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External Financing in South Asia: The Remittances Option

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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 in 2008 reveal that nearly 1.4 billion people in the developing world were living on less than US$ 1.25 a day in 2005.[1] 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 in order to eradicate 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 levels actually increased from 420 million people in 1981 to 455 million in 2005 (though declining as a share of population).

Recognizing 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 level to achieve poverty reduction, of which the United Nations Millennium Development Goals (MDGs) has been a key initiative. An area that requires more attention, however, is that of resource constraints that have constantly plagued this and other similar poverty alleviation efforts.

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.

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, which includes debt relief as one of its vital components, 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 the recent years, it has become essential to consider other types of private sources of external financing that could help these developing countries realize their development goals.

Given the important role to be played by sources of private external finance, the remainder of this brief will discuss the relative magnitudes of the various sources of external finance to developing countries on the whole, with a specific focus on the individual South Asian countries.[2] We also attempt to shed some light on the degree of stability of these components as sources of financing for development.

Trends and Patterns in External Financing to Developing Economies

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 surpassed US$ 1,420 billion compared to about US$ 290 billion in 2002 (Table 1).

Net FDI inflows and workers' remittances clearly emerge as the most significant components of external financing for the developing countries. Over the period 2000-07, on average, about three quarters of the total private inflows into the developing countries involved FDI and workers' remittances.[3] The remaining two components of external financing are portfolio equity inflows and short-term debt inflows. While net portfolio equity inflows experienced more than a ten-fold rise in the recent years, up from about US$ 13.5 billion in 2000 to US$ 139 billion in 2007, net short

[1] See World Bank (2008), available at http://go.worldbank.org/T0TEVOV4E0 (Accessed on 29 September 2009).

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

[3] An important point that needs to be borne in mind about FDI is the fact that a growing share of FDI going to the developing countries seem 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.

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

Year	Workers' remit-tances	Net FDI Inflows	Net Portfolio Equity Inflows	Net Short Term Debt Flows	Net Total Private Inflows (Incl. Remit-tances)
2000	84.5	165.5	13.5	-6.4	271.5
2001	95.6	166	6.3	22.9	292.9
2002	115.9	152.5	9	-5.4	272.7
2003	143.6	155.5	25.5	61.5	412.7
2004	161.3	216	38.7	68.5	557.8
2005	191.2	279.1	68.1	86.6	760.9
2006	229	358.4	104.3	110.1	968.2
2007	265	520	138.6	202.5	1,422.5
2008e	305	583	15.7	-16.3	1,011.9

Source: Based on World Bank (2009).
Note: e – Estimates

term debt flows have also witnessed an even more dramatic increase from about US$ 3 billion in the year 2002 to nearly US$ 203 billion in 2007. However, both these components tend to be highly variable and hence might be considered rather unstable sources of financing (more on this later).

Importance of Remittances to South Asia

Workers' remittances alone have constituted one third of net total private capital flows into the developing countries, second only to FDI flows. Despite this, somewhat less attention has been paid to this source of financing. Available data from the World Bank shows that there has been a marked increase in the magnitude of workers' remittances into the developing countries from about US$ 85 billion in 2000 to about US$ 28 billion in 2007 and is estimated to surpass US$ 300 billion in 2008. Among the developing countries, South Asia has, on average, received about 20 per cent of global remittance receipts destined to the developing countries between 2000 and 2007.

It is interesting to observe that remittance inflows to this region have actually remained quite resilient even during the global financial crisis. It is well known that South Asia, like most other emerging economies in Asia, experienced sharp net capital outflows following the crisis. According to available estimates from the World Bank, net private capital inflows which were US$ 112 billion in 2007, almost halved to US$ 66 billion in 2008. In contrast, remittance flows to South Asia actually remained stable with a slight upward bias, rising from US$ 52 billion in 2007 to an estimated US$ 66 billion in 2008, the same amount as total net private capital inflows to the region (World Bank, 2009).[4] Given the significance of remittance inflows into individual South Asian economies, we consider this component in more detail below.

As Table 2 shows, a lion's share of the remittance inflows has gone into India over the years (about 70 per cent). The average remittance inflows to India between 1995 and 2007 stood at about US$ 16 billion. For the corresponding period, the average inflows into Bangladesh and Pakistan were about US$ 2.7-2.8 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 per cent of aggregate South Asian output. Referring to Table 2 again, it is clear that in 2007 Bangladesh had the highest share of remittances as a per cent of its GDP (10 per cent), followed closely by Sri Lanka (8 per cent).[5] Pakistan and India lag with shares of 4 and 3 per cent, respectively. While

[4] The 2008 figures should be taken with a pinch of salt as they are estimates. Other shocks such as the Dubai debt crisis may be a source of some concern to South Asia in terms of remittance flows in 2009-2010, though the extent of which remains to be seen.

[5] 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 per cent 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.

Table 2: 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 Online, The World Bank.

Table 3: Total Private Sources of External Financing in South Asia and Relative Share of Remittances

Year	Bangladesh		Pakistan		India		Sri Lanka	
	Total Private External Financing (USD Billion)	Remittances as a % of Total Private Financing	Total Private External Financing (USD Billion)	Remittances as a % of Total Private Financing	Total Private External Financing (USD Billion)	Remittances as a % of Total Private Financing	Total Private External Financing (USD 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 Online, The World Bank.

Note: Components of private sources of external financing – exports of goods and services, Net FDI inflows, worker remittances, net portfolio equity inflows, commercial banks and other lending.

Bangladesh has experienced a steady rise in remittance inflows as a share of GDP, there appears to be no obvious pattern in the shares of other countries.

Another useful indicator that underlines the significance of remittances to these economies is its share of total external private sources of financing. The average share (over the period 1995-2007) of remittance inflows expressed as a per cent of total private capital flows stands at about 25 per cent for Bangladesh, the corresponding figures for the other four South Asian countries being about 15-17 per cent (Table 3). Clearly workers' remittances are an important source of external financing in absolute and relative terms for the South Asian economies, especially Bangladesh.

Relative Stability of Remittances

After decades of neglect, workers' remittances have become recognized by policymakers and observers as important sources of external finance. There is, in fact, a growing body of literature that deals with this issue (World Bank, 2006). One of the most important features of the remittances component 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.[6] We compute CVs for the individual South Asian countries over a period of 12 years from 1995 to 2007.[7]

Figure 1 reveals the volatilities of the various sources of financing for the individual South Asian countries. The CVs corroborate the earlier discussed point about remittances being relatively more stable compared to the rest of the sources. 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". Computing such CVs for all the developing countries lumped together produces broadly similar results.

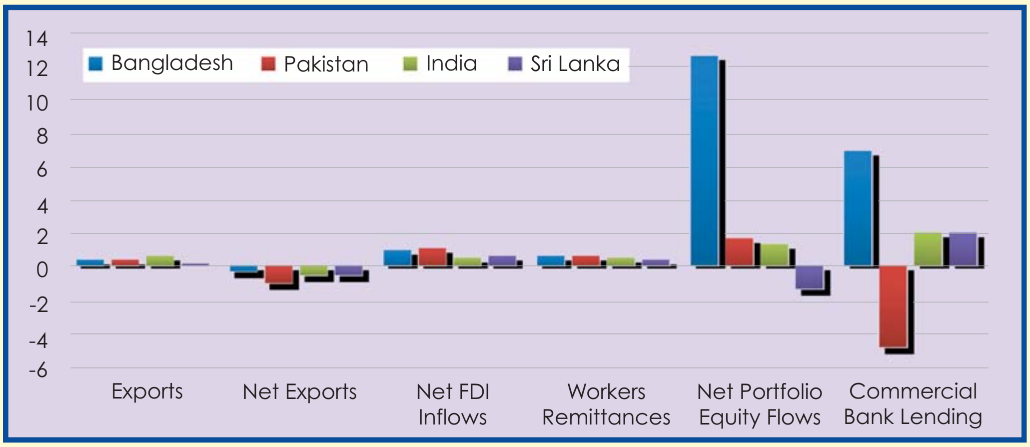
Beyond this measure of volatility, arguably of more importance is that fact that while private capital flows are generally considered *pro-cyclical*, viz. capital flows rising at times of growth booms and falling during busts, remittances are generally expected to *counter-cyclical*. Thus, remittances could serve as macro-economic stabilizers during times of an economic slowdown, as migrants are expected to increase the amounts of money they remit back home when most needed (i.e. during a downturn in their home country). It is worth noting that there is a small but growing body of empirical work confirming the presence of *counter-cyclical* behaviour of remittances, though much more work remains to be done in this area (for instance, see Frankel, 2009). As a significant portion of migrants' incomes is 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.[8]

[6] 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.

[7] We confine the period to 2000 and 2007 for calculating CVs for the cluster of developing countries as a whole.

[8] Some have argued that the large inflows of remittances into a particular country could result in a "Dutch Disease" type of a 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. 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.

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



Source: Authors' Calculations based on World Development Indicators Online, The World Bank.

Conclusion

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

An important area of policy concern that needs to be addressed by all concerned countries is the presence of excessively high transactions costs associated with remittance transfers. Some estimates indicate that remittance service providers in the formal sector charge a remittance fee that is 10-15 per cent higher than the principal amount, which typically leads to a reduction in the amount of net funds transferred. Effective bilateral cooperation arrangements between the remittance-originating countries and the remittance-recipient countries could prove to be useful in reducing such high transaction costs (see World Bank, 2006 for details). Apart from the huge financial burden that is placed on the remitters, the presence of high transaction costs has also resulted in the growth of informal channels of remittances. This implies that workers' remittances are in reality much more significant than what the official numbers suggest.

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

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This policy brief draws upon and updates a longer article by the authors (see Gopalan and Rajan, 2009).

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