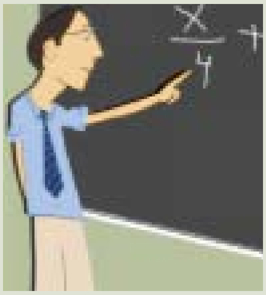
BACK TO BASICS



# Remittances:

## A Lifeline for Development

*Dilip Ratha*

WHEN MIGRANTS send home part of their earnings in the form of either cash or goods to support their families, these transfers are known as workers' or migrant remittances. They have been growing rapidly in the past few years and now represent the largest source of foreign income for many developing countries.

It is hard to estimate the exact size of remittance flows because many transfers take place through unofficial channels. Worldwide, officially recorded international migrant remittances are projected to exceed $232 billion in 2005, with $167 billion flowing to developing countries. These flows are recorded in the balance of payments; exactly how to record them is being reviewed by an international technical group. Unrecorded flows through informal channels are believed to be at least 50 percent larger than recorded flows (see *Picture This* on page 44). Not only are remittances large but they are also more evenly distributed among developing countries than capital flows, including foreign direct investment, most of which goes to a few big emerging markets. In fact, remittances are especially important for low-income countries.

### How is the money transferred?

A typical remittance transaction takes place in three steps. In step 1, the migrant sender pays the remittance to the sending agent using cash, check, money order, credit card, debit card, or a debit instruction sent by e-mail, phone, or through the Internet. In step 2, the sending agency instructs its agent in the recipient's country to deliver the remittance. In step 3, the paying agent makes the payment to the beneficiary. For settlement between agents, in most cases, there is no real-time fund transfer; instead, the balance owed by the sending agent to the paying agent is settled periodically according to an agreed schedule, through a commercial bank. Informal remittances are sometimes settled through goods trade.

The costs of a remittance transaction include a fee charged by the sending agent, typically paid by the sender, and a currency-conversion fee for delivery of local currency to the beneficiary in another country. Some smaller money transfer operators (MTOs) require the beneficiary to pay a fee to collect remittances, presumably to account for unexpected exchange-rate movements. In addition, remittance agents (especially banks) may earn an indirect fee in the form of interest (or "float") by investing funds before delivering them to the beneficiary. The float can be significant in countries where overnight interest rates are high.

### Why are remittances helpful?

Remittances are typically transfers from a well-meaning individual or family member to another individual or household. They are targeted to meet specific needs of the recipients and thus, tend to reduce poverty. In fact, World Bank studies, based on household surveys conducted in the 1990s, suggest that international remittance receipts helped lower poverty (measured by the proportion of the population below the poverty line) by nearly 11 percentage points in Uganda, 6 percentage points in Bangladesh, and 5 percentage points in Ghana.

How are remittances used? In poorer households, they may finance the purchase of basic consumption goods, housing, and children's education and health care. In richer households, they may provide capital for small businesses and entrepreneurial activities. They also help pay for imports and external debt service, and in some countries, banks have been able to raise overseas financing using future remittances as collateral.

Remittance flows tend to be more stable than capital flows, and they also tend to be counter-cyclical—increasing during economic downturns or after a natural disaster in the migrants' home countries, when private capital flows tend to decrease. In countries affected by political conflict, they often provide an economic lifeline to the poor. The World Bank estimates that in Haiti they represented about 17 percent of GDP in 2001, while in some areas of Somalia, they accounted for up to 40 percent of GDP in the late 1990s.

### Is there a downside?

There are a number of potential costs associated with remittances. Countries receiving migrants' remittances incur costs if the emigrating workers are highly skilled, or if their departure creates labor shortages. Also, if remittances are large, the recipient country could face an appreciation of the real exchange rate that may make its economy less competitive internationally. Some argue that remittances can also create dependency, undercutting recipients' incentives to work, and thus slowing economic growth. But others argue that the negative relationship between remittances and growth observed in some empirical studies may simply reflect the counter-cyclical nature of remittances—that is, the influence of growth on remittances rather than vice-versa.

Remittances may also have human costs. Migrants sometimes make significant sacrifices—often including separation from family—and incur risks to find work in another country. And they may have to work extremely hard to save enough to send remittances.

## Can high transaction costs be cut?

Transaction costs are not usually an issue for large remittances (made for the purpose of trade, investment, or aid), because, as a percentage of the principal amount, they tend to be small, and major international banks are eager to offer competitive services for large-value remittances. But in the case of smaller remittances—under $200, say, which is often typical for poor migrants—remittance fees can be as high as 10–15 percent of the principal (see table).

Cutting transaction costs would significantly help recipient families. How could this be done? First, the remittance fee should be a low fixed amount, not a percent of the principal, since the cost of remittance services does not really depend on the amount of principal. Indeed, the real cost of a remittance transaction—including labor, technology, networks, and rent—is estimated to be significantly below the current level of fees.

Second, greater competition will bring prices down. Entry of new market players can be facilitated by harmonizing and lowering bond and capital requirements, and avoiding overregulation (such as requiring full banking licenses for money transfer operators). The intense scrutiny of money service businesses for money laundering or terrorist financing since the 9/11 attacks has made it difficult for them to operate accounts with their correspondent banks, forcing many in the United States to close. While regulations are necessary for curbing money laundering and terrorist financing, they should not make it difficult for legitimate money service businesses to operate accounts with correspondent banks.

An example where competition has spurred reductions in fees is on the U.S.–Mexico corridor, where remittance fees have fallen by 56 percent from over $26 (to send $300) in 1999 to about $11.50 now. In addition, some commercial banks have recently started providing remittance services for free, hoping that would attract customers for their deposit and loan products. And in some countries, new remittance tools—based on cell phones, smart cards, or the Internet—have emerged.

Third, establishing partnerships between remittance service providers and existing postal and other retail networks would help expand remittance services without requiring large fixed investments to develop payment networks. However, partnerships should be nonexclusive. Exclusive partnerships between post office networks and money transfer operators have often resulted in higher remittance fees.

Fouth, poor migrants need greater access to banking. Banks tend to provide cheaper remittance services than money transfer operators. Both sending and receiving countries can increase banking access for migrants by allowing origin country banks to operate overseas; by providing identification cards (such as the Mexican *matricula consular),* which are accepted by banks to open accounts; and by facilitating participation of microfinance institutions and credit unions in the remittance market.

## Can governments boost flows?

Governments have often offered incentives to increase remittance flows and to channel them to productive uses. But such policies are more problematic than efforts to expand access to financial services or reduce transaction costs. Tax incentives may attract remittances, but they may also encourage tax evasion. Matching-fund programs to attract remittances from migrant associations may divert funds from other local funding priorities, while efforts to channel remittances to investment have met with little success. Fundamentally, remittances are private funds that should be treated like other sources of household income. Efforts to increase savings and improve the allocation of expenditures should be accomplished through improvements in the overall investment climate, rather than targeting remittances. Similarly, because remittances are private funds, they should not be viewed as a substitute for official development aid. ■

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*For further information see* Global Economic Prospects 2006: Economic Implications of Remittances and Migration, *World Bank; and* Remittances: Development Impact and Future Prospects, *2005, edited by Samuel Munzele Maimbo and Dilip Ratha, World Bank.*

### Transfer costs

Remittance fees could be reduced significantly if they were converted to a flat fee instead of a percentage of the principal transferred.

**Approximate cost of remitting $200** (percent of principal)

| | Major MTOs[1] | Banks | Other MTOs | Hawala |
|---|---|---|---|---|
| Belgium–Nigeria | 12 | 6 | 9.8 | – |
| Belgium–Senegal | 10 | – | 6.4 | – |
| Hong Kong–Philippines | 4.5 | – | – | – |
| New Zealand–Tonga ($300) | 12 | 3 | 8.8 | – |
| Russia–Ukraine | 4 | 3 | 2.5 | 1-2 |
| South Africa–Mozambique | – | 1 | – | – |
| Saudi Arabia–Pakistan | 3.6 | 0.4 | – | – |
| UAE–India[2] | 5.5 | 5.2 | 2.3 | 1-2 |
| United Kingdom–India | 11 | 6 | – | – |
| United Kingdom–Philippines | – | 0.4-5.0 | – | – |
| United States–Colombia | – | 17 | 10 | – |
| United States–Mexico | 5 | 3 | 4.7 | – |
| United States–Philippines | 1.2-2.0 | 0.4-1.8 | – | – |

– Data not available.
Source: World Bank *Global Economic Prospects 2006: Economic Implications of Remittances and Migration.*
Note: Figures do not include currency-conversion charge.
[1]MTOs: money transfer operators.
[2]UAE: United Arab Emirates.