CHAPTER

2 Literature on Remittances

The growing body of literature on migration and remittances provides a useful framework to analyze these phenomena in Moldova, as well as to help with policy conclusions and recommendations.[1] Analytically, this literature can be organized around three main topics: motivation behind remittances, use of remittances, and macroeconomic impact of migration and remittances.

The literature on the motivation behind remittances primarily considers migrants to be altruistic individuals whose utility function takes into account the consumption of the household members who remained in the home country. Other possible motivations include attachment to the home country and portfolio diversification (see Elbadawi and Rocha, 1992). Attachment to the home country can be viewed as a willingness to maintain ties at home through nonfinancial assets such as real estate and business investment, often managed by relatives. If the level of remittances is largely driven by altruism and attachment, then it is reasonable to expect remittance flows to be fairly stable and, given appropriate economic policies, partly channeled toward business investment. Moreover, the altruistic migrant would be expected to react to an economic crisis at home, or a job loss in the household, by raising the amount of remittances. Thus, remittance flows by altruistic migrants tend to be predictable and countercyclical—a blessing for policymakers. By contrast, migrants who care about diversifying their portfolios would tend to equalize returns on financial and fixed assets in their host and home countries. These remittances would be sensitive to interest rate differentials, political risk, and uncertainty, and would tend to be procyclical. In short, they behave like capital flows. As such, they are more problematic for policymakers, since they carry the usual risk associated with capital flow volatility.

[1]For a succinct and comprehensive review of the literature on remittances, see Bouhga-Hagbe (2004).

Typically, the literature on the motivation behind remittances has modeled their level on the basis of demographic, economic, and financial variables. Economic variables describe the economic situation facing the migrant and the family, such as wages and income in the host and home countries. Demographic variables describe the strength of the family ties. For example, the longer a migrant stays in a host country, the weaker the ties to the home country, thus the smaller the remitted amounts. Financial variables attempt to capture portfolio allocation behavior. The most reliable stylized fact from the empirical literature on the cause of remittances is that the demographic and economic variables tend to be significant in most model specifications, while the financial variables' significance depends on the sample size and specification (see Chami, Fullenkamp, and Jahjah, 2003).

The literature on the use of remittances explores the purposes for which funds are remitted to the home country. Three stylized facts emerge from this literature (Chami, Fullenkamp, and Jahjah, 2003): (1) a significant portion (often the majority) of remittances is spent on consumption; (2) a significant (but smaller) portion of remittances is channeled to savings or investments (houses, land, and related expenditures, such as renovations); and (3) such savings and investments are not necessarily productive for the overall economy, since the purchase of a house or land is not in itself a productive activity.

The macroeconomic impact of remittances is significant and acts through various channels. Remittances have become increasingly important as a source of external financing worldwide. Ratha (2003) reports that they are the second largest source of external financing in developing countries, after foreign direct investment (FDI), and are more critical for development and poverty reduction than foreign aid. They are mainly used for consumption and, to a lesser extent, for saving and investment. Investment, moreover, tends to be "unproductive" and is often concentrated in real estate. Although remittances finance investment in education, their net effect on human capital development can be negative, since emigration can potentially lead to brain drain.

The extent of brain drain varies considerably among countries. Adams (2003) finds that, for most countries, migration does not cause significant brain drain. For a few countries, however, especially those with wealthy neighbors, high proportions of the most highly educated people leave. Furthermore, the potential negative impact of brain drain on economic development has to be weighed against the positive impact of migration on human capital development and growth through several channels. First, returning migrants bring back their skills and work experience, thus boosting productivity. These new skills can offset the loss of migrants and may even lead to a "brain gain." For example, returnees from the United States established half of all the companies in Hsinchu, the largest science park in Taiwan Province of China, and the Chinese Ministry of

Science and Technology estimates that returning overseas students started most Internet-based ventures (Cervantes and Guellec, 2002). India's software industry has been built in part on the skills of returning migrants. Second, the possibility of migration for higher wages and economic opportunities can stimulate individuals to pursue higher education. Because not everyone will leave, the result will be an increase in the average skills of the workforce. Third, international trade may flourish between countries that export labor services and countries that import them (*The Economist*, 2002).

The impact of remittances on economic agents and the economy varies over time. The contribution of remittances to growth appears to be positive in the short term. Part of remittances-induced consumption spending benefits domestic producers, thereby creating a Keynesian-type multiplier effect. Indeed, several studies report positive multiplier effects of remittances on short-term growth. Remittances also have a positive impact on poverty reduction, because they are transferred directly to households and are thus naturally well targeted, instead of being channeled through the government—as is the case with foreign aid. Moreover, remittances can also contribute to macroeconomic stability, since they tend to be relatively stable and countercyclical. Finally, remittances are not debt-creating foreign exchange flows. In the long term, remittances' contribution to growth appears to be weaker. When analyzing panel data across 113 countries, Chami, Fullenkamp, and Jahjah (2003) find that remittances are negatively correlated with economic growth, mainly because they are generally not used to finance productive investment. The authors suggest that one important explanation for this result is moral hazard, since remitters cannot directly observe the behavior of recipients.[2]

However, there are other potential negative effects generally associated with emigration and remittances. While emigration reduces labor supply, the related remittances increase demand for goods and services, putting pressure on wages and on the real exchange rate and increasing costs for domestic producers. Also, if remittances are large, they can generate Dutch disease–type appreciation of the exchange rate and further reduce the competitiveness of the export sector. These factors discourage investment in sectors that do not benefit from remittances (including the export sector). Moreover, if the inflows of remittances were to dry up quickly, the economy would become vulnerable, much in the same way that an oil-exporting country suffers when oil prices plummet. However, this sudden drop in remittances is usually associated with a situation in which workers have

[2]However, causality may play a role in these results. People usually migrate for lack of better opportunities at home. Thus, one would expect a negative correlation, a priori, between the real rate of economic growth and the amount of remittances.

migrated predominantly to one host country and this country is hit by an economic crisis or political and social turmoil. In this regard, since Moldovans' remittances originate predominantly from Russia, followed by Italy, Moldova remains exposed to economic and political events in these two countries.