8 The Policy Context

The erroneous supposition that remittances are used primarily for the consumption of imported consumer goods (World Bank 1991, Fairbairn 1991a, 1991b) has increased concern among policy makers and international donors that they have little or no impact on domestic investment and thus do little to enhance the longer-term economic sustainability of island economies (Forsyth 1992; Cuthbertson and Cole 1995). Though many studies demonstrated, sometimes in considerable detail, that consumption is of considerable importance (e.g. Faeamani 1995), they also showed that higher levels of consumption were a major welfare gain and contributed to meeting basic needs that were otherwise sometimes poorly satisfied (Tongamoa 1987). They also showed that remittances have been increasingly important for both investment and savings (Walker and Brown 1995) as the entrepreneurial behavior of Nuku'alofa market vendors attests. Further support for this transition from consumption to investment comes from Foster's (1995) econometric analysis of secondary Tongan and Samoan data which suggests that remittances are sensitive to interest rates because of the desire of migrants to hold assets. There is, however, varied support for the view that as migrant income grows, remittances also grow, and that they will grow much faster if interest rates are favorable. The scant evidence that exists does suggest that using remittances for investment and for savings increases over time, even though in small, isolated island states there are very substantial constraints to such productive use. Remittances are also invested in economic activities, in human capital, and in the well being of others. Some of this perpetuates the migration remittance nexus and increases the flow of funds.

Other important findings have emerged from studies of migration and remittances in the region. It has become apparent that the official, aggregate data on remittances, income, and savings provide a highly misleading picture of the actual extent, form, and use of remittances. Remittances appear to be making a substantial contribution toward savings, but this is not reflected in the official data because of the form in which savings are often held and because of the inadequate, inconsistent, and sometimes quite inappropriate manner in which aggregate savings rates are calculated and treated in most macroeconomic analyses. Cross-sectional data from recent studies strongly indicate that remittance levels do not appear to decline with length of absence

from the home country and that an increasingly significant motivating factor for migrants to remit is the accumulation of assets and investment there. Both of these conclusions are contrary to many previous studies of migration and remittances in the island Pacific and in many other parts of the world.

Several recent studies have demonstrated that the remittance decay hypothesis has limited validity, at least as far as the remittance behavior of individual migrants is concerned. Although Tongamoa (1987) found some evidence of support for this among Tongan migrants in Sydney, other studies have found that decay was minimal for Cook Islanders, Fijians, Samoans, Tongans, and Tuvaluans in various cities in Australia and New Zealand (Fuka 1985; Loomis 1990; Stanwix and Connell 1995; Simati and Gibson 2001). While these were the results of relatively small sample surveys, similar and more statistically reliable results were derived from a more detailed study of Samoans and Tongans in Brisbane (Walker and Brown 1995; Brown 1998). These data show few signs of the remittance decay that in other studies may have been confused with the effect of slowing income growth among individuals and households in host countries. In fact, remittances did not appear to decay despite higher levels of unemployment and lower average real wage levels, offering evidence of the sacrifices made by some migrants. As income rises, saving appears to become more important in determining remittances in both host and home countries.

Consequently, it is neither the availability of savings nor the unwillingness of recipients to invest that explains the relatively poor performance of small Pacific island economies. The development problem is as much one of resource use and investment allocation as it is of generating savings. This suggests that there are areas where public policy interventions would be appropriate as they have previously been in Asia (Brown 1994, 1995; Russell 1986, 1992). Generally in the Pacific, there have been very few attempts to intervene in the, "…normal laissez-faire structure of migration; those that have been made have been limited in their extent, effectiveness and applicability" (Connell l987). Even attempts to influence the structure of international migration other than to promote it, let alone to direct and benefit from the flow of remittances, have been conspicuous by their absence.

Three key policy contexts exist. The first is accommodating measures designed to remove or minimize problems with migration. In an international context, these measures have included employment agreements with host governments and some of the Polynesian countries. For some time, Tonga had such a relationship with New Zealand (Connell 1983), but it is now of limited significance. The labor migration to Nauru from Kiribati and Tuvalu is of greater contemporary importance, though this has virtually ended. Kiribati and Tuvalu and to a lesser extent the Marshall Islands, Wallis and Futuna

(and perhaps Samoa and Tonga), are the only countries in the region that have actively encouraged international labor migration although others, like Cook Islands, have not usually sought to discourage the flow. (Since the 1990s, Niue has discouraged migration, encouraged return, and rewarded immigration with very high per capita aid because the population has fallen below 2000 and may not be sustainable. This pressure increased after Cyclone Heta in 2004). Pacific island states overall have therefore effectively sought to achieve accommodation through increased migration. Indeed in situations where remittances are rather more stable and sustainable over time than receipts from agricultural exports or tourism, as is the recent experience of Cook Islands, Samoa, and Tonga, it is probably an optimal policy to specialize in labor export (Poirine 1998).

Only two national development plans, Samoa's Third National Development Plan of 1975 and to a lesser extent Tonga's Sixth Development Plan of 1991, have commented on the negative impact of international migration, and hence the need to minimize it, though Tonga's plan noted that the only real negative feature of international migration was the failure to maximize its benefits.

A large proportion of Tongan migrant remittances is spent on consumer goods and not channelled into investment for the development of the productive capacity. Savings bonds denominated in foreign currency could be issued and offered to non-residents. This development would imply that returns on domestic securities be consistent with those offered to Tongan migrants, as Tongan residents would otherwise be encouraged to seek access to non-residents' instruments (Tonga 1991).

There is no evidence that any of the proposed policy interventions were seriously considered, let alone implemented despite their perceived urgency. Concerns over the loss of skills were also stressed in the 1980 and 1992 Samoa Development Plans but have not been subsequently repeated. Elsewhere in the region they have rarely if ever been discussed because of the economic benefits from migration. Generally, in fact, there have been few attempts to direct or influence the structure of international migration in the South Pacific due to official respect for the rights of individuals to move freely.

Secondly, there is a range of development policies that might increase the gains from international migration that could be initiated by home countries with the cooperation of host countries. Schemes where groups of labor migrants from a number of countries travel overseas for several months to generate funds from donations or employment for specific local social or economic development projects might make better use of remittances. This possibility is under consideration in Australia (Australia 2003).

Thirdly, there are policies that might influence the productive use of remittances, yet it is also clear that existing financial systems and related policies do not attract remittances into financial assets in the home economies. Real interest rates have been negative or very low. This has encouraged recipient families to invest in noninterest bearing assets such as housing or consumer durables. Migrants may, quite rationally, choose to hold their savings abroad, perhaps to be remitted home and invested at some point in the future.

POLICIES TO FOSTER REMITTING THROUGH OFFICIAL CHANNELS

It is generally accepted, at least informally, that policies are needed to encourage the use of remittances to promote longer-term growth and income security in home economies. Pacific island countries have yet to develop policies that (i) send more remittances through official rather than informal channels; (ii) increase the levels of remittances by encouraging migrants to hold their savings in financial assets in the home country rather than keeping them abroad (or spending their savings on consumer goods); or (iii) encourage migrants to become investors in productive assets in the home economies.

Governments of labor-exporting countries elsewhere in the world have introduced a variety of schemes with these policy objectives in mind, namely (i) repatriable foreign exchange accounts to encourage the greater use of official channels, (ii) foreign currency denominated bonds to encourage more use of financial assets in the home country, and (iii) self-employment investment schemes to stimulate more direct investment in productive assets. Athukorala (1993) reviewed policies in seven major labor-exporting countries in Asia. All except Indonesia provided temporary and permanent migrant workers with the incentive to remit to repatriable foreign currency accounts in domestic banks which effectively means that the migrant is not subject to foreign exchange controls in current account transactions and capital transfers. In addition, India and Pakistan offered premiums over the interest rates available in the international financial market. Bangladesh offered additional incentives through a preferential exchange rate on conversions of foreign exchange from the repatriable foreign currency account to local currency and a wage earners' scheme that enabled migrants to sell their foreign exchange to importers at daily auctions (Mahmud 1989). In Pakistan, there was the added advantage that the Habib Bank was allowed to open branches in many of the labor importing Arabian Gulf countries to facilitate migrants' use of official channels (Abella 1989). Sri Lanka also offered its migrants duty free domestic shopping (Saith 1989). Since most migrants from Pacific

island states are settlers rather than labor migrants some of these provisions are not relevant.

In other instances, governments have resorted to mandatory remittance ratios. For instance, the Philippines introduced a decree in 1983 that required migrants to remit a given percentage of their foreign earnings through official channels to be converted to domestic currency at the official exchange rate. This proved both unpopular and impossible to implement and was scrapped in 1986. A mandatory remittance scheme was also adopted by Thailand but with little success (Quibria 1986, Quibria and Thant 1988).

In order to encourage migrants to hold their savings in financial assets in their home rather than host countries, many governments have introduced foreign currency denominated bonds. Athukorala (1993) pointed out that these have an added advantage over RFCAs in that they guarantee anonymity of the asset holder who is still entitled to repatriate the funds when the bond is redeemed. For instance, Bangladesh has a wage earner development bond offering interest rates above those on domestic bonds as well as an insurance scheme based on a one-off premium in foreign currency. Pakistan has for some time had Khaas deposit certificates denominated in local currency and issued to migrants on payment of foreign exchange that upon redemption can be converted back to foreign currency at the official exchange rate (Kazi 1989). Somewhat more recently, Pakistan introduced foreign exchange bearer certificates that carry an interest rate above the Euro rate (Kazi 1989), and a dollar bearer certificate offering a return linked to the London interbank offered rate (Kardar 1992; Athukorala 1993). India has a similar scheme (Gordon and Gupta 2004).

The third policy area concerns schemes to encourage migrants themselves to become investors. The first country to introduce such measures was Turkey through the formation of village development cooperatives whose members then gained preference for migration (Swamy 1981, Russell 1986). Pakistan has a scheme that allows migrants to import machinery at concessional rates of duty and to invest in export processing zones (Kazi 1989). In Bangladesh too, migrants have been offered special fiscal incentives to invest domestically (World Bank 1981).

Despite very different socioeconomic conditions in the labor-exporting Asian countries, their experience cannot be ignored. The findings of the most recent studies in the Pacific indicate that there is substantial scope for government policy interventions to increase flows of remittances to their economies, yet there has been virtually no concerted effort by any government to offer incentives for migrants to remit more through official channels. All the evidence suggests that migrants' remittances would be responsive to financial incentives of the sort that have been adopted in Asia (Foster 1995).

While it needs to be acknowledged that this runs counter to the conclusions from econometric analysis of secondary data in other remittance receiving countries (Swamy 1981, Straubhaar 1986), it also needs to be stressed that these studies relied exclusively on secondary macroeconomic data.

Policy makers must therefore regard remittance levels as potentially responsive to policy interventions and the provision of special incentives. Until such time as the financial authorities in the South Pacific offer internationally competitive real interest rates to savers, migrants may choose, quite rationally, to hold their savings elsewhere. Indeed there is some evidence that although extended families are behaving to some extent as transnational investment institutions (Marcus 1981), the countries of the Pacific are unwilling to develop policies that may be seen to favor those who have, through international migration, achieved a greater degree of success than those who either chose to remain at home or were unable to migrate.

There is scope for a careful consideration of policies, such as the transfer of pension rights, to maximize the benefits of international migration in most countries in the region. This is true even though migrants from Pacific states are more likely to be permanent residents. One strategy that might be of value is attracting and retaining stocks of migrant savings for investment. In host country recessions, it is likely that remittances for saving and investment will be reduced instead of those for family consumption. Channelling migrant savings to home country assets can provide security in such situations.

POLICIES TO FOSTER SAVINGS AND INVESTMENT

It is generally recognized that policies to promote remittances and to channel them into more productive investments have not met with tremendous success. One of the most cited studies in this regard is Swamy's (1981) study for the World Bank. Using pooled time series data on official remittances from three countries (Greece, Turkey, and Yugoslavia) over 18 years, she found that policy measures such as relative interest rate schemes and premium exchange rates were unsuccessful in increasing remittance flows. Another study using secondary time series data from Turkey showed that, "…neither variations in exchange rates (reflecting government intention to attract remittances by premium exchange rates) nor changes in the real return on investments (reflecting government intention to attract remittances by foreign exchange deposits with higher returns) turned out to affect the flows of remittances (Straubhaar 1986). Investment schemes like the village cooperatives attempted in Turkey also had little success (Swamy 1981; Russell 1986). In Asia too, Saith (1989) pointed to the high failure rate of the self-employment schemes attempted by governments of labor-sending countries to convert return migrants into small entrepreneurs.

In the Pacific, there have been virtually no concerted efforts by governments to offer incentives for migrants themselves to invest remittances in productive activities. It has not therefore been possible to assess policy interventions from an *ex post* perspective. The limited success of policies adopted in Asia suggests that it would not make good sense to replicate them, but on the other hand, it is not necessary to dismiss them. Much can be gained not only in the Pacific from analysis and assessment of the potential of the policy environment. First, the conditions under which policies would be effective must be identified, and second, the extent to which such conditions exist must be ascertained.

It is useful to begin by identifying the assumptions underlying policies to stimulate a greater flow of remittances into sustainable investments that have been adopted elsewhere.

(i) Investment is limited by savings and/or the availability of foreign exchange. (If this were not the case there would be no reason to believe that increasing the inflow of migrants' remittances would induce, or at least, enable, additional investment).
(ii) Investment in the economy of the home country is necessary if the long-term income security of the population is to be sustained.
(iii) Migrants themselves are the appropriate agents for investing their remittances; they are all, in effect, latent entrepreneurs.
(iv) If remittances are to be channelled into productive investments in the home economy, they must be transferred through official channels.
(v) Migrants' savings in the home country and their remittance levels are sensitive to relative real interest rates. This, in turn, implies that migrants are motivated to remit for reasons of self interest (financial gain) and not only to meet the needs of nuclear and extended families.

The most recent economic studies provide considerable information on these assumptions. First, it is now evident that migrants' remittances are potentially responsive to financial incentives since they remit not only for family support and that a significant proportion of their remittances appears to be motivated mainly by investment. Second, the fact that a significant part of unofficial remittances goes into investment goods suggests that remittances have a greater impact on domestic investment than is generally thought and that they need not be transferred through formal banking channels for this purpose. Third, from surveys of both migrants and recipients, it is evident that some are saver rentiers, others are saver investors, and some, like the Tongan flea market vendors have evolved into full scale entrepreneurs with investment links with other sectors of the economy (Brown and Connell 1993).

From the micro survey data available, it is not possible to assess the extent to which suitable avenues and opportunities for investment in the domestic economies of Pacific island states exist and the extent to which they are limited by savings and foreign exchange. Foster's (1995) econometric analysis of secondary data on savings and remittances in Samoa and Tonga questioned assumptions that investment was limited by saving levels, that the most appropriate use of migrants' savings was domestic investment, and that migrants would necessarily make the best entrepreneurs. In practice, real interest rates in Samoa and Tonga (and probably elsewhere) have been negative or very low which could account for the shortage of loan funds. These findings led Foster (1995) to conclude that attractive interest rates are likely to attract greater savings.

It is therefore reasonable to conclude that it is neither the availability of savings nor an unwillingness to invest on the part of recipients of private remittances that explains the relatively low growth performance of the Samoan, Tongan, and other home economies. Where this is the case, it appears that the problem is more one of resource use and investment allocation than of savings. In this context, the role of financial institutions becomes very relevant. One possibility that warrants further investigation is the scope for links between remittances and microfinance institutions as an alternative to state and commercial banks.

Financial institutions could play a more active role in mobilizing investment funds by providing stronger incentives to individual savers through more attractive real interest rates. However, family security and development priorities should, wherever possible, be kept separate. Economic development projects should, as now, be funded mainly through foreign aid and kept quite distinct from commercial lending for normal purposes. It is inappropriate to substitute migrant funds for aid flows in development.

None of the recent studies concludes that remittances should be directed towards domestic investment and that the migrants (or their families) would necessarily make the best entrepreneurs though some have indeed become entrepreneurs. Where opportunities arise, remittances can be motivated by and used for investment (Faeamani 1995; Walker and Brown 1995; Brown and Connell 1993). Yet even where migrants possess the necessary entrepreneurial potential, if the general investment climate in the home economy is not conducive it cannot normally be expected that migrants will risk their savings when safer alternatives exist elsewhere.

In several Asian countries, Saith (1989) questioned the wisdom of adopting policies to convert migrant-savers into migrant-investors. It would instead make better sense for policy to be geared more towards the majority of migrants to encourage them to become more active in domestic capital

markets as saver rentiers. As suggested previously, this would necessitate Pacific island economies offering savers competitive real interest rates. The loan funds accumulated in this way could then be invested either in larger domestic projects, or, where no suitable opportunities exist, they could be held as overseas assets denominated in foreign currency at the best possible rate of return. The accumulation and disbursement of loan funds into viable investment projects has been hampered by past government development and monetary policies. Fostering investment requires the formation of an independent financial institution that uses best practices to attract funds from migrants and to lend them domestically and internationally.

Direct financial incentives might be provided for investing remittances such as national development bonds from national development banks. This has never been seriously contemplated in the region although there were attempts in Samoa at the start of the 1980s to encourage skilled migrants to invest in housing and thus increase their commitment to the country. The Bank of Tonga has designed saving instruments specifically for migrants that include an international interest differential (the Bank of Tonga target savers' rate minus the Australian fixed deposit rate). In 1991, it also offered a "return to Tonga" savings account, but was on the point of discontinuing the scheme in 1995 because it had not attracted much capital (P700, 000) possibly because it was unable to maintain the confidentiality of the accounts. These policies raise questions of equity and preferential treatment for return migrants or overseas residents, and Pacific island states have hitherto not chosen to move in that direction. Moreover, some countries may even wish to oppose special provisions for migrants in circumstances where limited development and investment opportunities exist.

The accumulation of financial assets abroad could provide income security for migrant households and a buffer against adverse developments like cyclones in the home country and recessions and rising unemployment in the host country. Indeed, Kiribati and Tuvalu have such buffers in place, and the northern Micronesian states are moving towards similar schemes. Kiribati set up a Revenue Equalisation Reserve Fund in 1956 as a trust fund to be built up from the profits from its nonrenewable phosphate exports. Tuvalu established the Tuvalu Trust Fund along similar lines in 1987. These funds are invested abroad and have achieved high rates of return that in Tuvalu's case averaged 19% in the first 4 years of operation. The revenues from the funds are used for national budgets. Nevertheless, though both countries have growing trust fund balances to provide national economic security, both have significant socioeconomic difficulties and no clear strategy for using their considerable assets to promote socioeconomic well being without risking reductions in much-needed aid.

MONETARY AND ANTI-INFLATION POLICIES

The governments of Pacific island states need to implement monetary policies that result in positive, internationally competitive interest rates. Without positive real interest rates, individuals and families cannot be expected to hold savings except in the short term. Clear differences in the inclination to save were evident in both Samoa and Tonga in line with differences in real interest rates (Foster 1995).

Rules are required for granting subsidies and guarantees to keep all lending rates low, not just rates provided by aid supported development banks that already have interest subsidies. Legislation would have to be drafted so that all financial institutions could hold overseas assets denominated in foreign or local currency. It would be best if relevant financial institutions were run as independent state corporations along the lines of existing national provident funds despite their somewhat checkered history. It is clear from the experience of Kiribati and Tuvalu (if not Nauru) that governments can handle overseas investments very effectively in conjunction with a reliable agent. Governments should not be able to borrow funds directly from these financial institutions in order to protect investors and to prevent crowding out of private investment.

Development and national security considerations often necessitate budget deficits. In the case of small Pacific island countries, aid can cover such deficits, but there is danger of inflation since aid increases liquidity. This may worsen the trade deficit or drive up prices, particularly when there is no immediate increase in the supply of goods and services from development spending. This undermines savings flows since it drives real interest rates to low or negative levels. Funds channelled through development banks may dissipate into consumption subsidies and reduce the propensity to save domestically. In such circumstances, aid should be used mainly for labor-intensive infrastructure projects to generate employment and for funding state pensions for the old and education for the young. Funding business investment should be strictly the province of financial institutions that recycle domestic and migrant savings. Governments and aid agencies are not competent to do this.

There is little doubt that attractive interest rates induce savings, either directly or indirectly, and that this is advantageous. If holding overseas assets is permitted, central banks need not be concerned with liquidity overhang. There is no simple link between the volume of financial assets and inflation. The inflation experience of Pacific island states suggests that it has been related to aid-funded government spending, to rises in import prices, and to natural disasters, not to large budget deficits.

It is appropriate that central banks should continue to avoid persistent budget deficits but should also promote savings as insurance for the future. The evidence presented here offers some indication that as their incomes rise, migrants accumulate financial assets provided interest differentials warrant it. Evidence from Walker and Brown's study (1995) suggests that migrants hold significant quantities of savings in their countries of residence, so the potential for accumulating savings in the home country clearly exists. The extent to which migrants might repatriate savings in different financial circumstances is obviously unknown, and there are grounds for caution over the degree to which migrants might welcome certain kinds of investment and development in their absence.

Recent studies also point to the need for financial policy reforms that take into consideration the real rate of return for the saver in relation to rates of return available to the transnational family in both financial and non-financial assets, both domestically and abroad. The details of these need to be worked out on a country-by-country basis, taking into account the particular financial, institutional, and policy environment of each case and the forms, channels, and determinants of remittance flows.

Conflict can arise between savings and investment strategies and anti-inflation measures. However, during the 1990s, inflation subsided as a central problem in many countries providing an opportunity to reorient economic policy towards growth and sustainability. The proposals suggested here concerning saving and investment do not pose any risk of inflation. Inflation is not caused by the public holding stocks of financial assets provided they are not lent to government to finance expenditure and provided that such assets are not used as a conduit for lending aid funds with a low probability of repayment (Foster 1995). Aid funds should continue to be managed by development banks or agencies.