Economic Modelling 28 (2011) 2600–2608

Contents lists available at SciVerse ScienceDirect

Economic Modelling

journal homepage: www.elsevier.com/locate/ecmod

Remittances flow and financial development in Bangladesh

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ARTICLE INFO

Article history:
Accepted 21 July 2011

JEL Classification:
F24
F41
F43

Keywords:
Remittances
Financial development
Bangladesh
Cointegration
VECM
PcGETs
Endogeniety test

ABSTRACT

Workers' remittance is a major source of foreign exchange earnings and plays an important role in the economy of Bangladesh. It accounts for 12% of GDP in 2010. This paper examines with annual data for 1971–2008, whether the flow of remittances is contributing positively to the development of the financial system of the country. Our results suggest that remittances have a significant positive effect on financial development. However, financial sector's development is neutral in its effect on the inflow of remittances.

1. Introduction

Cross border movement of labour in search of employment and remitting labour income back to the country of origin is not a new phenomenon. Globalisation from the mid 1980s has renewed a rapid increase in the total number of migrant workers and the inflow of remittances. In 2010, the global flow of remittances exceeded $440 billion compared to a mere $18 billion in 1980. It is believed that a large part of the flow of remittances remains unrecorded which could be as large as 20 to 200% of the officially recorded remittances (Aggarwal et al., 2006; World Bank, 2006; Choucri, 1986). USA is the topmost source of remittances followed by Saudi Arabia and about US $75 billion remittances have originated from these two countries in 2009. Developing countries received about 75% of all remittances and supplied 80% of the global migrant workers in 2010. Workers' remittances are the second largest source of foreign exchange earnings and exceeded private capital flows and foreign aid to most developing countries (World Bank, 2011).

Although the primary motive for the migrant workers to remit is cited as altruism, repayment of loans and self interests including savings and investment are also demonstrated as important reasons in the remittances literature. Remittances make a significant socio-economic contribution through both direct and indirect channels on different sectors of an economy, and eventually on the growth of the economy (Rao and Hassan, 2010). The flow of remittances acts as a significant macroeconomic stabiliser and often counter cyclical as it is observed to be increased during economic downturns in the developing countries (Sayan, 2006).

Bangladesh is one of the leading remittance recipient countries through the export of its labour services to the Middle East and South East Asian countries since the early 1970s. Remittance income increased from $24 million in 1976 to $11.1 billion in 2010 and contributing to 12% of GDP of the country (World Bank, 2011). These large inflows of remittances are having colossal development effects in the country and a single paper is inadequate to examine all these effects. Therefore, the scope of this paper is restricted to analyse the effects of remittances on the development of the financial sector of Bangladesh. An efficient and wide spread financial sector can facilitate the mobilisation of excess funds from remittance recipient saver families to the investors, which in turn can improve economic growth of a country (Acosta et al., 2009; IMF, 2005). Despite the vast development implication of remittances on financial system, research on the topic is limited at the country specific level. This study, therefore, fills this gap for Bangladesh.

This paper is organised as follows: Section 2 presents the literature review on the development effect of remittances; Section 3 illustrates the flow of remittances to Bangladesh economy over 1971–2010; Section 4 discusses the methodology and the data employed to study the long-run effect of remittances on financial development of the country. Section 5 presents the result of the empirical study and Section 6 draws the conclusion and policy recommendations.

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0264-9993/$ – see front matter
doi:10.1016/j.econmod.2011.07.013

2. Literature review

Remittances literature is mainly centred on the issues of economic growth and the poverty alleviation effects of remittances. Majority of the existing studies illustrate the positive, direct and indirect, growth effect of remittances especially for the developing countries employing cross country data (Barajas et al., 2009; Beck et al., 2004; Chami et al., 2003; Giuliano and Ruiz-Arranz, 2005; Rao and Hassan, 2010; Ratha, 2003).

Chowdhury and Chowdhury (1992) demonstrate the positive effect of remittance as it augments domestic savings, investment and enhance economic growth of Bangladesh. Durand et al. (1996) illustrates that the 'migra-dollars' increase economic activities and create higher level of employment, investment and income for Mexico. Other studies (Cornelius, 1990; Massey and Parrado, 1994) also indicate that an overwhelming portion of remittances is used for consumption rather than productive investment in Mexico. This in turn, made the economy dependent on 'migra-dollar' for consumption which Stuart and Kearney (1981) dubs as "dangerous dependence". Ratha (2003) indicates possible multiplier effect of remittances flow through increase in the rural consumption on domestically produced goods in the developing countries.

Studies on poverty alleviation effects of remittances on developing countries are mixed. Adams (2005) and Taylor et al. (2005) suggest that remittances reduce both the level and severity of poverty in Guatemala and Mexico respectively. Adams (2006) also finds a substantial improvement of poverty situation of the 'poorest of the poor' due to inflow of remittances while using large household survey in Ghana. A World Bank (2006) study shows that the remittances reduce poverty level by 6% in Bangladesh, 5% in Ghana and 11% in Uganda. In a cross country analyses, Ratha (2009) finds a 10% increase in remittances that reduces poverty by 3.5%.

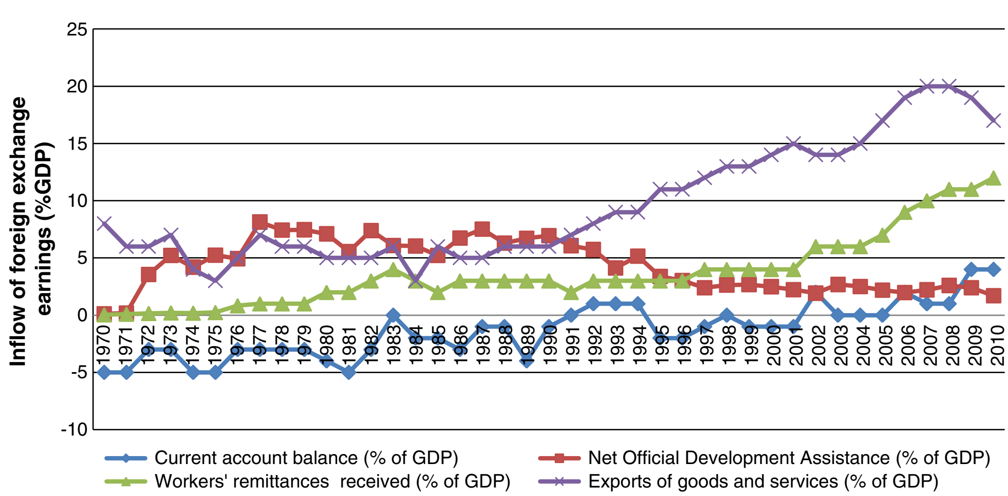
Gupta et al. (2009) suggest a positive effect of remittances on poverty reduction through increased income and higher standard of living by remittance receiving families. Maimbo and Ratha (2005) indicate that the flow of remittances reduce rural poverty in the developing countries as majority of the migrant workers are from rural background. In contrast, Barajas et al. (2009) find no direct effect of remittances on poverty situation of developing countries. Chami et al. (2003) rather find a negative effect of remittances on economic growth as it reduces the incentive to work by the migrant family members.

Adams (1991) in rural Egypt, Cox Edwards and Ureta (2003) in El Salvador, Gorlich et al. (2007) in Moldova, Hanson and Woodruff (2003) and Lopez (2005) in Mexico illustrate the positive effect of remittances on increasing schooling and literacy rate and thus augmenting human capital formation. Several other studies (Maimbo and Ratha, 2005; Woodruff and Zenteno, 2001; Yang, 2005) suggest a positive relationship between remittances recipient families and entrepreneurship.

The importance of a sound and well-developed financial sector on economic growth has been documented in several influential studies (King and Levine, 1993; Levine, 1997, 2004; Levine and Zervos, 1998). Nonetheless, two recent studies (Aggarwal et al., 2006; Gupta et al., 2009) explicitly illustrate the relationship between remittances and financial development. Aggarwal et al. (2006) show a significant positive relationship between remittances and bank deposit to GDP ratio and credit to GDP of ninety nine developing countries, with the latter relationship being less robust. Gupta et al. (2009) also illustrate that the flow of remittances significantly and positively facilitates the financial sector's development in Sub-Saharan Africa. Using data for Central America, Mexico and Dominican Republic, Mundaca (2005) demonstrates that the indirect effect of remittances on growth is stronger while taking financial development in terms of domestic credit expansion into account. Rao and Hassan (2010) confirm this finding in 40 high remittance recipient countries using a System GMM panel data analysis and find that remittances indirectly facilitate economic growth by increasing the ratio of M2 to GDP. Beck et al. (2000a) illustrate that a large proportion of population in the informal sector have no access to bank credit which reduces their productivity and slows down economic growth. In another study Beck et al. (2004) confirm the poverty and inequality reduction effect of remittances through the financial development using cross country data of 58 developed and developing countries. Thus, a less developed financial market hinders capital accumulation and economic growth. In contrast, Giuliano and Ruiz-Arranz (2005) indicate that the growth effect of remittances is stronger in countries where the financial sector is weaker while using a cross country data set of 100 developing countries. They argue that remittances can compensate for the lack of access to credit in countries with less developed financial sector.

3. Trend of remittances to Bangladesh

Prior to the World War II, a substantial migration had taken place from Bangladesh to Burma which was then a thriving economy. During the 1950s and 1960s, Bangladeshi workers migrated abroad, especially to UK and obtained British citizenship by naturalisation after staying four to five years. Also a limited number of Bangladeshi workers had taken up employment in Saudi Arabia and Qatar mostly by individual initiatives during 1960s. However, after the independence of Bangladesh in 1971, pattern of workers' migration changed dramatically. Several delegations



Source: Annual series are constructed by the author from various World Bank, World Tables, IMF, Bangladesh Bank data sources.

Fig. 1. Inflow of Remittances and Other Foreign Exchange Earnings to Bangladesh 1970–2010 (% GDP).