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## Remittances and the Informal Economy\*

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### Abstract

Many developing countries are characterized by a large informal sector, and are also often heavily dependent on remittance inflows from abroad. We develop a general equilibrium framework to understand better the dynamic absorption of remittances in a two-sector small open economy, by incorporating many of the stylized features of the informal sector. Calibrating the model to yield a long-run equilibrium consistent with sample averages for 56 developing countries for the period 1990-2014, we show that the effect of remittances depends critically on how they impinge on the recipient economy, i.e., whether these inflows are (i) permanent or temporary, (ii) associated with a collateral effect to securitize borrowing, and (iii) exogenous or countercyclical. We also identify the conditions under which remittances are associated with an expansion of the informal sector, as well as the Dutch Disease effect.

**Keywords:** Remittances, informal sector, real exchange rate, Dutch Disease, collateral effect, capital mobility, labor mobility.

**JEL Classification:** E2, E6, F2, F3, F4.

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