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## Working Paper

### **A New Transatlantic Channel Between Latin America and Spain: Remittances and Their Role in Economic and Financial Development**

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# A New Transatlantic Channel Between Latin America and Spain: Remittances and Their Role in Economic and Financial Development (WP)

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*“I propose to you constructing  
A new canal,  
Without sluices  
or excuses,  
One that finally connects  
Your Atlantic glance  
With my natural Pacific”  
Mario Benedetti*

## Summary

The purpose of this article is to offer an overview of the remittance phenomenon, mainly from a Latin American and Spanish perspective and with a primarily economic focus.<sup>1</sup>

## Introduction

Links between Latin America and Spain have been deep and permanent –but not always easy– for the last five centuries. In the past decade, economic ties have undergone a major transformation that has mainly affected the economic realm. However, the existence of long-standing historical and cultural links has to a large extent shaped the deepening that has been observed recently.

Economic links can encompass many areas and markets. The market for goods is linked by trade flows, and here no fundamental changes have been observed. Spanish trade with Latin America remains limited –just 5% of Spain’s overall commerce–, and Spain represents an even smaller share for Latin America. It was in capital markets where the revolution began in the mid 1990s as Latin America enacted reforms and deregulation. Spanish investment poured into almost every country of the region, driven in many cases by privatisation of state-owned firms, and targeted a wide range of areas –banking, energy and distribution, construction, etc-. It also shook up economic structures and relationships on both sides of the Atlantic. In Latin America, Spanish investment served as a support for the process of transforming market structures, and in Spain it marked a milestone in the internationalisation of companies. Many of these firms moved up to the rank of multinationals as a result of this expansion, which they later consolidated in other geographical areas and sectors. The third kind of tie, also by chronological order, is that of the labour markets. It is interesting to note that this link goes in the opposite direction to the others: emigration flows headed from Latin America to Spain in growing numbers starting in the 1990s.

From a macroeconomic standpoint, the deepening of financial and labour-market links is in line with the theory that capital flows from developed countries to developing ones.<sup>2</sup> But there are two factors to explore in this case: (1) the intensity in which both processes –investment in one direction and migration in the other– have taken place in the last decade; and (2) the stunning changes this has meant for Spain, which has gone from being a net recipient of foreign investment to one of the main investors of capital overseas, and from being a country that traditionally saw many people

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1 The opinions expressed here are not necessarily those of the institution he represents. Luis Molina helped with graphic material.

2 A theory that tends not to work in practice, as empirical evidence has shown and as illustrated currently by the contrast between the large current account surpluses of developing countries and the US deficit.

emigrate in search of a new life to being one of the main recipients of immigrants. This transformation has been fuelled not only by economic development in the past few decades but also to a large extent by the process of economic and financial globalisation.

Latin American immigration has fuelled the development of another link with a wide-ranging nature, somewhere between financial and labour-related, which is the focus of this article: remittances. Remittances are monies sent privately between residents of two countries, be they legal or not, in particular by emigrants who send part of their income to relatives back in their native country. So remittances are a natural consequence of work-driven emigration and a regular resource for relations or other people who stayed behind, with the money serving to help cover expenses or as an investment.

Remittances are thus of a mixed nature, which explains why studying them requires a multidisciplinary focus. The sociological, development, labour-market and financial aspects intersect in the different approaches that are adopted. In any case, what is beyond question is the growing importance of this phenomenon and the attention being given to it. The growth of migratory flows in recent decades explains the magnitude of remittances and attracts growing interest in them, but there are also other factors behind all the attention being paid to this issue in the academic, social and political worlds, both in the countries affected –Spain and Latin America– and in international financial organisations. The peculiarities of the remittance market and the people involved in it, the implications they can have for development and reducing inequality and the very fact that remittances are of an international nature have led to a flurry of studies and analyses, many of them at the initiative of governments and international financial and development agencies.

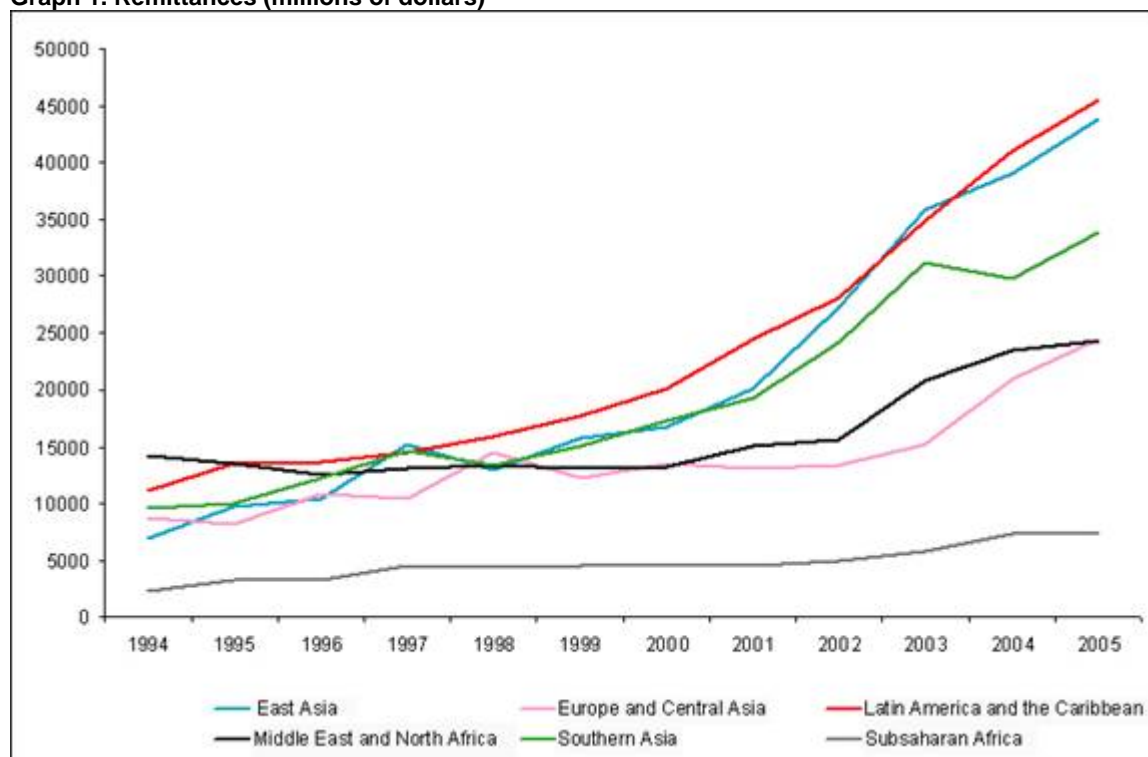
The purpose of this article is to offer an overview of the remittance phenomenon, mainly from a Latin American and Spanish perspective and with a primarily economic focus. Most of the article deals with description and analysis. We will begin by measuring the importance of remittances through a quantitative analysis, then move on to describing the characteristics of the remittance market and its determining factors. In the second part we will look at the economic impact of remittances, with an emphasis on their role as a potential catalyst for financial development. Finally, the third part of the study summarises the main economic policy implications that flow from the earlier analysis and the initiatives carried out by institutions.

We arrive at the conclusion that remittances can play an important but limited role in the economic development of receiving countries. To a certain extent, this role can be enhanced by government institutions. However, the extent of the remittances' impact on development depends on the rest of the conditions for development and growth being present. So remittances are a useful tool whose impact is optimum when the setting is right, but they are not a panacea.

### **The Growing Phenomenon of Remittances**

Remittances sent by emigrants are an increasingly common method for transferring resources from developed countries –normally recipients of immigrants– to developing countries that are sources of emigration, and are also one of the latter's main ways to lure capital from abroad (Ratha, 2003). The World Bank says that in 2005 the flow of remittances from industrialised countries to developing ones reached the figure of US\$179 billion, compared with just US\$31 billion in 1994, and the rate of growth has exceeded 10% in almost all recipient regions in the last decade (see Graph 1 and Table 1). Remittances from emigrants make up 30% of the money flowing into developing countries and 2.5 % of their GDP. Compared with other kinds of funds, they represent more than twice the development aid these countries receive and around 80% of the direct foreign investment.

**Graph 1. Remittances (millions of dollars)**



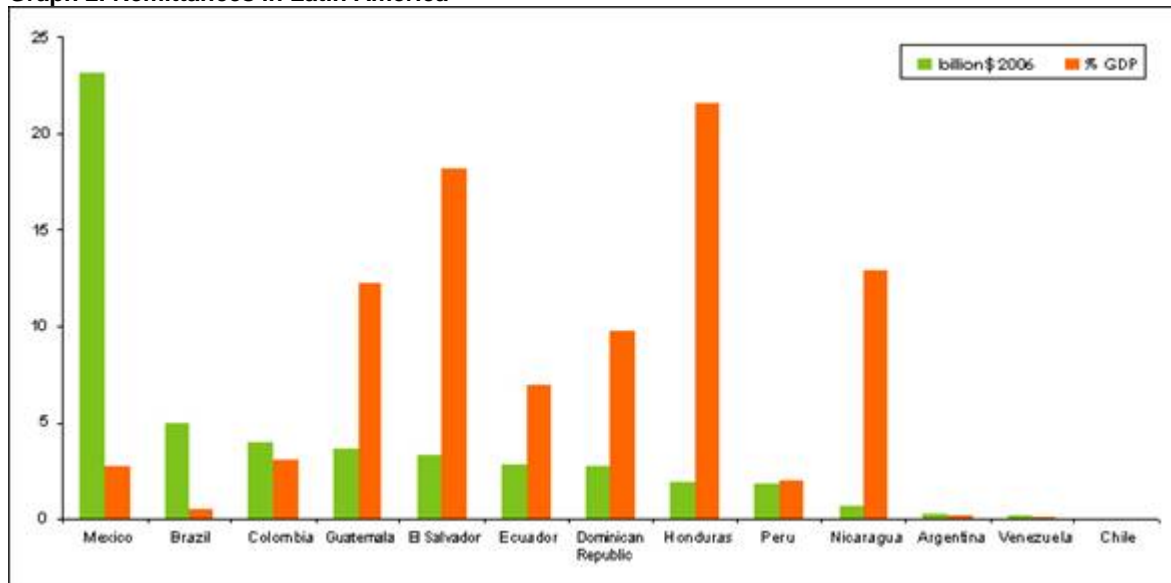
**Table 1. Growth of remittances**

	Level in 2005 (millions of dollars.\$)	Growth (1995-2005)	% Total 2005
East Asia	43,770	19.8	24.4
Europe and Central Asia	24,385	11.2	13.6
Latin America and the Caribbean	45,608	13.9	25.4
Middle East and North Africa	24,309	5.6	13.5
Southern Asia	33,929	12.8	18.9
Subsaharan Africa	7,425	12.1	4.1
<b>Total for developing countries</b>	<b>179,426</b>	<b>12.0</b>	<b>100.0</b>

Source: World Bank.

Remittances are especially important in Latin America, which in 2005 took in US\$45 billion, more than 25% of the world total. The distribution of remittances among countries is very uneven, as seen in Graph 2. In fact, in the countries of the Southern Cone remittances play a relatively small role, whereas in the countries of Central America they surpass 10% of annual GDP and in the Andean nations they also account for a significant portion of the economy. In absolute terms, Mexico has practically caught up with India as the leading recipient of remittances, with US\$23 billion in 2005. Colombia, Brazil, the countries of Central America, Ecuador, Peru and, more recently, Argentina, are in this order the main recipients in the region. Measured *per capita*, the regional average without weighting by country is around US\$100, although El Salvador and the Dominican Republic are the exception, taking in US\$200 per person.

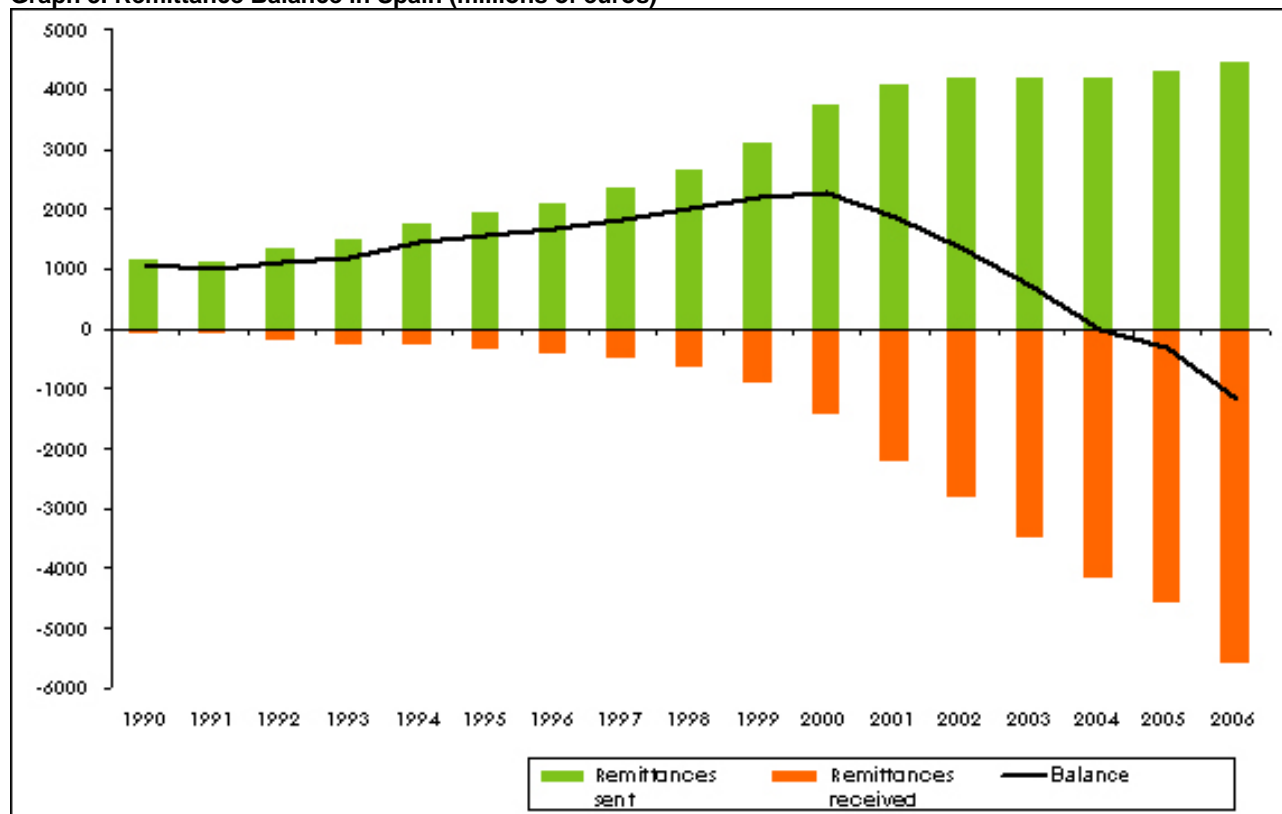
Graph 2. Remittances in Latin America



The flip-side of the coin are the countries that are sources of remittances, which are normally more developed economically. In the past few years Spain in particular has become one of the main senders of remittances, climbing quickly in the world ranking as the phenomenon experiences intense growth. Spain has witnessed an immigration boom in the past decade as seen in the increase in the foreign-born population, which has gone from 2.2% of the population in 1999 to 8.5% in 2005. At the same time remittance payments have grown substantially, expanding nearly 30% a year and exceeding €5 billion –more than half a percentage point of GDP- in 2006, according to figures from the Bank of Spain’s Balance of Payments. Graph 3 shows the recent evolution of remittances and how the net figure only began to be negative –Spain sent more than it received in remittances– starting in 2005. This is because the entry of remittances in Spain has continued to be very strong due to the country’s history of being one of emigration rather than immigration.<sup>3</sup>

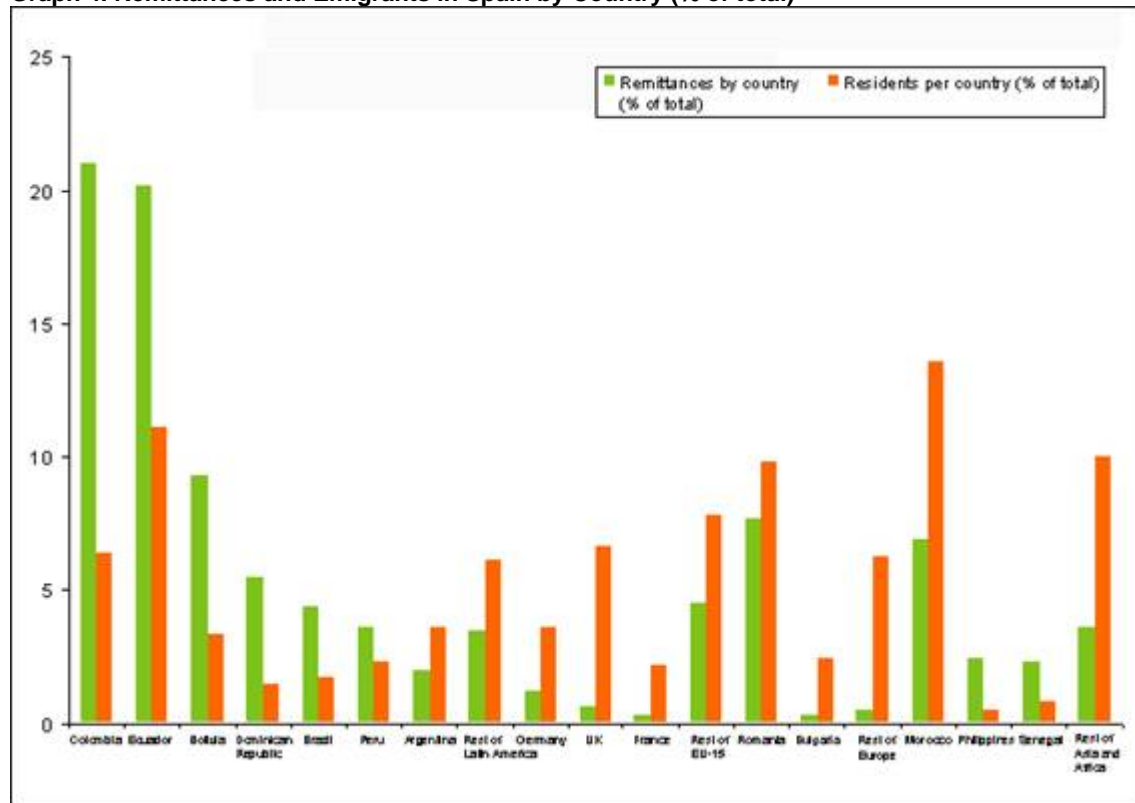
<sup>3</sup> In recent years, the growth of remittances has been linked to reception of income (pensions) by foreign residents of Spain, mainly retirees. Statistically, this revenue is counted as remittance.

**Graph 3. Remittance Balance in Spain (millions of euros)**



Of the total, almost 70% goes to Latin America, a figure that gives an idea of the propensity of Latin American emigrants living in Spain to send money back home, as they make up just 36% of the immigrant population. Graph 4 shows percentages of residents and remittances sent by the main countries. The three leading recipient countries of remittances from Spain are in Latin America: Colombia, Ecuador (both with more than 20% of the total) and, following somewhat further behind, Bolivia. Next come Romania and Morocco. It is worth noting that the latter has the largest immigrant community in Spain (around 13%), but they account for just 6% of the remittances. This is due in part to the fact that Moroccans are less inclined to send remittances but also to the fact that Morocco is very close to Spain and Moroccans have the habit of taking money home personally or sending it through intermediaries.

**Graph 4. Remittances and Emigrants in Spain by Country (% of total)**



### **Motivation and Determining Factors in Sending Remittances**

Remittances are transactions between private citizens that, unlike commercial operations, are not driven by profit and tend to be aimed at people with scant economic resources and in many cases limited knowledge of financial dealings.

Altruism has been identified as the main reason for sending remittances (Solimano, 2003), although in many cases there are others that determine the amount and frequency of them. Three have been cited: (1) repayment of money lent by family members; (2) the reassurance of having money waiting back home if the emigrant’s experience turns out badly; and (3) self-interest, since in many cases the money is earmarked for investments in the home country, done by or on behalf of the emigrant.

Altruism implies that concern for and responsibility to the family are fundamental motives for sending remittances and that therefore the emigrant derives a utility from this action. This contrasts with typical consumers under Standard economic theory who find their utility simply through consumption. So the degree of altruism and the amount of remittance, or percentage of their income that a person sends, depends on the characteristics of the emigrant and the conditions of the family in the country of origin. The economic impact of remittances, which we will analyse further on, also depends on the characteristics of the recipient. So it is a good idea to look at this issue in a bit more depth.

The percentage of recipients of remittances and their socio-economic situation varies greatly from country to country. According to Fajnzylber and López (2007), there are countries in which a significant percentage of the population receives remittances –in some cases more than 20%, as in Central American countries- while in others it is concentrated in fewer households, such as in Peru, Bolivia and Ecuador, where it does not reach 5%, according to data from surveys of households. Thus, the figure for Mexico is between 5% and el 10%, and for Colombia no data are available. An even more interesting issue for the economic and legal implications of remittances is the position of

remittance-receiving families on the income scale. It turns out there are big differences among countries. In Mexico, recipients are predominantly poor households (61% of households are in the 20% of the population that is the poorest), and this is also the case in Ecuador, while in Peru it works the other way round. In other countries remittances are spread among different population groups. One important factor for determining the recipients is the social origin of the emigrants and this in turn is linked to their country of destination. In countries close to the US, and for which it is the main destination, the cost of emigrating is lower. So emigration tends to be a thing of poorer people. But for most South American countries the preferred destination is Europe, which involves greater expense and this is reflected in a tendency for emigrants to be of a higher class. However, there are significant exceptions, such as Nicaragua, where the main recipients of remittances are higher class, or, in the opposite direction, Ecuador, where the recipients and presumably the emigrants are at the lower end of the income scale.

The length of time an emigrant has spent in the country of destination is a particularly important issue in determining the size of remittances. The proportion of income that a person sets aside for a remittance tends to be small at the beginning –because of the tenuous status of the emigrant– and peaks over time, between five and 10 years of residence. Later, the proportion falls as the emigrant’s salary increases, but also because links with the home country weaken as family members join the emigrant in the new country and due to other factors. Other characteristics of the emigrant are also relevant when it comes to measuring propensity to send remittances. Thus, the least-trained emigrants tend to send more remittances, and so do women. And in this case the remittances are more regular.

Besides these subjective factors, empirical research (Solimano, 2003) has identified other factors in the remittance phenomenon that are linked to the economic conditions of the country to which the money is being sent. Thus, the worse off the country is economically, the more remittances will be sent. Contributing to this are both the altruistic nature of remittances (the greater the economic difficulties of the recipient, the more help is sent) and the fact that emigration increases in such situations. This counter-cyclical nature of remittances is very attractive for recipient countries and contrasts with other financial flows, such as direct investment or short-term capital, which are pro-cyclical and thus contribute to worsening the economic situation in times of crisis. It has also been observed that the better a country’s economic policies and institutions are, the greater the amount of remittances will be. Restrictions on currency exchange, economic or political instability and doubts about creditors’ rights and adherence to contracts tend to discourage remittances or at least redirect them towards channels that are less transparent. The unfavorable tax treatment that remittances receive in some countries –taxes on financial transactions, for instance– is also a factor that limits the sending of remittances in a major way. Finally, other intrinsic characteristics of countries linked by remittances explain the size of the flows, such as the existence of a shared border or language or both belonging to an economic integration area, etc.

To a large extent the characteristics of emigrants explain the peculiar make-up of the remittance market, which we will address now. Meanwhile, the peculiarities of the market and the remittance factors identified complete the framework for analysing how the remittance market can be improved. Therefore, they are at the heart of initiatives designed for users to benefit more from remittances.

## **The Remittance Market**

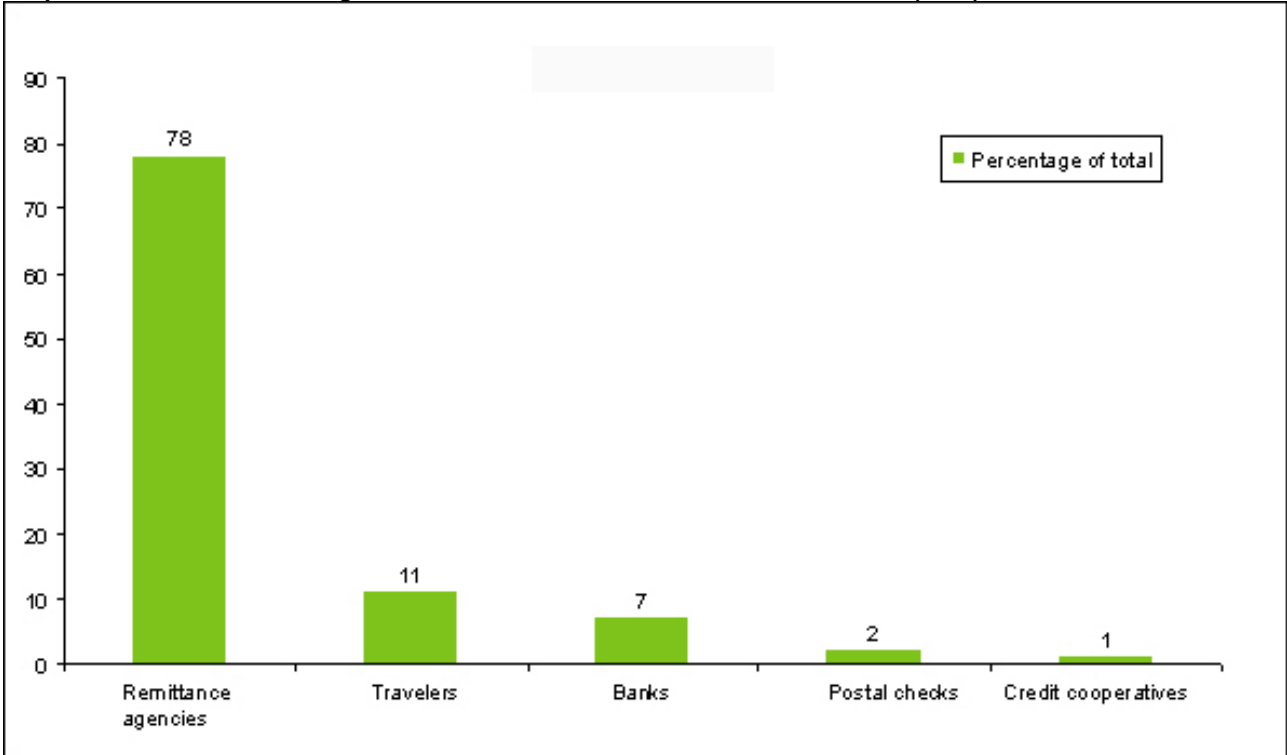
At a global level, the remittance market is dominated by a small number of non-banking operators, the so-called remittance agencies. These firms control 75% to 90% of the sending of remittances, depending on the place of origin and destination of the remittances. These companies act simply as money couriers (they do not offer financial services along with the sending of the remittance, as would be the case with banks) but they work very effectively. Indeed, the remittance agencies have



a highly specialised profile that allows them to compete in the remittance market with an advantage, given the characteristics of senders and receivers. The capillarity of the network of remittance agencies, which often act through widely varying agents and establishments, both at the source and the destination of the money, and a money-transfer system designed specifically to have it arrive quickly and in small amounts all over the world, have given these companies a significant advantage over alternative channels for sending money.

It is noteworthy that the banking industry –the natural financial intermediary and a pillar of international financial transactions– has not achieved an important presence in the remittance market. The World Bank estimates that only 7% of remittances sent to Latin America go through the banking system, as shown in Graph 5. It is true that traditionally banks have not shown much interest in the remittance business, although this has changed in recent years. However, there may be objective reasons making it difficult for them to replace or compete effectively with remittance agencies.

**Graph 5. Channels for sending remittances to Latin America and the Caribbean (2004)**



As we have pointed out, the characteristics of the customers –emigrants and their families– contribute to reducing the banks’ ability to compete in this market. The first factor is the very structure of banks –less diversified and with less flexible payment systems– which limits their effectiveness in competing with remittance agencies, whose way of operating is designed specifically for this kind of transaction. But there are other limits that have to do with the habits and perceptions of the clients. Some authors (Suro *et al.*, 2003) have found that many emigrants are wary of banks and other financial institutions. In many cases this lack of trust stems from experiences with financial crises (by the emigrants or their families) that involved their savings losing value. At the same time, banks require more documentation and transparency than remittance agencies and this favors the latter, as in many cases emigrants work without papers or illegally in the destination country.

The fees charged for sending remittances depend on the type of service rendered (speed of delivery, home delivery, etc.) and the companies tend to apply an exchange rate that is less favorable to the client than the rate on the open market. In 2001 these costs varied from 8% to 40% of the amount sent. Despite a cost reduction in recent years that was brought about by greater competition and

technological advances, fees for sending remittances are still perceived as being high, and vary greatly depending on the origin and destination of the transaction. These features reveal a market that is fragmented and has a non-competitive structure, which allows companies to earn large profits (Orozco, 2003). Furthermore, remittance markets are rather closed –in other words, there are objective reasons limiting the entry of new competitors– given the need for networks of correspondents and international transfers, etc.

The perception of this situation is behind an emphasis on increasing competition as part of a series of initiatives to improve the functioning of the remittance market. However, the precarious economic situation of emigrants and their families justifies attempts to reduce the cost of sending money and thus increase the amount of money they end up receiving. However, in order to evaluate properly the benefits of an increase in remittances for society in general and a country's development, it is important to measure the economic impact of remittances. The next few pages do just that.

### **The Economic Impact of Remittances**

In general there exists a positive perception of the economic impact of remittances. As we shall see, a growing mass of evidence does not refute this conclusion, although it does reveal some cases in which the favorable effect of remittances can be weakened. In any case, one must keep in mind that in the end remittances are the consequences of prior processes of emigration, with all this carries with it in terms of social, human and economic costs. Emigration involves the loss of human capital, sometimes relatively well-skilled in the source country –as we know, brain drain is a problem not limited exclusively to developing countries– and also the loss of revenue and production generated by the emigrant.

Having made this point, we will now go on to summarise the main conclusions to which the academic literature has arrived. One must note that until not long ago there was scant evidence with which to work, but recently it has multiplied with studies in the macro- and micro-economic fields. Here one can highlight the contribution made by an extensive and rigorous study done for the World Bank (2007) which is also focused on Latin America. It is the main reference source for what follows in this article.

Remittances affect individual economies in a direct way, so an initial look at their impact should be done from a microeconomic standpoint. The first factor to point out in comparison with other kinds of resources coming in from outside –such as development aid– is that they should not be administered by an intermediary entity, such as a development agency or governments. This might raise questions about the efficiency of their use at a social level, but it also avoids problems with distribution, bureaucratic hurdles and even irregular transfers that affect some other kinds of resources.

The study mentioned above suggests that remittances are not consumed entirely, to the effect that they help increase a country's rate of savings. Furthermore, the money that is spent goes mainly to durable goods, education, health care and housing. There is also some evidence that remittances encourage a greater entrepreneurial spirit among recipients and emigrants themselves, who use part of their income to set up businesses for themselves or their families. Both effects –greater savings and fuelling of entrepreneurial activity– mean that the potential for investment also increases, and it has been observed that this happens mainly in low-income households. These norms for spending stemming from remittances exert a positive effect on other social welfare yardsticks: they tend to improve human capital through a greater dedication to spending on education, allowing households to depend less on child labour. Remittances also enhance the average health of recipients and the quality of home life. This is because the head of household or relation in the country of origin can

spend more time looking after his family, or invest in improving housing conditions, or do less unhealthy work.

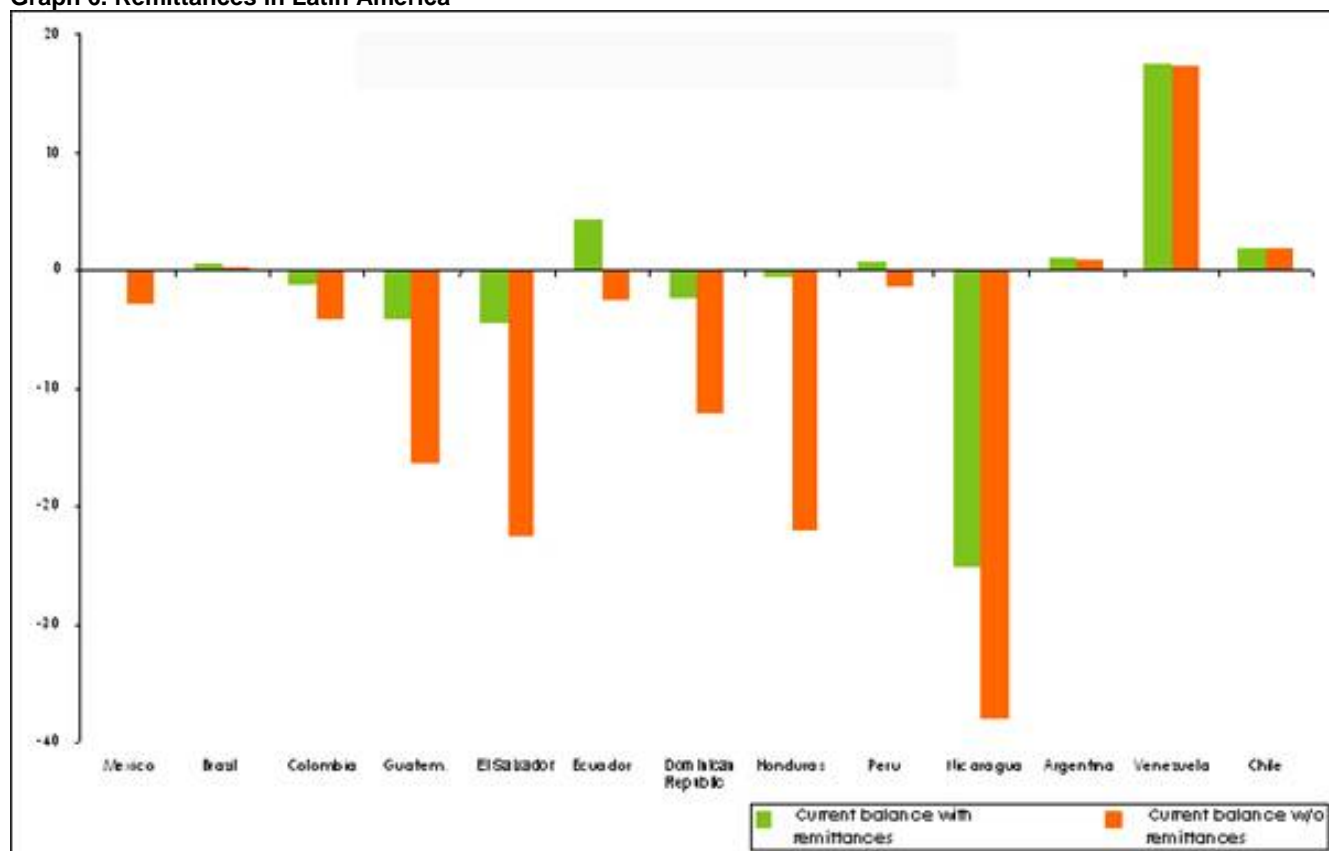
However, it is in the workplace where the research has identified some negative effects from remittances. The first one is a reduction in the labour force: part of the labour supply is removed from the market because of a greater reserve salary (the minimum for which a worker is prepared to work). However, as we have said, although it is true that often this kind of work is done in very precarious conditions and affects child labourers –and thus the reduction of this kind of work is desirable– the economic implication is that of less labour market flexibility and an upward pressure on wages. From a socio-economic point of view, the reception of remittances can also create a culture of dependency which ultimately makes the labour market more rigid. In summary, from a microeconomic standpoint remittances tend to have a positive impact, although the study we cite also finds that this is of a limited nature and varies among recipient groups, depending on their levels of income and education, country, etc.

Moving on to the macro-economic area, in other words, the impact of remittances on the large aggregates of the economy, the first factor –one we have already pointed out– is the function of remittances in external financing of the economy. In the balance of payments, the reception of remittances counts as transfer of income from abroad and therefore helps improve the current account balance (see Graph 6). But remittances are also revenue and thus make for a greater capacity for expenditure and investment by recipient countries. If this were done completely, the current account balance would suffer, offsetting the earlier effect. But, as we have said, part of the remittance money arriving in a country is saved, so the final impact on the current account balance is positive.<sup>4</sup> This effect is particularly relevant for Latin America, where external imbalances have ended up setting the stage for financial crises. And the regularity of remittances, compared to the volatility of other financial resources, and their counter-cyclical quality are two more highly positive factors because they moderate the adjustment that is necessary. Indeed, remittances help ease the vulnerability of economies that are intrinsically vulnerable. This is probably the main positive effect of remittances from a macroeconomic standpoint.

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<sup>4</sup> In a symmetrical way, remittances contribute to the current account deficit of the countries sending money. In the case of Spain, sending remittances increases the current account deficit by nearly one percentage point of the GDP, although in net terms, as we have seen, the negative balance of remittances represents just one tenth of a percentage point of GDP.

**Graph 6. Remittances in Latin America**



It has also been observed that remittances have positive effects on the distribution of wealth and easing poverty, although the results are modest: for each percentage point of increase in remittances as part of GDP, the rate of poverty goes down 0.4%; the distribution of income also improves slightly in most countries. But in both the cases of poverty and distribution of wealth, there are countries in the World Bank study in which the results are the exact opposite.

As seen in the review of macro-economic aspects, remittances tend to increase savings, consumption and investment and therefore in the aggregate of the economy they have a positive effect on growth, making it more stable. Still, the impact is quite limited. In the sample analysed in the World Bank study, it is estimated at just two-tenths of a percentage point of GDP per capita for each percentage point of increase in remittances as a proportion of GDP.

The review of the evidence on the economic effects of remittances leads one to the conclusion that, except in the case of reducing vulnerability and strengthening a country's external position, remittances do have a positive effect but it tends to be relatively small and vary from one country to the next.

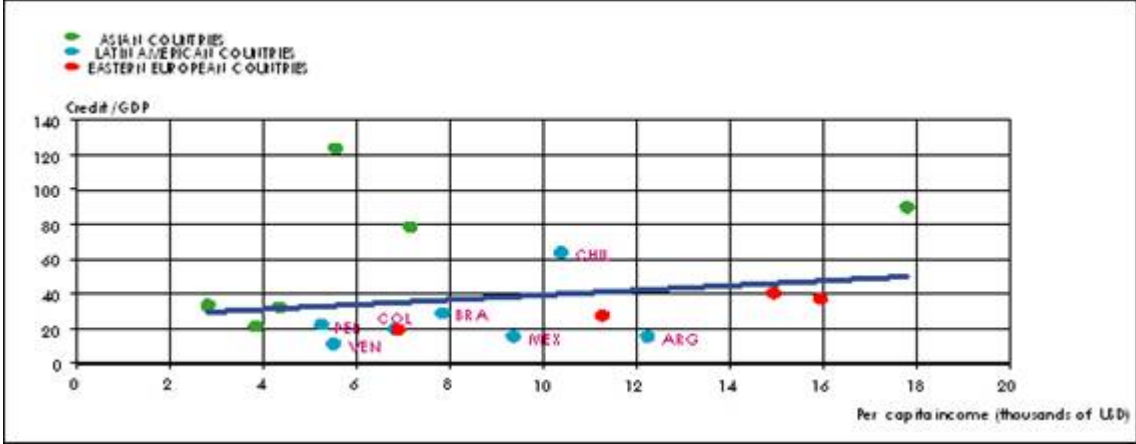
As a corollary to this conclusion, one infers that the effects of remittances depend on the individual characteristics of recipients and the structural features of the recipient countries. Therefore, as we shall point out in our conclusions, economic policy actions should have two goals: increase the attractiveness of the remittance market for its users and modify the economic and financial environment to maximise the positive impact of remittances on the economy.

### **Remittances, Financial Development and Access to Banking**

One area in which remittances have an impact that is potentially very useful is in the financial development of recipient countries, a factor which researchers have shown is fundamental for economic growth (Levine, 1997).

For the countries of Latin America this effect would be especially desirable because its financial deepening –measured as the amount of credit as a proportion of GDP– is smaller than in other developing regions, even when income level is taken into account. This under-development is observed in Graph 7, as all Latin American countries except Chile are below the line of regression calculated for all emerging countries; this means they are below the average amount of credit as a proportion of GDP for their income level. An area in *which* Latin America must move forward in order to make progress in its financial development is access to credit and financial services.

**Graph 7. Per Capita Income and Credit (average 2000-2005). Percentage of GDP and thousands of dollars.**



But the role of remittance companies as catalysts for financial development depends on how the money is channeled. The predominance of remittance agencies in the transfer of this money means that most of it remains outside the financial system. It is true that in many cases the recipient turns to collaborating banks to pick up a remittance, but seldom does the money end up deposited in an account.

So how can remittances contribute directly to financial development? By a greater use of banks. In other words, for the money to be processed through banks and held in bank accounts. On the one hand, in many countries recipients of remittances are among the poorer sectors of the population, as we have seen, and therefore they lack access to financial services; on the other hand, a constant flow of remittances could serve as collateral for a recipient to take out a loan. This money tends to be a stable resource and carry on or even increase when the financial situation of the recipient family gets worse. Furthermore, the considerable amount of remittances that some countries receive would increase substantially –if they were incorporated into the banking system– the amount of money this system could spread around as loans. Through a greater granting of credit this would increase the financial deepening in the whole of the economy.

It may be that some of these potential effects would be limited by the very characteristics of the recipients. On the one hand, we have already said that on average the savings capacity of remittance recipients is relatively limited, so bank deposits would not increase that much. On the other hand, many of those receiving remittances live in rural areas, making it hard for this money to be introduced into the banking system. However, even if usage of the banking system were limited to the sending of remittances and not the reception, this would tend to create links of trust between financial institutions and clients in both directions and improve the financial savvy of emigrants and remittance recipients. This could be a prior and complementary step to incorporating remittances into the banking system. There are other fundamentally non-financial institutions such as cooperatives, micro-credit agencies or associations that could play an intermediary role, as has been observed in some cases in the region. For all of these reasons, getting banks involved in the handling of remittances would have not only quantitative positive effects on financial development but also qualitative ones.

Among the beneficial effects of channeling remittances through the banking system we have not discussed an additional one that is more direct, and which we mentioned earlier: given the fundamental role of banks in the financial system, getting them involved in the remittance market would boost competition and thus reduce costs.

In a recent study (Alberola and Salvado)<sup>5</sup> we used a theoretical model to study the role of bank handling of remittances in reducing costs and improving living standards for families that send and receive this kind of money. In this model, banks are saddled with a competitive disadvantage with respect to remittance agencies due to the factors discussed earlier in this article (lack of trust, less efficiency in handling remittances, etc.), but this can be offset by the advantages banks have as financial intermediaries. The study points to two positive effects on living standards of emigrants and their relatives: lower costs to send money due to greater competition and the benefits of being able to earn interest on accounts holding remittances and gain access to credit. One interesting aspect of the model is that although the first benefit outweighs the second from the recipient's point of view, for banks it is essential to play the role of intermediary in handling remittances because they can make money by granting loans with funds from remittances or use this money for others kinds of investment.

What is happening in actual practice? It must be noted that in recent years, financial institutions both in Spain and in countries receiving significant amounts of remittances are developing initiatives to increase their presence in this market. It is worth pointing out, however, that with these plans the banks are not necessarily acting as financial intermediaries per se, neither in the countries sending the remittances nor in the recipient nations.

In the case of Spain, banks and savings banks are making a big effort to consolidate their presence in the remittance market, but the strategy we have observed is focused on luring emigrant customers –whose numbers and economic might are growing in Spain– but not the families in recipient countries. In fact, being able to send remittances under favourable terms is offered more as an attractive additional financial service than an end in and of itself. As for the other end of the chain, it is common for banks in the source country to hook up with agents in the destination countries, including remittance firms, to facilitate remittances' reaching targeted families, but this is done outside the banking system.

This means that in practice, incorporating remittances into the banking system in the recipient country is not a relevant element of this strategy. So even though a greater presence of banks in this market boosts competition and reduces costs, banks are not necessarily getting more involved in the recipient countries and therefore their impact on financial development in nations receiving remittances is reduced. On the other hand, initiatives carried out by some financial institutions in recipient countries do contribute directly to getting remittances working within the system and thus have a positive effect on financial development. But the scale of these operations is limited.

It is interesting to stress that the Spanish banking industry is in a good position to encourage incorporating remittances into banking in destination countries because it is one of the few nations –along with the UK, France and the US– in which financial institutions have a strong presence in countries receiving a large portion of the remittances. In the Spanish case it is Latin America. If remittances were channeled between Spanish banks and their offices in Latin America, the costs of these transfers would fall, and the speed with which they are done would rise, as they are being done by consolidated companies. Information and follow-up costs would also fall significantly, so the banks' profitability threshold would come down and there would be a major positive effect on living standards in the recipient countries.

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<sup>5</sup> For a non-technical explanation of the model, see Alberola (2006).

Why don't Spanish banks in particular and banks in remittance-source countries in general show more interest in getting this money incorporated into the banking system in the countries receiving the funds? It must not be forgotten that banks, like any other company, seek profits and therefore their operations are based on the money they expect to earn. The model we have mentioned shows that for banks the viability of this kind of operation depends on the money they can earn off families depositing remittances in bank accounts in destination countries. Therefore, if banks do not follow this strategy, it is because the expected profitability –taking into account the risk of the investment– is not enough, even though interest rates are much higher than in Spain. This is the case for several reasons –economic instability, institutional problems, property rights that are not clearly defined, uncertainty, etc-. In the end, these are the same factors that hinder financial and economic development in these countries.

### **International Initiatives to Encourage Remittances and Their Impact**

After all we have discussed, it is evident that remittances are very important in terms of economic policy. On the one hand they are a fundamental source of resources for many countries and low-income families; on the other hand there is a generalised perception that their costs are high and have much margin for being reduced. Furthermore, as we have stated, if conditions are right, remittances can be an important tool for financial and economic development in general. Finally, as international transactions they are a potential element of cooperation between governments and of attention for multi-lateral institutions.

It should come as no surprise that there has been a flood of initiatives in recent years regarding how to deal with remittances, mainly on how to lower costs.<sup>6</sup>

In early 2004 at the Summit of the Americas, presidents committed to lowering costs of sending remittances by one-half within four years. One month later the G-7 backed the initiative, which was later endorsed by the G-8 meeting of that summer. In the Iberoamerican realm there have also been parallel efforts and one of the first acts of the Iberoamerican secretariat, which began operating in 2005, was to promote a commitment to this effect. It was reached at the Montevideo summit in November 2006. It says, among other things, that 'we must facilitate the sending of remittances, reducing their cost and guaranteeing access to banking services.'

In this context, the World Bank and the Committee on Payment and Settlement Systems of the Bank for International Settlements created a working group that prepared a report on General Principles for International Remittance Services, which was published in March 2006. Its development and specifics are being carried out as Specific Directives by international financial institutions.

The five general principles are these:

- (1) Transparency and adequate protection for the consumer.
- (2) Encouraging an improvement in the infrastructure of systems for paying remittances.
- (3) A regulatory and legal system that is solid, proportioned, predictable and non-discriminatory.
- (4) Encouraging competitive market conditions, including access to domestic payment-system infrastructure.
- (5) Good governance and adequate risk management practices.

These principles are designed to reduce costs, allow users and intermediaries greater access to the remittance market and lead to greater security and transparency in these transactions. The measures identified for achieving these objectives include the following:

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<sup>6</sup> For a more detailed explanation, Fajnzylber y López (2007).

- Reducing the regulatory and bureaucratic requirements for companies to get into the remittance business.
- Transparency and ease of understanding of prices of services and encouraging comparison among prices of alternative services.
- Security with regard to illegal activities, fraud or financing of terrorism.

These principles and measures have an impact that varies in its degree of directness on incorporating remittances into the banking system, and this impact does not always work in the same direction. Thus, greater facility to access payment systems would **help remittance agencies**, which in many cases now have to turn to banks in order to use international transfer systems. On the other hand, requirements of greater transaction security would tend to help banks –with more demanding rules for transparency and identification– compared with remittance agencies which, as we have seen, traditionally have had the comparative advantage of their informal nature and the limited legal visibility of their users. In fact, Spanish legislation which recently went into effect toughens rules for identifying users and this could sap remittance agencies’ relative lure as a channel for sending remittances, especially for immigrants who do not have residency and work papers.

Aside from these generic measures, in recent years specific initiatives to bring remittances into the banking system have been observed. The first is the creation of cross-border payment systems designed for a specific kind of remittance. One that stands out is the service known as *Directo a México*, devised jointly by the Bank of Mexico and the Federal Reserve in the US. It allows remittances to be sent through banks at a much lower cost than that of alternative channels. Meanwhile, initiatives have been developed to improve access to formal remittance-sending services, particularly bank channels, both in source and destination countries. In these cases the efforts made by the authorities have also been noteworthy. Again the US case is worth pointing out, not only through *Directo a México*, but also because of the facilities that Mexican immigrants have for opening accounts in the US simply by using their consular identification number. But these efforts run up against the wariness of the immigrants themselves –many of them illegal– who fear the information will be shared with the authorities. So far the *Directo a México* service has met with little success, and at least part of this could be attributed to this reticence.

Early this year in Spain, the banking industry and savings banks signed a letter of intent with the government (the Labour and Foreign Affairs ministries) to get both sides more involved in efforts for remittances to have a greater impact on financing development in recipient countries. The government committed to improving transparency and competition in the market. A highlight of these initiatives is a pledge to bring remittances into the banking system in the destination country, both by the government and the banks. This emphasis on incorporating remittances into the banking system is particularly welcome in the context of what has been discussed in this article.

## Conclusions

In recent years remittances have become one of the main focuses of attention in development-related economic policy, in both the domestic and international realms. The reasons stem from the economic importance that remittances have taken on –which will not decline in coming years– their impact on poor sectors of the population, their multinational and inter-disciplinary character and ultimately from the perception that the costs of sending them are excessive.

The main goal of the many initiatives taken in recent years has been to lower the cost of sending remittances by encouraging competition and reducing technical, bureaucratic and regulatory barriers for sending and receiving them. Given the fall in costs that has been seen in recent years, this goal is being achieved, at last partially. And for this, all sides –users, agents and institutions– should be pleased.



Still, this article has insisted on two points we feel are fundamental for optimising the impact of remittances on economic and financial development in receiving countries.

The first is to bring remittances into the banking system in destination countries. This process is different from the one that is now being observed in actual practice, in which bank intermediaries act mainly in the source countries and use remittances as a banking service. We have stressed that in order for remittances to serve as a lever for financial deepening in the destination countries, which are the ones that need this, it is essential that banks or other financial institutions be the ones that handle remittances. This would be a decisive and direct step for enhancing access to financial services for part of the population –the one that has emigrant relatives abroad and low levels of income– which until now had been excluded from such services.

The second idea is related to the first one because it stems from the fact that banks do not seem to find enough incentives for competing to take in remittances in destination countries. While we acknowledge the importance of the ease that remittance agencies provide in transmitting and receiving remittances, the reticence of financial institutions to get involved shows for the most part that remittances are not an attractive business. To resolve this, one must go first to the primary causes, which in many cases are outside the concrete realm of remittances. Specifically, the leeway that financial institutions have to operate in receiving countries may be too restrictive to be attractive. Therefore, it is necessary to carry out structural reforms in the financial sector. It is important to sweep away obstacles for banks and their customers to operate –for instance by eliminating taxes on financial transactions which remain in effect in several countries despite the powerful dissuasive effect on financial deepening. Another step in the right direction would be to encourage the authorities to broaden access to financial services.

In the end, remittances' potential for aiding financial development depends on the right conditions being in place for them to enter the financial and economic process efficiently. Major progress has been made on some fronts, such as that of financial stability –lower inflation and fiscal imbalances-. But one must go further with others that stretch well beyond policies regarding remittances and involve destination countries addressing structural problems, with help and support from international institutions. It is at this point when the new transatlantic channel that Benedetti speaks of will flow freely and benefit everyone, but above all the people and countries that receive remittances.

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