



Does development finance pose an additional risk to monetary policy?

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Abstract

This study investigates whether remittances entail extra risk for macroeconomic policy management and examines the role (if any) that the financial system can play in the interaction between remittances and monetary policy. Employing panel data for 106 developing countries from 1970 to 2013, the results from our panel vector autoregressive (PVAR) model reveal that remittance volatility reduces macroeconomic risk in developing countries while simultaneously stimulating a reduction in domestic interest rates. This finding remains robust to alternative specifications of remittance volatility and monetary policy risk and to variations in the degree of financial development. The key lesson from this study is that developing countries can leverage the positive impact of remittances in reducing macroeconomic instability by implementing policies that induce remittances.

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1. Introduction

Remittances have become an important source of development finance. Thus, it is not surprising that remittances have engaged the attention of researchers, policy makers, global development financial institutions and other development partners. While policymakers continue to look to researchers for ideas to use remittances more effectively, research in this area has been clustered around the microeconomic implications of remittances (Ncube and Brixiova, 2013). These micro-level studies focus on the role of remittances in poverty reduction (Acosta et al., 2008, 2007; Adams, 2004; Adams and Page, 2005; Gupta et al., 2009), child growth (Antón, 2010; Carletto et al., 2011; Mansuri, 2006), employment (Amuedo-Dorantes and Pozo, 2006; McCormick and Wahba, 2000; Taylor, 1999), and household expenditures and investment (Adams and Cuezuecha, 2010; Adams, 2006; Yang, 2008), to name a few.

Thus, a gap remains in the empirical literature regarding the macroeconomic implications of remittances. Even the limited research on the macro-level impact of remittances has focused mainly on remittances' impact on growth (Barajas et al., 2009; Chami et al., 2012; Fayissa and Nsiah, 2010; Ncube and Brixiova, 2013; Nsiah and Fayissa, 2011; Pradhan et al., 2008; Waheed, 2004). Nonetheless, for policymakers in both developing and emerging economies, gaining insight into the macroeconomic influence of remittances is fundamental for putting their countries on the path towards accelerated and pro-poor growth (Ncube and Brixiova, 2013).

In particular, the impact of remittances on monetary policy seems to have eluded the attention of empirical researchers, which has resulted in a limited understanding of the relationship between remittances and monetary policy (Vacaflores, 2012). However, economists have recently begun to test the existence of the link between remittances and monetary policy (Adenutsi and Ahoritor, 2008; Chami et al., 2008; Mandelman and Zlate, 2012; Ruiz and Vargas-Silva, 2010; Vacaflores, 2012). As limited as the research in this field is, the evidence that has been uncovered has been rather contradictory. For instance, Ruiz and Vargas-Silva (2010) examine the Mexican context and find no significant relationship between remittances and domestic monetary policy,

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although Adenutsi and Ahortor (2008) had earlier revealed a significant relationship between monetary policy variables and remittances in Ghana.

This confusion has been exacerbated by the proposition by Ruiz and Vargas-Silva (2010, p. 174) that remittances that are small relative to the size of the economy will not have an impact on monetary policy. ‘If these flows are not large and/or not significant given the total size of the economy, then their impact on variables such as inflation, exchange rates and output will be minimal’. However, if the size of remittances is so important, then why would they matter to monetary policy in a small economy, such as Ghana’s, in which they constitute only 0.4% of GDP and why would they be rather insignificant in Mexico where remittances add up to approximately 2.0% of GDP?

Furthermore, the previous literature on the interaction of monetary policy and remittances consists mostly of single-country studies: El-Sakka and McNabb (1999) focused on Egypt, Adenutsi and Ahortor (2008) on Ghana, Ruiz and Vargas-Silva (2010) on Mexico, and Mandelman (2013) on the Philippines. The problem with single-country studies is that they do not allow for wider applicability of the knowledge they generate. The previous literature on the subject on the whole also does not allow for the potential moderating effect of financial development in the remittance-monetary policy nexus. For instance, financial markets are known to play an intermediary function in the link between capital flows and economic growth (Agbloyor et al., 2014; Osabuohien and Efobi, 2013). However, will this moderating role hold in the case of the monetary policy-remittance link? This question is one of the unresolved issues on the topic.

Notwithstanding the perceived linkages among macroeconomic policy, remittances and the financial system, financial and development economists have been largely silent on this tripartite nexus. In our literature search in connection with this study, we have yet to encounter a study that examines the interactive effect of monetary policy and remittances on financial development and the interactive effect of remittances and the financial system on monetary policy efficiency. Thus, we have been presented with a fertile opportunity for research, and the present study exploits this opportunity and fills this void.

In this paper, we employ panel vector autoregression (PVAR) to overcome endogeneity problems; to establish causality among monetary policy, remittances and other macroeconomic variables; and to generate orthogonalised impulse responses. We then use generalised impulse responses to identify the effects of remittance shocks on monetary policy. Unlike the usual Cholesky impulse responses, the use of generalised impulse responses helps us generate shocks that do not vary with the variable ordering.

We employ country-level panel data (annual) from 106 developing countries to analyse the dynamics of monetary policy decisions and remittance inflows. In the main, we investigate how remittance volatility affects monetary policy volatility. We argue that if remittances flows are indeed countercyclical to the domestic economy, then remittance volatility must be negatively related to the monetary policy rate and to monetary policy rate

volatility. In addition, a contractionary domestic monetary policy must trigger a remittance inflow that is consistent with the countercyclical view of remittances. To test the first hypothesis, we compute the five-year rolling standard deviation of remittances and the monetary policy rate and model them in a PVAR framework. To test the second hypothesis, we simulate monetary contraction following the Mundell–Fleming–Dornbusch model within the framework of Cholesky innovations and orthogonalised generalised impulse response functions. In so doing, we document a significant negative relationship between remittances and remittance volatility, on one hand, and monetary policy rate and monetary policy volatility, on the other. In addition, controlling for the level of financial development and the magnitude of remittances does not nullify this relationship, thus supporting our claim that remittance volatility reduces both domestic interest rates and monetary policy risk.

Our paper contributes in a number of ways to the financial economics discipline. First, the use of PVAR helps us to analyse the dynamics of domestic monetary policy and remittances, in addition to country-specific fixed effects at the same time. Second, the use of orthogonalised impulse responses enables us to uniquely isolate the impact of shocks from each of the system variables on the other variables, one at a time.

Our paper further extends the frontiers of knowledge in financial economics by presenting new evidence showing that a contractionary domestic monetary policy will activate the inflow of remittances. We also add to those recent panel data studies that confirm a causal connection between monetary policy and remittances (see, Termos et al., 2013; Vacaflores, 2012). Although most previous studies focus on remittances and monetary policy levels, we take the step further to examine the dynamics in the volatilities of the two variables. In particular, we find that remittances and remittance volatility reduce the domestic interest rate and monetary volatility. Our results are in line with Craigwell et al. (2010) and Bugamelli and Paternò (2011), who find that remittances reduce receiving countries’ macroeconomic risks.

Our paper also contributes to the recent debate on the intermediary function of financial development in the link between capital flows and growth (see, Giuliano and Ruiz-Arranz, 2009; Ramirez, 2013). This literature shows that remittances substitute for financial markets in economic growth when capital markets are shallow. Our results are consistent with this literature and scales up the analysis to cover how finance enhances the mitigating impact of remittances on economic policy risk.

This paper is also related to Bugamelli and Paternò (2011), who analyse the impact of remittances on output volatility. These authors employ an instrumental variable approach to establish causality between the two variables. Unlike Bugamelli and Paternò (2011), however, we explore the effects of remittances on interest rates and monetary policy risk. We argue that output is only an objective of monetary policy and that a more direct assessment of the effect of remittances on monetary conditions is therefore required. In addition, whereas Bugamelli and Paternò (2011) focus on remittances, we examine both remittances and remittance volatility. In terms of measurement, whereas Bugamelli and Paternò (2011) measure volatility in terms of deviations from the mean, we employ five-year rolling

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