Impact of Remittances on Financial Development and Economic Growth

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Abstract

The research subject is remittances and their impact on growth and financial development. The fact that remittances might affect financial development in developing countries is based on the concept that money transferred through financial institutions give access for recipients to other financial products and services, which they might not have otherwise (as outlined by Orozco and Fedewa, 2005). Remittances played a significant role in the economy of Romania, both as financial support for relatives, and also from the viewpoint of expenses for consumption and even investments (dwellings, high-price movable goods) realized from resources related to remittances. The authors analyze the impact of remittances on the Gross Domestic Product.

Key words: *remittances, migrants, financial development, economic growth*

JEL Classification: *F24, F43*

Introduction

Remittances become the second largest type of flows after foreign direct investment.

According to World Bank, officially recorded remittances to developing countries registered an increase of 0.4 percent in 2015, $ 431.6 billion, over $ 430 billion in 2014.

United Nations reported that migrant workers in Europe sent home almost $110 billion in 2015, and destinations were manly European countries.

As reported by International Fund for Agriculture and Development (IFAD) Europe has only 10 percent of the world's population but 20 percent of all migrant workers and makes 25 percent of all remittances.

10 European Union countries are among those that receive remittances, including Hungary, Poland and Romania.

Remittances - transfers of resources from individuals in one country to individuals in another - are an important source of private funds in developing countries.

Despite the financial crisis and economic downturn **remittances are more robust and tend to be stable, thus helping to cushion domestic economic shocks**. And they are of direct benefit to the individuals and households that receive them.

Remittances are associated with **improved schooling outcomes for children**, by helping to relax household's constraints and provide better access to health services for recipients.

Also remittances are used for **entrepreneurship** as the extra source of income could be put in new income generating activities.

Remittances promote economic growth in less financially developed countries by having a positive impact on financial development.

Literature review

Remittances are not a new phenomenon in the world, being a normal concomitant to migration which has always been a part of human history. Several European countries, for example Spain, Italy and Ireland were heavily dependent on remittances received from their emigrants during the 19th and 20th centuries. Italy was the first country in the world to enact a law to protect remittances in 1901 while Spain was the first country to sign an international treaty (with Argentina in 1960) to lower the cost of the remittances received.

Migration has become an important socioeconomic factor in almost all countries of the world: people move when the expected future benefits outweigh the financial costs. As long as developed economies need migrant labor, immigrants will continue to migrate. As a result, when the global economy recovers, remittance flows will do the same.

The remittances increasing volume was noticed and a growing number of studies have analyzed their development impact along various dimensions, including: poverty, growth, education, infant mortality and entrepreneurship.

The most important mechanism for both remittances and senders and their families is to increase the share of income that goes to vital goods and services. More than 60% of remittances are used to purchase daily necessities such as food, clothes and shelter, remittances are **a key poverty reduction tool** (Adams and Page 2005; Acosta et al. 2008).

The 20-40% of remittances that is used to save or invest is the key to achieving a family's **longer-term financial independence**.

International Monetary Fund (IMF) surveys have shown that 30-50% of remittances recipients have **access to a bank account**. To expand this area, banks can offer a greater range of financial products such as: microcredit, insurance and remittance-backed mortgages.

Remittances may also reduce credit constraint of household receipts for entrepreneurial activity and private investment could increase (Yang, 2004; Woodruff and Zenteno, 2004).

Anghel, Piracha and Randazzo (2015) developed on the role of migrant remittances in globalization. Anghelache (2016) analyzes the status of the Romanian economy, covering aspects related to remittances. Pasca (2016) realizes a case study on remittances in Romania. Zelizer (2014) studies the remittance circuits. Gherboveţ (2014) develops on forecasting the remittances. Anghelache and Anghelache (2013), Anghelache, Manole and Anghel (2015), Anghelache, Anghel, Sacală (2014) focused on the Gross Domestic Product of Romania. Paunica et.al. (2009) approach the usefulness of business intelligence instruments in financial management.

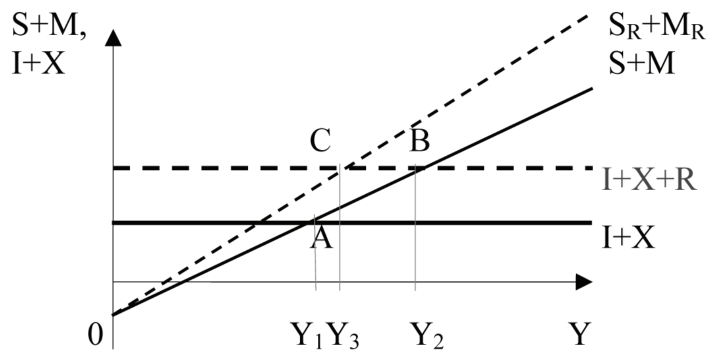
Economic Models using Remittances

Some authors have tried to include remittances in the main macroeconomic models: the Keynesian Model, the IS-LM Model and in the National Accounts System.

1. The Keynesian Model. The variable used are: the effective demand for goods (D) total final consumption (C), savings (S), global investment (I), income or production (Y), imports (M) and exports (X) . In *Figure1* is represented this model.

The Keynesian Model

Figure1



Source: Moraru Angela (2009), "Remittances and their economic impact on Moldova"

The equilibrium condition is:

$$Y = D \tag{1}$$

$$D = C + I \tag{2}$$

$$Y = C + S \tag{3}$$

$$S = I \tag{4}$$

For an open economy equilibrium condition must be supplemented with the influence of external transactions:

$$Y + M = D + X \tag{5}$$

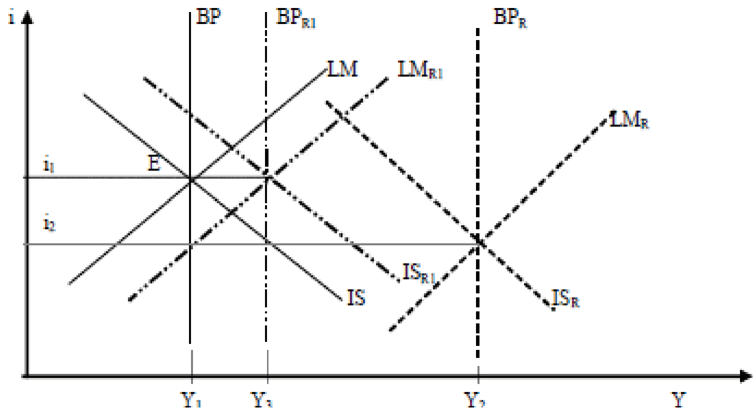
$$S + M = I + X \tag{6}$$

An increase in Y due to the increase in the remittances (R) flows can be represented either by an independent increase of exports receipts, either through additional investment. An additional inflow in R will increase the income balance from point A to point B (Figure 1). The final income balance will depend essentially on the R influence on the propensity to saving and consumption of imports. Co-outs will force back the final balance from point B to C. We cannot exclude the case in which the flows of remittances are not considered, and then Y will remain unchanged or will decrease.

2. The IS-LM Model. In *Figure 2* the real sector (IS), the monetary sector (LM) and the external one (BP) are in equilibrium (point E), at a given level of income Y_1 and a certain rate of interest i_1.

The IS-LM Model

Figure 2



Source: Moraru Angela (2009) "Remittances and their economic impact on Moldova"

BP curve is perfectly inelastic. Forced by remittances flow, the monetary expansion will lead to increased revenue (Y_2), which, in turn, will condition cheaper domestic credit, as the real sector will be growing. However, foreign currency inflows will put pressure in the direction of exchange rate appreciation. Decrease in exports following the appreciation will increase the trade deficit, which will take a substantial part of the growing impact of monetary expansion and will reduce income from Y_2 to Y_3, interest rate being equal to the initial one. But, according to elasticity, Y_3 is likely to be less than Y_1.

3. The National Accounts System. The additional remittance flows increases the aggregate demand and is integrated in the gross national income available. Overall, this can be expressed as follows:

$$Y = (C + I)_p + (C + I)_g + Y_f + Tr_f + (X - M)$$

where Y represents the available gross national income, $(C + I)_p$ - consumption and private investment, $(C + I)_g$ - consumption and government investment,

Y_f - foreign income,

Tr_f - net current transfers from abroad,

X - exports of goods and services,

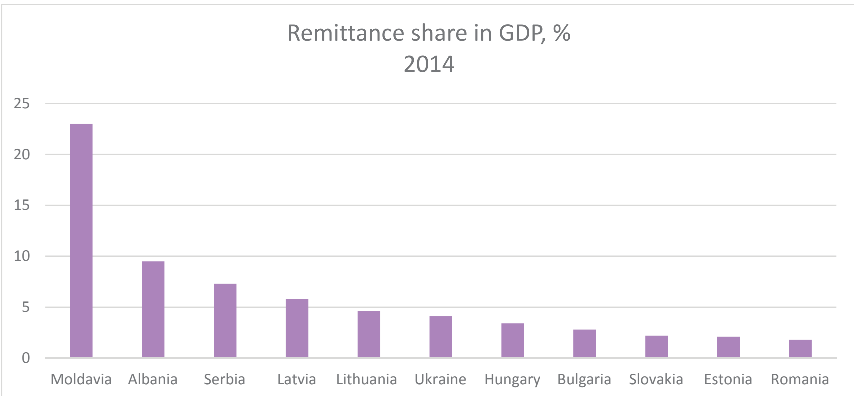
M - import of goods and services.

As we can see, the available gross national income contains the current account of the balance of payments CAB as $CAB = (X - M) + Y_f + Tr_f$.

Figure3 shows the European remittance recipient countries for the year 2014, measured as a percentage of GDP.

Remittance share in GDP

Figure3



Source: Eurostat

Moldova (23%), Albania (9.5%), Serbia (7.3%) are among the largest recipients of remittances as percentage of GDP as shown in *Figure3*.

Conclusions

Remittances promote growth in less financially developed countries by providing an alternative way to finance investment. Remittances act as substitutes for financial services in promoting growth, by offering the response to the credit needs and insurance that the market has failed to provide. This means that there is an investment channel trough which remittances promote growth.

A positive impact of remittances on credit market development could be if banks become more willing to extend credit to remittances receipts because the transfers they receive from abroad are perceived to be significant and stable.

When investigating the impact of remittances on bank deposits, as well as on bank credit to the private sector, it was found that remittances have a significant and positive impact on bank deposits and credit to GDP.

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