ESSAYS ON MIGRANTS' REMITTANCES AND THE FINANCIAL SECTOR

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0. Introduction: Essays on Migrants' Remittances and the Financial Sector 6

I. Remittances and Development on the International Policy Agenda 7

II. Shifting Paradigms on Migration, Remittances, and Development 8

III. The Research Question: What is the Impact of Remittances on the Financial Sectors of the Receiving Countries? 11

IV. Essays on Migrants' Remittances and the Financial Sector: Key Findings and Contribution to Research 14

V. Conclusion 21

1. Are Remittances a Substitute for Credit? Carrying the Financial Burden of Health Shocks in National and Transnational Households 24

I. Introduction and Related Literature 25

II. Model Specification and Data Description 30

III. Results 39

IV. Conclusions 50

V. Appendix 52

2. Are Remittances a 'Catalyst' for Financial Access? Evidence from Mexican Household Data 53

I. Introduction 54

II. Remittances and Financial Access: State of Current Research 57

III. Data Description 61

IV. Model Specification 71

V. Regression Results 73

VI. Conclusion 84

VII. Annex 87

3. Remittances and Financial Sector Development. Lessons from the Salvadoran Case 88

I. Introduction 89

II. State-of-the Art: Links between Remittances and the Financial Sector 93

III. Remittances and Financial Access – The Salvadoran Case 96

IV. Testing the Outreach of Commercial Banks to Remittance Receivers: Methodological Approach 103

V. Empirical Results 109

VI. Conclusion 119

4. Remittances for Financial Access: Emerging Forms of Governance in Latin America 121

I. Introduction 122

II. Remittances and Governance of Microfinance: Linking two Research Fields 126

III. Remittance-Markets, Microfinance Sectors, and Governance Initiatives in Three Latin American Case Studies 133

a) El Salvador: the strong role of banks and pioneering credit unions 136

b) Dominican Republic: powerful MTOs and nascent initiatives in the MF-sector 140

c) Mexico: a segmented microfinance sector and an active state-owned development bank 145

d) Comparing country experiences: What shapes governance in the remittances-microfinance link? 152

IV. Conclusion 159

5. Literature 162

6. Annex: List of Publications and Conference Presentations 175

0. Introduction: Essays on Migrants' Remittances and the Financial Sector

I. REMITTANCES AND DEVELOPMENT ON THE INTERNATIONAL POLICY AGENDA

Officially registered remittances to developing countries – the money sent home by migrants to support their families back home – have grown extraordinarily in the last two decades, from 55 billion USD in 1995 to an estimated 325 billion USD in 2010 (Mohapatra, Ratha, and Silwa 2011). For the group of developing countries, these transfers are an important and stable source of external finance (Dilip Ratha 2003), second in value only to foreign direct investment and three times the value of official development aid (Mohapatra, Ratha, and Silwa 2011). Whereas the United States is by far the world's largest remittance-sending country, the three largest receivers of remittances in the world are India (55 bil. USD estimated in 2009, World Bank 2010), China (51 bil. USD) and Mexico (23 bil. USD). In relative terms, small and poor countries with large diasporas are the most dependent on remittances. In Latin America, many Central American and Caribbean countries had shares of remittances of up to ten per cent of GDP or higher in 2009; these countries included Honduras, El Salvador, Haiti, Jamaica, Nicaragua, and Guatemala (ibid). Remittances have proven to be relatively resilient to macro-economic turbulence, resisting the strong cyclical movements that characterize other international financial flows such as foreign direct investment, bank lending, and short-term portfolio investment. During the most recent financial crisis, remittance flows were less affected than other private capital flows and recovered relatively quickly from a 5.4 per cent decline in 2009 (Mohapatra, Ratha, and Silwa 2011).

The importance of remittances for many countries has triggered a lot of interest among policy-makers, who have 'discovered' remittances as a potentially important source of capital for development in receiving countries. In recent years, most leading

international organizations have dedicated flagship reports to the nexus between migration, remittances, and development (IMF 2005; World Bank 2006; UNDP 2009; OECD 2005), raising the question of whether remittances would become a new mantra in the development discourse – one which responds to the search for a third communitarian way of development between pure market liberalism and state-led development strategies (Kapur 2004; cp. de Haas 2010, 275), and where diasporas play an important role in the economic development of their home countries.

II. SHIFTING PARADIGMS ON MIGRATION, REMITTANCES, AND DEVELOPMENT[1]

The growing interest in the development potential of remittances has been accompanied by numerous academic publications on the direct and indirect positive or negative effects of remittances on receiving countries. While it is widely accepted that remittances have contributed significantly to the material well-being of receiving households and to poverty reduction (R. Adams and Page 2005), they also affect receiving countries through several secondary and indirect channels that have to be taken into account when analysing their impact on receiving countries. These indirect effects of remittances include consumption multipliers from spending remittances (Glytsos 2005; Durand, Parrado, and Massey 1996), or consequences for the labour market through rising wages (Mishra 2007; Airola 2008). Other economy-wide effects have been attributed to the impact of remittances on exchange rates. On the one hand, remittances have contributed to the macro-economic stability of receiving countries: because remittances are less volatile than other private capital flows, they tend to

[1] This subchapter draws on previous contributions in Ambrosius et al. (2012a; 2012b) and Fritz et al. (2010).

stabilize the exchange rate and may sustain current-account deficits (Buch and Kuckulenz 2010; Singer 2010). On the other hand, large inflows of foreign currency tend to appreciate the nominal or real exchange rates, leading to negative effects on the competitiveness of export-oriented sectors (Amueda-Dorantes and Pozo 2004; P. A. Acosta, Lartey, and Mandelman 2009), similarly to the phenomenon known as “Dutch disease” in the literature on natural resource booms.

The wider implications of these direct and indirect effects of remittances on the economic development of receiving countries have been interpreted in different manners. Early research on remittances and development was dominated by structuralist positions, with a mostly critical tone regarding the impact of remittances on migrant-sending communities (cp. de Haas 2010; Durand, Parrado, and Massey 1996, 424f). These critical views, often formulated by sociologists and anthropologists, stemmed from the observation that income from remittances is, to a large degree, spent on receiving households’ daily consumption rather than on ‘productive’ investment or on luxury goods, with few benefits for the local economy (Wiest 1979; Lipton 1980; Mines 1981; Reichert 1981; and Binford 2003; Cortina, de la Garza, and Ochoa-Reza 2005; Canales 2005 for more recent contributions along similar lines). In this tradition, authors with a critical perspective on globalization, such as Delgado Wise and Márquez Covarrúbias (2008), argue that remittances are the result of strangled economic and social development rather than a tool for growth and well-being. In their view, these flows help sustain the fragile socioeconomic situation of the migrants’ countries of origin, expanding the asymmetries between North and South and exacerbating phenomena such as employment insecurity, poverty, and social marginalization. Therefore, instead of altering structural development constraints, remittances, according to these authors, at best constitute a palliative measure against the deteriorating

socioeconomic situation of the population, which has been caused by failed macro-economic structural policies (Canales 2006; Canales 2008a).

While critical views on the impacts of migration and remittances have not vanished, the 1980s and 1990s saw a paradigmatic shift towards more positive views on the role of migration and remittances in the development process. Earlier studies that criticized the 'unproductive' ways in which remittances were spent have been contested by more recent contributions that have compared spending behaviour among receiving and non-receiving households, finding that remittances have a positive impact on investment in human and physical capital. According to these studies, remittances enable households to undertake investments in human or physical capital they would not otherwise be capable of making. Remittance-receiving households have therefore been found to spend a higher share of their income on education (R. Adams and Cuecuecha 2010; Hanson and Woodruff 2003; Cox Edwards and Ureta 2003), health (Amuedo-Dorantes and Pozo 2009; Valero and de Lourdes Treviño 2010), and entrepreneurship (Massey and Parrado 1998; Woodruff and Zenteno 2007). Many of these more recent contributions have been influenced by the insights of the New Economics of Labor Migration (NELM, see Stark and Bloom 1985; Lucas and Stark 1985; Rosenzweig and Stark 1989), a school of thought that led to a re-thinking of the relationship between remittances and development by putting the transnational household at the centre of analysis. Earlier analyses of migration's impact on home countries usually stopped with the act of migration, which was seen as constituting a loss of human capital for migrant-sending communities. In contrast to these positions, the NELM studied migration as an implicit family arrangement that involves the whole household. According to this view, migration and remittances are informal household mechanisms of asset-accumulation and self-insurance that can be modeled within absent or rudimentary markets for

finance and insurance (Stark and Levhari 1982; J. E. Taylor 1986; E. J. Taylor and Wyatt, T.J. 1996), a feature typical of rural areas in developing countries. Families invest in sending one or more members abroad and receive a return in the form of remittances, the monetary expression of a long-term relationship with emigrating family members. Following the work of the NELM, a number of studies have analysed migration decisions as part of the risk-management and asset-building strategies of transnational households: remittances are seen to provide insurance for those family members who stay behind, through the diversification of household incomes, and tend to increase in the case of negative events (e.g. Agarwal and Horowitz 2002; Gubert 2002; Yang 2008; Yang and Choi 2007).

III. THE RESEARCH QUESTION: WHAT IS THE IMPACT OF REMITTANCES ON THE FINANCIAL SECTORS OF THE RECEIVING COUNTRIES?

Although migration and remittances can be perceived as 'self-help' strategies enabling households to self-insure and to finance investment in human or physical capital in the context of absent or rudimentary formal institutions for finance and insurance, migration and remittances do not take place in an institutional vacuum. Departing from and extending the ideas of the NELM, the guiding research question of this dissertation is as follows: How do migration and remittances, while they take place within a context of incomplete or rudimentary institutions for credit and insurance, influence financial markets in the migrants' countries of origin?

This research question is addressed by the following two hypotheses. The first hypothesis postulates that access to transnational money transfers functions as a substitute for financial services. The second hypothesis proposes that remittances improve receiving households' access to financial services. These two hypotheses are

less contradictory than they sound: Remittances can be a substitute for credit and insurance from financial institutions and a 'catalyst' for improved access to financial services at the same time. Recent research based on financial diaries has shown that poor households mix and combine different financial tools and instruments to cope with expected and unexpected financial gaps (Rutherford 2003; Collins et al. 2009). Since migration and financial services are both asset-building and risk-management tools, remittances and financial services may, in some cases, substitute for each other – for example, when family members in the US function as a source of capital from outside the regular household to cover emergency spending, similarly to credit or insurance from financial institutions. In other cases remittances and financial services may complement each other because financial institutions offer a way of saving remittances or because financial institutions may accept remittances as collateral for loans.

Linkages between remittances and the financial sector have a high relevance with respect to the impacts of these transfers on receiving countries. First, receivers themselves may benefit from more efficient asset-building strategies through monetary savings options and, eventually, from improved access to other financial services such as credit and insurance products. Access to adequate financial services among poor households plays an important role in reducing poverty and may lead to a more equitable distribution of income (Jalilian and Kirkpatrik 2002; Thomas Beck, Demirgüç-Kunt, and Levine 2007). Beyond these direct benefits to receivers, the linking of remittances with financial services has potentially wider economic effects. Savings from remittances can be channelled to their most productive use and be matched with the demand for credit elsewhere, thereby also benefiting those who do not directly receive remittances themselves. There is a broad consensus among development economists that financial institutions play a crucial role in the process of economic

development (see Levine 1997 for an overview). For example, cross-country studies have shown that a relative increase in savings and credit is associated with an increase in both growth and per capita income (Goldsmith 1969; R. G. King and Levine 1993; Thorsten Beck, Levine, and Loayza 2000a; Thorsten Beck, Levine, and Loayza 2000b).

The regional focus of this Ph.D. thesis is on Latin America, with single case studies on Mexico and El Salvador, and a comparative study that includes Mexico, El Salvador, and the Dominican Republic. The Mesoamerican and Caribbean regions that these countries represent have the highest remittance dependency rates worldwide, with remittances sent mainly from emigrants in the US (World Bank 2010). Mexico, one of the main recipient countries of remittances in the world, has more than 10 per cent of its population of approximately 110 million people living outside their country of birth. Mexicans make up the largest group of immigrants in the US (Pew Hispanic Center 2009). Despite a 16 per cent decrease in the sending of remittances following the 2008 US financial crisis, remittances still play an important role in the Mexican economy. In 2009 they were approximately the same in value as foreign direct investment (FDI) to Mexico, contributing 2.5 per cent to the country's GDP (ibid). In El Salvador remittances are even more important to the economy, and the country ranks among the world's top ten receivers of remittances, which amount to 16 per cent of the country's GDP (2009, ibid.). Today, 1.6 million Salvadorans live in the US; of these people, one million were born in El Salvador, representing 16 per cent of the country's population of roughly six million (US Census 2008, cited from Pew Hispanics Center 2010). In the Dominican Republic, the size of the diaspora is one million (10 per cent of the population), and the remittances equal 7 per cent of GDP (World Bank 2010).

At the same time, all of the countries studied are characterized by weakly developed domestic financial sectors, with the level of domestic credit provided by the banking

sector at 40 per cent (Dominican Republic) and 45 per cent (Mexico and El Salvador) of GDP in 2010, compared to an average of 113 per cent in developing Asia and an average of more than 200 per cent in OECD countries (World Bank 2011a). Access to financial services is also strongly limited in all three cases: According to Honohan (2008), less than a third of the adult population has access to formal financial services (measured by usage of savings accounts), compared to rates above 90 per cent in Western Europe. A general judgement in policy reports (e.g. Orozco 2006; Jaramillo 2005), which is also supported by the analysis of household data used in this Ph.D., is that many remittance receivers belong to lower-income groups, often from rural areas, and are usually not serviced by the commercial banking sector. In the sending countries, too, many migrants do not hold bank accounts due to language barriers or the fact that they are undocumented residents (Paulson et al. 2006). Because of this, remittances from Latin American immigrants in the US are in most cases sent and received in cash via money transfer operators (MTOs).

IV. ESSAYS ON MIGRANTS' REMITTANCES AND THE FINANCIAL SECTOR: KEY FINDINGS AND CONTRIBUTION TO RESEARCH

This doctoral thesis addresses a research gap that exists between research on remittances and research on financial sector development. In spite of the high ranking of linkages between remittances and receiving countries' financial development on the policy agenda, few academic studies so far have brought both research areas together, with the exception of those by Aggarwal et al. (2010) and Aslı Demirgüç-Kunt et al. (2011). Reasons for a relative lack of systematic work on these topics may lie in the fact that scholars are usually specialized either in financial sector development or in migration research and little communication occurs between these fields of research. Moreover, the scarcity of detailed data including information on both financial service

usage and migration histories and/or remittances poses a challenge to researchers. By applying a variety of quantitative and qualitative research methods that range from micro-econometric panel data techniques to comparative case study designs, this thesis contributes to a better understanding of the relationship between remittances and the financial sector. The four single papers[2] of this cumulative dissertation can be divided into two broad thematic topics. Papers one, two, and three analyse the impact of remittances on the financial sectors of the receiving countries. While papers one and two use Mexican household panel data to study the question of whether remittances are a substitute for credit (paper one) or a 'catalyst' for financial access (paper two), paper three provides further evidence on the impact of remittances on the development of the financial sector from a case study on El Salvador. Paper four (co-authored with Barbara Fritz and Ursula Stiegler) takes a closer look at the institutional settings of financial markets in remittance-receiving countries, borrowing partially from research questions and methods more commonly used in political science. In this paper we analyse those initiatives that capitalize on remittances in order to improve access to further financial services within the institutional setting of the financial market in in El Salvador, Mexico and the Dominican Republic.

In the following section I provide a short summary of the research questions of each of the four essays, explain the methodology used and highlight each essay's main contributions to the current research. Because each paper is intended to stand on its own, certain arguments, and the way they are framed in relation to the current research, are similar in more than one of them.

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[2] All papers are either under review (papers one, two, and four), orforthcoming (paper three) at the time of submission of this doctoral thesis.

1. ARE REMITTANCES A SUBSTITUTE FOR CREDIT? CARRYING THE FINANCIAL BURDEN OF HEALTH SHOCKS IN NATIONAL AND TRANSNATIONAL HOUSEHOLDS

Although several authors refer to the substitution of credit through remittances as a theoretical argument for their empirical findings (explicitly for example Woodruff and Zenteno 2007; Giuliano and Ruiz-Arranz 2009), to my knowledge, the question of whether remittances and credit are substitutes for each other has not been directly tested in previous studies. In this article, Mexican household panel data is used to study the effect of exogenous events – health-related shocks – that create a demand for finance among exposed households and to compare the effect that these events have on the debt levels of national and transnational households. The results from the treatment-effect model show that, while the occurrence of serious health shocks that required hospital treatment doubled the average debt burden of exposed households compared to the matched control group, households with close family members (a parent, child, or spouse) in the US did not see an increase in their debt due to health shocks. These findings are consistent with the insights of the New Economics of Labor Migration that remittances respond to the needs of transnational families to finance emergencies. The results from this research also call into question the unidirectional interpretation of the correlation between remittances and health spending (Amuedo-Dorantes, Sainz, and Pozo 2007; Amuedo-Dorantes and Pozo 2009; Valero and de Lourdes Treviño 2010) or health indicators (Kanaiaupuni and Donato 1999; Frank and Hummer 2002; Hildebrandt and McKenzie 2005; López Córdova 2005) in previous studies. Here, the opposite perspective is taken: Increased health spending caused by health shocks may create demand for alternative financial sources such as credit or remittances in liquidity-constrained households, thereby reducing a household's need to rely on debt financing.

2. ARE REMITTANCES A 'CATALYST' FOR FINANCIAL ACCESS? EVIDENCE FROM MEXICAN HOUSEHOLD DATA

A number of policy reports have emphasized that linking remittances with additional financial services increases the development impact of these financial flows (see, for example, Orozco 2004a; Terry and Wilson 2005; Orozco and Fedewa 2006). Receivers may benefit from more efficient asset-building strategies through monetary savings options and, eventually, from improved access to other financial services such as credit and insurance products. Beyond these direct benefits to receivers, linking remittances with financial services has potentially wider economic effects. Savings from remittances can be channelled to their most productive use and be matched with the demand for credit elsewhere, therefore also benefiting those who do not directly receive remittances themselves.

As mentioned above, remittances might not only be a substitute for financial services, but might also function as a driver of institutional change at the local level. In policy discussions it has been claimed that remittances often create an initial contact with formal financial institution, paving the way for further financial services (e.g. Orozco 2004a; Orozco and Fedewa 2006). However, although remittances figure prominently in policy discussions, academic publications on the impact of remittances on financial development are scant, with the notable exceptions of Aggarwal et al. (2010) and Aslı Demirgüç-Kunt et al. (2011), who have found evidence that remittances are correlated positively with indicators of financial development at the cross-country (macro) level (Aggarwal et al.) and the municipal (meso) level (Demirgüç-Kunt et al.). The case study on Mexico adds to this recent line of research, and is the first study that uses household panel data to investigate the relationship between remittances and financial development. This approach allows me to analyse the relationship between remittances

and access to financial services in a more detailed way than previous studies have done, and to control for unobserved time-constant household heterogeneity through household fixed effects.

The results show that receiving remittances is strongly correlated with the holding of savings accounts and, to some degree, with the availability of borrowing options. These effects are stronger and more significant for the rural subset, and the linkages between remittances and the financial sector are more important for non-traditional financial institutions from the micro-finance sector than for commercial banks. These results support the argument made by Orozco and Hamilton (2005), Hastings (2006), and Orozco (2008), among others, that institutions from the micro-finance sector are often ‘closer’ to remittance receivers, both socially and geographically, and are therefore better positioned to link remittances with further financial services. The household data used in this study indicates that remittances function as a ‘catalyst’ for financial access, especially for rural households from lower-income groups, which tend to use non-traditional financial institutions from the micro-finance sector more than commercial banks.

3. REMITTANCES AND FINANCIAL DEVELOPMENT: LESSONS FROM THE SALVADORAN CASE

The case study on El Salvador adds further evidence regarding the impact of remittances on the financial sectors of receiving countries by extending research to a new country setting. El Salvador presents an interesting case, and not just because of its strong dependence on remittances, which amounted to 16 per cent of GDP in 2009 (World Bank 2010). The government also followed an active policy of 'banking' migrants in the 1980s, dividing the US market among the major state-owned banks in order to capture remittances for the domestic banking sector. Moreover, next to traditional banks, a relatively consolidated micro-finance sector has been engaged in paying remittances in El Salvador since the late 1990s.

The first part of the paper, which is based on interviews with experts from financial and government institutions, discusses how different kinds of financial institutions have responded to the demands of remittance receivers for financial services in the Salvadoran context and analyses their potential to provide financial access to remittance receivers. Challenges for the micro-finance sector in remittance markets differ from those faced by commercial banks: While commercial banks have to downscale their supply to reach low-income households and those living in rural areas, the challenge for pro-poor financial institutions from the MFI sector is to link their rural and low-income focus with access to global payment systems.

The second part of the paper focuses on the commercial banking sector, for which official data is available, and analyses the correlation between remittances and indicators of financial development. In contrast to the paper on the Mexican case, which uses household panel data to study the relationship between remittances and financial

access, this paper follows the approach previously used by Aslı Demirgüç-Kunt et al. (2011) and crosses banking data with remittance data at the municipal level. Although coverage of the banking sector is limited to larger municipalities and those with better-than-average socioeconomic indicators, the empirical results show that the banking sector in remittance-intensive municipalities is more developed in terms of per capita savings and the number of accounts. However, in spite of banks reaching out to remittance receivers, existing inequalities have also been reproduced through the traditional banking sector. Poor and geographically isolated households are largely excluded from banking services and therefore hardly benefit from the banking of remittances.

4. REMITTANCES FOR FINANCIAL ACCESS: EMERGING FORMS OF GOVERNANCE IN LATIN AMERICA

The role of financial institutions in remittance markets varies across countries. However, systematic research on the institutional contexts of financial markets and how they relate to remittances is scant. It has been dominated by best practices and case studies on initiatives that have included remittances in their product portfolio, offering financial services to remittance-receiving households from low-income groups, often from rural areas.

This joint work, with Barbara Fritz and Ursula Stiegler, links research on remittances and micro-finance from the discipline of economics with political science insights on multi-actor governance. We analyse initiatives that link remittances with access to further financial services within the particular institutional setting. Adopting a comparative approach, we look at the Dominican Republic, El Salvador, and Mexico. While the context of a high level of remittance dependency creates similar challenges in

all cases, the emerging forms of governance show remarkable variety. Our research finds that this is explained by neither agency nor structure alone, but rather by the interplay of for-profit, non-profit, and state actors embedded in the specific structures of the remittance markets and micro-finance sectors of each country. Whereas a high level of institutional development within micro-finance institutions (MFIs) facilitates the establishment of strategic networks between MFIs and institutions on the sending side, it can be difficult for deposit-taking financial institutions to break into existing monopolies when transfer markets are heavily dominated by MTOs. Finally, governments have been crucial in shaping financial and remittance markets, not only by taking on indirect roles through regulation and rule-setting but also by intervening directly in remittance markets.

V. CONCLUSION

While much of the growing research on migrants' remittances has focused on poverty effects and the spending of remittances, this doctoral thesis contributes to an understanding of how remittances influence the economies of receiving countries by focusing on a relatively neglected research topic, the linkages between remittances and the financial sector. This is an important issue, as it draws attention to some of the indirect effects of remittances, whereas concentrating solely on the spending of this source of income misses an important part of the picture. The linkages between remittances and the financial sector increase the former's development impact by providing receiving households with additional risk-management and asset-building tools, and by channelling savings from remittances to fulfil demands for credit elsewhere.

Adding to this relatively recent line of research, the thesis adopts different perspectives on the impact of remittances on financial sector development and applies a variety of methodological approaches ranging from micro-econometric panel data techniques (causal inference using a treatment effect model in the first paper and household fixed effects in the second paper), to mixed qualitative-quantitative methods (third paper), to multi-actor governance analysis and a comparative case study (fourth paper). The mix of quantitative and qualitative methods, together with the interdisciplinary perspectives applied, has proven to be useful in gaining a more complete understanding of the behaviour of transnational households within their institutional contexts.

The main message of this thesis is that remittances can be both a substitute for credit as well as a 'catalyst' for improved access to financial services in receiving countries. These findings are not contradictory: Migration and remittances on the one hand and financial services on the other are both part of the risk-management and asset-building strategies of households. They partially replace absent or rudimentary institutions for formal credit and insurance and partially complement each other – for example, when financial institutions provide households with savings options or accept remittances as collateral for loans. This interpretation contrasts with critiques of the overly 'consumptive' spending of remittances. Instead, this study's observations from the case studies on Mexico and El Salvador indicate that remittance receivers demonstrate a strong demand for savings options. Moreover, in countries such as El Salvador, where remittance inflows are large relative to the size of the financial sector, savings from remittances can contribute to liquidity of the financial sector in an important way.

The linkages between remittances and the financial sectors of the receiving countries depend on the specific institutional setting in each country. Consequently, the second part of this thesis emphasizes the institutional frameworks and specific initiatives that

link remittances with additional financial services, and, more generally, the role that governance by the state and other actors may play in creating favourable conditions for economic and social development. Remittances are the private income of transnational households. Institutional frameworks that open up monetary savings and borrowing options and facilitate the more efficient use of remittances for families are therefore more promising than a paternalistic debate on the 'correct' use of these incomes.