The Remittances Boom
What does it mean for the work of development?

By Lisa Taber, FSE

More than US$93 billion in remittances poured through formal channels into developing countries in 2003, and these cash flows have nearly quadrupled over the last seven years. While the explosion in migrant remittances has received a lot of attention, less has been said about the specific implications these massive transfers have upon the work of development, and vice-versa.

There is no doubt, however, about their relevance. "We know that remittances really reduce poverty in developing countries," says Richard Adams (DECRG). Adams, along with colleague John Page (AFRCE), analyzed data from 74 low and middle-income countries last year and found that international remittances, defined by their share of country GDP, have a strong statistical impact on poverty reduction. Adams's analysis of household survey data from Guatemala, Pakistan and Egypt shows that domestic and international remittances also reduce the level and depth of poverty, and that migrant households tend to spend remittance income on housing and education—investments with a high welfare payoff.

So, the 93 billion dollar question is: how do we enhance remittance flows and maximize their development impact? There is one obvious answer: by reducing costs, which are typically between 10–20% of the amount remitted. How to achieve cost reduction is a more difficult question, and a basic understanding of cross-border money transfer systems is needed even to approach it.

How do remittance systems work?

Simply put, there is an agent in the sender's country, or province, known as an “originator”, who takes in the remittance and communicates the amount and the recipient's name to a partner, or “distributor”, in the recipient's country or province. The sender alerts the recipient, who collects her money from the local distributor, or from his sub-agent. The originator and distributor must then have a way to settle the debt.

Informal remittance agents commonly use trade networks to reconcile their accounts. To send money to a customer's relative in Kinshasa, for example, a shopkeeper in New York City may rely directly on a contact there or on a network of traders, and their contacts. Either way, the shopkeeper communicates the amount transferred and the intended recipient to his counterpart in Kinshasa. The resulting debt is usually settled through shipments of goods, from one agent directly to another or through a circuitous network of traders. Samuel Munzele Maimbo (SAFSP), who has studied informal remittance channels in Afghanistan, Pakistan and several African countries, points out that these systems have been a relatively safe, low-cost, fast and accessible means of sending money overseas for centuries.

They are also used, in some cases, to launder money and finance illicit activities, and some efforts to protect the integrity of remittance flows have sought to suppress informal remittance channels altogether. But informal agents have long responded to the legitimate needs of people who may not speak the language of formal service providers, or even know how to read the forms they're required to fill out. Informal networks generally have better geographic reach into recipient towns and villages, as well. Maimbo and others are working on practical and realistic guidelines to better monitor these systems, but most would agree with him that “the best way to deal with the informal sector is to improve formal channels— to make them more attractive.”

Formal remittance systems generally rely on a series of bank account debits and credits. The remitting migrant makes a payment to an originator. Usually, the originator deposits the payment into a bank, crediting the account of a distributing agent in the recipient country. This bank must either have a branch in that country, so the local distributor can claim the funds, or a relationship with a bank that does. At the same time, the local bank may have reason to credit an account that belongs to its foreign partner, for instance if a local vendor of imported goods wants to “send” a payment to his foreign supplier.
In some cases, the origination and distribution functions are provided by the same firm, like Western Union, or a bank that has branches in both the sender and recipient countries. These companies may also contract grocery stores or other banks, for instance, to act as originators or distributors in exchange for a small portion of the commission. But each of these business models rely on banks to settle the accounts between originators and distributors, even when they are part of the same company. (Western Union has its own banking subsidiary, but sometimes relies on other financial institutions as intermediaries, depending on the country.)

Where separate financial institutions are used to make the transfer between originator and distributor, the local bank and its foreign partner must net out, or “clear” their accounts at the end of some period. They will then settle the balance due through a wire transfer, or by transferring ownership of a short-term treasury bill, for instance. Correspondent banking partners simply maintain the balance as an asset or liability on their respective balance sheets. In each case, reducing the costs of clearing and settling accounts between banks is one of the keys to reducing the costs of remittance payments—lowering payment distribution costs is another.

**Cooperate on infrastructure, compete on services.**

When more banks share the use of a clearing house—where the debits and credits of all the member institutions are tallied up and netted out over a certain period—the costs of clearance are lower. While some countries have separate clearing houses for credit cards and for payment instruments, the important thing is that banks use the same infrastructure for the same types of transactions, according to Massimo Cirasino of FSE. Similarly, the expense of settling final balances decreases as the number of payments included in the settlement increases. The cost of handling a single remittance payment, therefore, is partly a function of the number of banks participating in the clearing house, and of the number of payments each institution settles at once.

To more efficiently clear and settle payments across borders, Cirasino recommends that banks join one of the existing international clearing houses. Companies like Visa and MasterCard provide these services for thousands of institutions worldwide, thus offering tremendous network benefits to member participants and scale economies that lower processing costs. There are other options but again, domestic banks (and their customers) would benefit from cooperating when it comes to choosing a clearing house and negotiating fees as a group.

Beyond clearance and settlement, cooperation among financial institutions is key to the efficient distribution of payments from points A to B. By sharing communications networks and entry points into the payments system—including ATMs and Point of Sale (POS) devices—banks and other institutions can significantly lower the costs of moving cash from one location to another. Achieving interoperability among ATM and POS devices and cards would make their placement in less densely populated areas more economical. This is why “financial service providers must compete on services,” says Cirasino, “but cooperate on infrastructure.” Ideally, remittance senders should be able to deposit funds into an account or remotely load value to pre-paid cards, so that recipients can use ATM or POS systems to efficiently access those funds.

**The role of the regulator.**

Getting banks to share clearing houses and proprietary payment systems, among themselves and with other intermediaries, like financial cooperatives, is tricky. There are ways that central banks can encourage cooperation, however. Regulation (and the threat of sanctions) are important, but concerted effort and moral suasion, according to Cirasino, are usually effective.

Beyond these infrastructure issues, regulators are essential to the development of more competitive and trustworthy systems. Dilip Ratha (DECPG) and Jose de Luna-Martinez (FSE), who are surveying central banks and money transfer agents, have found that there are many different players in the remittances business and, as Ratha explains: “Regulation varies widely depending on the type of business and specific services they provide.”

Harmonizing the licensing or registration requirements, the reporting rules, and the foreign exchange controls that are applied to the various operators of money transfer services would spur more competition. Requiring transfer agents to divulge fees and commissions in a standardized way would also help.

These issues and others will be treated by a joint World Bank—Bank for International Settlements Task Force, which is in the process of developing general principals for remittance systems policies and oversight, and includes central banks in both predominantly sender and receiver countries. In addition to providing for competition and efficiency, regulators on both sides of the borders share responsibility for protecting the consumers of remittance services and complying with international anti-money laundering standards.
Development impact: the importance of good numbers.

The careful tracking of remittance channels and flows that good oversight requires is also vital to development in a number of ways. As Tracey Lane (ECSPE), the Country Economist for Kosovo, puts it: “Remittances have a huge impact on macroeconomic stability.” Lane recently commissioned a study by the Development Prospects Group to review workers’ remittances. Over the last four years, economic growth in Kosovo has been driven by massive external financing in the form of both aid flows and remittances. These are expected to continue to decline and could potentially produce a negative multiplier effect on economic growth. Forecasting the potential macroeconomic impact from changes in remittances, and planning to mitigate those effects, requires accurate estimates of the amounts involved.

Information about the volumes of remittances flowing to and from different locations is also vital for the development of strategies to attract competition—especially from financial services providers. Raul Hernández-Coss (FSEFI), who has recently completed an extensive study of the remittance corridors that exist between the US and Mexico, and from Canada to Vietnam, emphasizes this point.

For the US-Mexico corridor, Hernández-Coss finds that average remittance costs are significantly lower for transfers sent from Chicago to Michoacan, compared to those sent from Las Vegas to Guanajuato, though the volumes are similar. Such differences suggest that the US and the Mexican governments may want to focus on bringing migrant workers who are living in Las Vegas into the US financial system. In Chicago and other cities, the US Federal Deposit Insurance Corporation and the Mexican consulate have sponsored Finance Festivals in conjunction with local banks, inviting Spanish-speakers to request official ID documents and open new accounts. And the costs of sending money to Mexico from these cities is lower.

Involving financial services providers

On the distribution side, information about the volumes of remittance flows has motivated Mexican banks to set up mini-branches in some areas, where they offer a range of savings and credit services to clients receiving remittances. Places that receive less volume may be unattractive to commercial banks but appeal to specialized microfinance institutions (MFIs). With Bank support, the government of Mexico is building the capacity of financial cooperatives to handle remittances and provide other financial services, especially in rural areas.

In some other cases, MFIs or their umbrella institutions, including the ICICI, in India; the Equity Building Society, in Kenya; and the World Council of Credit Unions, have forged alliances with national or international banks or transfer agents such as MoneyGram and Western Union. These arrangements allow the MFIs to distribute remittances as agents or sub-agents of other financial institutions, and to cross-sell their products to recipients.

Forging agreements between MFIs and international money transfer agents is a promising way to extend the reach of the remittances distribution network, and add to their value by providing financial services to recipients. There are a number of challenges and policy considerations involved in developing MFIs to act as remittance distributors, however. CGAP is preparing a note on strategic and operational issues related to the incorporation of MFIs into money transfer networks that will explore some of these specific issues. Remote areas that receive low volumes of funds or have too few recipients to support even the most efficient MFI will require more innovative solutions, perhaps including some form of government-sponsored service provision, potentially through post offices. This may be the case in many parts of Vietnam, says Hernández-Coss.

Facilitating productive investment at the last mile

The role of government is better understood when it comes to ensuring safer, more competitive, and transparent remittance flows, and in facilitating access to complimentary financial services. Strategies for maximizing development impact at the last mile are less clear. With better information, however, there are some specific actions that governments can take to enhance productive investment in recipient communities.

Targeting scarce public funds for transportation and energy infrastructure to areas that receive high volumes of remittance payments may be appropriate. Local economic development initiatives and targeted improvements to the local investment climate, like one-stop shops for business regulation at the municipal level, for example, could also help boost the economic punch from remittance flows. One reason why coming up with specific recommendations is difficult, however, is because oftentimes the data just isn’t there.