

The Business Transactions of Migrants: Remittances

By:
*Professor Enrique R. Carrasco**

In my IBT course, we typically study the international business transactions of hypothetical individual entrepreneurs, major businesses and corporations. Among other things, we study how these actors might use letters of credit, or pursue an international franchise, or engage in foreign direct investment. Over the past few years, another actor and business transaction have become prominent: migrants engaging in international remittances. Although the practice of migrants in developed countries sending funds home to family members still residing in developing nations has been occurring for many decades, the magnitude of remittances has skyrocketed. This paper presents an overview of this phenomenon.

I. The Nature and Extent of Remittances

International remittances are transfers of funds by foreign workers—“remitters”—who are living and working in developed countries typically to their families who are still living in their home countries. Examples include Middle Easterners living in Europe, Latin Americans in the United States, and Koreans or Filipinos in Japan. Although the use of remittance funds varies from country to country, the recipients of remittances commonly rely on them for living costs, education, and investments.

The topic of remittances has become a popular one in the international financial community in recent years as both the rate and volume of remittances have increased exponentially. Gathering accurate data on international remittances has been very difficult for a number of reasons, including the fact that a good portion of the transfers is made on an informal basis. Some official statistics do exist, however, and they present startling numbers. In 1995, remittances to developing countries totaled about \$57.8 billion and shot up to \$96.5 billion by 2001. The World Bank estimated that in 2005 migrants sent home approximately \$167 billion, up 73% from 2001 (the true amount could be 50% higher or more). In 2006, the World Bank reported that remittances grew to approximately \$206 billion; others put the figure at \$298 billion. These flows have led analysts to conclude that the growth of remittances has exceeded private capital flows and official development assistance to developing countries. Moreover, remittances are a reliable source of foreign capital; in the 1990s they were the least volatile source of foreign exchange.

As these numbers indicate, remittances have developed into an important source of income for many developing countries and, thus, have significant effects on their economic stability and growth. To illustrate on a global scale, remittances now account for almost a third of global external finance. For many of the developing nations they flow into, remittances can increase the national gross domestic product (GDP) by a significant percentage. For example, in 2000 the U.N. reported that remittances increased the GDPs of El Salvador, Jamaica, Jordan, and Nicaragua by 10%. The World Bank reported that in 2004 remittances accounted for approximately 31%, 25%, and 12% of Tonga’s, Haiti’s, and Nicaragua’s GDP, respectively.

II. Remittances in the U.S.--Latin American Corridor

* Professor of Law, University of Iowa College of Law. Many thanks to Jane Ro, my research assistant, for her assistance with this paper.

Economists and policymakers have studied remittance trends between Latin America and the United States extensively. Since this relationship has developed into one of the largest volume remittance markets in the world, it offers important illustrations of international remittances at work and how remittances create a vital tie between developed and developing countries.

A significant study conducted by the Inter-American Development Bank (IDB) in 2004 provides useful insight into remittance and related migration patterns between Latin America and the United States. The study reveals that over 60% of the 16.5 million Latin American-born adults who resided in the United States at the time of the survey regularly sent money home. The remittances sent by these 10 million immigrants were transmitted via more than 100 million individual transactions per year and amounted to an estimated \$30 billion during 2004. Each transaction averaged about \$150-\$250, and, because these migrants tended to send smaller amounts more frequently than others, their remittances had a higher percentage of costs due to transfer fees.

Migrants sent approximately 10% of their household incomes; these remittances made up a corresponding 50-80% of the household incomes for the recipients. Significant amounts of remittances were sent from 37 U.S. states, but six states were identified as the “traditional sending” states: New York (which led the group with 81% of its immigrants making regular remittances), California, Texas, Florida, Illinois, and New Jersey. The high growth rate of remittances to Mexico (not the total amount) is unlikely to continue. In fact, according to the Mexican central bank, remittances grew just 0.6 during the first six months of 2007, as compared to 23% during the same period in 2006. Experts attribute the slowdown to a contraction in the U.S. construction industry, tighter border controls, and a crackdown in the U.S. on illegal immigration.

As the foregoing statistics illustrate, increased migration from Latin America to the United States has resulted in a very significant amount of remittance activity. The numbers also help us understand the dependence between a developed country and developing countries: The United States needs Latin Americans to supply its labor markets—the migration improves business profitability and reduces the costs of production, while Latin American countries depend on the flows of remittances that result from the migration of labor. This dependence has also resulted in what experts call “micro-geographies,” tightly-knit networks that integrate U.S. communities with communities throughout Latin America, such as migrants from Oaxaca, Mexico who have settled in Venice Beach, California. Oaxacans not only send money back to their communities, but they also travel back and forth extensively.

III. Remittance Mechanisms and Their Costs

Migrants send money to their home countries through formal and informal channels. Formal channels include major money transfer operators (MTOs), such as Western Union and Money Gram, and banks, such as Bank of America. Some migrants use formal channels, but language barriers as well as related costs for these services may deter remitters from using them. Consequently, most remittances occur through informal channels. For instance, migrants may carry cash home themselves or send cash through the mail or a friend.

Cost is not usually an issue for large remittances, such as those relating to trade. However, cost is a significant factor for small, personal transfers. The IDB estimated that the total cost of sending remittances to Latin America and the Caribbean approached \$4 billion in 2002 (approximately 12.5% of the amount of remittances to this region). The Pew Hispanic

Center estimated that the total cost of the average remittance transfer ranges between 15-20% of the total.

The costs typically include a fee charged by the sending agent and a currency-conversion fee—e.g., converting U.S. dollars sent by the remitter to Mexican pesos that can be used by the recipient. In some cases, the recipient may have to pay an additional fee to collect the remittance. Costs may be higher when the remitter is using an MTO such as Western Union as opposed to a bank. Funds that have to be remitted quickly through, say, an electronic transfer will involve higher costs as well. The amount of the remittance will also factor into costs. For example, the World Bank has reported that MTOs channeling money from the United States to Mexico charge more than 10% for transfers of \$100, as compared to less than 3% for \$500. Moreover, sending agents' fees in many instances far exceed the costs they incur in making the remittance, which translates into higher profits. For instance, in 2004 Western Union enjoyed an average profit of \$8 to \$9 dollars per remittance transaction.

The World Bank has noted that reducing remittance costs and improving the infrastructure would be beneficial in several ways. By reducing costs, remitters will have more disposable income, which may translate into increased remittances. Reduced costs will also increase remittance flows through formal channels, such as banks. And improved infrastructure will promote better financial access among the poor in developing countries.

Given these significant benefits, in 2004 the G-8 (a governmental forum comprised of Canada, France, Italy, Japan, Russia, the United States, and the United Kingdom) met in part to come up with projects to help facilitate remittances by lowering former-channel transaction costs. This led to the creation of a task force of experts, co-chaired by the World Bank and the Bank for International Settlements, whose purpose was to establish develop principles for international remittance services. In January 2007, the task force published a report containing General Principles for International Remittance Services, which focuses on the payment system aspects of remittances.

In addition to the high costs associated with remittances of smaller amounts, the report notes that migrants may not have adequate access to remittance services if they do not speak the local language or have the necessary documentation. Moreover, poor financial infrastructure in some developing countries may make it difficult for the recipients to collect the remittances. The services may be unreliable, the markets may not be sufficiently competitive to reduce costs, or there may regulatory barriers that impede the transmission of remittances.

Accordingly, General Principle 1 stresses that the remittance markets should be transparent and offer adequate consumer protection. General Principle 2 encourages the improvement of payment system infrastructure in order to increase the efficiency of remittance services. General Principle 3 focuses on the legal and regulatory framework by encouraging soundness, predictability, non-discrimination, and proportionality (i.e., laws that effectively address problems). General Principle 4 calls upon countries to create competitive market conditions, including appropriate access to domestic payment infrastructures. General Principle 5 focuses on remittance services and calls upon governments to provide appropriate governance and risk management practices. The report notes that remittance service providers and public authorities must work together to implement the General Principles effectively. Although the Principles are not prescriptive but rather provide guidance, their application “should help achieve the public policy objectives of having safe and efficient international remittance services, which require the markets for the services to be contestable, transparent, accessible, and sound.”

The effort to reduce remittance costs through competition has paid off. The World Bank has reported that remittance costs in the United States-Mexico corridor have declined considerably. For example, in 1999 it cost \$26 to send \$300 from the United States to Mexico, whereas in 2005 it cost only \$11—a 60% drop. The drop is attributable to the break-up of exclusive dealing arrangements between one dominant MTO and its distributors, allowing banks to enter the market.

IV. The Effect of Remittances on Developing Countries

Most observers have concluded that on balance remittances are beneficial to developing countries. An obvious benefit is that a portion of most funds sent to home countries goes toward the welfare and improved livelihood of the families receiving them. The recipients commonly spend the funds on necessities such as health, education, food, and clothing. Remittances are also invested in businesses and infrastructure in developing countries—e.g., a \$10 million hospital in Touba, Senegal, a new international airport in Kerala, India, and a metal bridge in Jomulquillo, Mexico.

On the broader macroeconomic plane, remittances may help recipient countries cope with economic crises because migrants tend to send more money back to family and friends during hard times. Remittances can also improve a receipt country's creditworthiness. This is because such inflows would effectively reduce the country's indebtedness relative to its exports (its income), thereby improving the country's credit ratings and lowering its borrowing costs on the international capital markets. And remittances also help developing countries raise external financing through securitization. In this type of transaction, developing-country banks that receive remittances can issue bonds to foreign investors backed by the future flow of those remittances. Various developing countries, led by Brazil, have raised billions of dollars through this technique.

Still, remittances are not hazard-free. For instance, large inflows into small economies can cause the domestic exchange rate to appreciate (i.e., the domestic currency becomes more expensive relative to foreign currency), thereby making tradable items, such as cash crops and manufactured goods, less profitable. Also, governments may develop a dependency on large flows of remittances, thus creating a disincentive to pursue aggressive economic policies to promote sustained development. Moreover, a good portion of remittances might not be productively invested. A study done on twenty-two migrant communities in Mexico in 2001 reported that only about 10% of remittance funds were invested or saved. Instead, the bulk of the money went to raising the standard of living for the receiving family—i.e. a new house, a car, a bigger T.V., etc. The study also theorized that remittances created an “easy money” cycle where the receivers of remittances treated the money like allowances and, thus, had little incentive to work. This resulted in significant social costs, such as a reduction in the labor supply, which hinders economic development. Thus, many developing countries are watching their best and brightest leave to put their valuable human capital to use elsewhere—the “brain drain”, while the money they earn and send home contribute little to the home country's economic growth, despite the resulting increased consumption.

This phenomenon is not inevitable, however. For example, although most remittances go to individuals or families, some migrants participate in associations that send collective remittances to their home communities. The funds are used for a variety of investments, such as building schools and churches or dealing with local emergencies such as hurricane devastation. The Latino Home Town Associations in the United States are a well-known example of such a community association. In addition, in some countries such as Guatemala, the recipients put the

majority of their remittance earnings into savings or towards investment, rather than spending it on consumption. Generally, one should take into consideration that the net impact of remittances will vary greatly between countries and even regions within countries, depending on the structure of the local economy, the usage patterns of the funds by the recipients, and the availability of invest opportunities. In many cases, well-intentioned efforts to invest remittances in businesses in home communities have failed.

Overall, the relationship between remittances and economic growth is unclear because of a lack of extensive research on this relationship at this point. Some analysts and scholars argue that remittance benefits are only felt at the individual receiver's level, but some case studies suggest that the benefits of remittances to individuals have spill-over effects that can translate into a positive impact on the local economy. One highly cited study published in 2003, "Are Immigrant Remittance Flows a Source of Capital for Development," covering 113 countries found a negative effect that remittances had on growth. The authors of the study attribute this negative effect on the moral hazard problem that remittances create, which was alluded to above. Essentially, the study concluded that income from remittances allows receiving families to decrease their own work and productivity, which then translates into a reduction in the labor supply for the developing country.

This study stands in stark contrast with others, such as a recent IMF^F study covering 100 developing countries from 1975 to 2002 which indicated that remittances enhanced growth in countries with less developed financial systems. In these settings, remittances function as a means to finance investment where the limited domestic financial system offers none. This same study found no such effect within countries that have better functioning domestic financial markets.

V. Conclusion

As this paper suggests, incorporating a case study of how diasporic communities contribute to international business transactions via remittances would significantly enrich the study of IBT in the classroom.

