The Role of Remittances in Financial Development in Fiji

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Abstract

Using time series data this study examines the impact of remittances on financial sector development on the supposition that money transferred through financial institutions enables the recipients to gain access to other financial products and services, which they might not have otherwise. The empirical results show that remittances increase the efficiency of Fiji's financial system through the proliferation of money transfer facilities and development of other financial products and services. Other factors such as the quality of legal institutions in the country, inflation, capital account openness and financial market liberalization are crucial for the development of the financial sector through various other channels.

Introduction

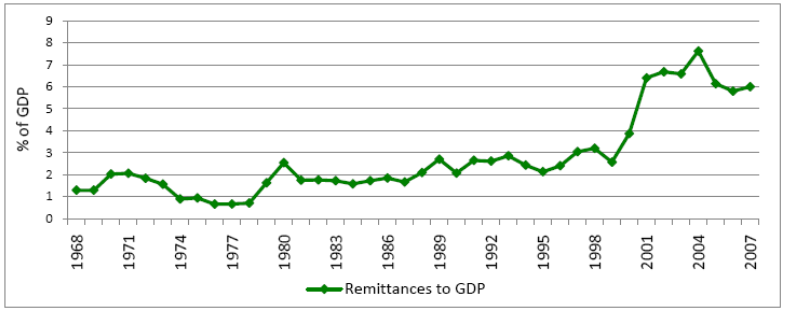
International migration and remittances have become an important area of focus for many developing countries. Remittances by international migrants to their countries of origin constitute the largest source of external finance for several developing countries after foreign direct investment (Fajnzylber and Lopez, 2008; Ratha, 2007). With the increasing volume and stable nature of remittance flows to developing countries, assessment of the development impact of remittances along various dimensions such as economic growth, inequality and poverty, human capital and entrepreneurial development has gained growing interest. However, despite the increasing importance of remittances, the relationship between remittances and economic growth has not been adequately studied on

specific country basis. This is because remittances are used mostly for consumption so they may have a minimal impact on long-term growth of the recipient country.

Whether and how remittances might affect financial development is *apriori* unclear. However, the notion that remittances can lead to financial development in developing countries is based on the concept that money transferred through financial institutions paves the way for recipients to demand and gain access to other financial products and services, which they might not have otherwise (Orozco and Fedewa, 2005).

Fiji has experienced an exodus of skilled labour over the last two decades; this includes the number of migrants taking up short-term overseas employment. These factors explain the inflow of remittances, which has been generally increasing since 1980s (Figure 1), a period which also marked the commencement of financial sector reforms in the country. The increasing trend from 2000 is noteworthy. As a share of GDP, remittances were around 4 percent in 2000 which increased to 6.4 percent in 2001 and 6.7 percent in 2002.

Figure 1: Remittance Flows to Fiji (% of GDP), 1968-2007



Source: World Bank (2008), Reserve Bank of Fiji (personal communication, 2007).

Against this background, this study attempts to fill the gap in existing literature by empirically evaluating the impact of remittances on Fiji's financial sector development. In doing so, the paper seeks to explain whether reforms in the financial sector have facilitated remittance flows. From a policy point of view, this study, to the best of our knowledge is the first study that models remittances-financial development nexus within a time series framework.

The econometric methodology applied to investigate remittances-

financial development nexus is the Autoregressive Distributed Lag (ARDL) approach to cointegration.

Remittances and Financial Development: The Theory

The financial system of a country is important because it performs a number of key economic functions. In particular, Levine (1997) emphasizes four key roles of the financial sector that includes mobilizing of savings (thereby creating concentrations of capital that allow exploitation of economies of scale), allocation of capital (helping judge where returns are most likely to be obtained), monitoring the use of the loanable funds by entrepreneurs, and transforming risks by pooling and repackaging them. In this regard development of the financial systems has been shown to foster growth and reduce poverty (King and Levine, 1993; Levine, 1997; Rajan and Zingales, 1998; Beck, Levine and Loayza, 2000a, 2000b; Beck, Demirguc-Kunt, and Levine, 2004).

Remittances as financial flows are inevitably linked with financial systems. Using a newly-constructed dataset for remittances covering about 100 developing countries Giuliano and Ruiz-Arranz (2006) find that the impact of remittances on growth is not significant when remittances are simply added as an explanatory variable in a growth regression. They note that the impact of remittances on growth may depend on some structural features of the economy and find evidence that remittances enhance growth in countries with less developed financial systems by providing an alternative way to finance investment and helping overcome liquidity constraints.

The notion that remittances can lead to financial development in developing countries is based on the concept that money transferred through financial institutions enables recipients to demand and gain access to other financial products and services, which they might not have otherwise (Orozco and Fedewa, 2005). Providing remittance transfer services also allows banks to 'get to know' and reach out to unbanked recipients or recipients with limited financial intermediation. For example, remittances may have a positive impact on credit market development if banks become more willing to extend credit to remittance recipients because the transfers they receive from abroad are perceived to be significant and stable. Furthermore, because remittances are typically large, recipients may need financial products that allow for the safe storage of these funds, even if most of these funds are not received through banks. For the households that receive remittances through banks, there are chances that they learn about the potential financial products and thus demand for the same.

Orozco and Fedewa (2005) discuss recent efforts by banks in Latin America to convert remittance recipients into bank clients.

Remittances,on the other hand,can also have negative effects. They can create a dampening effect on the credit market as individuals may lower their demand for credit because their funding constraints are met by inflow of remittances (Aggarwal et al., 2006). Another instance where remittances may not lead to an increase in private sector credit is when these are used to finance government expenditure. Yet again remittances might not increase bank deposits when they are immediately consumed or where remittance recipients distrust financial institutions and prefer other ways to save these funds.

Existing evidence of the impact of remittances on financial sector deepening is limited. Hunte (2004) uses cross-country panel data for 18 developing countries to uncover the positive and significant relationship between remittances and financial deepening. Aggarwal et al., (2006) use balance of payments data for over 90 developing countries for the period 1975-2003 to establish a positive relationship between remittances and financial development. However, this study looks at the combined effect on all developing countries and does not test whether this relationship holds across regions.

An extension to this study was World Bank (2006a) in which the regional aspect, specifically for Latin America, was looked at and was also complemented with a micro level analysis. The macro level analysis suggests that overall remittances have a positive impact on the financial development of developing countries, but this effect is smaller for Latin American countries. The micro level analysis reveals that while there is evidence that the likelihood of using deposit accounts is higher among remittance recipients, no such effects are present thus far when it comes to bank credit (World Bank, 2006a).

Gupta et al., (2007) similarly follow the specification of Aggarwal et al., (2006) and investigate the impact of remittances in Sub-Saharan Africa using an unbalanced panel of 44 countries over six time periods. Their findings show that remittances which are stable, private flows have a direct effect on mitigating poverty and promoting financial development. Shahbaz et al., (2007) use annual time series data for Pakistan to test whether remittances promote financial sector's performance both in the short and long-run. They use ARDL and Johansen cointegration approaches for robustness of long-run relationships among the concerned variables and find that remittances promote financial sector in the long run.

The use of specific variables are vital, as noted in the studies by Ag-

garwal et al., (2006), World Bank (2006a), Gupta et al., (2007) and Peria et al., (2008), in explaining the remittance and financial development effects.[1] Shahbaz et al., (2007) argue that improvement in the efficiency of the financial sector in the current period is also enhanced by policies and development of the financial sector in the previous period. The issues discussed here are taken into consideration in the empirical analysis.

Empirical Analysis: Model Specification, Data and Methodology

Using the analytical framework discussed above, this section presents the empirical model utilized to examine the impact of remittances on Fiji's financial sector development. Equation (1) represents the model estimated for the period 1968 to 2007. Appendix Table A1 presents the summary statistics for the financial development variables used in the study. The equation takes the following specific form:

$$FD = \lambda_0 + \lambda_1 REM + \lambda_2 LYPC + \lambda_3 INF + \lambda_4 CAP + \lambda_5 FL + \eta_t \quad (1)$$

Where *FD* Credit to the private sector as a share of GDP (proxy for financial sector development);

REM Remittances as share of GDP;

LYPC Log of real GDP per capita;

INF Annual inflation rate;

CAP Capital account openness measured as a sum of FDI and foreign aid as a share of GDP;

FL Dummy variable employed to capture the effects of financial liberalization; after 1980 it takes the value of 1 and 0 otherwise; and

η_t Random error term assumed to be normally distributed with mean zero and variance σ^2

Remittances are expected to increase the efficiency of the financial system, hence the expected sign for λ_1 is positive. It is, however, noted

[1] These studies use the ratio of bank credit to the private sector and the share of bank deposits (percentage of GDP) as proxy for financial development. Other variables are the log of real GDP (measure of the country size), log of real GDP per capita (measure the level of economic development), inflation, presence of dual exchange rate rates, trade openness, capital account openness (other flows to GDP ratio), corruption, internal conflict and political risk. Additionally, these four studies control for random and fixed effects and reach the same conclusions. However, in a time series analysis Shahbaz et al., (2007) use the lag of the dependent variable (ratio of the bank credit to the private sector expressed as a percentage of GDP) in their analysis.

that remittance data used in most studies (including this study) is limited as it does not give a total picture of the size of remittance flows given that large sums of remittances are transmitted through informal channels. According to the *2006 Global Economic Prospects* around 50 percent of the remittances are under recorded as they are transmitted through informal channels (World Bank, 2006b).[2]

The log of real GDP per capita (*LYPC*) measures the level of economic development of a country, which has the potential to affect its financial development. Financial sector development requires paying fixed costs that become less important, thus, the larger the size of the economy, the richer the country (Aggarwal et al., 2006). Also, GDP per capita can be used as a proxy for the quality of legal institutions in the country which have been shown to have a positive impact on financial development (Honohan, 2004; Aggarwal et al., 2006). Thus λ_2 is expected to affect financial development positively.

Inflation (*INF*) retards the development of the financial sector through its detrimental channels. Boyd et al., (2001) state that inflation distorts economic agents' decision making regarding the nominal magnitudes, discouraging financial intermediation, and promoting savings in real assets. Thus λ_3 is expected to be negative. Capital account openness (*CAP*) measured by the share of other flows to GDP has a positive impact on financial development, thus λ_4 is expected to be positive (see Chinn and Ito, 2002 for details). The liberalization of the financial system by way of interest rate removal promotes financial sector development (Dermirguc-Kunt and Detragiache, 1998). Financial sector reforms in Fiji have been undertaken since the 1980s, thus it is expected to have a positive impact on financial sector development, hence a positive λ_5 is expected. The data for Fiji's credit to the private sector as a share of GDP, annual inflation rate, GDP per capita and capital account openness have been sourced from the World Bank (2008). The dataset for remittances has been sourced from the RBF (personal communication).

The methodology used to estimate the relationship between remittances and financial development is the ARDL approach to cointegration developed by Pesaran and Pesaran, (1997); Pesaran and Shin, (1999); and Pesaran et al., (2001). The ARDL method does not involve pre-testing of the variables. In other words, the ARDL approach to testing for the existence of a long-run relationship between variables (in levels) is applicable

[2] Narube (2005) states that for Fiji unrecorded remittances are over F$150 million. The impact of remittances on the recipient countries can be much more pronounced if informal remittances can be captured in the formal statistics.

irrespective of whether the underlying regressors are *I*(0), *I*(1) or mutually cointegrated. The statistic underlying the procedure is the Wald or *F*-statistic, which is used to test the significance of lagged variables under consideration in a conditional unrestricted error correction model (ECM) (Pesaran et al., 2001). Amongst the other advantages, the ARDL method of cointegration analysis is unbiased and efficient as it also performs well in small samples.[3] This approach is used as the long and short-run components of the model and can be estimated simultaneously, removing problems associated with omitted variables and autocorrelations.

The two-step procedure used in estimating the long-run relationship is, first, an initial investigation of the existence of a long-run relationship among the variables is preceded by an estimation of the short and long-run parameters; the second step is only possible if a long-run relationship is established in the first step. *F*-tests are used for testing the existence of the long-run relationships.[4] Microfit econometric package developed by Pesaran and Pesaran (1997) is used to estimate the model.

Empirical Results

In the first step the existence of a long-run relationship among the variables in equation 1is investigated. The estimated results of the bounds tests are given in Table 1.

Table 1: Bounds *F* tests for Economic Growth Models

Equation	k	Critical Value Band Intercept & No Trend*		Calculated *F*-Statistic	Pass/Fail
		I(0)	*I*(1)		
Equation (1)	4	3.82	5.12	7.83	Pass

Note: k = number of variables in the regression and * is the 1% significance level.

[3] Gounder in her various studies (1999, 2001, 2002) utilizes the ARDL methodology in the empirical analysis of political economy and development, aid-growth nexus and the governance-growth relationship for Fiji.

[4] The null hypothesis of no cointegration amongst the variables is tested against the alternative hypothesis (of existence of a unique long-run relationship amongst the variables). If the computed *F*-statistic falls either above or below the critical values of the band then a conclusive decision can be made without knowledge of whether the underlying variables are *I*(0) or *I*(1). However, if the computed *F*-statistic is in the bounds of the critical values then information on the order of integration is required before making decisions regarding the long-run relationship of the variables. The appropriate critical values of the F-statistics for different number of regressors are tabulated in Pesaran and Pesaran (1997).

The computed *F*-statistic for equation (1) is higher than the upper bound critical value at the 1 percent level which confirms that there is a unique long-run relationship between the regressors.

Table 2: Remittances-Financial Development Nexus – Fiji
(Dependent Variable: Credit for Private Sector as a Share of GDP)

ARDL Estimates		Long-Run Estimates	Short-Run ECM Estimates	
Variable	**Coefficient**	**Coefficient**	**Variable**	**Coefficient**
FD_{t-1}	0.72			
	(8.98)***			
REM	0.09	0.33	ΔREM	0.09
	-0.56	-1.23		0.56
LYPC	16.76	59.29	ΔLYPC	16.76
	(2.56)**	(2.78)***		(2.56)**
INF	-0.05	-0.19	ΔINF	-0.05
	(-0.45)	(-0.46)		(-0.45)
CAP	0.11	3.64	ΔCAP	0.11
	-0.55	(3.04)***		-0.55
CAP_{t-1}	0.39		ΔCAP_{t-1}	-0.53
	(2.18)**			(-2.61)**
CAP_{t-2}	0.53			
	(2.60)**			
FL	2.83	10.01	ΔFL	2.83
	(2.03)*	(2.58)**		(2.03)*
Constant	-56.68	-200.52	ΔConstant	-56.68
	(-2.67)**	(-2.69)**		(-2.67)**
			ECM_{t-1}	-0.28
				(-3.54)***
Adjusted R^2	0.94			0.27
F-statistic	71.43			3.13
$SC\chi^2(1) = 0.02$, $FF\chi^2(1) = 0.38$, $N\chi^2(2) = 0.53$, $H\chi^2(1) = 0.66$				

Notes: ***, ** and * are the levels of significance at the 1, 5 and 10 % levels of *t*-ratios written in brackets. Test descriptions are as follows: Adjusted R^2 is the coefficient of determination, adjusted for the degrees of freedom. SC stands for serial correlation. FF is Functional Form. N is the normality of the residuals and H stands for Heteroscedasticity. The critical values of the chi-square distribution for the tests are: $\chi^2(1)=6.63$, $\chi^2(2)=9.21$.

Having established the existence of the long run relationship (Table 1), the next step estimates the remittances-financial development effect. The empirical results are reported in Table 2. The model diagnostics perform well in terms of the adjusted R^2 and *F*-statistics and are significant at the conventional levels. Tests for serial correlation, functional form, normality of the residuals and heteroscedasticity indicate no concerns.

The remittances variable (*REM*) is positively related to financial development but is not significant. The results compare well with that of Hunte (2004), Aggarwal et al., (2006), World Bank (2006a), Shahbaz et al., (2007), Gupta et al., (2007) and Peria et al., (2008) who find that remittances exert positive impact on financial development of the recipient country. The insignificance of the estimated coefficient in the case of Fiji can be attributed to the underdeveloped technology supporting international funds transfer within Fiji's commercial banking sector. Shaw (2007) states that bank-based transfer options are uncompetitive and expensive in Fiji as a result of which most remittances are not deposited. The results suggest that remittances may be used for household consumption purposes, thus rarely entering the banking system thereby failing to create the multiplier effects for financial sector's growth.

The reform initiatives such as the provision of rural banking services began in only 2004 with the Australia New Zealand (ANZ) Bank taking the lead role. Such reforms can successfully help formalize remittances and thus deepen Fiji's financial sector.[5] However, as Shaw (2007) notes, rural banking services are currently confined to the island of Viti Levu, while other commercial banks have demonstrated little interest in developing a low-end rural customer base. This implies that the impact of remittances on Fiji's financial sector development is subject to the successful implementation of the reforms targeting unbanked remittances. Compared to other international capital flows (i.e. Foreign Direct Investment (FDI) and foreign aid) remittances as a share of GDP is relatively smaller for most of the estimation period hence remittances, though inducing a positive impact, do not have a significant effect on financial development.[6]

The log of per capita GDP (*LYPC*) is a measure of economic development. It has a positive and significant long-run coefficient which implies that increases in the size of the real GDP per capita improves the

[5] See Jayaraman, 1996 on financial deepening in Fiji.

[6] The studies by Gounder (1999, 2001, 2005) on the contributions of private capital, FDI and foreign aid in the case of Fiji notes the contribution of these capital flows to economic growth.

performance of the financial sector. Gounder (2007) states that in the case of Fiji, the rise in labour demand due to globalization has a substantial positive impact on the economy while also increasing the per capital income of the recipient households. The findings for Fiji are consistent with the findings of Aggarwal et al., (2006) in the case of 99 developing countries where financial development is seen to be positively affected by GDP per capita. Shahbaz et al., (2007) and Gupta et al., (2007) similarly find positive and significant impact of per capita GDP on financial development, albeit a smaller magnitude.

Inflation (*INF*) affects financial development negatively as indicated by the negative long-run coefficient; this impact, however is not significant. Studies by Aggarwal et al., (2006) and Shahbaz et al., (2007) similarly established that financial development is negatively influenced by inflation.

The capital account openness (*CAP*), measured as a sum of FDI and foreign aid to the share of GDP, has a positive coefficient and is significant at the one percent level. The magnitude of the coefficient is larger than that for remittances, as Fiji is a recipient of various forms of aid and at the same time attracts foreign investments. In their study on Sub-Saharan Africa, Gupta et al., (2007) find that capital account openness is associated with greater financial development while Aggarwal et al., (2006) find that the size of capital inflows appear to have no effect on the development of the financial sector in their cross-sectional study.

Liberalization of the financial sector, measured with the dummy variable (*FL*) contributes positively and significantly to Fiji's financial sector development. The results suggest that reform efforts (since the 1980s), which took various forms including the deregulation of interest rates, equity market development, removal of priority sector lending requirements, reduced controls over foreign entrants and increased availability of bank credit, have indeed contributed to financial sector development in Fiji. The findings of Aggarwal et al., (2006) differ in this regard. They measure financial liberalization with a dummy for periods of liberalization only in domestic interest rates and find that the same has not been effective on financial development. In the case of Fiji the dummy variable captures the effects of the consolidated reforms since 1980; the results show that these reforms are a significant contributor to financial sector development.

The error correction term (ECM_{t-1}) of the financial development model has a negative and significant coefficient suggesting that the model is error correcting and dynamically stable. It is significant at the one percent level, ensuring that the series is non-explosive and that long-run

equilibrium can be attained. The coefficient of -0.28 implies that a deviation from the long-run inequality in this period is corrected by about 28 percent in the next period.

Conclusion

The paper examines the impact of remittances on financial sector development in the case of Fiji. The results of the empirical study show that remittances have a positive but weak effect on financial development. This may reflect the possibly substantive use of remittances for household consumption which contributes to unbanked remittances. High costs of money transfers also discourage the use of formal means of money transmission, thereby, retarding growth of the financial sector. Whilst reform initiatives such as rural banking services can help formalize unbanked remittances, the results for Fiji broadly imply that the financial system must be made lucrative to encourage its use amongst economic agents' that will stimulate growth in the financial sector.

Other factors like the level of economic development and capital account openness, including flows of foreign direct investment and foreign aid, contribute towards financial sector growth in the long-run. Also Fiji's financial sector reforms contribute significantly to the sector's development, implying the need for reforms that address high cost structures and domestic regulatory or payment system that contribute to unbanked remittances. Easing these may eventually multiply the effects of migrants' dollars and thus contribute substantially to financial sector development in a sustainable manner.

Appendix Table A1:
Summary Statistics of Financial Development Variables

Variable	Annual Averages for 5-year Sub Periods							
1968-2007	1968-1972	1973-1977	1978-1982	1983-1987	1988-1992	1993-1997	1998-2002	2003-2007
FD Mean = 26.81 (9.72)	12.96	16.45	20.23	25.64	33.69	38.51	28.81	38.16
REM Mean = 2.75 (1.88)	1.70	0.94	1.68	1.71	2.42	2.57	4.54	6.43
LYPC Mean = 3.43 (0.12)	3.28	3.37	3.40	3.37	3.39	3.44	3.46	3.70
INF Mean = 6.30 (4.49)	8.23	11.42	9.32	4.78	7.50	2.92	2.76	3.51
CAP Mean = 5.40 (2.25)	6.75	5.44	5.37	4.65	7.43	5.24	3.60	4.76

Notes: SD is standard deviation.
Source: World Bank (2008b), RBF (2007).
Legend: *FD* is credit to the private sector as a share of GDP (proxy for financial sector development); *REM* is remittances as share of GDP; *LYPC* is log of real GDP per capita; *INF* is annual inflation rate; *CAP* is capital account openness measured as a sum of FDI and foreign aid as a share of GDP; and *FL* is *d*ummy variable employed to capture the effects of financial liberalization in Fiji, period after 1980 takes the value of 1 and 0 otherwise.

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