

EXECUTIVE SUMMARY

Workers' remittances have become a major source of financing for developing countries and are especially important in Latin America and the Caribbean (LAC), which tops the ranking of remittances-receiving regions in the world. Remittances in LAC represent about 70 percent of foreign direct investment (FDI) and are five times larger than Official Development Assistance. To a large extent this is a recent phenomenon, which is reflected in the scarcity of standardized data both at the aggregate and the microeconomic level. In fact, two decades ago, remittances to LAC represented only one tenth of their current value, in real terms. Not surprisingly, during recent years development practitioners in the region have grown increasingly interested in understanding the nature, potential development impact, and policy implications of remittances flows.

While there has been a recent surge in analytical work on worker's remittances, *Close to Home: The Development Impact of Remittances in Latin America* (henceforth *Close to Home*) is motivated by the large heterogeneity in migration and remittances patterns across countries and regions, and by the fact that existing evidence for LAC is restricted to only a few countries—for example, Mexico and El Salvador. Thus, as the nature of the phenomenon varies across countries, its development impact and policy implications are also likely to differ in ways that at present are still largely unknown. This study attempts to help fill this gap by exploring, in the specific context of Latin American and Caribbean countries, some of the main questions faced by policy makers when trying to respond to increasing remittances flows.

What is the profile of Latin American and Caribbean migrants and remittances recipients? How do these flows affect poverty and inequality? Do remittances contribute to higher investment and faster growth, or are they mainly directed towards consumption? Are remittances recipients more or less likely to keep their children in school? Does labor supply diminish as a result of remittances inflows? Does financial development accelerate in recipient countries? Are there negative Dutch disease effects? What are the challenges faced by policy makers in order to make the best of remittances flows and enhance their developing impact? What changes in the regulatory environment are needed in order to minimize transaction costs in remittances transfers while maintaining system security?

While *Close to Home* does not attempt to provide definitive answers to all these questions, the goal is to present a well-grounded general picture of how the various economic effects of remittances vary across the recipient countries of the region. That does not mean, however, that the study is based only on micro-econometric country case studies—performed when possible with a common methodological approach and using household survey data for as many as 11 countries. The study also makes use of cross-country analysis based on large samples of countries encompassing other regions of the world. Whenever possible our approach is to use those cross-country frameworks to investigate potential LAC specificities in terms of the development impact that remittances may have in the region.

A first set of findings relates to the socioeconomic characteristics of LAC migrants and remittances recipients. For the latter, household surveys analyzed in the study show that their

characteristics vary considerably across countries, both in terms of their position in the income distribution and their educational attainment. In some cases (for example, Mexico and Paraguay), households with remittances come primarily from the bottom of the income and educational distribution; the opposite pattern is found in others (for example, Peru or Nicaragua). As a result, the impact of remittances on poverty and inequality cannot be expected to be the same across the different countries of the region. Moreover, differences in migration patterns are also relevant to the size of remittances flows, which the study shows to be inversely related to migrants' educational levels.

The existence of a sizable heterogeneity in migration patterns is confirmed by U.S. census data, which show that Mexican and most of the Central American migrants are drawn from the lower end of the education spectrum of their home countries. By contrast, migrants from the Caribbean and South America tend to be proportionally more educated than those who remain behind. One possible explanation of this finding is that it is relatively less costly for Mexican and Central Americans to migrate to the United States, whether through legal channels using family preferences or without proper documentation. On the other hand, the cost of migration may be higher in South America and the Caribbean, making it an option only for those with higher levels of schooling and income.

Another relevant finding is that while Mexico and Central America tend to top the ranking of migrants in absolute terms, small Caribbean islands clearly dominate the charts when migration is measured in relation to each country's population. As of 2000, on average 30 percent of the labor force of many Caribbean islands had migrated, as opposed to about 10 percent for non-Caribbean countries (6 percent for South America). Moreover, the data confirm that "brain drain" is a serious problem for many small Caribbean countries. More than 80 percent of people born in Haiti, Jamaica, Grenada, or Guyana who have college degrees live abroad, mostly in the United States. On the other hand, fewer than 10 percent of college graduates from South America, and between 15 and 20 percent of those from Mexico and Central America, have migrated.

As for the development impact of migration and remittances, *Close to Home* suggests both good and bad news. Among the former is the finding that remittances have a generally positive impact in terms of reducing poverty and inequality. Not so good, however, is the news that the above effects are generally modest. For poverty, the study's cross-country and micro-based estimates indicate that for each percentage point increase in the share of remittances to gross domestic product (GDP), the fraction of the population living in poverty is reduced by an average of about 0.4 percent. However, household survey-based estimates suggest that migration and remittances reduce poverty headcounts in only 6 out of the 11 LAC countries for which data is available—the exceptions being Mexico, Nicaragua, Paraguay, Peru, and the Dominican Republic—and they reduce poverty gaps in only three cases—Ecuador, Guatemala, and Haiti. In two cases, the Dominican Republic and Nicaragua, we even found that those flows were linked to small increases in extreme poverty.

Similarly, the differences between observed Gini coefficients and those that would have prevailed in the absence of migration and remittances are generally small. The largest reductions are obtained for Haiti (7.7 percent), Guatemala (2.9 percent), El Salvador (2.1 percent),

Nicaragua (1.8 percent), and Honduras (1.1 percent). The inequality-reducing effects of migration and remittances are much smaller in the other countries, and small increases in the Gini coefficients are obtained for Mexico and the Dominican Republic.

A similar story applies to the impact of remittances on investment and growth. Indeed, while the estimated effects are positive and respond to corrections for the potential endogeneity of remittances and the use of a wide set of control variables as potential investment and growth determinants, their magnitude is relatively small in economic terms. As an example, the increase in remittances observed for the average Latin American country in our sample from 0.7 percent of GDP in 1991–1995 to 2.3 percent of GDP in 2001–2005 is estimated to have led to an increase of only 0.27 percent per year in per capita GDP growth, of which about one-half is estimated to be due to increased rates of domestic investment. However, on the positive side, we also find that remittances behave countercyclically in most countries of the region and increase sharply after macroeconomic crises. Moreover, after controlling for various sources of external and policy shocks, we find that remittances significantly reduce growth volatility, both directly and by diminishing the impact on the economy of external and macroeconomic policy shocks.

Close to Home also reviews microeconomic channels through which remittances could affect growth, namely through household savings and expenditure patterns, human capital outcomes, labor supply, and entrepreneurship. Once again the results are quite mixed, both across countries and between different socioeconomic groups within each country. On the positive side, we found evidence that remittances are not entirely consumed—that is, households save a positive fraction of remittances income. However, while saving rates increase among poorer recipient households, the opposite effect is obtained for richer ones. By contrast, while the composition of household expenditures is altered in the direction of increasing human capital investments, with the exception of Mexico, this effect is restricted to households located in the middle to upper segments of the income distribution.

With regard to human capital, there is evidence that for some specific groups—defined by country, gender, and urban status—remittances increase children’s educational attainment. However, the impact is often restricted to children with low levels of parental schooling. In the case of health outcomes, we were able to analyze only two cases—Nicaragua and Guatemala—and found that in both countries remittances improved children’s health, particularly among low-income households. A positive link is also found between remittances and entrepreneurship, but the effects, once again, vary considerably by income quintile. Finally, although the effects are often restricted to individuals with low levels of schooling, we find that remittances have a negative effect on labor supply, which as mentioned below could contribute to the exacerbation of potential Dutch disease effects (i.e. the loss of external competitiveness resulting from a real exchange rate appreciation associated with a surge in remittances).

A complementary channel through which remittances could promote economic growth is by increasing access to financial services among recipient households and promoting an overall increase in the level of financial development of recipient countries. This effect is indeed present in Latin America, but it is weaker than in the rest of the developing world. Moreover, at the microeconomic level, remittances are found to increase access to deposit accounts, but the use of credit by recipient households remains unchanged. Among the implications of these findings is

the need to step up ongoing efforts by financial institutions and regulators to increasingly “bank” migrants and remittance recipients.

Another important policy challenge facing recipient countries is that, at least in Latin America, remittances are found to be accompanied by real exchange rate appreciation pressures. While this is consistent with natural adjustments towards new equilibriums following positive shocks (that is, the surge in remittances), evidence in this study suggests that at least a fraction of the observed appreciations is linked to real exchange rate misalignments. That, in turn, justifies the desire by policy makers to take mitigating actions in order to minimize competitiveness losses owing to remittances. While there are no general answers to the question of how to respond to possible misalignments, the study discusses various possibilities, including the use of fiscal policy restraint while avoiding the sterilization of remittances inflows, and the use of microeconomic interventions aimed at reducing rigidities in labor and product markets.

In addition to addressing the potential external competitiveness problems mentioned above, *Close to Home* shows that policy makers can take actions in traditional economic reform fronts that are estimated to enhance the development impact of remittances. Indeed, we show that progress in the areas of education, institutional quality, and the macroeconomic policy environment can contribute to increase the positive impact of remittances on growth. While deepening reforms on these areas would be desirable even in the absence of remittances, it becomes even more important when those flows are significant.

Finally, there are also policy challenges associated with the regulatory environment for remittances services. Recent high-level multilateral initiatives led by the World Bank have produced a set of “General Principles for International Remittances Services.” These principles cover key features and functions that should be satisfied by remittances systems, providers, and financial intermediaries to reduce the costs of sending remittances while avoiding criminal misuse of remittance channels. To address this issue, the study’s recommendations include actions that would ensure contestability in remittances markets by establishing regulatory requirements that balance the need to maintain security in the system with the goal of eliminating hurdles to bona fide entrants. Moreover, the study recommends that unduly burdensome regulatory barriers to the direct or indirect use of payment and settlement systems be removed. At the same time, regulators and service providers should take a proactive stance to increase market transparency and accessibility to financial services among remittances senders and recipients.

On the whole, the overall conclusion of *Close to Home* is that remittances are an engine for development, but they are neither “manna from heaven” nor a substitute for sound development policies. First, the migration flows that logically precede surges in remittances are not without costs, both for the households directly affected and their countries. For instance, once reductions in households’ earnings-generating potential are taken into account, net income increases fall well below observed remittances inflows—simply because the migrant was usually economically active. As a result, the potential poverty and inequality reduction of remittances is, in most cases, quite modest. Similarly, while there are some positive growth-enhancing effects associated with remittances—for example, higher savings, human capital investments, increased

entrepreneurship, and higher bank deposits—the bottom-line effects on investment rates and per capita GDP growth are relatively small.

Second, the way countries benefit from remittances appears to be positively related to a given country's institutional and macroeconomic environments. Thus, countries that rank low on these fronts should expect even more modest impacts from remittances. In addition, if one considers that remittances may reduce labor supply and lead to real exchange rate over-valuation, it becomes clear that countries experiencing large remittances inflows will also face considerable policy challenges that may require corrective actions. Thus, given the positive effects of remittances, the private nature of remittances flows, and the fact that they may be here to stay, it appears that a healthy stance is to combine measures to minimize negative effects on competitiveness with a focus on complementary growth-enhancing policies and improvements in the regulatory environment that seek to promote secure and low-cost remittances services.