Pattern seen in governments' currency policies

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Every day around the world, vast numbers of migrants wire money back to their home countries, trying to support families and friends in need. In fact, these transfers of money -- 'remittances' -- constitute a significant part of the global economy.

Consider that in El Salvador, Haiti, Honduras, and Jordan, the level of remittances exceeds 15 percent of each nation's gross domestic product (GDP), the value of all goods and services produced annually. In 2004, 42 countries in the developing world received remittances greater than 5 percent of GDP. Or try this for perspective. There are about 31,000 McDonald's franchises around the world, often serving as symbols of unstoppable globalization. But there are 410,000 worldwide offices of the money-transfer firm Western Union, notes David Andrew Singer, an assistant professor of political science at MIT, and remittances are a rapidly growing phenomenon. Money transfers to developing countries totaled $31 billion in 1990, but more than $300 billion in 2007.

Indeed, as Singer has discovered in new research, migrants send so much cash sloshing around the globe that it has a major impact on one of the highest-level decisions governments in the developing world make: The more remittances that flow into a country, the more likely that country is to fix its exchange rate, a critical policy matter that often dictates how much control a country has over the state of its own economy.

“This is a tremendously important, highly political decision,” says Singer. “It affects everybody in society, whether they know it or not.” And yet, as Singer points out in a new paper, “Migrant Remittances and Exchange Rate Regimes in the Developing World,” to be published in the *American Political Science Review*, in order to predict what a country’s exchange-rate policy will be, it makes sense to look beyond the corridors of power and follow the money moving through those Western Union offices, one wire transfer at a time.

Fixed rate or floating currency?

Many people think about exchange rates only when they are traveling abroad. Americans, for instance, know a strong dollar helps their purchasing power in foreign countries. But there is a clear benefit to having a relatively lower-value currency: It allows a country’s exports to be purchased more widely around the globe, a particular benefit in hard economic times. So there is no one-size-fits-all rule about whether it is good to have a strong currency. It depends.

A separate but related question is whether a country should fix its currency at a certain value, or let it fluctuate in international markets. A government that opts for flexibility can cope with a sudden economic downturn by devaluing its currency, in order to keep its businesses selling goods abroad — which means those firms are still employing people and keeping the national economy churning. (Although, in such circumstances, imports will become more expensive.)

By contrast, notes Singer, “When you fix your exchange rate, you can’t adjust your monetary policy to changing economic circumstances. You tie your own hands.”

And yet, developing countries have particular reasons to set their currencies at fixed rates. “With a fixed exchange rate, a country can attract investment or establish stable import-export relationships,” says Singer. “If I’m a foreign investor interested in a developing country and I want to set up a production facility, it might be easier if I’m assured the exchange rate isn’t going to fluctuate, so I know the value of my investment isn’t going to change dramatically day to day.”

That is why, Singer observes, “developing countries really face a difficult dilemma when it comes to their exchange-rate policy. The trade-off is between flexibility and stability.”

Follow the money

In that case, how do developing countries arrive at a decision? This is where Singer has found a distinct pattern. Remittances are a standard line item on governments’ balance-of-payments records, reported to both the International Monetary Fund and the World Bank. After looking at World Bank data for 74 countries over most of the last three decades, Singer noticed that in countries with fixed exchange rates, remittances are 7.9 percent of GDP, while in countries with floating exchange rates, remittances are just 3.5 percent of GDP.

This is because the remittances provide liquidity, a flow of money, helping governments ease the costs of having fixed exchange rates. Crucially, as Singer notes, the pattern of money transfers is largely "counter-cyclical" — that is, it increases when a developing country's economy is sputtering. The central bank of the Philippines, for instance, reported that remittances increased 11 percent in November 2009, compared to the previous November, a rise largely due to migrants sending money home after two large typhoons battered the country.

"Remittances have this wonderful characteristic, which is that they tend to increase when times are bad in the receiving country," says Singer. "What a government might normally do in those circumstances is to make credit easily available to spur investment, but if you fix your exchange rate, you can't do that. But because migrants know their families are struggling, they increase the amount of money they send home." And that money comes without strings attached, unlike loans; it is just much-needed cash, washing through the local economy.

Off the record

Because many factors affect large-scale economic decisions, Singer scrutinized the data to see that he had identified a cause-and-effect relationship, not a mere correlation. Even when accounting for matters of government stability, forms of government, and a country's reliance on exports, Singer found, the connection between remittances and exchange-rate policy remains significant.

Singer's colleagues say his results are significant, but unexpected to the extent that it is forcing them to closely scrutinize and reevaluate the possible cause-and-effect relationships at work in this area.

"It's an important paper because it flies in the face of how we think about this relationship," says David Leblang, a professor of politics at the University of Virginia. "But the truth is, I didn't believe it at first. My gut tells me that exchange rates influence remittances — that people will send more money home if they have favorable fixed rates. But this paper makes people like myself question those assumptions. And that's the purpose of academic research."

For his part, Singer holds to the notion that remittances cause exchange rates to be fixed, not that fixed rates increase the flow of remittances. He notes that the pattern of emigration from the developing world to advanced industrial countries — from which migrants send high levels of remittances home — does not correspond to existing exchange-rate regimes, meaning there seems to be no overarching pattern of migrants being motivated by preexisting policies. Moreover, survey data of migrants' behavior indicates they do not transfer less money when their original countries have floating exchange rates. In general, Singer asserts, migrants "behave like family members" when sending money home, not "like financial investors."

Perhaps, Leblang notes, if central bankers acknowledged that remittances were behind their policy decisions, it would add another layer of support to Singer's thesis. However, having spoken to many government bankers about the issue, Singer believes that policymakers are loathe to talk publicly about the topic.

"The central bankers and treasury officials understand how important this is," says Singer. "But it's very difficult to get a central banker to say, 'Yes, this type of capital flow helps me decide to continue fixing the exchange rate.' If you have a fixed exchange rate, the last thing you want to do is generate uncertainty about whether you can maintain it. So if you say you have a fixed rate because of remittances, and remittances decline, it would cause other countries to lose confidence in you."

For now, the numbers tell a highly suggestive story. And Singer believes the data on remittances can form the basis for future research, on the relationship between money transfers and domestic policy throughout the developing world. Globalization, he writes, is not a simple force at work, but more like a “tug of war with various capital flows pulling policymakers in different directions.”

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