



Remittances, finance and growth: Does financial development foster the impact of remittances on economic growth?



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ABSTRACT

There is no consensus in the literature regarding the long-run impact of remittances on economic growth. Previous studies have shown that it might be related to financial development in the transfer-receiving country, but the direction of the link remained unclear. I contribute to this literature by using a newly created index of overall financial development and two different estimation methods. I measure the importance of remittances given financial development for economic growth in developing countries. As there is no widely accepted measure of financial sector development, I estimate an index of overall financial conditions. It is created by means of an unobserved components model and used to determine the relevance of the financial sector as a transmission channel for remittances to affect economic growth. I show that the more financially developed a country is, the smaller the impact of remittances on economic growth. Remittances can foster growth, but the effect is significant only at low levels of financial development. This is in line with previous studies, which found remittances and financial development to be substitutes. However, the interaction between the two factors becomes weaker once size, depth and efficiency of the financial sector are taken into account. My results suggest that, while attracting migrants' transfers can have important short-run poverty-alleviating advantages, in the long-run it might be more beneficial for governments to foster financial sector development.

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1. Introduction

Remittances are migrants' transfers in money and kind sent to their home countries.¹ In the last 15 years these flows have been increasing rapidly, exceeding official development assistance (ODA), and more steadily than foreign direct investment flows (FDI) (cf. Fig. 1). Economists have become interested in these international money flows, since they can be an important source of development financing.

Migrants' transfers were recently debated in the context of the post-2015 Sustainable Development Agenda of the United Nations Development Programme (UNDP, Agenda adopted in September 2015). There are 17 newly proposed Sustainable Development Goals (SDG) and their achievement relies on public as well as private financing from industrial countries. Remittances have been recognized as one of the potential sources of funding for the SDG during the UN Third International Conference on Financing for

Development in Addis Ababa in July 2015.² The importance of remittances in supporting families in developing countries was recognized and a well-functioning financial sector was considered necessary to boost migrants' transfers through lower costs and better service availability.

Existing academic studies on short-run and long-run economic effects of remittances have ambiguous conclusions. Rapoport and Docquier (2006) provide an extensive review of the literature and the studies more closely related to this one are summarized in Section 2.

In this paper I consider a sample of 61 emerging and developing countries over the time period 1970–2010. I evaluate the impact of remittances on economic growth, taking into account financial sector development measured with a newly constructed index. There are several challenges associated with answering this question. They are related in particular to capturing financial sector development in a comprehensive way, considering its size, depth and efficiency at the same time. For many developing countries data on financial

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¹ In this paper I focus on remittances in money, transfers in kind are not included in international statistics.

² Resolution adopted by the General Assembly on 27 July 2015, Sixty-ninth session, Agenda item 18, available at http://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf, accessed on May 25, 2016.

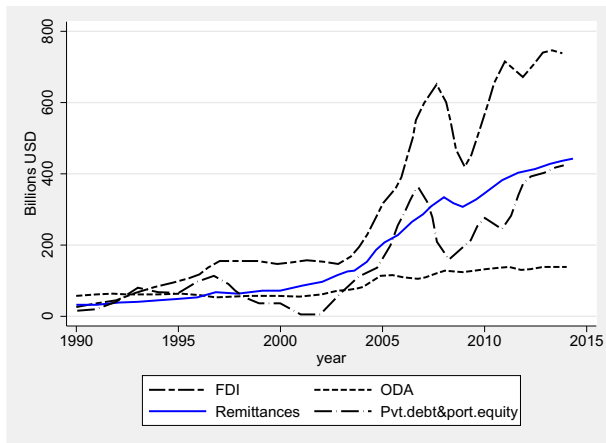


Fig. 1. Foreign financial flows to developing countries – Remittances, official aid and private flows. Source: World Bank Migration and Development Brief from April 13, 2015. Notes: Remittances to developing countries exceeded 400 billion USD in 2012 and are estimated to reach almost 480 billion by 2017. Up to 75% of all remittance flows go to these countries, with only a slight majority coming from the “North” (industrial countries). While still half as large as foreign direct investment, remittances prove to be more resilient to changing global economic conditions. Private debt and portfolio flows on average reach similar levels as migrants’ transfers but are also more volatile. Official development flows are even more stable than remittance inflows, but they have a much lower rate of increase.

indicators³ are generally available only for short time periods or with gaps. There is also no consensus as for an adequate measure of financial development – in a related study [Giuliano and Ruiz-Arranz \(2009\)](#) used four different proxies: deposit to GDP ratio, loan to GDP ratio, credit to GDP ratio and M2 to GDP ratio to provide some insights about different aspects of financial sector development. All of them refer only to the size of the financial sector, for which reason [Bettin and Zazzaro \(2012\)](#) also used a measure of bank inefficiency, but due to data availability their sample is limited to the time period from 1991 to 2005, which may not be enough to pick up long-run trends.

For these reasons it is worthwhile to create a measure of financial development which would capture more aspects of the financial sector at the same time. It would help to evaluate the impact of remittances on growth and the role of the financial intermediaries in this process. In this paper I tackle this problem by using an unobserved components model in which a financial development indicator is extracted from available information stemming from existing measures describing the size, depth and efficiency of the financial sector, combined into one number.

The measure proposed in this paper can provide information about the overall impact of financial sector development on the remittance-growth relationship. This can be of interest for policy makers in transfer-receiving developing countries, since it provides the answer to the following question: once the financial sector is well developed (large and efficient), what is the impact of remittance inflows on economic growth? Growth regressions including such measures as financial deposits or credit to GDP ratio answer this question only partially, because they do not capture efficiency of the financial sector.

By combining elements of size and efficiency of the financial sector, it takes into account the fact that availability of credit in the economy is determined both by bank efficiency (bureaucracy related to the application and decision process) and by availability of financial resources. The proposed measure assigns lower values of financial development to countries who have high deposits or credit to GDP ratio but have inefficient banks and non-banking institutions. Similarly, in the opposite situation, the score of

countries with very high efficiency but low size proxies is also adjusted downwards. The first case accounts for loans which were not given out for the most productive use, and the second case accounts for the fact that even if procedures related to obtaining a loan are simple, applicants may not be able to receive financial support due to the lack of resources.

The main purpose of this paper is therefore to verify whether size or efficiency matter more, or in other words – which of the effects dominates? Does the “overall financial development” strengthen the effect of remittances on economic growth in transfer-receiving developing countries (positive coefficient on the remittance-finance interaction term)? Or is it a substitute for remittances, removing credit constraints, providing financial resources for productive activities and allowing transfer recipients to spend remittances in a different, non-growth-enhancing way (negative sign of the remittance-finance interaction term and diminishing or even negative impact of transfer inflows on GDP per capita growth)?

Another issue pertaining to this research question, and to growth regressions in general, is the potential endogeneity of financial development and remittance measures (and other potential determinants of long-run economic growth). In this paper I rely on the assumption of weak exogeneity of the variables of interest. I account for it by lagging the regressors by one year with respect to the dependent variable when forming 5-year averages. Then I use two estimation methods, consistent under this assumption. The quasi-maximum likelihood for dynamic panel data with fixed effects (QML-FE) is the first method. I discuss the results of it in more detail, as the preferred ones, given that system GMM, the other method used, may suffer from weak instrument problems described by [Roodman \(2009\)](#) and [Bazzi and Clemens \(2013\)](#). GMM methods are more popular in the literature and can also be seen as a robustness check if my explanatory variables do not fulfill the exogeneity requirement. Moreover, to remove most common sources of cross-sectional dependence, year fixed effects are included in all regressions.

The results of this paper show that the impact of remittances on economic growth indeed depends on the level of financial development. For countries with the least advanced financial sector there is evidence for positive partial correlation between remittances and growth, but the effect turns negative with increasing financial development and migrants’ transfers become irrelevant. A country could even experience long-run output losses if it achieved very high levels of financial development and at the same time experienced an increase in remittance inflows. The results do not change significantly when the years 2007–2010 (global financial crisis and following economic slowdown in industrial countries) are excluded from the sample, preserving the negative sign of the remittance-finance interaction term in my growth regressions.

The structure of the paper is as follows. After a brief literature review in Section 2, Section 3 gives a detailed description of the data used for the creation of the index and for estimation, Section 4 includes an overview of the methodology applied, both for the index formation and for growth regressions. In Section 5 I present the results concerning the financial development index and in Section 6 I show the results of the growth model for a cross-section of countries over the time period 1970–2010. Section 7 shows that no strong structural shifts took place during the financial crisis so that the role of the financial sector as a substitute for remittances has remained unchanged. Section 8 concludes.

2. Related literature

There is a vast literature on the importance of remittances for development and poverty alleviation. Given their large values,

³ For example in the Financial Development and Structure Dataset.

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