What Are Remittances?

For many countries, money transfers from citizens working abroad are a lifeline for development

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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 economies.

It is hard to estimate the exact size of remittance flows because many take place through unofficial channels. Worldwide, officially recorded international migrant remittances are projected to reach $596 billion in 2017, with $450 billion flowing to developing economies. These 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. Not only are remittances large but they are also more evenly distributed among developing economies than capital flows, including foreign direct investment. Remittances are especially important for low-income countries and account for nearly 4 percent of their GDP, compared with about 1.5 percent of GDP for middle-income countries.

Getting the money there

A typical remittance transaction takes place in three steps:

- 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.
- The sending agency instructs its agent in the recipient's country to deliver the remittance.
- The paying agent makes the payment to the beneficiary.

For settlement between agents, in most cases, there is no real-time funds transfer; the balance owed by the sending agent to the paying agent is settled periodically 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 operators charge the beneficiary a fee to collect remittances, presumably to account for unexpected exchange-rate movements. And 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.

Remittances are typically transfers from one person to another person or household. They are targeted to specific needs of the recipients and thus tend to reduce poverty. Cross-country analyses generally find that remittances have reduced the share of poor people in the population (Adams and Page 2003, 2005; Gupta, Pattillo, and Wagh 2009). World Bank studies, based on household surveys, suggest that international remittance receipts helped lower poverty by nearly 11 percentage points in Uganda, 6 percentage points in Bangladesh, and 5 percentage points in Ghana. Between a fifth and half of the 11 percent reduction in poverty in Nepal between 1995 and 2004, a time of political conflict, has been attributed to remittances.

In poorer households, remittances may buy 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 help pay for imports and external debt service; in some countries, banks have raised overseas financing using future remittances as collateral.

More stable than capital flows

Remittance flows tend to be more stable than capital flows, and they tend to be countercyclical—increasing during economic downturns or after a natural disaster when private capital flows tend to decrease. In countries affected by political conflict, they are often an economic lifeline to the poor. The World Bank estimates that in Haiti they represented about 31 percent of GDP in 2017, and in some areas of Somalia, they accounted for more than 70 percent of GDP in 2006.

Remittances proved to be resilient during the financial crisis in source countries such as the United States and western European countries. The crisis affected migrants' incomes, but they tried to absorb the income loss by cutting consumption and rental expenditures. Those affected by the crisis moved to jobs in other sectors. While the crisis reduced new immigration flows, it also discouraged return migration because migrants feared they would not be able reenter the host country. Thus, the number of migrants—and hence remittances—continued to rise even during the global financial crisis and even more so in recent years in the face of conflicts and natural disasters such as hurricanes and earthquakes.

There are potential costs associated with remittances. Countries that receive remittances from migrants 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 real exchange rate appreciation that may make its economy less competitive internationally. Some argue that remittances can undercut 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 influence of growth on remittances rather than vice versa.

Remittances also have human costs. Migrants sometimes make significant sacrifices—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.

High transaction costs

Transaction costs rarely affect large remittances (for the purpose of trade, investment, or aid): as a percentage of the principal amount, they tend to be small, and major international banks are eager to compete for large-value remittances. But for smaller remittances—under $200, say, which is often typical for poor migrants—fees typically average 7 percent, and can be as high as 15–20 percent in smaller migration corridors (see table).

Cutting transaction costs would help recipient families. Here's how:

First, the fee should be a low fixed amount, not a percentage, because the cost of remittance services does not depend on the amount of principal. 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, competition would bring prices down. New market players can be encouraged 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 terrorism financing since the 9/11 terrorist attacks on the World Trade Center has made it difficult for them to maintain accounts with their correspondent banks, forcing many in the United States to close. Regulations are necessary, but they should not make it difficult for legitimate money service businesses to maintain accounts with correspondent banks. A risk-based approach to regulation—checking only suspicious transactions and exempting small transactions below, say, $1,000 from identity requirements—can reduce costs and facilitate flows.

Competition has spurred reductions in fees in the US–Mexico corridor, where remittance fees fell more than 50 percent from over $26 (to send $300) in 1999 to about $12 in 2005, and have leveled off since then at around 5 percent for $200 in the first half of 2017. Some commercial banks provide free remittance services, hoping to 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, nonexclusive partnerships between providers and existing postal and other retail networks would help expand remittance services without large investments to develop payment networks.

Fouth, poor migrants could be given greater access to banks, which tend to charge less. 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) that are accepted by banks to open accounts; and by facilitating participation of microfinance institutions and credit unions in the remittance market.

TRANSFER COSTS

Remittance fees could be reduced significantly if they were a flat fee instead of a percentage of the principal transferred. Approximate cost of remitting $200 (as a percent of principal) between:

	MTOs	Banks
Australia–Fiji	10.0	15.3
Germany-Serbia	6.6	20.9
Japan-Brazil	10.1	18.1
Malaysia-Indonesia	6.5	10.0
Russia-Tajikistan	1.6	—
South Africa–Zimbabwe	14.9	19.2
Saudi Arabia–Pakistan	4.3	4.5
United Arab Emirates–India	3.0	—
United Kingdom–India	3.0	7.3
United States–India	3.0	—
United States–Mexico	5.1	—
United States–Philippines	3.6	—

Source: World Bank Remittance Prices Worldwide database.
Note: — denotes that data are not available. Data are for the third quarter of 2017. Figures include currency-conversions charge. MTOs = money transfer operators.

Boosting flows

Governments sometimes offer incentives to increase remittance flows and to channel them to productive uses. But such policies can be more problematic than efforts to expand access to financial services or reduce transaction costs. Tax incentives may attract remittances, but also may 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 by targeting remittances. FD

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