

The role of remittances in pakistan economy economics essay



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South Asia is the source of cheap labour in the world because of growing population many developed countries focus these countries in south Asia to overcome labour shortage as well as hiring skilled labour to work in their countries. So developing Economies of Asia specially India, Bangladesh and Pakistan also supports this labour exports to empower youth and stabilize economic situation through higher remittances.

These Remittances save the economy from different financial shocks and in natural hazards as Remittances tend to grow when domestic country's economy suffers from bad situation this increase in remittance depends on intentions of remitter and his self-interest. Migrants send remittance to domestic country for consumption purpose to support their families in bad time while on other hand these remittances shows negative trend if migrants want to use these for investment purposes.

Workers remittances grows rapidly in South Asia in the last decade from 18 billion in 1980 to almost 328 billion in 2008 shows almost 18 fold increase in inward flows of remittances, Specifically Pakistan remittances depicts increasing trend and increased from 136 million US\$ in Fiscal year 1973 to 13186 US\$ in fiscal year 2012 shows 5% share in GDP significantly grows rapidly after 2001 when Pakistan becomes ally of USA in war on terror after that foreign direct investment and favourable and consistent economic policies results in increasing rapid growth of remittances inflows.

Different factors determines the inflows of remittance which includes Micro Factors(Demographic and Social factors) and Macro Economic factors such

as number of workers, black market Premium, inflation, host country income, GDP of host and domestic country etc.

Micro-Economic Factors of Remittances (Social and Demographic Determinants)

Years since worker migration

Household income level of migrant

Ratio of females in the host country

Employment status of other members of family

Professional level of migrant in the host country

Matrimonial status of migrant

Above factors determine inflows of remittances other Altruistic factor is also important because mainly remitter self-interest determines the flow of remittance mostly money is sent for supporting family. This altruistic behaviour is more prevalent when crisis situation happens in the domestic country because an immigrant wants to help their family to survive in crisis.

Macro-Economic Determinants of Remittances:

Mostly literature on remittances focus on social and demographic factors but this focus is shifting towards exploring macro-economic factors as well for building consensus on different determinants of foreign remittances.

Different factors shows consistent and significant results in literature as number of workers, wage rates and income levels but most macro-economic factors still depicts contrasting views as domestic country income, inflation, <https://assignbuster.com/the-role-of-remittances-in-pakistan-economy-economics-essay/>

exchange rate premium, Interest rate differential, GDP of domestic and host country and most importantly Black market premium etc. Below we will explain further these determinants and model;

Model:

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Where;

RM= Remittances inflows

GRO= Growth of Domestic and host countries in measured by GDP

WKR= Number of workers

WGR= Wage rates for workers earning in host country

ER= Exchange Rate

INF= Inflation in domestic country

BMP= Black Market Premium

YHOST= Per Capita income of host countries

PRK= Political Risks in domestic country

IRD= Interest Rate Differential

MGOVDMY= Military Govt Dummy

= Error Term

Explanation of Variables and Hypothesized Relationship:

Growth: This variable represents economic activity of domestic and host country measured by gross domestic product. Countries with higher GDP accelerate the flow of remittances both inward and outward. The contrasting views regarding relationship of GDP and Remittances shown in the literature. Relationship depends on motives of remitter that either he is sending money for consumption purpose or for investment purpose. Literature shows Positive relationship among GDP and Remittances if the person sending money for consumption purpose while negatively related when sending of money for investment purpose.

Number of Workers: This represents the number of Workers in the host country and earning money from occupation. More number of workers sends more money to domestic country and this significant positive relationship is also confirmed by literature on remittances.

Wage Rates: Wage rate is the remuneration paid to worker in the host country. This is represented by Per Capita income and shows positive relationship with remittances means more earnings leads to more remittances.

Exchange Rates: It is the rate against which one currency is converted to another higher the exchange rate of one currency decrease the value of other currency. Literature on exchange rate shows divergent results in literature it may affect economic growth positively or negatively depends on circumstances. If Exchange rate is higher for host country than flow of

remittances is increased towards domestic country but vice versa is true in case of investment purpose because investors will lose money in long term.

Inflation: It is the rate on which prices of goods and services are rising and purchasing power of persons falling. Different studies depicts different results on inflation and Remittances relationship as this depends on the altruistic behaviour of remitter if he send money for investment purpose than it is negatively related and on other hand if he do so for supporting his family in consumption than remittances are positively related to inflation.

Black Market Premium: It is the exchange rate of currency that differs from official exchange rate. It is used when official exchange rate bears less relationship with actual value of currency. This is prohibited by law in most of countries and absence of this exchange rate overvalues the currency this is positively related with remittances.

Income of Host countries: This represents per capita income of income of host countries. Literature shows this is positively related with the remittances flow because of higher income of immigrants they save more and send more money to domestic country.

Political Risks: Political risk is uncertainty of domestic countries this poses serious threat to remittances. in unfavourable situation immigrants hesitate to sending remittances to domestic country because of uncertainty of policies and lack of trust on ruling govt. So Political risks is negatively related with remittances more political risks leads to lower remittances.

Interest Rate Differential: It is the differential which measures the gap between two currencies interest rates it is used in forward exchange traders set a rate for trading two currencies and sets discount and premium. it shows contrasting results in literature showing positive relationship if used as incentive and negative in case of higher risks.

Military Govt Dummy: This represents dictatorship period in the domestic country indicated as dummy variable where (1) represents military Govt and (0) democratic govt. As military Govt increase risks and creates law and order situation in domestic country so this is negatively related with the inward flow of remittances.

Introduction:

Remittance play vital role in foreign exchange earnings for developing countries like Pakistan. Past three decade proves very successful for developing countries which show increasing trend of remittance inflow.

Remittance was \$18 billion in 1980 which come up \$328 billion in 2008 an increase of 18 folds. Worker's remittance for Pakistan increase over last one decade. United States, UAE, other GCC countries and Saudi Arabia accounted for over 79 per cent of total inflow of remittances in Pakistan.

Here it is important to understand the three important terms which often used further i. e. foreign exchange reserve, foreign remittance and GDP.

Foreign exchange reserve is the deposit of foreign currency held by the state bank, keeping foreign currency in hand as an asset allows government to get stable the local currency. Foreign remittance inflow is the flow of foreign currency from host country to the recipient country. GDP is a measure of the

value of the total production in a country, usually in a given year. Gross domestic product is calculated by adding together total consumer spending, total government spending, total business spending, and the value of net exports. GDP is considered one of the leader indicators of the health of a nation's economy

A question comes in every mind that why foreign remittance is so much important for developing countries? It is important because it affects numerous sector of economy, it help in developing living standard, remittance inflow do not cause any debt burden on the country which can help to develop financial sector of recipient country. Economic growth can be achieved by foreign remittance as it supports the individuals for their consumption expenditure. Role of remittance for economic development of Pakistan can never be ignored as it provide employment opportunity, poverty reduction, improve standard of living, prevent from the crises of balance of payment, increase foreign exchange reserve, less volatility on exchange rate and improved credit rating of country.

In general, when local currency appreciate then remittance growth decline due to negative relationship between them but remittance increases with the increase of real GDP growth and lower unemployment in remitting country. House hold use remittance for consumption purpose rather than investment purpose which ultimately improve their health care and education but show less role in stabilizing the economy.

Foreign remittance can be done through formal and informal way (Hawala). Remittance through formal way play positive role in developing the economy

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as these remittance are under the observation of state bank but Hawala is fast, safe and less costly way to transfer the funds. As such, it is an informal fund transfer system that works parallel but independently to the formal banking system. Such type of system was introduced to facilitate trade and facilitate the areas where normal banking systems were absent.

A customer usually a migrant worker approaches a Hawala broker and gives him a sum of money to be transferred to a beneficiary (usually a relative) in another city or country. The Hawala broker often runs a legitimate business in addition to the financial services he offers and has a business contact, a friend or a relative in this city/country. The Hawala operator contacts their Hawala partner usually a contact from their personal or business network - in the recipient city/country by phone, fax or e-mail. The operator instructs the partner to deliver the funds to the beneficiary, providing amount, name, address and telephone number of the recipient and promises to settle the debt at a later stage. The customer does not necessarily receive a receipt but is given an identification code for the transaction. The Hawala broker in the recipient city/country contacts the beneficiary and delivers the funds. The recipient can receive the funds without producing identity documents other than the previously agreed code. There is no recorded agreement or written contract for the transaction. The deal is secured by the trust between the parties with no legal means of reclamation.

Survey of Literature on Remittances Role in Economic Development

Most of the literature on the determinants of remittances depict contrasting results so for clarity of concept we will focus on review of literature of <https://assignbuster.com/the-role-of-remittances-in-pakistan-economy-economics-essay/>

determinants of remittances specifically role of remittances on economic development. We will conclude with summary findings at the end of this paper for generating consensus about the relationship of remittance on economic development.

As we know from literature it is the fact that remittances inflow smooth out consumption patterns and eliminate poverty by uplifting the households at micro level that contributes to economic development at macro level but literature on remittances on economic development depicts contrasting results, results varied from country to country and use of different estimation procedures of economic development yielded different results.

Remittances constitute large portion of remittances for any economy some time it is higher than foreign direct investments and other inflows of capital.

contributed to literature by examining the remittances impact on economic growth in the long run. Authors claim that remittances contributes large portion of earnings of developing countries which is increasing at 1% every year in over the period(1995-2004) authors argued impact of remittances on economic growth is well known that means remittances inflows leads to higher consumption. And as a result GDP is increased so because of these, policy makers show interest in the results of these research studies. Authors further analysed the impact of remittances impact on long term growth by taking sample of 84 countries using annual observations data over the period(1970-2004) authors produced results by panel growth regression method unfortunately results suggests that remittances is not significantly related to long term growth. These results might disappoint policy makers

possible reason for this might be the under developed infrastructure of channelization of remittances. In the literature endogeneity problem also present in the relationship in case of altruistic behaviour of remitter because of this lower economic performance leads to higher remittances other problem that might be prominent is the bad governance which leads to higher outward migration and increase in remittances.

For generalization of results this endogeneity problem poses a serious challenge to researchers in this area without doing these results about relationship overstated which will not be realistic and leads to wrong direction of economic policies. So For mitigating this problem of endogeneity many researchers used different techniques described below;

First study of compare the ratios of host countries income to US\$ and host countries real interest rate to US\$ by using panel data regressions utilizing data over the period(1970-1998) for annual GDP per capita by regressing worker remittances to GDP share and change in ratio and controlling other variable concluded that domestic investments and inflows of private capital is positively related to growth, gdp share depicts negative or insignificant relationship that remittances were negatively related with growth also these results holds by taking instrumental variables as solution of endogeneity.

In other study conducted by World Bank improves method for dealing with endogeneity by making the distant variable time variant by multiplying distance of host and home country with respective country's gdp or unemployment rate. Migration share is also used as instrumental variable indicates migration to top 5 OECD countries suggests that home country is

main determinant of remittances. Above instruments estimated from cross country data over period (1991-2005) other variables are controlled which includes secondary school enrolment ratio, log of gdp per capita, ratio of real imports and exports to gdp and political risks are main variables and time dummies. This estimation yielded positive relationship between remittance to gdp ratio with and without investments but without investments results becomes insignificant.

Other study by argued that solve for endogeneity by introducing distance by migrant's home country to host country author analysed by taking sample of 68 countries over the period(1980-2004). Further document that this study is different because he did not controlled investments rates concluded that total remittances to Gdp share is significantly and positively related while incorporating instrumental variables makes the results insignificant but positive.

focus on estimation of impact of foreign remittances to economic development of Caribbean and Latin American countries by adopting panel unit root, co integration tests authors also used fully modified ols methodology consisting sample of 23 countries over the period (1990-2005) results shows that remittance inflows positively related to economic development and this relationship is more strong in financially developed economies.

conducted study on MENA countries by using data from (1975-2004) by regressing remittances on GDP indicates positive and significant relationship

between remittances and output growth that indicates better channelization of remittances.

analysed remittances as stabilizer of output by using sample of 70 countries over the period (1970-2004) by estimating results use of simple ols, instrumental variables and GMM approach shows negative relationship between remittances and volatility of growth(S. D of Per capita growth) over five year period. Results suggests remittances inflows stabilize gdp per capita volatility.

Other Author tried to solve the endogeneity problem using instrumental variables and generalized method of moments method developed by in addition to simple ols and fixed effects model also used threshold estimation for robustness. Author, s main focus on link between remittances and growth also considering financial development as well. by using new dataset of 73 countries for period(1975-2002) which is measured in 5 years averages by regressing remittances to gdp per capita and gdp to growth share controlling other variables. Concluded that remittances are significantly positively related in those countries where financial sector is under developed.

investigated the relationship of remittances and its role in economic development by considering not profit inflows of remittances for consumption purpose using sample of 113 countries and panel dataset over the period(1970-1998) finds significant negative relationship among remittances and growth suggesting that does not serve as source of uplifting economy.

also analysed the direct and indirect effects of remittances on long term growth using GMM approach utilizing unbalance data of 40 countries over the period(1965-2004) concludes that remittances shows insignificant effect on growth but IRAT and M2RAT have direct effect on growth but small. Suggest policy makers to focus on short term growth and be optimistic for enhancing economic growth.

also determine the impact of remittances and macro-economic effect in Indian economy by analysing dataset over period(1971-2008) author concluded that remittances significantly and positively affects GDP, foreign reserves and investments so by channelizing remittances India can overcome the problem of scarce capital for investment.