

UICIFD Briefing No. 3: Remittances

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The impact of remittance transfers on the economies of developing nations is only beginning to be ascertained. Remittance transfers have existed for centuries, but have only garnered the attention of economists and international financial institutions within the last two decades. The reasons for this oversight include both the relatively small amounts of money sent with each transfer, and the often-marginal social status of both the sender and the receiver. This brief explains what a remittance transfer is and which players are involved. It also assesses the positive and negative impacts that remittances may have on development and developing economies.

1. What is a remittance transfer?

A “remittance transfer” refers to the transfer of money from an individual, usually a person who has emigrated from her city or country of origin, to another individual, usually a relative who remains at home. Remittance transfers are typically person-to-person payments and of low monetary value. There are two basic categories of remittance transfers: domestic and international. Domestic remittance transfers occur when an individual transfers funds from one location to another within the same country. The predominant pattern within this category is that the individual sending the funds, *i.e.*, the remitter, hails from a rural area and has relocated to an urban center. In contrast, an international remittance transfer involves an immigrant in a new country sending funds to his country of origin, or to individuals (usually family) in a third country. Frequently, the remitter has moved, for the purpose of employment, from a developing country to an industrialized one. Remittance transfers include *neither* the international sale and

transfer of goods *nor* the cross-border transfer of funds between businesses. For the purposes of this brief, a remittance transfer will refer only to international remittances.

Compilers of statistics tracking the amount of money that is remitted each year gather their data largely from the formal Remittance Service Providers (RSP). Formal RSP's are those that are regulated and operate openly within the sending and receiving countries. These include banks, credit unions, and many wire-transfer services. The World Bank's estimate of worldwide remittances in 2005, which is approximately US\$ 167 billion, includes accountings of only the *formal* RSPs. However, an array of *unofficial* and *informal* modes of transferring funds and sending money exist, yet remain unmonitored. Informal modes vary widely: from a temporary worker or traveler mailing cash or checks using the regular postal service, or, alternatively, carrying cash on her person when she returns to her home country, to the *Hawala* or *Hundi* system used in Asia, the Middle East, and Africa since the Middle Ages, in which *hawaladars* (brokers), scattered across hundreds of cities, function as private RSPs. When transfers are made using unofficial techniques, remitters can avoid or mitigate commissions and fees. Moreover, they can bypass official currency-exchange rates and governmental regulation. In certain countries, the use of unofficial modes of remittances, and their lack of transparency, allows the remitter to avoid taxes and may also be favored due to immigration concerns. Because most informal transfers are neither reported nor monitored, measuring them accurately is problematic, so projections for unofficial remittances are speculative. Nevertheless, experts place the total (i.e., formal and informal) amount of global remittances at over US\$ 230 billion.

2. How do remittance transfers work?

Functionally, most RSPs operate in similar ways. In order to send and receive funds, RSPs must be networked. First, they must all have access points, or physical locations along the

remittance “chain.” At one end of the remittance chain, the “capturing agent” collects the funds from the sender, or remitter and, at the other end of the chain, the “disbursing agent” disburses the funds to the receiver. These access points may be banks, wire transfer offices, or grocery stores, to give but a few examples, and are the most visible components of the network. Apart from the physical access points, most of the remittance system remains invisible to the public. RSPs must provide a way for the capturing agent to communicate information to the disbursing agent with regards to the transfer that is occurring—this is referred to as “messaging”. A “settlement”—comprised of some arrangement for the actual transfer of the funds—is also required. Whether considered formal or informal, the World Bank separates avenues for international remittances into four categories: unilateral, franchised, negotiated, and open.

Unilateral remittance networks involve only a single RSP. This occurs when a bank, credit union, or other financial institution maintains branches in both the sending country and the receiving country. A unilateral RSP has physical locations in both the sending and receiving countries, and is therefore able to capture, message, settle, and disburse the funds entirely intra-RSP. Unilateral remittance networks also include the electronic transfer of funds, where the access points are virtual rather than physical. A virtual remitter sends the funds from one remote access point, such as her home computer, directly to the receiver, who is at another virtual access point in his home country. Though efficient, unilateral providers are rare. Their scarcity is due to the unavailability and uneven distribution of physical access points, as well as remitters’ lack of access to electronic banking or banking in general. Even so, the development of unilateral RSPs is an area of future growth.

In a **franchised service**, an RSP creates the network for transfers without necessarily owning any of the physical access points. Generally, the RSP provides the messaging and

settlement portions of the transfer, and relies on capturing and disbursing agents who have franchised the service based on standardized and contractual terms. Wire-transfer services, such as Western Union, fall into this category. A **negotiated service** involves an RSP in one country that has negotiated and established a network with an institution, or institutions, in other countries. Agreements between banking institutions, credit unions, and even the unofficial *hawaladars* can constitute negotiated services. In many negotiated services, the messaging and disbursement of funds often occurs *before* the actual settlement, such that the disbursing agent releases funds to the receiver based on the expectation of *future* settlement by the capturing agent. This practice leads to fees and interest rates higher than more formal systems. In an **open service**, the RSP in the sending country locates an RSP in the receiving country. These networks are not pre-established and usually result in the messaging segment of the transfer occurring simultaneously with the settlement of the transfer.

3. Who participates in remittance transfers?

It is estimated that one out of every ten people participates in some form of remittance transfer. Of the estimated US\$ 167 billion of formal remittances that transpired in 2005, almost US\$ 50 billion went to Latin American and Caribbean countries (LAC) with nearly US\$ 22 billion bound for Mexico alone. The LAC represents the highest volume, and most rapidly growing, market for international remittances and is therefore of special focus throughout this brief.

Although transfers to the LAC represent a major portion of international remittances, remittances occur in one form or another in almost every nation. Countries are designated as *net remitters* when their total outgoing remittances are greater than incoming transfers. The United States, Saudi Arabia and Germany have the highest volume of outgoing remittances. Other

countries, such as India and Mexico, are *net receivers*, with the incoming flow of remittances received exceeding the sum of those sent. Of the estimated US\$ 230 billion in global remittances, around US\$ 167 billion are believed to have gone to developing nations, thereby exceeding the amount of official aid, and equivalent to 90% of foreign direct investment (FDI) received by those same countries.

In the United States, it is estimated that 70% of migrant workers remit funds on a regular basis; of these, three out of five are considered working poor and nearly half are under the age of 35. Both obligatory and voluntary purposes motivate these remitters. Although some remittances arise from familial obligations, as with a short-term loan or prearranged repayment for educational expenses, reports indicate that many remitters transfer money for altruistic reasons. Studies show that remitees spend the majority of the money they receive on household goods, such as food and clothing, as well as housing and health care, thereby supplementing income and providing necessities in areas that are typically impoverished. Remitees are able to access the transferred funds using a number of methods that are contingent upon the available infrastructure in their country.

4. Positive Impacts on Development

One positive aspect of international remittances is that they represent a flow of income for families in the developing world who might not otherwise receive assistance. Whether it is because of their location or social status, the majority of remittance receivers are the “invisible” poor. Remittances also help to foster a sense of financial democracy. Unlike other official forms of aid, they are distributed directly to an individual who retains full discretion to decide how it will be used. Remittances are non-reciprocal in that they are one-way financial flows with no anticipation of return or reimbursement. The availability of remitted funds may also indirectly

help the communities within developing nations where the money is spent. For example, the extra income from remittance transfers may cover the basic needs and free up money which can be spent on education and health care, thereby resulting in a more productive and healthy citizenry. It is estimated that even a 3% increase in the number of temporary visas issued to migrant workers would raise the world income by US\$ 16 billion. It is also estimated that for every one-percent increase in remittances as a fraction of a receiving country's GDP, the population living in poverty is reduced by approximately four-tenths of a percent.

Remittances are also a stable form of external finance, and, unlike other forms of private capital inflows, remittances remain stable and often increase during times of economic hardship. This stability is due, in part, to the altruistic tendencies of those living abroad to send more help when more help is needed, and also because, in general, the remitter is located in a less economically depressed country. It is usually held that the amount of money remitted is inversely related to the strength of the receiver's national economy. That is, remittances increase sharply following economic crises. Remittances, therefore, provide a safety net during sudden economic downturns, financial crises, and unexpected short-falls. The impact of remittances may be even more pronounced in countries experiencing warfare or unrest. With respect to such countries, the increased remittance flow diminishes the number of citizens who must flee for reasons of financial (in)security. Moreover, when displaced refugees come to have financial or political leverage in their new countries, they may be able to indirectly or directly mount pressure against their home country in order to promote peace and stability.

5. Negative Aspects and Potential Drawbacks.

When the immigrants continuously remit funds to their home countries, the potential exists for the receiving community to become dependant upon those remittances. An abrupt halt

in the flow of remittances in such a case, can be devastating. For example, the large population of Nicaraguans who sought asylum in the United States, habitually send remittances home. Although much of the violence in Nicaragua has subsided, and economic stability is increasing, if the refugees were to suddenly return home, a major flow of money into the country would stop and a crisis would likely follow. The risk of such a calamity is greater in countries where the amount of remittances represent a high percentage of that nation's GDP. In a number of LAC economies—as well as those of other developing regions—remittances account for a large part of the GDP. In Haiti, for instance, remittances account for 54% of the GDP, in El Salvador they make up 15% of the GDP, and in Jamaica 17%.

Another potential drawback informs the debate as to whether remittance transfers, as a whole, increase or decrease inequality between the “haves” and the “have-nots.” According to one study in 2005, the global trend may suggest that remittances do, in fact, increase the rift between the poor and the wealthy. However, when looking at those countries whose remittance amounts are the highest in relation to their respective GDPs, studies arrive at the opposite result. This is due, in part, to the make-up of the immigrant communities. In developing countries, where remittances account for a high percentage of the GDP, émigrés tend to be less educated than the average citizen; they leave their home country looking to increase their employment opportunities. In industrialized countries, the remitter is often more educated than the general population of her home country, and has immigrated to accept an employment opportunity or follow an educational pursuit. However, most of the criticism that surrounds international remittance transfers is centered on the lack of transparency of formal systems and the almost opaque quality of informal ones.

Lack of transparency is of particular concern with respect to open-network RSPs. Often, the sender is not aware of or able to discern what fees may be applied to the receiver. Depending upon the local economy and the network, a disbursing agent may charge a fee in order to ensure he is compensated for his role in the remittance. Lack of transparency and hidden fees are further problematic in light of the disproportionate participation of the “invisible” working poor, who lack access to bank accounts or other official institutions and financial services, and are therefore exposed to potentially deceptive practices on both ends of the remittance chain, such as unusually high fees or interest, as well as altering the rate of exchange in order to garner more profits. Often, the remitter is in a foreign country with limited use of the language and is unable to investigate alternative avenues for money transfers. In many instances, neither the sender nor the receiver is aware of the actual exchange rate between the currencies and is therefore vulnerable to corrupt service providers. In the last few years, increased government awareness of international terrorist financing has amplified concerns over the transparency of remittances. Informal remittance-service providers have been used to launder money, and fund terror or other criminal activities. In order to curb this illegal usage, and to better regulate the remittance system, financial institutions, wire services, and even *hawaladars* worldwide have recently been proposing changes.

6. Possible Remedies

In order to improve the transparency of remittance services, and thereby provide adequate consumer protection, the World Bank recommends that the following information be provided to both sender and receiver: (1) The amount paid by the sender. (2) The amount disbursed to the receiver. (3) The total fees paid by the sender and the receiver. (4) The time that the remittance will be available to the receiver. (5) The location that the remittance will be disbursed.

Transparency is not the only problem facing international remittance services. Indeed, the World Bank has identified five features in the remittance market which lead to inefficiencies or abuses, and should be remedied: (1) Lack of transparency or understanding on the part of the user. (2) Weaknesses and inefficiencies in the payment system infrastructure used to provide the service. (3) Unpredictable, unconscionable, and discriminatory regulatory and legal frameworks. (4) Lack of competitive market conditions. (5) Lack of appropriate governance and risk management practices.

Counter-terrorist-financing policies are increasingly relevant in the regulation of remittance transfers. Groups such as the Financial Action Task Force have issued special recommendations on how to prevent terrorist-financing and the laundering of illegally acquired funds, while still encouraging remittance transfers. These recommendations, however, would be ineffectual in practice and could potentially lead to increased use of informal channels of remittances.

Many participants in remittance transfers are working poor with only limited access to financial institutions, both in their home countries and abroad. As the issue of remittances has gained more global attention, various entities have addressed the problem of accessibility. In 2000, the Inter-American Development Bank's Multilateral Investment Fund began to analyze remittances to the LAC. It appears that economic pressure and increased regulations have had some positive impacts. Since 2000, for example, the average cost of a \$200 transfer from the United States to Mexico has decreased from approximately 15% to nearly 5%. Moreover, a number of financial institutions have been expanding their services in order to cater to the working poor and increase their access to financial institutions. Often the senders and receivers

are mostly “un-banked” and a system that promotes inclusion of these classes also introduces them to the global financial system in a broader sense.

Although immigrants have been sending money home for generations, the data on remittances are only now being analyzed. Some view international remittances as an important economic tool assisting underdeveloped countries while providing a mobile labor-force to more developed nations. In order to increase the amount of assistance and minimize abuse, new regulations are being proposed. Broad improvements to the networks of RSPs and their operations should lead to greater transparency, consumer protection, and financial security. In addition, the extension of financial services and products to the poor should lead to increased financial democracy.