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A Contribution to WDR 2005 on Investment Climate, Growth and Poverty

Migrant Remittances and the Investment Climate: Exploring the Nexus

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Key Messages

1. Migrant remittances are the second largest source of private capital flows into developing countries after FDI. Officially recorded remittance flows alone amounted to about USD 80 billion in 2002.
2. Remittance flows augment forex reserves, strengthen the deposit base, and are beginning to improve country credit ratings. Although migration may result in a brain drain, these flows and the capital and human skills of migrant returnees, can contribute to investment and wealth creation.
3. Remittances can be facilitated by improving financial infrastructure and systems which will also enhance the investment climate.

The views and opinions expressed in this study are those of the author and do not necessarily correspond to the views or policies of the Department for International Development (DFID), UK.

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Introduction

> *"A positive investment climate is important for the effective utilization of all types of capital flows, including FDI, remittances, aid and debt."* Nicholas Stern, World Bank Chief Economist and Senior Vice President for Development Economics. (World Bank News Release No: 2003/266/S)

1. Migrant remittances[1] to developing countries have become a key source of global development finance, reaching USD 80 billion (2002).[2] They have more than doubled in the past decade and are outpacing the growth in migration. By 2001, remittances have far surpassed ODA flows (equivalent to 260% of ODA) and are the second largest source of private capital flows into developing countries after FDI (equivalent to 42% of FDI flows). Compared to other financial flows they are much less volatile and often counter-cyclical, buffering external shocks such as natural disasters.[3] They make important contributions to human and social capital and also to the generation of capital assets.[4]

2. There is a dialectical relationship between remittances and the investment climate: remittance flows are not only affected by the investment climate in a country (through monetary policies and financial infrastructure, for instance) but also affect the investment climate (such as through the availability of forex reserves and through future-flow securitisation). This paper explores the nexus between remittances and the investment climate and points to some policy reactions and challenges.

Remittances Change the Investment Climate

3. Migrant remittances to all developing countries equal 1.3% of their GDP and are equivalent to 3.9% of total imports. The effect is most pronounced for low income countries, where they represent 1.9% of GDP and are equivalent to 6.2% of imports. For small island nations, such as Tonga, Cape Verde or Jamaica, the per capita and GDP contributions are highest (Ratha, 2003), and for countries such as Tonga, Lesotho,

Albania and Jordan remittance flows exceed all other financial flows (Buch et al., 2002). Remittance flows are heavily underreported in official statistics so that the true importance of remittances is likely to be far greater than the figures above suggest. (Gammeltoft, 2002; Sander, 2003)

4. Migrant remittances also augment forex reserves. Not only does this provide foreign currency for servicing public debt but also for the private sector, particularly where there is a strong dependence on imported inputs or capital goods, which may be constrained by the availability of forex.

5. In fact, as the growth profile and stability of remittance flows is becoming established in an increasing number of country cases, migrant remittance flows have begun to improve country credit ratings and are also being used for future-flow securitisation, for instance for national bond issues – as is the case in Brazil (Ketkar et al., 2001), the Philippines, Mexico and Turkey (Ratha, 2003). Future-flow securitisation has also been suggested as a sectoral instrument for agriculture lending in Africa (Rutten et al., 2003).

6. Another effect of remittances is a strengthened deposit base for the domestic banking system. While remittances cover in large part daily expenditures of recipients, even the small amounts of between 1 and 10% frequently reported as flowing into savings constitute a significant expansion to typically low deposit bases in developing countries.

7. Similarly, considering that domestic sources fund nine tenths of investments in developing countries (Stern, 2003), migrant remittances and savings of return migrants constitute one source of capital for business investments. Studies document that investments in businesses are partially financed through remittances – though proportions vary greatly and tend to be at a single digit percentage of the total remittance flow. In aggregate terms, however, remittances are equivalent to just below 6% of domestic investment (Ratha, 2003). Again, much of the effect is likely to be

underestimated as, for instance, remittances are also likely to be the capital behind many informal loan arrangements, especially within families, and to thereby again contribute to business investments.

Remittances Invested in Savings and Businesses

In Albania, a country with unusually high remittances and a high proportion of their investment, a survey found that 16% of remittance receipts are saved, 14% invested in business and 7% invested in property. Remittances were also the second most important source of capital in establishing a business with 18% compared to 56% in own capital. In addition, some of the loans from family and friends providing 16% of the capital may also be financed from remittances. In contrast, loans from financial institutions accounted for about 6%. (Kule et al., 2002)

In Mexico, one study found that almost 20% of capital invested in microenterprises in urban Mexico came from remittances (Woodruff et al., 2001). Another study of Mexico shows estimates of about 5% of remittances being invested in small business (Coronado, 2002).

A more typical distribution of remittance use, however, is about 80% for consumption as investment in human capital (daily expenses, health and education), up to 10% in savings (often through assets, such as livestock), and a small percentage of direct business investments. (Sander, 2003)

8. Many of these businesses tend to be at a micro or small scale and are often in services or trade – in part because productive businesses are harder to finance and riskier. Even with service or trade businesses, however, apart from the direct effects such as employment creation, the strengthening of the domestic business sector also provides actual and potential service and supplier businesses for investors in productive businesses as well as serving the employed population – for instance through IT support, accounting services, or canteens. In addition, returnees often bring know-how and skills which can make them more easily employable than their peers. They also tend to have surplus capital to buy essential personal assets, such as a car or mobile

phone, either for operating a microbusiness or for better access to jobs. Other aspects of the human capital generation through remittances include the better welfare and often also the higher educational levels of remittance receivers relative to their peers.

9. A flipside of all these effects on a national level is a potential for overspending on imports and also for dependence on remittance flows which, though less volatile than FDI for instance, can experience major dips due to events in key host countries. This includes examples of wars such as in the Gulf or in Ivory Coast, or changes in migration or labour policies, all of which can lead to reduced opportunities for migrants or their forced or voluntary return home. Another effect observed can be delays in structural reforms as both migration and remittances can reduce the urgency to deal with them (see, for instance, Koç et al., 2001, on Turkey).

Facilitating Features for Remittance Flows and Their Investment

10. As remittances are first and foremost a private financial flow of migrants back to their families, personal and welfare motivations are the key factors behind remittance flows. The volume of remittances is largely a function of migrant profiles and their destination and motivations are typically also strongly determined by factors pertaining to the host country. Higher remittance volumes are more likely for countries: with high emigration which is motivated by economic reasons; with migrants who have left behind close family, intend to return home, or are part of what has been labelled as 'circular migration' (cycles of departure and return); and for countries with high shares of migrants in host countries featuring relatively high and stable income levels.[5]

11. While determinants such as variations in market rates of foreign exchange seem to have no consistent effect on the level of remittance flows (Buch et al., 2002), recipient country policy initiatives such as liberalising foreign exchange rates (e.g. Uganda, Kasekende, 2000) or offering special terms on deposits (e.g. India, Rapoport et al., 2003) influence remittance behaviour: they tend to affect how remittances are sent and how they are used. These are often the same factors typically used to characterise

the investment climate more generally, such as economic stability, financial infrastructure, and a regulatory environment which facilitates businesses.

12. Data on remittance flows[6] and use is still too sketchy to attempt a thorough analysis of remittance flows compared to investment climate factors. Ratha (2003) in an analysis of aggregate data, however, observes associations between remittance flows and the investment climate in recipient countries similar to other capital flows, though less pronounced:

> *"During 1996–2000, for example, remittance receipts averaged 0.5 percent of GDP in countries with a higher than median level of corruption (as indicated by the index of the International Corruption Research Group) compared to 1.9 percent in countries with lower-than-median corruption (table 7.3). Countries that were more open (in terms of their trade/GDP ratio) or more financially developed (M2/GDP) also received larger remittances. In contrast to capital flows, however, remittances were significantly higher in countries that were high-risk (as measured by their Institutional Investor rating) and had a high level of debt relative to GDP. This is consistent with the finding (…) that low-income countries, which are usually high-risk, receive relatively more remittances as a share of GDP than do countries with higher incomes. In fact, in 1996–2000 remittances tended to be higher in poor countries that had lower than median growth rates, probably because most remittances to low income countries that are performing poorly are for consumption. By contrast, middle-income countries with higher-than-median growth rates had higher remittances, presumably because remittances tend to behave more like investment flows in these countries (table 7.4)."* (Ratha, 2003)

Workers' Remittance Receipts in Developing Countries based on *Institutional Investor* rating

% of GDP, 1996–2000

	High	Low
Corruption	0.5	1.9
Inequality (Gini index)	0.9	1.5
M2/GDP	1.2	0.9
Trade/GDP	1.2	1.0
Debt/GDP	2.3	0.8
Country risk	2.4	1.0

Note: High and low usually refer to above and below median of the concerned variable. The numbers reported are the sum of remittances of all countries in the group divided by the sum of GDP of the same countries. Average remittances and average GDP during 1996–2000 are used for each country included in these calculations. Lesotho is excluded from these computations. Source: WDI, GDF, IMF balance-of-payments data, World Bank staff estimates.

Source: Ratha, 2003, Table 7.3.

Remittances as % of GDP, 1996-2000

	Poor countries	Other
Higher than median growth	3.4	1.0
Lower than median growth	4.2	0.8

Note: Poor countries and other developing countries are defined as in GDF 2002. Refer to table 7.3 for data sources and other notes.

Source: Ratha, 2003, Table 7.4.

13. While this analysis reflects remittances through formal financial services and reported in official statistics, additional flows of remittances through informal channels are thought to be of the same magnitude. The share of informally transmitted remittances varies by country: A higher proportion of remittances is sent via formal financial services in countries with liberalised foreign exchange regimes, where the local currency and polito-economic environment are relatively stable, and where the financial infrastructure is well developed. In addition, the freedom to expatriate funds again at any time, and the opportunity to keep deposits in foreign denominations, tend to attract remittances through formal channels.

14. The same factors facilitate or hinder the investment of remittances, starting from the availability of financial services. More importantly, and even more limited in many cases than money transfer services, is access to other financial services such as savings (in local or in foreign currency), the availability and accessibility of investment products (e.g. term deposits), and of retail debt products such as mortgages. (Sander, 2003; Sander et al., 2003)

15. Apart from the primary need to support consumption which remittances serve, the instruments to build up financial assets through these flows are not readily accessible to either remittance recipients or to migrants themselves, whether in their host or home countries. Many of them do not have access to financial services often because they are not available or do not cater to the client segment of which they tend to be part. Most financial service providers look at transfers of remittances solely as a transaction without recognising the potential for cross-selling other services, especially savings and also mortgage or other lending products which can be adjusted to work with remittance flows for security and as income streams for repayments. While officially recorded remittance flows have been growing, much of this market is being captured by dedicated money transfer companies such as Western Union, judging by the growth in their services and volumes. Banks in many developing countries concentrate on corporate clients and high value individuals as their clients and tend to be overly liquid and not well motivated to seek to expand their client base and outreach given also good returns on their investment in government treasury bonds. Similarly banks in migrant host countries are often not interested in migrants as clients. (Sander et al., 2003).

Policy Challenges and Reactions

16. Remittances can be a double edged sword. As they result from migration, it can lead to a 'brain drain' rather than 'brain gain'. And while remittances should ideally contribute not only to improved welfare but also to wealth creation and investment, they can create dependencies both for the recipient countries and individuals. Nonetheless, though evidence as to how much remittances contribute to economic growth is still

sketchy, "(…) remittances tend to bring about an overall positive economic impact in the short run (income effects and effects on the balance of payments) as well as in the long run (alleviation of liquidity constraints for households at the middle-to-bottom of the income distribution, increased investments in the urban and rural sectors)." (Rapoport et al., 2003) More research is needed to deepen our understanding of the effects of remittances on economic growth and poverty reduction.

17. Though not all developing countries have substantial migrant remittance receipts, of those that do only some can at least partially quantify and 'work' with this financial flow. Their challenge is to 'switch gears' from attracting public and private debt and foreign direct investment to, first, recognising remittances as an important financial flow and then identifying how it can be facilitated to benefit the individual recipients and also the country more generally. Many aspects in the investment climate that facilitate or hinder FDI or domestic investments also attract or reduce the flow of remittances and especially their investment. At the same time, they are a source of direct capital for domestic investment and also indirectly through their contribution to building human and social capital.

18. The key for governments is to facilitate rather than channel or control remittances as the latter tends to encourage informal remittance transfers, in part because it does not respect the source and motivation for remittances. It is important as well to build on the benefits remittances can offer through investment vehicles that offer good returns to the saver or investor but that also generate a stronger deposit base and other effects which contribute to a stronger investment climate.

19. Governments such as Brazil, Mexico, India and the Philippines have recognised the relevance and potential of remittances and aim to attract them to investment vehicles or programmes they have launched, such as migrant pension plans or insurance, (non-repatriable) investment schemes, preferential access to capital goods and raw material imports for recent returnees, preferential loans or matching grants for

business ventures, and investment and advisory services for business start-up. (Sander, 2003)

20. The overall policy lesson which emerges from these indicates that an enabling environment for personal savings and investment and for enterprise investments must include an improved financial service infrastructure. Without the availability, accessibility and a demand-oriented range of relevant financial services and vehicles, sending, saving and investing remittances is difficult.

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Notes

[1] Migrant remittances are monies sent from one individual or household to another. International remittances are those sent be migrant workers who left their home country. Domestic remittances are those sent by migrant workers who left their home village or town to work elsewhere in their home country (e.g. rural-urban migration; sometimes also referred to as national remittances). Typically remittances are in cash rather than goods. Imports or goods purchased on location are, however, also common.

[2] Ratha, 2003. In an update of data presented at a migrant remittance conference in October 2003, Ratha estimated total flows to developing countries at USD 88 billion (Ratha, 2003a).

[3] This can be observed in the growth of remittances to areas affected by hurricanes, for instance, such as hurricane Hugo in Central America.

[4] Ratha, 2003. For further details, see also Buch et al., 2002; Gammeltoft, 2002; Orozco, 2003; Sander, 2003; and Sander et al., 2003.

[5] Economic surges and demand for migrant labour, such as the labour attraction schemes in post-war Germany, the technology boom in the United States or the heavy demand for mine workers in South Africa, creates opportunities and increases flows, whereas inversely any downturns or instability cause slumps, such as the repatriation of Mozambicans and Vietnamese from East Germany following unification or the effect of the wars on migrant workers in the Middle East and Ivory Coast, for instance.

[6] IMF Balance of Payment statistics, the main source of migrant remittance data, for instance, records only transfers in foreign currencies sent through formal financial services which report to central banks, and lack data for significant parts of the developing world; for example, data is lacking for circa one third of all developing and transition countries; for some regions this is more pronounced, for instance Sub-Saharan Africa with data gaps for two thirds of the countries (Gammeltoft, 2002; Sander, 2003).