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What's Different about Monetary Policy Transmission in Remittance-Dependent Countries?

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Abstract

Despite welfare and poverty-reducing benefits for recipient households, remittance inflows have been shown to entail macroeconomic challenges; producing Dutch Disease-type effects, reducing the quality of institutions, delaying fiscal adjustment, and having an indeterminate effect on long-run growth. This paper explores an additional challenge, for monetary policy. Although remittances expand bank balance sheets, providing a stable flow of interest-insensitive funding, they tend to increase banks' holdings of liquid assets. This both reduces the need for an interbank market and severs the link between policy rate and banks' marginal cost of funds, thus shutting down a major transmission channel. We develop a stylized model based on asymmetric information and a lack of transparent borrowers and undertake econometric analysis providing evidence that increased remittance inflows are associated with weaker transmission. As independent monetary policy becomes impaired, this result is consistent with earlier findings that recipient countries tend to favor fixed exchange rate regimes.

Keywords: worker's remittances, monetary policy, lending channel, banking sector, trilemma

JEL Classification Numbers: E5, F24, O17, O23.

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[1] The views expressed here are those of the author and do not necessarily reflect those of the International Monetary Fund. Authors' E-Mail Addresses: abarajas@imf..org; rchami@imf.org; cebeke@imf.org; aoeking@imf.org. Corresponding author: Anne Oeking.