Migrant workers' remittances: what is the impact on the economic and financial development of Sub-Saharan African countries?

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Remittances from migrant workers have become a major source of financing for developing countries. Latin America and Asia have benefited since the mid-1990s from a particularly sustained rise in income transferred by their emigrant workers.

Migrant workers' remittances have also increased in Sub-Saharan Africa (SSA), where they play an essential role in poverty alleviation. Moreover, they have the advantage of building a more stable source of external financing than official development assistance (ODA) flows and foreign direct investment (FDI) and, by sustaining private consumption they have a stabilising effect on these countries' economies, acting as a buffer.

In contrast, their direct impact on long-term growth in SSA has not been established. Recent empirical studies carried out on this subject have not enabled a consensus to be formed, and the relationship between remittances and business investment is not clear-cut.

Nevertheless, workers' remittances can have an indirect impact on growth by favouring financial development in the recipient countries. Increased formalisation of remittances from African migrant workers would contribute to this objective, by enabling the local financial systems to fully play their role in the allocation of resources.

While the increased formalisation of workers' remittances is hindered by obstacles of a structural nature, notably the low financial depth in African economies, several avenues may nonetheless be explored. In sender countries, strengthened transparency and competition in the money transfer market could lead to a reduction in transfer costs. In recipient countries, improved access to financial services (notably via the growing role of microfinance and new payment technologies) and the continuation of structural reforms already underway are all important preconditions for increasing the efficiency of remittance transfers.

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In recent years, the role of workers' remittances in economic development has constituted a recurrent topic of research and political debate.

This paper emphasises the significance of workers' remittances in the financing of developing countries, notably in SSA, and their essential contribution to poverty alleviation. It describes the main results of recent studies that have examined the impact of workers' remittances on long-term growth in SSA. These studies have produced mixed results, particularly on productive investment (see Section 1). This paper also encourages increased formalisation of remittances from migrant workers to this region in order to contribute to the strengthening of local financial systems and to the improvement in the recipient countries' growth potential (see Section 2).

Lastly, this paper explores a number of avenues that could remove the obstacles to the formalisation of workers' remittances and improve their impact on growth (see Section 3).

1| The significance of remittances from migrant workers in Sub-Saharan Africa

1|1 An essential source of development financing

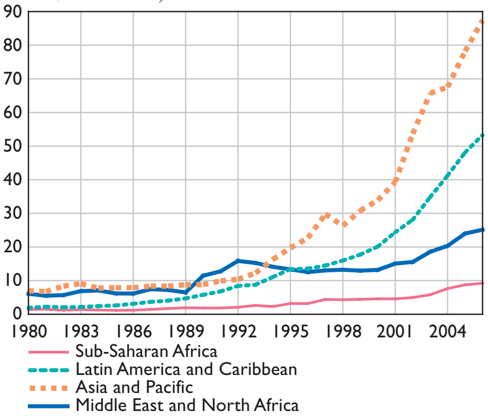
Since the mid-1970s, the amount of workers' remittances has increased fairly constantly, with a particularly sharp rise in Latin America and Asia as of the mid-1990s (Chart 1). Between 2000 and 2006, workers' remittances to developing countries more than doubled, overall, reaching around USD 180 billion, i.e. almost twice the amount of official development assistance (ODA) flows to these countries.

These overall developments are partly due to the increase in the number of migrant workers: between 1995 and 2004, the increase in the share of the foreign-born population in the total population in OECD countries ranged from between 0.6 point in Australia (23.6% of the total population in 2004) and 4.1 points in Ireland (11% of the population in 2004).[1] The growing integration of migrants in the economies of host countries has been accompanied by an improvement in migrant workers' incomes and, as a result, in their remittance capacity. The increase in total flows is also due to an improvement in the statistical recording of remittance flows in the balance of payments, together with the increased use of formal financial services by migrants from Latin America and North Africa.

1 Lemaitre, Thoreau, 2006.

Chart 1 Developments in remittances from migrant workers since 1980

(billions of current dollars, 1980-2006)



Source: World Bank, Global Development Finance Indicators, 2007.

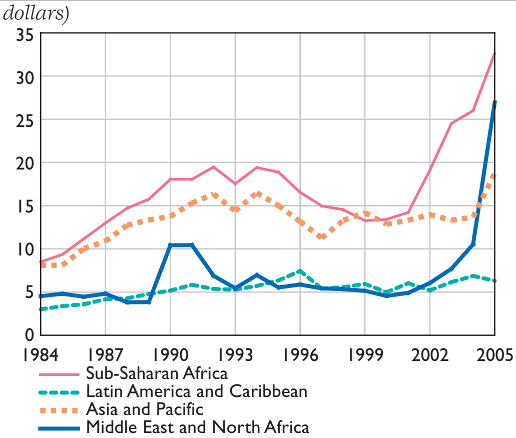
At the same time, ODA flows stagnated somewhat during the 1984-2005 period, with the notable exception of aid to SSA since 2000 (Chart 2).

By comparing the amounts of remittance flows and official assistance with FDI flows, attention may be drawn to the differences in external financing patterns of the four major emerging regions (Chart 3).

Latin America receives almost 30% of worldwide remittance flows to developing countries. The significance of North American investment in the zone accounts for the fact that it is also the region, along with SSA, that receives the most FDI as a percentage of GDP.

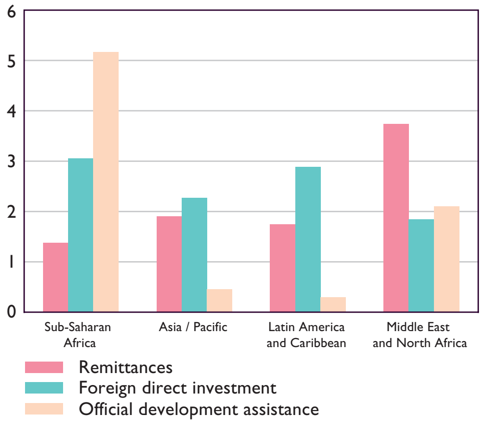
Chart 2 Official development assistance flows

(billions of curent dollars)



Source: World Bank, Global Development Finance Indicators, 2007.

Chart 3 Developing regions' main methods of external financing
2001-2006
(as a % of GDP)



Source: World Bank, Global Development Finance Indicators 2007.

Although Asian countries receive almost half of worldwide remittance flows to developing countries, this income represented less than 2% of their GDP on average during the 2001-2006 period.

In contrast, for North Africa and the Middle East, which receive around 15% of total remittance flows, this source of income is the largest in terms of its ratio to GDP of all developing regions (around 3.7% of the region's GDP). This is mainly due to the long history of North African migration to Europe and the development of bank networks accompanying the movements of migrants in Europe, which has favoured formal transfers.

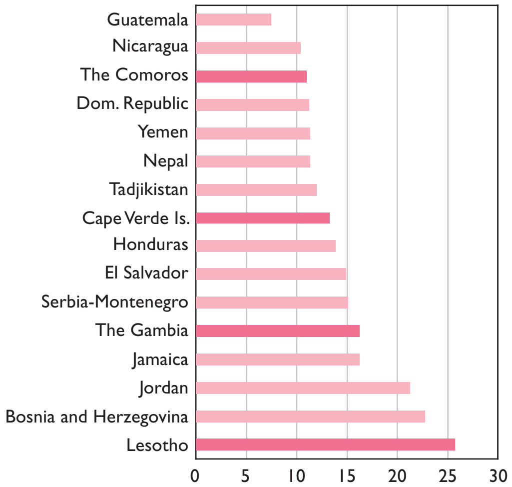
Sub-Saharan Africa remains the region most highly dependent on ODA, which represented an average of 5% of its GDP during the 2001-2006 period. While remittance flows towards SSA followed the overall upward trend and almost doubled between 2000 and 2006, reaching over USD 9 billion, they only account for 1.3% of the region's GDP and 5% of total funds sent to developing countries. This source of external financing in SSA has nonetheless enjoyed an unbroken increase since the beginning of the 1990s, while ODA and FDI flows have undergone strong fluctuations during the period.

For a number of small African countries (Lesotho, The Gambia, Cape Verde Islands, the Comoros), with rather undiversified productive structures, workers' remittances represent an even larger source of external financing, sometimes accounting for 10 to 20% of their GDP (Chart 4). In this regard, the example of the Comoros is very representative of these economies that are highly dependent on remittances. With remittances accounting for 14% of their GDP in 2005,[2] the Comoros apparently ranks 12th worldwide

2 *Source: Central Bank of the Comoros (BCC). The data includes, in private current transfers, estimated informal fund transfers.*

Chart 4 Main recipient countries of remittances from migrant workers 2001-2005

(as a % of GDP)



Source: World Bank, Live Data Base, 2005.

in terms of the ratio of remittances to GDP, according to the World Bank. The size of remittances also increased sharply between 1995 and 2005, representing an average of 160% of exports of goods and services and 72% of ODA, and even exceeding the volume of ODA flows as of 2003. Compared to the ratio of workers' private remittances to GDP of just 4% in 1995, this is an increase of 10 points in 10 years.

1|2 A varying impact on growth determinants

1|2|1 An active role in sustaining consumption and reducing poverty

In Sub-Saharan Africa, workers' remittances, by increasing the available income of recipient households, have a direct impact on the reduction of poverty and inequalities, as revealed in research by Gupta, Patillo and Wagh (2007). This research shows in particular that a 10% increase in remittance flows is associated to a 1% reduction in the level of poverty per capita and the dispersion of income per capita. Remittances help to smooth consumption (Kannan and Hari, 2002) by acting as an insurance mechanism in the event of adverse shocks (Lucas and Stark, 1985; Yang and Choi, 2007). A significant share of remittances is generally spent on non-durable consumer goods while a smaller share is saved or invested. In certain regions of SSA, the share of remittances spent on consumption can reach up to 80% (Maimbo and Ratha, 2005). A targeted study on the economy of the Comoros confirms the strong correlation between remittances and household consumption (see Box 1).

Box 1

The impact of remittances on macroeconomic variables: a case study of the Comoros

This box aims to study the relationship between the main macroeconomic variables of the Comoros' national accounts and workers' remittance flows.

Since 1985, gross fixed capital formation as a percentage of GDP has fallen markedly, dropping from 35% of GDP to 10% in 2005. Conversely, the share of household final consumption has remained stable, at around 80 to 90% of GDP, in a context of weak economic growth. It would therefore seem (see Chart below) that remittances have helped to sustain household consumption but not to counter the decline in domestic savings and investment, which began in the 1980s.

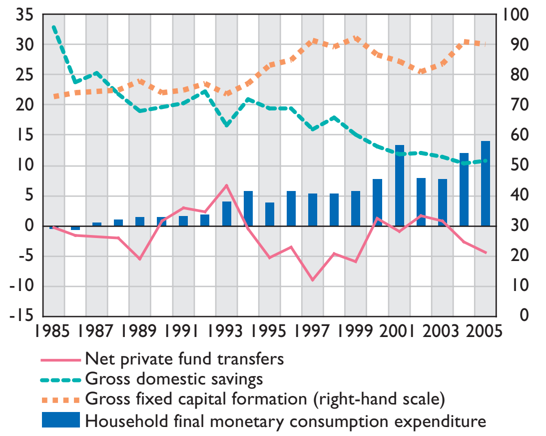
A study of the correlation between workers' remittances and the main macroeconomic variables highlights the strong positive correlation between household final consumption and remittances (the correlation coefficient is 0.94).

The negative correlation between the trade balance and remittances (- 0.80) could be explained by the fact that in the Comoros' case, an increase in funds sent reduces the trade surplus or increases the trade deficit via a rise in consumer goods imports.

In contrast, the relationship between remittances and gross fixed capital formation is affected by a weak correlation coefficient (0.25).

Developments in private fund transfers and in the national accounts
1985-2005

(as a % of GDP)



Sources: Central Bank of the Comoros; Franc Zone Annual Reports; African Development Bank. Banque de France calculations.

1|2|2 A less obvious impact on private investment and growth

A share of remittances is also allocated to the financing of investment in human capital (education, health) or infrastructure (housing), which influences long-term development and the reduction of inequalities (World Bank, 2006). Thus, remittances sent by Comorian community associations in France, which collect funds from migrants, finance investments in community amenities and infrastructure in the Comoros (schools, hospitals, etc.). However, a very small share is destined for productive investment.

This finding is supported by several empirical studies. Thus, in Mali and the Comoros, less than 10% of remittances are allocated to local investment (Martin et al., 2002). In Ghana, around 30% is invested in assets (land, buildings, etc.) (Schoorl, et al., 2000).

Furthermore, it is worth noting that the results of the main empirical studies available (Chami et al., 2008; Chami, Fullenkamp, Jahjah, 2005; Giuliano and Ruiz Arranz, 2003) have not enabled a stable and well-established relationship to be drawn between workers' remittances and long-term growth in recipient countries. In particular, positive and significant coefficients are only identified when the variables relative to investment are excluded from estimations.

However, a consensus exists as regards the stabilising effect of remittances on the growth of developing economies and their role as buffers. Thus, Chami, Fullenkamp and Jahjah (2005) find a negative and significant relationship (the estimated coefficient is equal to -16.98) between workers' remittances and the per capita income gap between these countries and the United States. Remittances are correlated to the weak economic performance of the recipient country.[3] This would suggest that the motive behind most remittances is to compensate income loss following deterioration in the economic environment. These results are supported by subsequent research carried out by Chami et al. (2008), showing that remittances have the property of reducing the volatility of the recipient countries' GDP growth. A one-point increase in the ratio of remittances to GDP would thus reduce the standard deviation of the recipient country's GDP growth by 0.16 point.

3 *This result is confirmed, for example, for the Comoros (the estimated coefficient is equal to -4.54) where remittances have increased rapidly over recent years (see Box 1). During the 1985-2006 period, the estimated relationship is as follows:*

$$d(logtf) = \underset{(-4.57)}{-4.54}\, d(yC\text{-}yUS) + \underset{(0.19)}{0.006}\, (rC\text{-}rUS) \qquad R^2=0.14$$

2| Financial development and formalisation of workers' remittances

The significance of remittances sent informally, rather than through financial bodies (banks, money transfer companies etc.), constitutes a specificity of funds sent to SSA, likely to affect the relationship between these flows, productive investment and growth in the recipient economies. The assumption used in this section is based on the idea that by enabling the local financial systems to play their role in the allocation of resources and by favouring financial development, increased formalisation of transfers is likely to contribute to long-term growth in developing economies.

2|1 From the formalisation of remittances to economic development

The lion's share of remittances from migrant workers is informal. Informal remittances account for 5 to 250% of officially recorded flows (Freund and Spatafora, 2005) (see Box 2). Nonetheless, there is considerable heterogeneity between the developing regions, as remittances to SSA are mainly sent via informal channels, whilst flows to Latin America are essentially conveyed through formal channels. Informal transfers only account for 15 to 20% of total remittances in El Salvador, while over 70% of remittances to the Comoros, Mali and Senegal from France are sent via informal channels (Freund and Spatafora, 2005).

Box 2

MEASUREMENT OF REMITTANCE FLOWS

Official data on cross-border payments sent by individuals to their home country are in principle collected and recorded in the balance of payments, in accordance with the standardised methodology defined by the IMF (fifth edition of the Balance of Payments Manual, 1993).

Remittance flows are normally listed according to three categories:

• workers' remittances (WRs), recorded in the current account under current transfers, cover current transfers by migrants employed in other countries than that of their citizenship for more than a year. WRs are generally preferred for the analysis of the macroeconomic impact of remittances. This approach is also used in the present paper;

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.../...

• compensation of employees (CoE), recorded in the current account under income, comprises wages, salaries and other benefits (in cash or in kind) earned by individuals for work performed for and paid by residents of those host countries, including seasonal or other short-term work (during a period of less than one year) carried out abroad;

• migrant transfers (MTs), recorded in the capital account under capital transfers, are contra-entries to flows of goods and changes in financial items that arise from the migration (change of residence for at least a year) of individuals from one country to another. The transfers recorded are thus equal to the net worth of the migrants at the time of migration (cash and goods transferred).

In spite of these efforts to standardise methodology, the collection and recording of reliable data in terms of money transfers remain particularly sensitive. One of the main sources of difficulties is the myriad of financial and non-financial institutions likely to capture all or some of the remittance flows, which involves, for central banks establishing balance of payments, the preparation of specific reports. A recent study (De Luna Martinez, 2005) has revealed that, out of a sample of 40 central banks in developing countries, only 65% of them collected data on the activities of bureaux de change, and just 35% and 38% on the activities of money transfer companies and post offices. However, the activity of commercial banks was better documented, with 90% coverage.

Another major constraint is in the estimation of the share of payment flows sent via informal channels. These flows comprise all money transfers that do not involve formal contracts, such as money transferred in cash or via another means (e.g. fax) between friends, family members or community members. The aforementioned World Bank study (De Luna Martinez, op. cit.) indicated that in this domain, only a quarter of central banks in the sample collected data on informal transfers, via the use of special inquiries, either by questioning migrants, upon return to their country, or recipient households.

In view of the risk of errors and approximations inherent in these methods of evaluation and the absence of monitoring of these flows by a large number of central banks, the balance of payments data therefore does not reflect the exact amount of the money transfers. Informal transfers to Latin America thus represent 5 to 20% of official payments. The proportion is higher for flows to SSA, where informal transfers represent 45 to 65% of formal flows (Freund and Spatafora, 2005).

Transactions via formal channels nonetheless provide the best guarantees in terms of security, not just for the sender and the recipient but also for the economic system as a whole, as formal transactions are subject to anti-money laundering legislation. There are also other positive externalities associated to the use of financial services for fund transfers. Indeed, by facilitating migrant families' access to financial institutions, the formalisation of transfers is likely to influence the financial practices of recipient populations, by inciting them to hold a current account or savings account, or providing them with access to financing, linked to remittance flows, for the creation of micro-enterprises. The formalisation of transfers can also contribute towards the financial development of the recipient country.

As is the case for growth, the causal links between the formalisation of migrant workers' transfers and the economic development of the host country remain uncertain. However, it seems that by working on the development of the financial sector, transfers can have an indirect impact on long-term growth. For example, the banking sector, by reducing the transaction costs, is in a better position to direct fund transfers to the most profitable projects, which could strengthen the developing countries' growth potential. Moreover, fund transfers may also offset the imperfections of the recipient countries' financial system by easing credit constraints for potential entrepreneurs who do not have access to loans from the banking sector. Workers' remittances can therefore impact productive investment by offering an alternative financing source to economic players excluded from conventional financing channels. These advantages are confirmed by Giuliano and Ruiz-Arranz (2005) and Levine (2004), who highlight the impact of money transfers and the level of financial development on the economic growth of recipient countries. For SSA, the significant impact of transfers on financial development has been more particularly underscored by the works of Gupta, Patillo and Wagh (2007).

2|2 Factors determining the degree of formalisation

African migrants' preference for informal transfers is due to a number of factors, based mainly on the relative cost of transfers via formal channels, but also on other non price barriers to bank access and use of banking services, such as physical access to bank branches and the geographic coverage of bank networks.

2|2|1 Transaction costs via formal channels

Often quicker than formal transfers, informal transfers present certain practical advantages: there is no need, for example, to hold a bank account. The costs involved are also markedly lower than those of formal transfers: the cost of informal transfers is generally estimated at 3 to 5% of the amount sent, whilst the cost of money transfer services offered by financial intermediaries are considerably higher, reaching up to 17% of the amount sent (see Table 1). On average, transaction costs of transfers via formal channels are estimated at 12% of the amount sent.

Table 1 Comparison of money transfer costs via formal channels

(as a %, for an amount of USD 200)

To Latin American countries	
From the United States:	
Ecuador	4.9
El Salvador	6.2
Mexico	6.9
Dominican Republic	10.4
Jamaica	8.1
Barbados	11.7
Venezuela	17.1
To African countries	
From the United States:	
Cape Verde	5.2
Ghana	7.5
Zimbabwe	11.9
From France:	
Morocco	4.5
Senegal, Mali	8.0 – 9.5
The Comoros	12.0 – 19.0

Sources: Latin American Council (2004 data for Latin American countries); Banque de France (2007 data for African countries with the exception of Ghana and Zimbabwe); Sander C. (2003 data for Ghana and Zimbabwe).
Note: With the exception of transfers from France to Morocco (via banks), all transfers are sent via money transfer companies.

The cost differential between formal and informal services is particularly due to differences in exchange rates, since those applied in the context of informal exchanges are considerably lower than those practiced by financial intermediaries. Moreover, formal services can also entail expenses in the recipient country, as well as various non-negligible fees.

However, the use of informal transfers assumes the acceptance of a high level of risk. Transfers via informal channels are particularly exposed to risks of loss, theft, misappropriation and/or fraud of various kinds.

Moreover, charges related to formal money transfer services diminish gradually in line with total volumes sent to home countries and the length of time the migrants have lived in the host country. The difference of costs observed between Morocco and the Comoros for transfers sent from France may therefore be partly due to the existence in France of a developed bank network specialised in transfers to Morocco.

2|2|2 Access to financial services in the recipient countries

Financial depth in recipient countries and the general conditions of access to financial services are also key factors in facilitating the use of formal transfers.

Table 2 Financial depth indicators (at end-December 2004)

	M2/GDP (%)	Credit to private sector/ GDP (%)	Bank deposits/ GDP (%)	Number of bank branches per 100,000 inhabitants	Population holding a bank account (%)
SSA (a)	26.3	16.7	19.0	2.6	12.6
WAEMU	26.5	17.2	21.5	0.9	3.8
CEMAC	15.1	7.8	12.2	0.6	4.6
Comoros	23.3	6.6	13.6	0.9	5.0
North Africa and the Middle East	62.1	39.8	28.3	na	na
South Asia	57.6	35.7	26.4	na	na
Latin America and the Caribbean	58.0	25.7	28.1	9.9	50.0

Sources: IMF, World Economic and Financial Surveys; Regional Economic Outlook Sub-Saharan Africa, May 2006; World Bank, Global Development Finance Indicators; Central Bank of the Comoros.
(a) SSA excl. South Africa and Nigeria.
na : non available.

In this regard, the various indicators used to measure financial depth in certain economies appear much weaker in SSA than in the other developing regions (see Table 2). The conditions of physical access to banking services are also more restricted.

All of these factors account for migrants' preference for informal transfers, in contrast with Latin American and North African migrants whose use of formal transfers via banks and money transfer companies has increased.

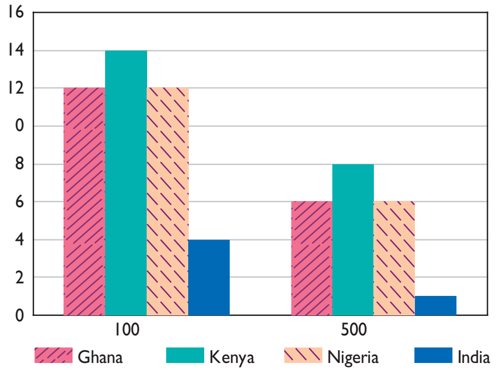
2|2|3 Ways of improving the impact of transfers on financial development

In sender countries: increased transparency and competition in the money transfer market

The authorities of immigration countries are likely to contribute to the reduction in transfer costs by favouring increased transparency in the international money transfer market. These countries in particular have an important role to play in the dissemination of detailed information on the various money transfer methods and their respective costs. The UK's Department for International Development (DFID) has introduced a transfer service and price comparison tool, blazing a trail in this domain, since this experiment has efficiently contributed to lowering costs in certain "corridors". In particular, increased transparency and competition for transfers to India have helped to considerably reduce costs, by 20% since 2005 (see Chart 5).

Chart 5 Comparison of money transfer costs from the UK

(GBP, as a % of the amount transferred)



Source: Department for International Development, 2006.

At the franc zone Member States meeting on 7 April 2005 in Cotonou, France committed to encouraging competition by developing public information concerning the conditions applied to money transfers. A transfer price comparison tool, available on the Internet,[4] was thus officially launched on 19 November 2007.

Strengthening supply and competition in the money transfer market may also be sought by developing balanced regulatory frameworks, favouring the entry of new players while upholding certain rules, notably those relating to anti-money laundering. In France, the current regulatory framework, which requires the status of financial company in order to carry out fund transfers, is both demanding, as it aims to ensure the safety of transactions and prevent these flows from being used for money laundering and terrorism financing, but is also open to development and competition. The Credit Institutions and Investment Firms Committee (*Comité des établissements de crédit et des entreprises d'investissement* – CECEI) has, over recent years, adapted its requirements to take into account the market's needs. Thus, after authorising the first financial company in 2003, the CECEI authorised two other French subsidiaries of major international money transfer companies in 2006, which should contribute to the notable strengthening of supply and competition.

The creation of a harmonised framework at the European level could also create opportunities to further facilitate migrant workers' remittance transfers while respecting anti-money laundering requirements. The Payment Services Directive, adopted on 13 November 2007 by the European Parliament and Council, defined, alongside the status

4 http://www.envoidargent.fr/

of credit institution, a new status of payment institutions, for which requirements, notably in terms of minimum capital (EUR 20,000 compared to EUR 2.2 million for the status of financial company), are substantially lower. By reducing the administrative burdens while maintaining strict requirements in matters of money laundering and terrorism financing, this text, which should be transposed into French law during 2009, is likely to contribute to stepping up competition in this market and thus reducing the informal sector's market share.

In recipient countries:

- **Improving conditions of access to financial services**

The pursuit of increased formalisation of remittance transfers and improved economic impact requires reflection on how to improve the conditions of access to financial services. In this respect, the stronger involvement of microfinance institutions in the money transfer services market could be sought. Indeed, the scope of micro-finance networks' geographic coverage and their proximity to rural populations where the banking sector is underdeveloped constitutes a comparative advantage compared with other operators. The mobilisation of microfinance in the setting up of new money transfer channels could thus facilitate the transfer of workers' remittances to their families. It could also encourage the development of a supply of financial products adapted to these populations (housing loans, equipment, etc.) and guaranteed by remittance flows.

Nonetheless, several obstacles are still hindering the expansion of the microfinance sector's role in the implementation of international money transfer services. Microfinance institutions do not have all of the management capacities necessary to supply such products (particularly liquidity management). Specifically, in order to be able to offer an efficient service presenting all relevant guarantees, microfinance institutions must have a healthy financial situation and be subject to rigorous supervision (Sander, 2004), which is not yet the case for the majority of microfinance institutions in SSA. Partnerships between microfinance institutions and banks are nonetheless starting to develop in the area of international money transfers (notably in Mali).

- **Facilitating the use of new payment technologies associated to mobile telephones**

The development of mobile phone use (m-banking) for deposits, withdrawals and transfers is also a solution with strong potential for SSA populations, which are considerably constrained in their access to conventional financial services. Although the mobile phone penetration rate in African countries only reached 25% in 2007, compared to almost 50% on a worldwide scale, the number of users in the region has practically tripled since 2002 (while in other developing regions they have doubled over the same period).

Pilot projects are now being carried out in South Africa, Kenya and Zambia, using various technical solutions. These can be based on a simple exchange of text messages or involve the use of more complex technologies using encryption to offer a higher level of security for transactions. Generally speaking, in countries where they have been introduced to provide greater access to financial services, new payment technologies associated to mobile phones have helped to facilitate transfers and reduce their costs. International money transfers by mobile phone generate an estimated cost of around 4% of the transaction price, on average.

One of the main challenges posed by facilitating the expansion of these technologies for money transfers is the capacity of financial regulatory authorities to set up a sufficiently flexible and innovative regulatory framework. This should both allow new players into the market, particularly from the telecom sector, and guarantee an adequate level of security, taking into account the services offered and the corresponding level of risk. The requirements in terms of money transfer security could notably be adapted according to the types of transactions carried out and the volumes transferred, like the measures taken in this area by the European Payment Services Directive (under certain conditions, dispensations to the ring-fencing of funds are planned, in relation to the volumes transferred).

• Continuing with reforms to modernise the financial sector

While the impact of workers' remittances on the financial development of recipient countries could be improved via the increased formalisation of transfers, structural reforms of the financial sector are also needed. Indeed, in the absence of reforms to improve the functioning of banking markets and to stimulate credit supply in developing countries, increased formalisation of remittances is likely to flood with deposits banking systems that already have excess liquidity, without contributing to financing development.

In particular, the channelling of workers' remittances into productive employment in recipient countries would be facilitated by the existence of a favourable business environment (efficient legal system, transparent and straightforward regulatory and tax systems, overall economic governance, etc.), tax incentives for the creation of companies and an efficient banking system, notably providing access to long-term financing. The search for a more effective use of transfers thus ties up with the broader objectives of the modernisation of financial systems in developing countries.

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