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**Remittances as a Source of External Financing in South Asia**[1]

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## Abstract

The decline in Official Development Assistance (ODA) extended to many developing countries in recent years has made it necessary for them to look beyond official sources of financing and tap the various sources of private external financing, including workers' remittances. This paper discusses the relative magnitudes and stability of the various sources of external finance available to developing countries, with a specific focus on individual South Asian countries. Particular attention is paid to workers' remittances which is an important and stable source of financing for the developing countries, especially those in South Asia.

## Introduction

Despite the notable improvements in the economic climates and growth prospects of many developing economies in Asia, poverty remains a complex and persistent issue confronting policymakers even today.

Poverty estimates published by the World Bank reveal that nearly 1.4 billion people in the developing world were living on less than US$1.25 a day in 2005.[3] While acknowledging that there has been considerable progress in reducing poverty levels – the corresponding numbers in absolute poverty were about 1.9 billion in 1981 – a lot more remains to be done in order to ensure that the benefits of economic growth are more evenly distributed, so as to make faster and deeper inroads into the goal of eradicating poverty worldwide.

Despite rapid growth in India and other regional economies, the World Bank data reveals that South Asia alone housed some 600 million people living on less than US$1.25 a day in 2005, in comparison to 550 million people in 1981. In India, using the same yardstick, the poverty

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1 This paper partly builds on Rajan (2005) and is based on a forthcoming working paper by the authors.

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3 See World Bank (2008), available at http://go.worldbank.org/T0TEVOV4E0. Also see Chen and Ravallion (2008).

levels actually increased from 420 million people in 1981 to 455 million in 2005 (though seen as declining when taken as a share of the population).[4]

Recognising the importance of undertaking effective and immediate policy action to reduce poverty in developing countries, several concerted steps have been taken at the multilateral, regional and country levels to achieve poverty reduction, of which the United Nations Millennium Development Goals (MDGs) has been a key initiative.[5] An area that requires more attention, however, is that of resource constraints that have constantly plagued this and other similar poverty-alleviation efforts.

**Sources of Development Finance**

While there are clearly many possible sources of internal finance that could and should be tapped (via streamlining government finances, improving domestic financial intermediation, possible use of foreign exchange reserves, and the like), developing countries will inevitably have to supplement these with external sources of finance to achieve their anti-poverty and pro-development goals.

This paper focuses solely on the external sources of financing. It is necessary to keep in mind that there could be both official and private sources of external financing. Most developing countries depend heavily on official sources of external financing such as grants and concessionary loans which are often referred to as Official Development Assistance (ODA). ODA includes debt relief as one of its vital components and is especially important for many of the poorest countries burdened by heavy debt service payments. However, in light of decreasing net ODA disbursements (ODA including debt relief) from donor countries in recent years, it has become essential to consider private sources of external financing that could help these developing countries realise their development goals.

It is useful to recall that the so-called Monterrey Consensus that took place in 2002 was an attempt to address the very concern of the sources of private external financing for development, particularly in light of ODA being lacklustre.[6] In fact, one of the key highlights of the conference was the pledge undertaken by all the major donor countries to provide the

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4 An important point needs to be noted here. India's national poverty line is pegged at US$1.02 per day and according to this benchmark, the number of people living below this poverty line has actually reduced from 296 million in 1981 to 267 million people in 2005. However, the number of poor below US$1.25 a day has increased from 421 million in 1981 to 456 million in 2005. This difference arises from the use of different poverty lines, when considering absolute numbers. But when taken as a percentage of the population, we see that, between 1981 and 2005, India has seen 60 percent of its population living on less than US$1.25 a day reduce to 42 percent. The number of people living below US$1.25 a day has also come down from 42 percent to 24 percent over the same period. For more details, see http://www.worldbank.org.in/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/INDIAEXTN/0,,contentMDK:21880804~pagePK:141137~piPK:141127~theSitePK:295584,00.html

5 The MDGs consist of a set of eight goals that respond to the main development challenges of the world. These goals were drawn from the targets contained in the Millennium Declaration which was adopted by 189 nations and signed by 147 heads of state and governments during the United Nations Millennium Summit in September 2000. One of the first and primary objectives of the MDGs is income poverty reduction by 2015, though there are others, including universal primary education, promotion of gender equality in primary/secondary education and empowerment of women, reduction of the infant (under five) mortality rate by two-thirds. For details, see http://www.developmentgoals.org.

6 The International Conference on Financing for Development was held from 18-22 March 2002 in Monterrey, Mexico. This was the first United Nations-hosted conference to address the key financial and development issues in the world and it was attended by 50 Heads of State or Government, over 200 ministers as well as leaders and senior officials from various organisations.

resources required to help achieve the internationally-agreed development goals including the MDGs. In particular, the donor countries agreed to work towards meeting the United Nations target of increasing their respective ODA to 0.7 percent of their respective Gross National Income (GNI).[7] This notwithstanding, even after close to six years since the adoption of this consensus there appears to be no obvious progress on ODA commitments.[8]

Recognising the limitations of official financing even if ODA targets were met, the Monterrey Consensus also stressed the need to focus on other private sources of development financing for development processes that include international trade (export revenues), private capital flows and workers' remittances.

**Trends and Patterns in External Financing to Developing Economies**

Given the important role to be played by the sources of private external finance, the remainder of this paper will discuss the relative magnitudes of the various sources of private external finance to developing countries on the whole, with a specific focus on individual South Asian countries.[9] We also attempt to shed some light on the degree of stability of these components as sources of financing for development.

The World Bank data on net resource flows to the developing economies on the whole reveals that net total private capital flows, including workers' remittances to all developing countries, peaked just prior to the Asian financial crisis in 1997 and has been on a gradual recovery since then. Net total private flows including workers' remittances to all developing countries in 2007 stood at above US$1,270 billion compared to about US$260 billion to US$270 billion in 2000-01 (Table 1).

Net foreign direct investment (FDI) inflows and workers' remittances clearly emerge as the most significant components of external financing for developing countries. Over the period 2000-07, on average, about three quarters of total private inflows into the developing countries involved FDI and workers' remittances.[10] The remaining two components of external financing are portfolio equity inflows and short-term debt inflows. While the net portfolio equity inflows experienced a significant increase in recent years, up from about US$13.5 billion in 2000 to US$145 billion in 2007, net short-term debt flows have also witnessed a dramatic increase from about US$3 billion in the year 2002 (negative values in previous years following years of deleveraging after the Asian crisis) to nearly US$130 billion in 2007. However, both these components tend to be highly variable and, hence, might

7 For more details about the 0.7 percent target, see http://www.unmillenniumproject.org/press/07.htm.

8 To be specific, recent data from the World Bank reveals that net ODA disbursements by major donors (consisting primarily of the Organisation for Economic Co-operation and Development countries) have been stagnant at just over US$105 billion in recent years. However, ODA disbursements from the donors, excluding debt relief, have been increasing over the years – from about US$60 billion in 1995 to a little over US$87 billion in 2007. Excluding debt relief, ODA increased from 0.23 percent of the GNI of donor countries to 0.25 percent between 2002 and 2007, still well below the 0.33 percent attained in the early 1990s and way behind the United Nations' target of 0.7 percent.

9 We focus on the four major South Asian economies – Bangladesh, India, Pakistan and Sri Lanka.

10 An important point that needs to be borne in mind about FDI is the fact that a growing share of FDI going to developing countries seems to be in the form of Mergers and Acquisitions (M&A). The macroeconomic implications of M&A can potentially be quite different from Greenfield investments. See Rajan and Hattari (2009) and Gopalan and Rajan (2009) on a discussion of M&As to and from emerging Asia and India, respectively.

be considered rather unstable sources of financing. This will be discussed in greater detail later in this paper.

**Importance of Remittances to South Asia**

Workers' remittances alone have constituted one third of net total private capital flows into developing countries, second only to FDI flows. Despite this, somewhat less attention has been paid to this source of financing. Table 2 clearly reveals that there has been a marked increase in the magnitude of workers' remittances into developing countries from about US$85 billion in 2000 to about US$265 billion in 2007. We can infer from the table that, among the developing countries, the South Asia countries have, on average, received about 20 percent of global remittance receipts destined for developing countries between 2000 and 2007. Given the significance of remittance inflows into individual South Asian economies, we consider this component in more detail in the following paragraphs.

As Table 3 shows, a large portion of the inflows has gone into India over the years (about 70 percent). The average remittance inflows to India between 1995 and 2007 stood at about US$16.2 billion. For the corresponding period, the average inflows into Bangladesh and Pakistan were about US$2.7 billion to US$2.8 billion, while that to Sri Lanka was about half that at US$1.4 billion.

While the absolute values indicate India's dominance as a host of South Asian remittance flows, this is not surprising in view of the fact that India constitutes about 80 percent of aggregate South Asian output. Accordingly, the relative significance of remittances to the respective economies would be better reflected when one examines workers' remittances as a share of the respective country's gross domestic product (GDP).

Referring to Table 3 again, it is clear that Bangladesh has the highest share of remittances as a percent of its GDP, with a share of about ten percent in the year 2007, followed closely by Sri Lanka with a share of about eight percent.[11] Pakistan and India lag with shares of four and three percent respectively. While Bangladesh has experienced a steady rise in remittance inflows as a share of GDP, there appears to be no obvious pattern in the shares in other countries, though there has been a marginal increase in India. Sri Lanka has seen its share grow over the years consistently until 2005 after which one can notice a marginal dip in its share. Pakistan's pattern has been quite volatile with varying shares over the years.

Another useful indicator that underlines the significance of remittances to these economies is their share of total external private sources of financing. According to Table 4, the average share (over the period 1995-2007) of remittance inflows expressed as a percentage of the sum of total private capital flows stands at about 25 percent for Bangladesh, the corresponding figures for the other four South Asian countries being about 15 to 17 percent. Clearly, workers' remittances are an important source of external financing in absolute and relative terms for the South Asian economies, especially Bangladesh.

[11] A caveat needs to be borne in mind. When one considers all the seven South Asian countries, Nepal emerges as the highest recipient of remittances in the region with its share being over 15 percent of the country's GDP in 2007 (World Development Indicators Online). But due to limited data availability of Nepal's other types of private sources of financing, we have excluded the country from our analysis.

**Relative Stability of Remittances**

After decades of neglect, workers' remittances have become recognised by policymakers and observers as important sources of external finance. There is, in fact, a growing body of literature that deals with this issue.[12] The most important feature of the remittances component, as highlighted in various papers, is the stability of such flows in contrast to other types of private capital flows. A simple way to examine relative volatilities over a short period is to compute the coefficient of variations (CVs) of the various sources of financing.[13] We compute the CVs for the individual South Asian countries over a period of 12 years from 1995 to 2007 and we confine the period to 2000 and 2007 for calculating the CVs for the cluster of developing countries as a whole.

Figures 1 and 2 reveal the volatilities of the various sources of financing for the individual South Asian countries and developing countries as a whole, respectively. The CVs corroborate the earlier discussed point about remittances being more relatively stable when compared to the rest of the sources. As is clear from Figure 1, one can see that workers' remittances are the least variable component when compared to the other types of capital flows, followed by trade flows and FDI flows. As expected, portfolio flows and short-term commercial bank lending appear to be the most volatile components in all countries. It is not without reason that these components are referred to as "mobile capital".[14] The results do not vary much when we look at Figure 2, where the volatility is shown for all developing countries lumped together.

Beyond this measure of volatility, arguably of more importance is the fact that while private capital flows are generally considered *pro-cyclical*, viz. capital flows rising at times of growth booms and falling during busts, remittances are generally expected to be *counter-cyclical*. Thus, remittances could serve as macro-economic stabilisers during times of an economic slowdown, as migrants are expected to increase the amounts of money they remit back home when most needed (that is, during a downturn in their home country).[15] As a significant portion of the migrants' incomes are being spent in destination countries, this could also provide for the much needed economic stimulus to spur domestic demand in times of economic distress. Also, in contrast to other types of capital flows, workers' remittances do not create liabilities such as debt servicing in future.[16]

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12 See Kapur (2003), Ratha (2003) and the World Bank (2006) for an in-depth discussion on the various issues concerning remittances.

13 The CVs become less effective (and misleading) as a measure of (in)stability if there is a trend in the data. Thus, it is inadvisable to use it for longer time periods when series have unit roots (Rajan, 2005 and references cited within).

14 See Rajan (2009).

15 Unless of course, there is a generalised global downturn, as in the case from mid- to late-2008 and early 2009.

16 Some have argued that the large inflows of remittances into a particular country could result in a "Dutch Disease" type of situation where the recipient country experiences an overvalued real exchange rate (due to an appreciation or strengthening of its currency) which would lead to a loss of export competitiveness that would in turn make the production of such tradable goods less profitable. Loser et al. (2007) provide a detailed discussion about the possibility of a 'Dutch Disease' phenomenon arising out of large flows of remittances in Latin America. However, there are a growing number of empirical studies that seem to suggest that this concern is misplaced. See World Bank (2006) for an overview.

## Conclusion

A preliminary analysis of the magnitude and relative stability of various sources of external financing to developing countries, especially the larger South Asian economies, reveals workers' remittances to be potentially the most stable and vital source of financing for developing countries.[17]

An important area of policy concern that needs to be addressed by all the countries involved is the presence of excessively high transaction costs associated with remittance transfers. According to some estimates, the providers of remittance services in the formal sector tend to charge a remittance fee that is 10 to 15 percent of the principal amount which typically leads to a reduction in the amount of net funds transferred.[18] Apart from the huge financial burden that is placed on the poor migrant remitters, the presence of high transaction costs has also resulted in the growth of informal channels of remittances (constituting about 50 percent of total remittance inflows).[19] Rightly or wrongly, these informal fund networks have been accused of promoting financial smuggling, money laundering and even sponsoring terrorist activities, apart from having larger macro-economic implications on inappropriate exchange rate movement and tax revenues in the recipient country.[20]

The presence of a weak competitive environment, inadequate development of technology supporting payment and settlement systems, and excessive regulatory and compliance requirements has resulted in the perpetuation of high transaction costs in the formal remittance market.[21] Thus, effective bilateral cooperation arrangements between the remittance-originating countries and remittance-recipient countries are crucial in enhancing the flows of remittances as they could go a long way in lowering these transaction costs. Apart from promoting competition, the governments could also take proactive measures in expanding the network of formal financial intermediaries in order to lower the intermediation costs of remittances.

In the final analysis, while remittances have become significant private financial resources for households in developing countries, they cannot be considered a substitute for other sources of development financing like FDI, which might generate broader multiplier effects on the economy.[22] Hence countries should work towards mobilising various international resources to meet their development objectives.

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17 An important caveat is in order. Due to data limitations, our data on capital flows are on a *net* rather than a *gross* basis.

18 World Bank (2006).

19 This also implies that workers' remittances are in reality much more significant that the official numbers suggest.

20 See Jongwanich (2007) for a detailed discussion.

21 For details, see Chapter 6 of World Bank (2006).

22 It is increasingly acknowledged that, in the right environment FDI has immense potential to foster growth in the economy by promoting competition, enhancing technological capabilities, boosting export competitiveness and generating significant employment opportunities in the economy (see Rajan, 2005).

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**Table 1: Components of Private External Financing in Developing Countries (US$ Billion)**

| Year | Workers' remittances | Net FDI Inflows | Net Portfolio Equity Inflows | Net Short Term Debt Flows | Net Total Private Inflows (Incl. Remittances) |
|---|---|---|---|---|---|
| 2000 | 84.5 | 165.5 | 13.5 | -6.4 | 271.5 |
| 2001 | 95.6 | 173 | 5.6 | -24.9 | 260.1 |
| 2002 | 115.9 | 160.7 | 5.5 | 3.1 | 285 |
| 2003 | 143.6 | 161.9 | 24.1 | 53.5 | 417.7 |
| 2004 | 161.3 | 225.5 | 40.4 | 67.5 | 573.8 |
| 2005 | 191.2 | 288.5 | 68.9 | 89.6 | 742.6 |
| 2006 | 221.3 | 367.5 | 104.8 | 94.2 | 981.6 |
| 2007 | 239.7 | 470.8 | 145.1 | 129.7 | 1268.6 |

Source: Based on Global Development Finance (2008), World Bank.

**Table 2: Remittance Flows to Developing Countries, 2000-07 (US$ Billion)**

| Year | Total Inflows to Developing Countries | Inflows to East Asia and Pacific | Inflows to Europe and Central Asia | Inflows to Latin America and the Caribbean | Inflows to Middle East and North Africa | Inflows to South Asia | Inflows to Sub-Saharan Africa |
|---|---|---|---|---|---|---|---|
| 2000 | 84.5 | 16.7 | 13.1 | 20 | 12.9 | **17.2** | 4.6 |
| 2001 | 95.6 | 20.1 | 12.7 | 24.2 | 14.7 | **19.2** | 4.7 |
| 2002 | 115.9 | 29.5 | 14 | 27.9 | 15.3 | **24.1** | 5 |
| 2003 | 143.6 | 35.4 | 16.7 | 34.8 | 20.4 | **30.4** | 6 |
| 2004 | 161.3 | 39.1 | 21.1 | 41.3 | 23.1 | **28.7** | 8 |
| 2005 | 191.2 | 46.6 | 29.5 | 48.6 | 24.2 | **33.1** | 9.3 |
| 2006 | 229.0 | 53.0 | 39.0 | 57.0 | 27.0 | **40.0** | 13.0 |
| 2007 | 265.0 | 58.0 | 51.0 | 61.0 | 32.0 | **44.0** | 19.0 |

Source: Based on Global Development Finance (2008) and Ratha et al., (2008)

### Table 3: Significance of Remittances in Select South Asian Economies

| Year | Bangladesh | | Pakistan | | India | | Sri Lanka | |
|---|---|---|---|---|---|---|---|---|
| | Workers' Remittances (US$ Billion) | % of GDP | Workers' Remittances (US$ Billion) | % of GDP | Workers' Remittances (US$ Billion) | % of GDP | Workers' Remittances (US$ Billion) | % of GDP |
| 1995 | 1.20 | 3.17 | 1.71 | 2.82 | 6.22 | 1.75 | 0.81 | 6.21 |
| 1996 | 1.35 | 3.31 | 1.28 | 2.03 | 8.77 | 2.26 | 0.85 | 6.13 |
| 1997 | 1.53 | 3.61 | 1.71 | 2.73 | 10.33 | 2.51 | 0.94 | 6.24 |
| 1998 | 1.61 | 3.64 | 1.17 | 1.88 | 9.48 | 2.28 | 1.02 | 6.48 |
| 1999 | 1.81 | 3.95 | 1.00 | 1.58 | 11.12 | 2.47 | 1.07 | 6.85 |
| 2000 | 1.97 | 4.18 | 1.08 | 1.45 | 12.89 | 2.80 | 1.17 | 7.14 |
| 2001 | 2.11 | 4.48 | 1.46 | 2.02 | 14.27 | 2.99 | 1.19 | 7.53 |
| 2002 | 2.86 | 6.01 | 3.55 | 4.92 | 15.74 | 3.10 | 1.31 | 7.65 |
| 2003 | 3.19 | 6.15 | 3.96 | 4.76 | 21.00 | 3.50 | 1.44 | 7.62 |
| 2004 | 3.58 | 6.34 | 3.95 | 4.03 | 18.75 | 2.68 | 1.59 | 7.69 |
| 2005 | 4.31 | 7.16 | 4.28 | 3.91 | 21.29 | 2.63 | 1.99 | 8.16 |
| 2006 | 5.43 | 8.77 | 5.12 | 4.02 | 25.43 | 2.78 | 2.18 | 7.73 |
| 2007 | 6.56 | 9.59 | 6.00 | 4.20 | 35.26 | 3.29 | 2.53 | 7.81 |

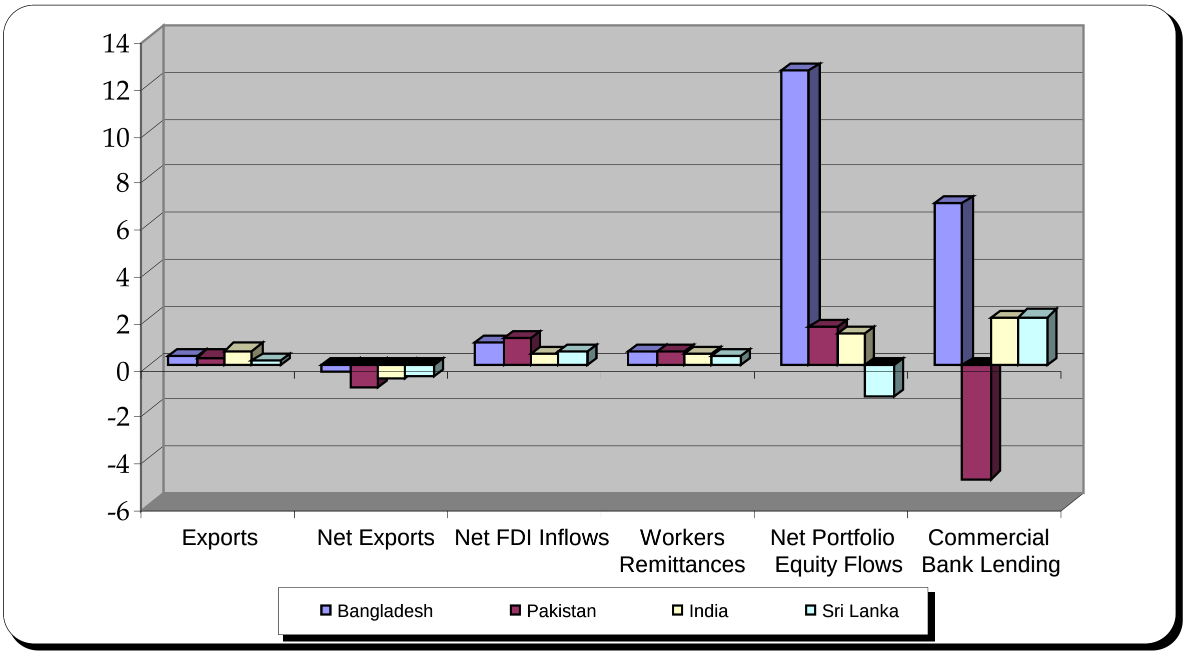
Source: Compiled from World Development Indicators, World Bank.

### Table 4: Total Private Sources of External Financing in South Asia and Relative Share of Remittances

| Year | Bangladesh | | Pakistan | | India | | Sri Lanka | |
|---|---|---|---|---|---|---|---|---|
| | Total Private External Financing (US$ Billion) | Remittances as a % of Total Private Financing | Total Private External Financing (US$ Billion) | Remittances as a % of Total Private Financing | Total Private External Financing (US$ Billion) | Remittances as a % of Total Private Financing | Total Private External Financing (US$ Billion) | Remittances as a % of Total Private Financing |
| 1995 | 5.60 | 21.47 | 12.97 | 13.19 | 48.82 | 12.75 | 5.59 | 14.48 |
| 1996 | 5.83 | 23.09 | 13.40 | 9.58 | 55.92 | 15.68 | 5.90 | 14.44 |
| 1997 | 7.15 | 21.34 | 13.59 | 12.56 | 60.38 | 17.11 | 7.06 | 13.35 |
| 1998 | 7.63 | 21.06 | 11.23 | 10.44 | 56.29 | 16.84 | 7.11 | 14.39 |
| 1999 | 8.21 | 22.01 | 10.22 | 9.75 | 66.53 | 16.72 | 6.73 | 15.94 |
| 2000 | 9.50 | 20.72 | 11.17 | 9.63 | 76.87 | 16.77 | 7.92 | 14.73 |
| 2001 | 9.25 | 22.76 | 11.74 | 12.45 | 82.28 | 17.35 | 7.39 | 16.04 |
| 2002 | 9.94 | 28.75 | 16.31 | 21.78 | 92.56 | 17.00 | 7.36 | 17.78 |
| 2003 | 11.50 | 27.75 | 18.84 | 21.04 | 121.31 | 17.31 | 8.06 | 17.84 |
| 2004 | 13.25 | 27.05 | 20.99 | 18.79 | 148.57 | 12.62 | 8.94 | 17.77 |
| 2005 | 15.68 | 27.51 | 25.66 | 16.68 | 199.96 | 10.65 | 9.90 | 20.11 |
| 2006 | 19.02 | 28.54 | 30.75 | 16.66 | 257.98 | 9.86 | 10.87 | 20.09 |
| 2007 | 21.44 | 30.61 | 34.14 | 17.57 | 87.95 | 40.09 | 12.49 | 20.23 |

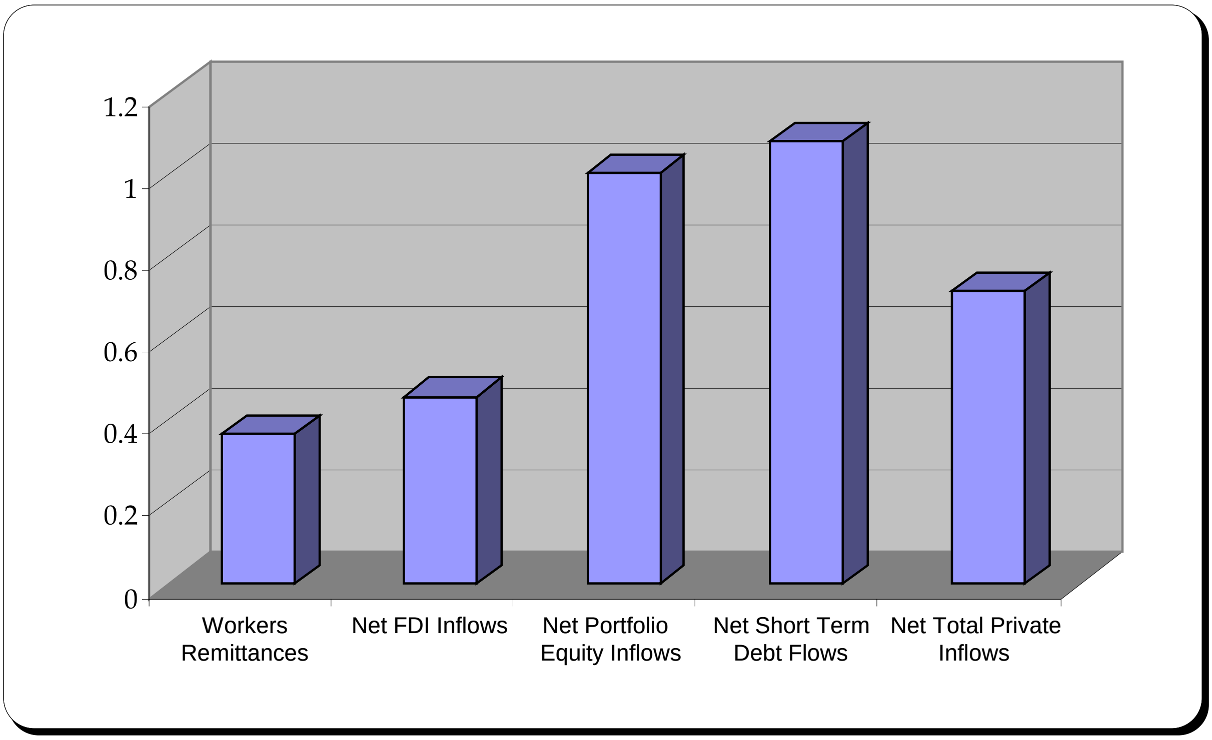
Source: Compiled from World Development Indicators, World Bank.

**Figure 1: Volatility of Components of Private External Financing in Select South Asian Countries (1995-2007)**




Source: Author's Calculations based on World Development Indicators, World Bank.

**Figure 2: Volatility of Components of Private External Financing in Developing Countries (2000-2007)**




Source: Author's Calculations based on Global Development Finance (2008), World Bank.