for small community development projects; but such programs may not be scalable, and may divert funds from other local funding priorities. Efforts to channel remittances to investment have met with little success. Instead, efforts should be made to improve the overall investment climate in the origin countries. Some governments have been toying with the idea of taxing remittances. Taxation of remittances would have a similar effect as raising remittance costs, and would hurt the poor migrants and their families in origin countries. Taxation would also drive remittance flows further underground.

Remittances should not be viewed as a substitute for official development aid. Fundamentally, they are private money that should not be expected to fund public projects. Not all poor households receive remittances; official funding is necessary to address the needs of such households.

Leveraging remittances for financial access of the migrants and their beneficiaries

Encouraging remittances through banking channels can improve the development impact of remittances by encouraging more saving and enabling better matching of saving with investment opportunities. If remittances are received as cash, they are less likely to be saved than if they were received through a bank account.

For many poor households and migrants, remittances are the only point of contact with the formal financial sector. By providing remittance services, banks and other financial institutions can attract new customers for their deposit and loan products. Micro-finance institutions can use the history of remittance receipts to judge credit history of potential customers.

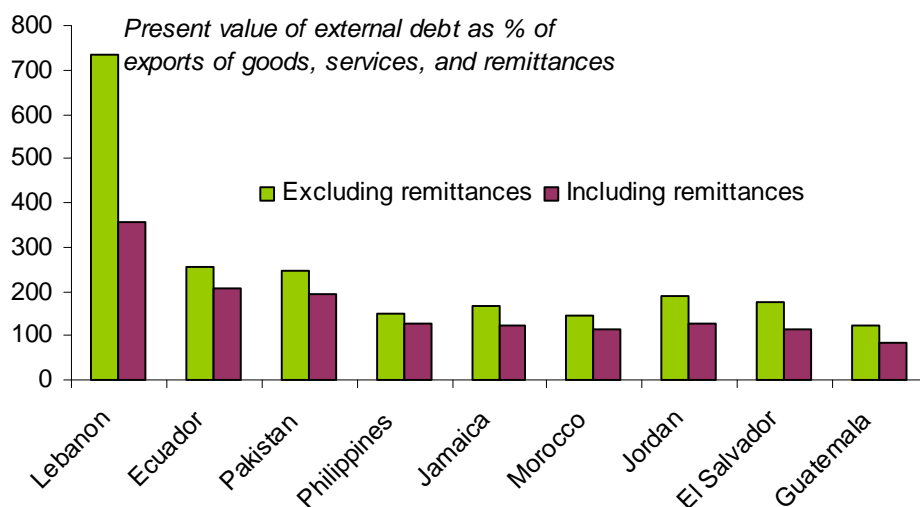
Both sending and receiving countries can increase banking access of migrants by allowing origin country banks to operate overseas, and providing identification cards (such as the Mexican *matricula consular*) which are accepted by banks to open accounts. Access to remittance services in rural and remote areas can be improved by encouraging the participation of microfinance institutions, credit unions, saving banks (including postal saving schemes) in the remittance market. Existing regulations may need to be amended in order to allow these institutions to more fully participate in providing remittance services. In many countries, microfinance institutions would need legal permission to receive foreign exchange. In some cases, they may need limited access to national clearance and settlement systems.

Leveraging remittances for capital market access of financial intermediaries

Remittances can improve a country's creditworthiness and thereby enhance its access to international capital markets. Hard currency remittances, properly accounted, can significantly improve country risk rating. The ratio of debt to exports of goods and services, a key indebtedness indicator, would increase significantly if remittances were excluded from the denominator (figure 5). Model-based calculations using debt to export ratios that include remittances in the denominator indicate that including remittances in creditworthiness assessments would improve credit ratings for Lebanon and Haiti by two notches; and result in implied sovereign spread reductions ranging from 130 to 334 basis points.

Future flows of remittances can be used as collateral to improve the rating of the sub-sovereign borrowers, allowing them to pierce the sovereign rating ceiling. Several banks in developing countries (e.g., Brazil, Egypt, El Salvador, Guatemala, Kazakhstan, Mexico, and Turkey) have been able to raise cheaper and longer-term financing (more than \$15 billion since 2000) from international capital markets via securitization of future remittance flows. By mitigating currency convertibility risk, a key component of sovereign risk, the future flow securitization structure allows securities to be rated better than the sovereign credit rating. In the case of El Salvador, for example, the remittance-backed securities were rated investment grade, two to four notches above the sub-investment grade sovereign rating. Investment-grade rating makes these transactions attractive to a wider range of "buy-and-hold" investors (for example, insurance companies) that face limitations on buying sub-investment grade. As a result, the issuer can access international capital markets at a lower interest rate spread and longer maturity. Moreover, by establishing a credit history for the borrower, these deals enhance the ability and reduce the costs of accessing capital markets in the future.

Figure 5: Remittances improve country creditworthiness



Reducing remittance costs

Reducing remittance fees would increase the disposable income of poor migrants, and their incentives to send more money home. Reducing remittance costs would also encourage the use of formal remittance channels.

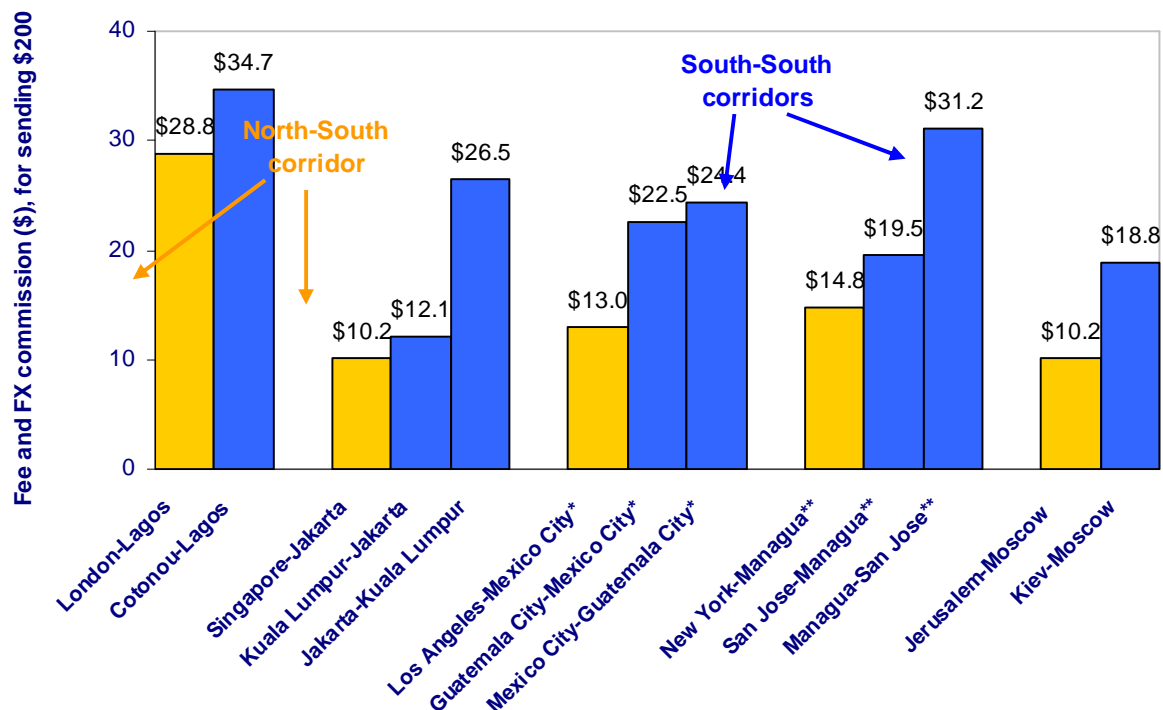
The cost of sending remittances tends to be high, and regressive. A typical poor migrant sends about \$200 or less per transaction. The average cost of sending remittances through the top 3 MTOs (Western Union, MoneyGram and Dolex) can be as high as \$16 for \$100 and \$18 for \$200. These fees tend to be highly regressive as smaller remittances used by the poor migrants cost more.

With increased awareness among policy makers and migrants, and falling costs of technology, remittance costs are falling in recent years. In the US-Mexico corridor, for example, the cost of sending \$300 fell by 54 percent between 1999 and 2004, from over \$26 to \$12. Since then, however, costs have remained sticky, dropping only to \$10.6 by the end of 2006.

South-South remittance costs are even higher than North-South remittance costs (figure 6). Nearly half of the migrants from the South live in the South. Yet South-South remittances are either impossible due to capital and exchange controls, or they are prohibitively expensive as the currency conversion charges have to be paid at both ends.

High remittance costs faced by poor migrants can be reduced by increasing access to banking and strengthening competition in the remittance industry. Banks tend to provide cheaper remittance services than money transfer operators. Costs could be cut by strengthening competition in the remittance industry. Entry of new market players can be facilitated by harmonizing and lowering bond and capital requirements, and avoiding overregulation such as requiring a full banking license for specialized money transfer operators.

Figure 6: South-South remittance fees are higher than North-South remittance fees



Source: Ratha and Shaw (2007)

While regulations for anti money-laundering and countering the financing of terrorism (AML/CFT) are necessary for security reasons, they should not make it difficult for money service businesses to operate accounts with correspondent banks. There is currently little clarity on these regulations, and to make matters worse, they are not systematic or harmonized. Developing transparent compliance guidelines on AML/CFT regulations should be a policy priority.

Sharing payment systems would avoid duplication of efforts. Establishing partnerships between remittance service providers and existing postal and other retail networks would help expand remittance services without requiring large fixed investments. However, exclusive partnerships between post office networks and money transfer operators have often resulted in higher remittance fees than when there are no such partnerships. Partnerships should be non-exclusive.

Requiring greater disclosure on remittance fees from remittance service providers would help remitters make informed choices. Poor migrants would also benefit from financial education.

4. Summary - the International Remittances Agenda

Remittances can contribute significantly to poverty reduction and other millennium development goals. Following the discussion above, the international remittances agenda can be summarized under four headings (annex diagram):

1. Monitoring, analysis, and projection
2. Retail payment systems
3. Financial access of individuals or households
4. Leveraging remittances for capital market access of financial institutions or countries.

1. Monitoring, analysis, and projection. This part includes understanding the size, corridors, channels, and costs of remittances (and migration) flows, and the cyclical behaviour of these flows; analysis of impacts on poverty, inequality, education, health, investment in remittance recipient countries; and analysis of policy factors affecting remittance costs—for example, entry barriers and exclusivity contracts affecting market competition and exchange controls affecting foreign exchange commission—and the effect of cost reduction on size and channels of flows also falls under this group.

2. Retail payment systems. The changes in the payment system relating to personal remittances impact all retail or small-value payments including those for person-to-business and business-to-business payments. The items in this category include new payment platforms or instruments (including cell-phone-based, card-based, or internet-based remittance instruments); prudential capital requirements and regulations governing access of remittance agents to clearing and settlement systems; compliance with anti-money-laundering and the countering of the financing of terror (AML/CFT); disclosure of remittance fees; and cross-border arbitration in the event that a remittance transaction is not delivered as per the service promise.

3. Financial access of individuals or households. While financial intermediaries such as banks, micro-finance institutions, credit unions and saving banks can help deliver remittance services, they can also benefit by offering remittance services which may attract new customers, and encourage them to save and invest. Besides encouraging saving out of remittances, these financial intermediaries can develop remittance-linked consumer or housing loans and insurance products; can use the history of remittance receipt for evaluation of a recipient's creditworthiness.

4. Leveraging remittances for capital market access of financial institutions or countries. Large and stable remittance flows undoubtedly improve country creditworthiness and thereby creditworthiness of sub-sovereign entities as well. Banks in many countries have used future remittances as collateral for raising significant bond financing (sometimes billions of dollars) from international markets. The interest spread on these bonds were lower, and tenor higher, than comparable plain sovereign bonds. Some estimates show that the potential for such bond financing remains untapped, especially in many poor countries that also receive significant remittances. The funds raised via these bonds can be targeted to specific development projects.

Annex Table: Global flows of international migrant remittances (\$ billion)

<i>INFLOWS</i>	2000	2001	2002	2003	2004	2005	2006 ^e	<i>Change 2005-06</i>	<i>Change 2001-06</i>
All developing countries	85	96	117	145	165	193	203	5%	112%
Low-income countries	22	26	32	40	42	48	52	8%	102%
Middle-income	63	70	85	105	123	145	151	5%	116%
Lower MICs	43	48	61	75	86	98	102	4%	113%
Upper MICs	20	22	24	30	37	47	50	6%	122%
East Asia and the Pacific	17	20	29	35	39	44	45	16%	170%
Europe and Central Asia	13	13	14	17	23	31	31	1%	144%
Latin America and the Caribbean	20	24	28	35	41	48	52	8%	113%
Middle-East and North Africa	13	15	16	21	23	24	25	5%	71%
South Asia	17	19	24	31	30	35	36	9%	102%
Sub-Saharan Africa	5	5	5	6	7	7	7	0%	89%
High income OECD	46	50	52	59	66	68	68	0%	37%
World	132	147	170	205	233	262	273	4%	86%
<i>OUTFLOWS</i>	2000	2001	2002	2003	2004	2005		<i>Change 2004-05</i>	<i>Change 2001-05</i>
All developing countries	12	14	21	25	32	38		19%	167%
High income OECD	76	83	88	98	111	119		7%	44%
High income non-OECD	22	22	22	21	20	22		7%	-1%
World	110	118	131	144	163	179		9%	51%

Source: Author's calculation based on data from IMF Balance of Payments Statistics Yearbook 2006. Remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers. The entire dataset is available at www.worldbank.org/prospects/migrationandremittances.

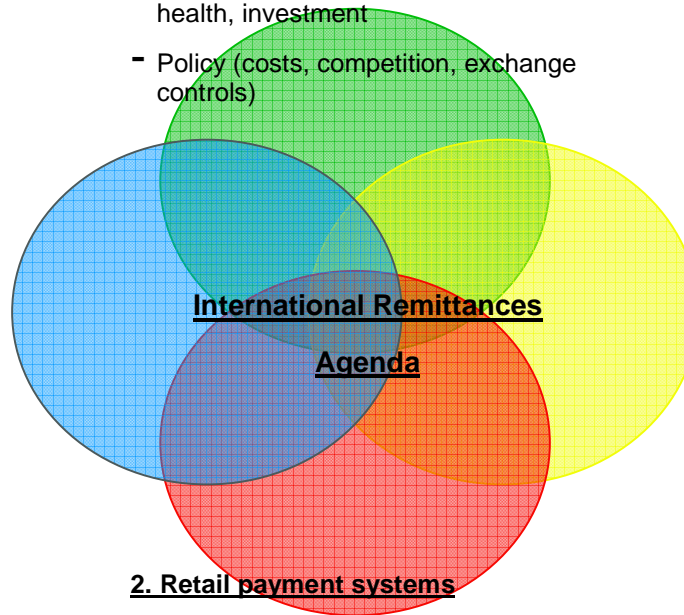
The International Remittances Agenda

1. Monitoring, analysis, projection

- Size, corridors, channels
- Counter-cyclicality
- Effects on poverty, education, health, investment
- Policy (costs, competition, exchange controls)

3. Financial access

- Deposit and saving products
- Loan products (mortgages, consumer loans, microfinance)
- Credit history for MFI clients
- Insurance products



4. Capital market access

- Private banks and corporations (securitization)
- Governments (diaspora bonds)
- Sovereign credit rating

2. Retail payment systems

- Payment platforms/instruments
- Clearing and settlement, capital adequacy, disclosure, cross-border arbitration
- AML/CFT