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THE REMITTANCE INFLOWS' IMPACT ON SAVINGS IN THE SERBIAN ECONOMY

Abstract

Remittance inflows represent one of the most significant sources of foreign funding for most developing countries. These funds have also proven to be one of the most stable sources of external financing for developing countries during the past few decades and in the period of the last global crisis. They are much less responsive to economic cycles and economic shocks than foreign direct investments and other private and official capital flows. The benefits that a developing country can have from stable cash inflows are various as far as they are directed in activities that contribute to economic growth and development. Theoretically, channeling remittances into savings and investments can lead to long-term economic growth. Formal transfer of remittances through the banking system and financial markets can lead to stronger financial stability and development of new financial instruments. Since remittances reduce the volatility of GDP and may contribute to financial system development they are able to additionally boost country's growth and development. Finally, these resources significantly contribute to the fight against poverty and inequality. Taking into account all the positive impacts the remittances may have in developing countries, the goal of this paper is to investigate in further detail the relationship between remittances and savings in Serbian economy. With this analysis, we aim to test whether there is a potential for remittance inflows channeling not only in consumption, but also in various investment alternatives that could provide long-term benefits to the local economy.

Keywords

Economic Growth and Development, Financial Sector, Investments, Remittances, Savings

1. Introduction

Over the past decade remittances to developing countries have significantly increased. Officially recorder remittances have reached around USD 401 billion in 2012 and are expected to reach USD 515 billions in 2015. They remain one of the most significant and stabile external financial sources after FDI that is surpassing the level of official foreign aid and private debt and portfolio equity flows to these countries (The World Bank, 2013, p. 1). It is important to notice that unofficially transferred remittances are estimated to represent additional significant unregistered inflows. The problem of underreporting is especially pronounced in developing countries with weaker financial system and economic and political instability.

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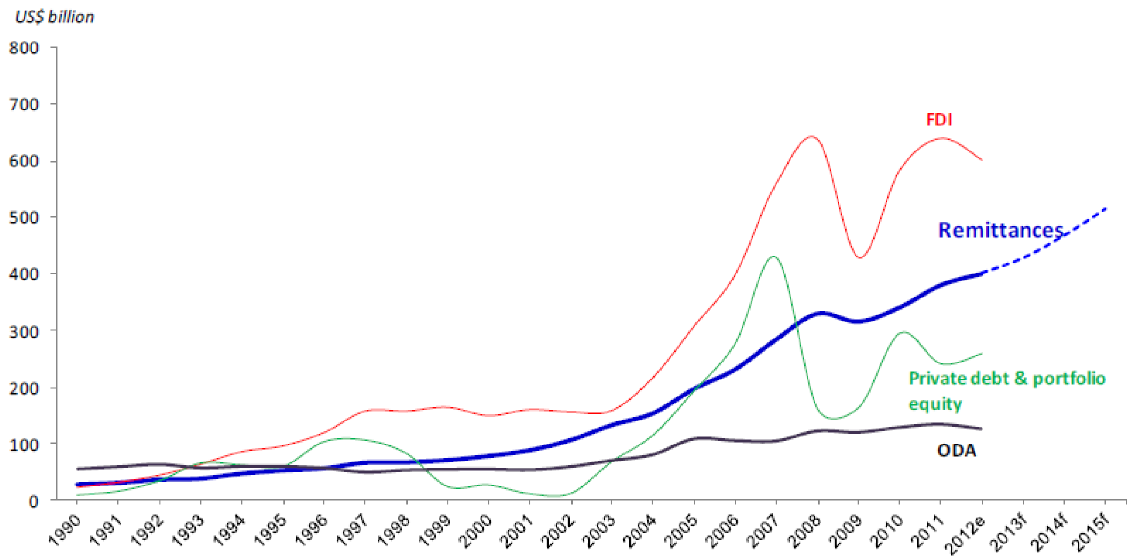

Chart 1: *Remittances and other international inflows to developing countries (The World Bank, 2013, p. 2)*

Most of the papers dealing with remittance flows to developing countries confirm their positive influence on local consumption and social position of local population. Recent theoretical and empirical studies suggest remittances' economic potential in circumstances when they are properly channeled into investment opportunities (land, housing, financial assets, microenterprises, education, etc.) that can boost economic growth.

The goal of this paper is to investigate the effects remittances may have on both, home country consumption and savings, which opens possibilities for their channeling into profitable investments. The theoretical discussion is followed by empirical evidences based on Serbian economic data. Finally, suggestions are provided for possible improvements of remittance channeling into productive uses.

2. Remittances and consumption in receiving countries

In this part of the paper we examine consumption patterns related to the inflow of remittances. The initial economic position and households' living standard are main determinants of remittances usage in the home country. Better initial economic situation allows migrants and their families to use remittances more for savings and investments. On the other side, for very poor migrants' families, the priority is to increase consumption and meet existing financial obligations rather than to save received funds.

The main motive for sending remittances to the country of origin is the concern for individuals and families. According to the so-called *Insurance hypothesis* (as it is defined in Kapur, 2003), remittances have a role of insurance in lower income countries and a significant impact on poverty and equality. Also, because they provide an additional income to individuals/households, they are critical for personal consumption in poor states. Empirical facts show that the inflow of remittances increases when home country experiences some sort of macroeconomic shock, which is in accordance with the above mentioned hypothesis. The increase of the value of remittance inflows is due to the fact that the remitter experiences a positive income shock due to the devaluation, while the receiver faces a negative income shock because of the recession. According to the results of one empirical research (Kapur, 2003) using balanced and unbalanced panel data, share of remittances in personal consumption is higher during the period of economic downturn than during the "regular" times.

Apart from this effect of poverty alleviation – resulting from the fact that remittances increase the average income and provide less vulnerability to shocks, it is especially important to emphasize their potential to increase the long-term consumption. Investing this additional income into savings, production or human capital can provide long-term benefits, by increasing the economic growth, future consumption and therefore reducing the dependence on external sources of financing.

Although savings and investments based on remittance inflows can generate various long–term benefits for individuals and the home country (see the next part of this paper), the effects they have on current consumption can also be very positive if remittances are used for consumption financing of domestically produced goods and services. Additionally, this positive effect is pronounced if that consumption provides an individual with better life conditions (household, hygiene and physical and mental well-being), which consequently increases labor productivity. As a result of higher consumption remittances also increase the amount of money collected from indirect taxes. As some previous research studies (see e.g. Kapur, 2003; Zarate-Hoyos, 2004) show remittance receiving households have higher propensity to save than non-remittance receiving households. At the same time, former households have lower income elasticity for current consumption and for durable consumer good expenditures than the later.

In literature, the negative effects of remittances were also stressed out and may include the following: inflation, depreciation, slower GDP growth, conspicuous consumption by migrants who do not invest money in productive uses, which then has a negative influence on the consumption behavior of non-migrants. Also, one additional negative effect can be found in literature – remittance receivers can lose the motive to work, because they are secured with the regular inflow of money.

In essence, the lack of productive investments based on remittances may be a consequence of insufficiently developed institutions and infrastructure which do not provide opportunities for productive and efficient usage of these resources. It is, therefore, important to emphasize that the state and the quality of institutions and regulations, and not only migrants, have the main role in channeling remittances into savings and investments.

3. Remittances and savings

Although migrant transfers to home country are mostly altruistic in nature, they may also significantly contribute to local capital accumulation. Total transfers to home country thus may be divided into two parts, remittances that support home families' present consumption, and the part that is put to savings that may potentially increase future consumption. That means that remittances may have indirect positive effects on both poverty and growth through channels such as savings and investments.

The use of remitted funds for savings and investments can be initiated either by migrants themselves or the receiving households. In general, migrants will diversify their asset by saving in both host and home country. The decision on asset allocation depends in great amount on the macroeconomic characteristics of both economies, the level of investors' protection, household characteristics (primarily original wealth level), cost of official money transfer, potential rate of return on investments, etc. Poorer families usually receive higher transfers. On the other side, investments in the home country are positively correlated with home country household resources. The wealthier migrants and their families usually save more (Osili, 2007, p. 447). Thus, there exists certain threshold income level necessary for present consumption (Balde, 2011, p. 16). If remittances received increase the income level above the threshold they may be directed to savings and investments. Investments in the host country are usually safer than investments in the home country, thus they should bring lower return to the migrant. But since home country investments have to be monitored from abroad and that effect is pronounced if the home country is less developed, that adds additional transaction costs and reduces net return for the migrant. Also, if he transfers returns generated in his origin country abroad to the country where he works, the exchange rate changes additionally affect generated returns.

The more often home country household receives the remittances from abroad within one year, the more it is inclined to potentially save some portion of that money (International Labour Organization, 2010, p. 4). However, the less developed the home country is and the less knowledge and trust is connected to saving opportunities in the local banking sector and other financial products, the more of the saved money is kept at home. The additional reason why this money sources are often kept out of banking sector include often small amounts of remittances received and high transaction cost incurred that follow remitting and depositing. In the first quarter of 2013, the global average total cost for sending remittances was 9.1 percent, as measured by the World Bank's Remittance Prices

Worldwide database.[3] In addition, local banking costs for depositing are stated to be significant although they vary among developing countries.

4. Some empirical evidence for Serbia

Remittances from abroad are a particularly significant source of foreign capital in Serbia, as their post-crisis amounts in absolute terms exceed all other categories of capital inflows from private and public sources. Unfortunately, Serbia ranks among countries with high transfer costs. The commission charges on money transfers to Serbia are, in percentages, relatively higher for smaller amounts, which decreases incentives for many migrants to send money through formal channels. The significant portion of these inflows enters the country through informal channels and is often not invested into productive activity. According to Suki, 2006, 2/4 to 3/4 of total remittances' inflows in Serbia are unregistered. The invested amounts were estimated to be insufficient and low. This may have negative long-term effects on economic growth and development.

The annual level of remittances sent to Serbia is very high (the average is EUR 2.24 billions, or 7,5% of GDP for the period 2007-2012). That is 70% higher than the average inflow of FDI in the same period. The amount of remittances sent home by Serbian migrants is estimated to have reached around EUR 2 billion or almost 11% of GDP in 2013 (the National Bank of Serbia – data at the end of the third quarter of 2013). As our previous papers show, these resources appear to be quite stable over time (Janković and Gligorić, 2012, pp. 215-236; Gligorić and Janković, 2013, pp. 212-222).

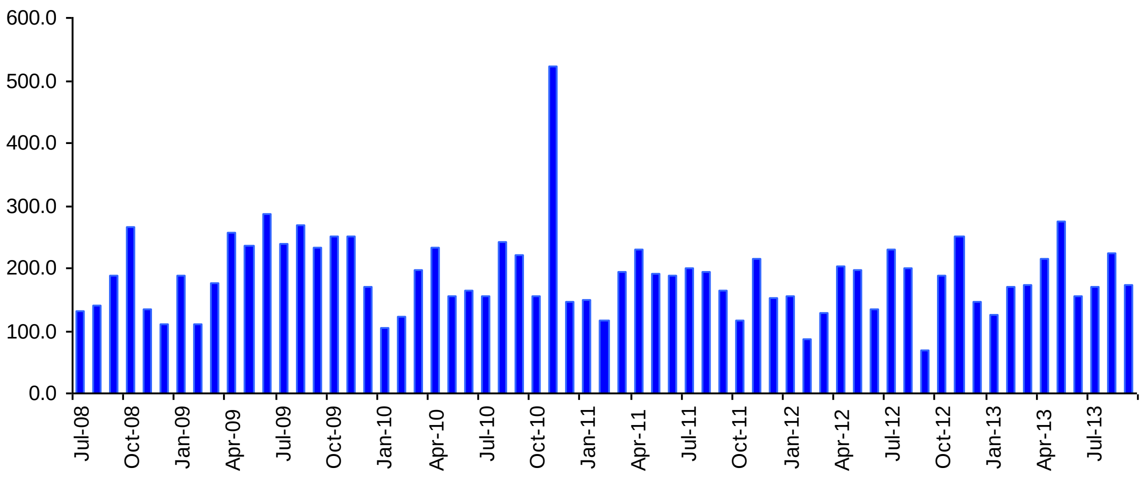

Chart 2: *Remittances inflows in Serbia, in millions of EUR (National Bank of Serbia)*

The question that remains is which part of remittances to Serbia is used for current consumption, to cover everyday needs, and how much remains for savings and investments?

[3] http://remittanceprices.worldbank.org

Because the data necessary to empirically estimate this is unavailable, we can only suppose, based on the facts that Serbia is a developing country with a relatively underdeveloped financial market, high private demand and low level of investments – that a larger part of remittances goes to current consumption and non-productive uses. The remittances sent to Serbia help local households to solve some of their financial problems and mostly are spent on immediate basic consumption. Dominant amount of these resources is altruistic in nature. Even though a certain part of remittances is used for savings, they should definitely be channeled more towards long-run development through increase in investments and production.

In Serbia we can also find a confirmation for the *Insurance hypothesis* if we take a look at data on remittance inflows before and during the crisis. Namely, remittance inflows in Serbia were extremely high in 2009 and 2010, as a consequence of providing more income to remittance receiving households in order to protect them from recession. Chart 3 presents the share of remittances in individual household consumption. It shows that this ratio has increased from the average of almost 14% in 2007 and 2008 to the average value of 19.5% in 2009 and 2010, but it decreased again in 2012 and 2013, when domestic economy started to recover.

Still, because of a high dependence on imports, we think that remittances in Serbia have significant influence on local currency appreciation, which consequently has an adverse impact on the trade deficit.

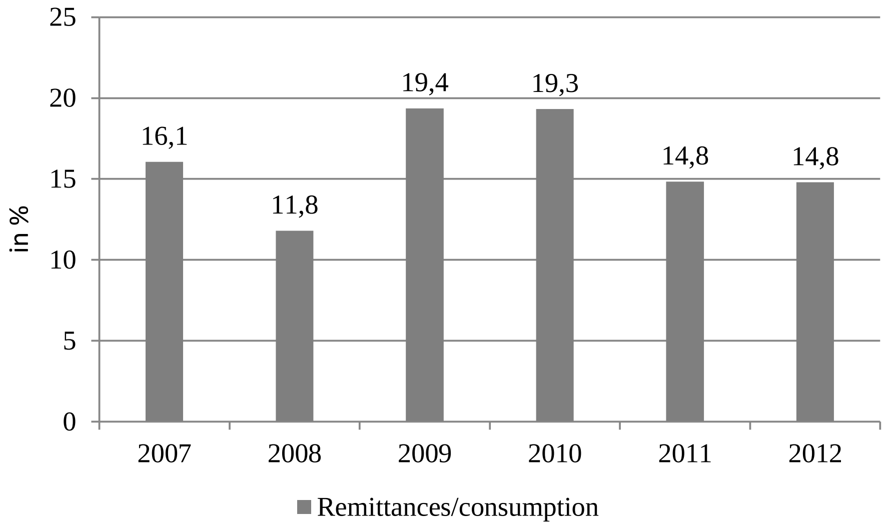

Chart 3: *Serbia: Share of remittances in individual consumption, 2007-2012, in % (Authors' calculations based on data from Statistical Office of the Republic of Serbia and National Bank of Serbia)*

In one survey that examined development financing and the remittance market in Serbia and Switzerland it is stated that (SECO, 2007, p. 17): "Migrant-sending households in Serbia use most of their remittances sent from Switzerland to help pay for recurrent living costs and basic needs. This is particularly true among older recipient households. Remittances are most commonly spent on: utilities (water, electricity, and gas), phone service, petrol for cars and farm machinery, food, medicine and healthcare, household appliances and furniture. Remittance income is very rarely used to pay for non-essentials. Beyond consumptive expenditures, recipients also use remittances for social expenditures such as basic education and health care, although at much lower rates".

Although the deposit base of the banking sector in Serbia is constantly growing, it is estimated that large number of remittances receivers keeps their savings outside of the formal banking and broader financial sector. However, it is important to note that official estimates on the level of remittances received are partially based on the household savings in the banking sector, indicating that some smaller amount of this resources passes through, predominantly, transaction deposits and short-term savings accounts to consumption. Thus, investments of these funds in longer-term sustainable economic activities are, for now, quite limited.

Since Serbia faces low external capital inflows based on FDI, portfolio and other investments, and at the same time copes with big external inequalities (high public and total foreign debt, high current account deficit), very limited opportunities and unfavorable borrowing conditions, as well as slow economic recovery in Europe and the rest of the world, money from remittance inflows will become even more important in the following period. Therefore, economic policy should be oriented and "wisely" devised to channel this stable and high inflow of money into productive uses. Giving up a part of current consumption for the sake of providing future growth and the prospect of larger consumption, as well as stronger economy and consequently better living conditions for all citizens, should be well devised and infrastructurally and institutionally supported by the state.

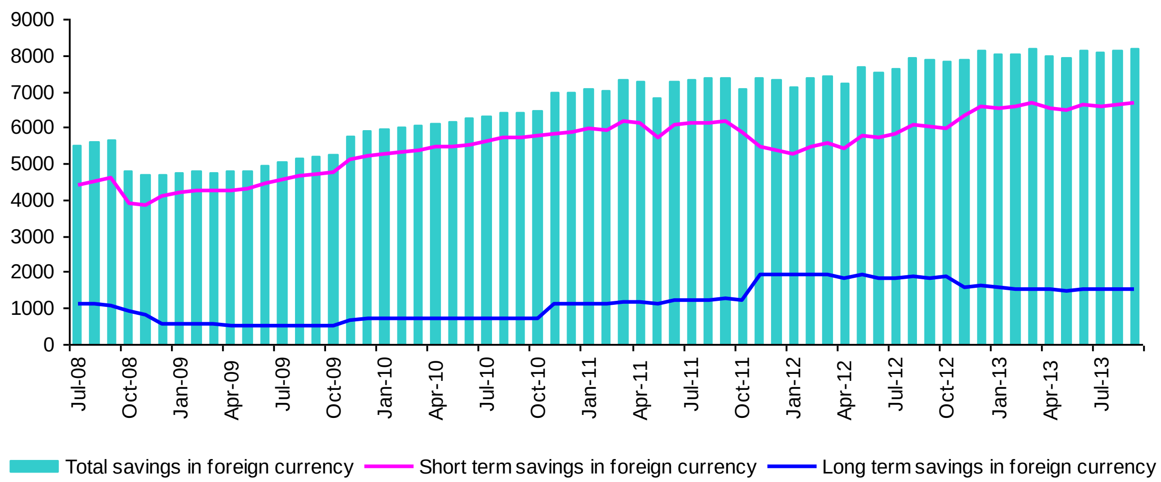

Chart 4. *Total, short-term and long-term household savings in foreign currency, in millions of EUR (Authors' presentation based on the National Bank of Serbia data)*

This is a reason why we continue with main recommendations for developing countries and Serbia that could stimulate more significant remittances' transfer through formal channels with clearer orientation on savings and productive investments.

5. Recommendations for greater remittances' channeling into savings and investments

Recommendations for more efficient channeling of remittances into savings and investments include:

- Better coordination between national authorities of remittance sending and receiving countries and reduction of administrative constraints for efficient remittances' transfer. Regulatory authorities in sending and receiving countries should enter into bilateral agreements in order to formalize and facilitate transferring, recording and channeling of funds. The process could take the form of a public-private partnership, with participation of financial institutions. In addition, a unified clearing system could be developed for all countries involved in this process.
- Higher efforts of monetary authorities in recording and channeling of remittance flows (some African and European banks have established agencies in countries with high migration to capture migrants' savings and help them channel these resources into productive uses in their home countries).
- A greater role played by banks in the transfer of remittances should lower transaction costs and increase the transfer speed and reliability of these resources. The decrease of transaction costs for remittance transfer and depositing in both urban end rural areas demands closer mutual cooperation between banking sectors in sending and receiving countries and also with Money Transfer Agencies. This should lower transaction costs of transfers and accelerate the sending of remittances through formal channels.
- A more developed infrastructure that supports money transfers from abroad would at the same time facilitate access to other financial services (such as current accounts, savings accounts, and credit instruments) for a broader population, which would, in turn, foster the development of the country's financial sector. This would also allow these institutions to encourage entrepreneurship and other investments by using the funds received to attract deposits and offer loans, advisory services, insurance and custody operations.
- Increased competition between formal transfer intermediaries and lower costs of transfer services would increase migrant interest in sending remittances through formal channels that provide numerous benefits to recipients, such as easier access to financial institutions, cheaper finance for the broader public, lower cost of investments due to more options for diversification, and better education of receivers about alternative forms of employing funds.
- Further development of formal channels for remittances' transferring could be based on creation of innovative products that would make it possible for migrants to directly invest into their home countries in land, real estate, education, microenterprises, insurance, etc. This proposal includes development of remittances-backed financial products (remittance backed micro loans, consumer loans,

educational loans, car loans, loans for houses/construction, loans for development of agricultural firms, event financing schemes, medical insurance products, etc.);

- Investments based on remitted funds could be additionally stimulated by creating a better climate for investing, as well as with incentives for putting funds to productive use (e.g. tax breaks, etc.).
- Very important aspect for more effective remittance channeling into investments that could boost economic growth is comprehensive education of remittance receivers about possible savings and investing schemes.
- Finally, the gradual regulation of remittance flows would be desirable, so that they could be better studied and this segment of the market developed without excessive government intervention that could abrupt additional inflows of these funds.

These and other possible improvements of the regulatory environment and financial system could contribute to greater remittances' inflows into Serbia through formal channels and their more efficient channeling into investments, which is expected to have a positive impact on economic growth and development of the country.

6. Conclusion

Remittances can play a significant role in home country development through both, poverty reduction and savings. Migrants' savings have a potential to increase investments and indirectly economic growth in labor exporting countries. The distribution of received resources between consumption and savings depends in large amount on migrant and home family income distribution. The large amount of transferred resources still reaches the receivers through informal channels. In this paper we have provided some recommendations that could help remittances channeling into productive uses via formal intermediaries. There still exists a big potential for financial institutions in Serbia to attract unused savings of those receiving remittances into financial system.

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