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Growing clout of workers' remittances

These salaries have become the second most important type of private external finance to developing countries after foreign direct investment

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ANOTABLE and much discussed trend in external finance to developing countries is the declining share of Overseas Development Assistance (ODA), as the OECD countries have consciously cut back their concessional grants since the early 1990s. Indeed, most developed countries have failed to meet the United Nation's suggested aid target of 0.7 per cent of GNP in 1970 (exceptions have been Denmark, Norway, the Netherlands and Sweden).

The reasons for the so-called 'foreign aid crisis' are manifold. They include the global political environment - in particular the end of the Cold War, which blurred ideological differences and removed much of the political motivation for aid; a general perception that aid has been ineffective in promoting economic growth and reducing poverty (due, for instance, to the possibility that aid substitutes for, rather than supplements, domestic resources); and the desire on the part of donors to reduce their own fiscal deficits.

On the other hand, there is growing evidence that foreign aid is effective in reducing poverty when combined with good domestic economic policy. So, it is important to focus on increasing the magnitude and effectiveness of ODA.

The need to encourage creditor countries in the Asia-Pacific to raise their regional aid commitments is particularly acute as there are concerns that aid from the US and other donors may henceforth be influenced more by strategic considerations (the war on terrorism, financing the reconstruction in Afghanistan and Iraq, and so on). This may result in a reallocation of aid from other countries in the Asia-Pacific region and elsewhere.

For the foreseeable future at least, for most developing countries, ODA should be viewed as an additional source of finance; domestic savings as well as private financial flows are the most vital components of development finance and will probably remain as such for some time to come.

Workers' remittances

While long ignored, it is increasingly recognised that worker remittances - which are the financial counterpart of the outflow of migration flows - have been and will continue to be an important and stable source of external financing for a number of developing countries.

Specifically, workers' remittances have maintained a steady and marked upward trend between 1995 and 2003, peaking to US\$93 billion in 2003 compared to US\$51 billion in 1995.

Workers' remittances have in fact become the second most important type of private external finance to developing countries after foreign direct investment (FDI). Asia's share of inward workers' remittances averaged almost 40 per cent in 2002 and 2003, half of which went to India and the Philippines. In Asia, Bangladesh, Thailand and Sri Lanka also receive sizeable

remittances. The three main source countries of remittances are the US, Saudi Arabia and Germany.

But the data noted pertains only to the narrowest definition of remittances, namely 'unrequited transfers'. Broader data coverage of remittances would include 'migrant transfers' and the 'compensation of employees' as recorded in the balance of payments statistics. Thus, the magnitude of remittances noted above is clearly understated.

Indeed, insofar as migrants make several payments directly to schools (tuition fees) or international airlines (airfares) on behalf of relatives or friends in their home country, the true magnitude of remittances transfers is probably much larger than captured by the above statistics.

While India clearly dominates as a destination for workers' remittances, these financial flows are more evenly spread out than private capital flows. For instance, in 2001 the top 10 remittance recipients received 60 per cent of total remittances to developing countries. This was below the share of the top 10 recipient countries for FDI export revenues (over 70 per cent each), dominated by China.

As important as the relative magnitudes is the relative stability (or lack thereof) of various sources of finance. A well known story is that during the crisis of 1997-98, FDI in Asia remained relatively stable while debt and portfolio equity flows collapsed. This is clearly borne out by the data.

Specifically, FDI, workers' remittances and trade flows have the lowest variability, while debt flows - specifically short-term debt - are the most variable, followed by portfolio equity flows.

This conclusion holds true when we limit the analysis to the crisis-hit economies in South-east Asia (Malaysia, Thailand, Indonesia, and the Philippines) or to just China and India.

In addition, while FDI as well as other private capital flows tend to be procyclical (rising as the host country is doing well and there is general bullishness about the country's prospects), the same cannot be said of remittances. This is so as remittances can be viewed as a self-insurance mechanism for developing countries, or there may be an element of philanthropy in the sense that the overseas diaspora increases remittances at times when most needed (for example, during periods of economic crises or natural disasters).

This low positive correlation between remittances and other types of private capital flows as well as their well-targeted nature (that is, person-to-person flows), makes remittances a particularly important source of finance to many developing countries. Such a stabilising role was historically played by ODA.

China versus India

A comparison is often made between FDI inflows to the two emerging Asian giants of China and India, both of which have among the world's largest overseas migrants in absolute terms. Even if one discounts round-tripping from Hong Kong (China) and adjusts for differences in FDI data in both countries (Indian sources have severely understated inward FDI, though adjustments have been made recently), China still shows up as having attracted far more FDI than India.

Part of the difference in FDI inflows is attributed to the relatively more aggressive rechanneling of resources by overseas Chinese to China compared to Non-resident Indian (NRIs). Overseas Chinese are said to invest 10 to 20 times more in China as NRIs do in India.

On the other hand, China has received relatively low remittances - about US\$1.5 billion dollars annually in the last decade (1995-2003), compared to US\$45 billion in FDI inflows), which was about one-eighth of India's receipts - US\$8.8 billion annually over the same period - compared to US\$3 billion in FDI inflows.

Thus, when one combines FDI and remittances (and makes the data on FDI comparable across both countries), the total contribution by the Chinese diaspora to China may not be significantly higher than that of NRIs to India.

It is commonly suggested that the difference in manner of capital inflows by the countries' respective diasporas is a function of the economic opportunities in both countries and economic characteristics between the two diasporas.

While there may be some merit in this, when one considers the fact that a large fraction of FDI in China (about one quarter) has been invested in real estate, while a sizeable proportion of remittances tend to be devoted to land and housing purchases as well, it underlines the possibility of significant statistical coincidence between remittances and FDI.

Substituting

More to the point, the foregoing suggests the existence of a degree of substitutability between remittances and FDI. Of course, there is a more obvious reason for substitutability between FDI and workers' remittances.

Insofar as FDI creates jobs domestically, there is less incentive for workers to go overseas to work, thus reducing the extent of remittances back home.

Overall, remittances have been growing in absolute terms as well as in comparison to other sources of external finance, and they are also a relatively stable form of finance. Nonetheless, the remittance business remains extremely segmented and inefficient; transactions costs tend to be high as a few players dominate the market and charge 'excessive' fees.

Remittances have hitherto largely been channelled via Money Transfer Operators, post offices, ethnic stores, couriers, and such (some of these go unrecorded, once again understating remittances). Reduction of the intermediation costs by encouraging more financial institutions to enter the remittance business and by establishing partnerships between retail banks with extensive branches and government post office networks can boost this source of external finance.

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The views expressed in this article are personal.

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