ELSEVIER
www.elsevier.com/locate/worlddev

World Development Vol. 37, No. 1, pp. 104–115, 2009
Published by Elsevier Ltd
0305-750X/$ - see front matter

doi:10.1016/j.worlddev.2008.05.007

Effect of Remittances on Poverty and Financial Development in Sub-Saharan Africa

SANJEEV GUPTA, CATHERINE A. PATTILLO and SMITA WAGH *
International Monetary Fund, Washington, DC, USA

Summary. — This paper assesses the effect of the steadily growing remittance flows to sub-Saharan Africa. Though the region receives only a small portion of the total recorded remittances to developing countries, and the volume of aid flows to sub-Saharan Africa swamps remittances, this paper finds that remittances, which are a stable, private transfer, have a direct poverty-mitigating effect, and promote financial development. These findings hold even after factoring in the reverse causality between remittances, poverty, and financial development. The paper posits that formalizing such flows can serve as an effective access point for "unbanked" individuals, and households.
Published by Elsevier Ltd.

Key words — remittances, poverty, financial development, Africa

1. INTRODUCTION

The flow of remittances into developing countries is attracting increasing attention because of their rising volume, and their effect on the receiving countries. In 2006, they totaled US$221 billion—twice the amount of official assistance developing countries received. [1] Moreover, there is evidence that such flows are underreported. Remittances through informal channels could add at least 50% to the globally recorded flows (World Bank, 2006). [2] Remittances to developing countries have increased on average by 16% in annual terms since 2000. Though at least some part of the growth is attributable to better reporting by recipient countries, it appears that over the last decade remittances have outpaced private capital flows, and official development assistance (World Bank, 2006).

There are marked regional differences in remittance flows. Since the 1980s, remittances to countries in Latin America, the Caribbean, and the East Asia, and Pacific regions have grown more rapidly than the average for developing countries generally. In 2006, the top three recipients—China, India, and Mexico—accounted for more than one-third of the remittances to developing countries. Among the top 25 recipients of remittances, only one (Nigeria) is in sub-Saharan Africa, but three of the eight countries in South Asia (Bangladesh, India, and Pakistan) appear on the list. [3]

Studies relying on household data in sub-Saharan Africa have yielded insights into how remittances impact at the micro level. This country-specific analysis has enabled researchers to draw qualitative inferences about remittances. For instance, using nationally representative household data from Ghana, Adams (2006) concludes that remittances reduce poverty in recipient households, especially when transfers are from abroad. Azam and Gubert (2006) utilize household survey data from the Senegal River Valley in Mali, and Senegal, and draw conclusions about the insurance, and moral hazard aspects of migration, and remittances. Dejene (2005) similarly utilizes a large dataset comprising urban Ethiopian households to study the characteristics of remittance-receiving households.

In contrast, this paper follows a different path; it analyzes the effect of remittances at the *aggregate* level in sub-Saharan Africa. Similar studies have been carried out for Latin America, or South Asia, where remittance volumes swamp those going to sub-Saharan Africa. In studying the aggregate effects, the paper recognizes that at their core remittances are private intrafamily/intracommunity income transfers that directly impact on the single most relevant challenge for sub-Saharan Africa—poverty. Further, the long-term development potential of such transfers is determined by the use of the portion of remittances left over after basic consumption needs are met.

While this approach yields broad quantitative results, caution is warranted in interpreting results because of uneven data quality. For instance, part of the recent increase in remittances might merely reflect improved data reporting as in the case of Ghana, Senegal, and Uganda. Also, the reported data most likely understate the full extent of intra-regional migration, and remittances. [4] Furthermore, remittances recorded against a country could reflect flows destined for neighboring countries (e.g., Kenya serves as a hub for remittances flowing into Somalia, Tanzania, and Uganda). Notwithstanding these data weaknesses, this paper makes a first attempt at supplementing country studies on remittances in sub-Saharan Africa with an analysis at the aggregate level.

The paper is organized as follows. The next Section 2 discusses the trends, and characteristics of remittances in sub-Saharan Africa. Section 3 estimates the effect of remittances on income, and consumption as well as on financial development. It is followed by a discussion of factors/policies that can lower the cost of remitting money (Section 4). Section 5 concludes.

2. REMITTANCES TO SUB-SAHARAN AFRICA

(a) *Recent trends*

Sub-Saharan Africa has been a part of the increasing global trend, although remittances to this region have generally increased at a slower pace than those to the developing countries

* The authors thank, without implicating, Benedicte Vibe Christensen, Anne-Marie Gulde, Thierry Tressel, Dilip Ratha, Sanket Mohapatra, and four anonymous referees for their helpful comments. Final revision accepted: May 15, 2008.

as a group. [5] However, the recorded remittances are only a small fraction of total remittances to sub-Saharan Africa. Freund and Spatafora (2005) estimate that informal remittances to sub-Saharan Africa are relatively high at 45–65% of formal flows, compared to only about 5–20% in Latin America. This could be attributable in part to "in-kind" remittances by those working within the continent, and in part to high transaction costs of remitting money through formal channels (see below).

In 2006, remittances to the 34 sub-Saharan Africa countries were estimated at about US$9 billion. Remittance flows to the region are relatively small, 4% of total remittances to developing countries and just 33% of those to India, which receives the most. In contrast, countries in Latin America, and the Caribbean received 25% of all remittances, as did the countries of the East Asia, and Pacific region.

Relative to GDP, too, the volume of remittances to sub-Saharan Africa is generally smaller than in other developing countries. In 2006, remittances to the region were 1.6% of GDP, compared to 3.5% for South Asia. However, there are striking exceptions in sub-Saharan Africa. In particular, remittances were almost 28% of GDP in Lesotho, and more than 5% in Cape Verde, Guinea-Bissau, The Gambia, Senegal, Togo, and Uganda. In absolute terms, however, Kenya, Nigeria, and Senegal are the largest recipients of remittances in the region. For some countries, remittances are also an important source of foreign exchange. For Lesotho, Cape Verde, Uganda, and Comoros, for instance, remittances have since 2000 amounted on average to more than 25% of export earnings (Figure 1).

In sub-Saharan Africa, aid flows are considerably higher than remittance receipts (Figure 2). Since 2000, aid flows to the region increased on average by about 13% a year, and reported remittances by almost 10%. However, during the 1990s, when aid flows to the region were more, or less stagnant, remittances grew annually at more than 13%. And while it is true that the region as a whole receives more aid than recorded remittances, the latter are consistently greater than official assistance in Lesotho, Mauritius, Nigeria, Swaziland, and Togo.

The balance of payments data used above probably underreports remittance flows between the developing countries. There is sufficient anecdotal evidence to suggest that intraregional migration is common in sub-Saharan Africa. Botswana, and South Africa attract migrants from neighboring countries (largely unskilled) in search of employment. The strong sociocultural ties among populations across different countries and periods of political instability in parts of the region have also influenced cross-border flow of labor.

(b) *Characteristics of remittances to sub-Saharan Africa*

One reason remittances have attracted attention is that they are seen as more stable than other foreign currency flows to developing countries. Remittances to sub-Saharan Africa are not only consistently less volatile than official aid; they are also less volatile than FDI, which is usually seen as the most stable private flow (Figure 3a).

Remittances might also be expected to be countercyclical to the extent that they are motivated by the altruism of migrant workers, and increase in times of economic distress in their home countries. Remittances to sub-Saharan Africa were countercyclical only during the 1996–2006 period (Figure 3b). The low (albeit negative) correlation coefficient demonstrates the stability of remittances overtime rather than any strong relationship to growth cycles. [6] The countercyclicality of FDI flows must be viewed in the context of the very high volatility of such flows.

Remittances can also contribute to stability by lowering the probability of current account reversals. Because they are a stable source of foreign currencies, remittances are likely to stem investor panic when international reserves are falling, or external debt is rising. These beneficial effects are particularly strong for countries where remittances are above 3% of GDP (Bugamelli & Paterno, 2006). While the average sub-Saharan Africa ratio is below that threshold, and current account reversals driven by investor panic are rare, remittances do offer the additional benefit of stability for some countries.

The effect of remittances on the real exchange rate, and export competitiveness, their Dutch-disease effect, is a matter of debate. As in the case of any other transfer (for instance, official aid) the effect depends on the proportion of such flows spent on domestic goods, in particular non-tradables (Gupta, Powell, & Yang, 2006). Since remittances are private transfers dispersed over a large number of poor households, it has been argued that their effect on domestic demand differs from that of donor-funded infrastructure projects (World Bank, 2006). Remittances may in fact be self-correcting as an overvalued currency deters remittances, and hence Dutch-disease effects are not sustained (Rajan & Subramanian, 2005). However, studies in Latin America (Amuedo-Dorantes & Pozo, 2004), and Cape Verde (Bourdet & Falck, 2006) have found evidence that remittances do have Dutch-disease effects on the competitiveness of the tradable sector. In countries where inflows are large compared to the size of the economy, where supply constraints are a significant hindrance to the expansion of the non-tradables sector, and where a significant portion of remittances are spent on domestic goods policymakers will need to be alert to the possibility of a Dutch-disease phenomenon.

3. EFFECT OF REMITTANCES

(a) *Direct income, and consumption effect of remittances*

Remittances are part of a private welfare system that transfers purchasing power from relatively richer to relatively poorer members of a family, or a community. They reduce poverty, smooth consumption, affect labor supply, provide working capital, and have multiplier effects through increased household spending. These transfers have typically been targeted to female-headed households. [7]

For the most part, remittances seem to be used to finance consumption, or investment in human capital, such as education, health, and better nutrition. [8] In Zimbabwe, for instance, households with migrants have less cultivated land but tend to be slightly better educated (De Haan, 2000). Quartey and Blankson (2004) find that migrant remittances to Ghana are countercyclical, and are effective in helping smooth household consumption, and welfare over time, especially for food crop farmers, who are typically the most disadvantaged socioeconomic group. Similarly, using data from a large household survey Adams (2006) finds that international remittances significantly relieved poverty among the "poorest of poor households." Ratha (2003) suggests that remittances that raise the consumption levels of rural households might have substantial multiplier effects, because they are more likely to be spent on domestically produced goods. Some studies (Cox Edwards & Ureta, 2003; Hanson & Woodruff, 2003) have found evidence for "forward" linkages between remittances, and human capital formation in Latin America.