

Remittances and Investment

by

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ABSTRACT

This paper studies the impact of remittances on investment. Workers' remittances to developing countries have grown to be an important source of financing, amounting to around \$300 billion a year. The funds are used for both consumption and investment in the home countries of the migrants. The importance of financial and institutional framework in the receiving countries and how they interact with remittances is stressed. Data on remittance flow to 79 developing countries during 1995-2005 is used. Dynamic panel data approach is applied for this purpose. The results reveal that remittances, high quality institutional framework and well developed credit market increase investment. However, it is also found that the marginal importance of remittances as a financial source for investment decreases with improved institutional framework and a more developed credit market.

Keywords: Remittances, Investment, Institutions, Financial Development, Panel Data

JEL classifications: C23, E22, F24, G21, I38, O16, O17

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1 Introduction

This paper aims to increase our understanding of how remittances can foster investment in the home countries of migrants by considering the institutional quality and financial infrastructure. The increasing amount of inflows migrants remit to their home countries is of great concern. These inflows are increasingly substantial in terms of their stability, growth rates and as a share of GDP. In 2000, the world remittance inflow stood at 131 billion US\$. By 2005, this figure more than doubled to 263 billion US\$ or 0.62% of the world's GDP. This is a substantial amount compared to the Official Development Assistance (ODA) to developing countries which constitutes less than 0.24% of the world GDP. The World Bank estimates indicate that in terms of external inflows, remittances are second only to Foreign Direct Investment (FDI). It is also important to point out that for the very poor nations, remittances have surpassed even FDI. Among the Least Developing Countries (LDCs), remittance inflows in 2005 are 5.4% of GDP whilst FDI stood at 2.7% of GDP in the same period. There must be some economic consequences in these numbers. These remittances could also be one of the tools in the quest to making poverty history. Despite this, the nature of the economic implications of remittance inflows to developing and emerging countries is not fully understood.

We contribute to the literature by examining the role of financial and institutional development in the remittances and its relation to investment. Our empirical results suggest that remittance inflows are important in relaxing the financial constraints, particularly under the conditions of crippling institutions and inadequate financial intermediation. We find that remittance inflows are a lifeline to investment where the very institutions that give life to capital are non-existent.

Empirical evidence suggests that financial institutions are crucial in enhancing growth (see e.g. Levine, 1997; Kilpatrick, 2005; and Jalilian and Kilpatrick, 2005). We build on this research and look specifically at investment and not growth *per se* but focus in particular on one stream of funds remittances. Most of the earlier research about remittances looks at growth and comes to somewhat different conclusions. Mundaca (2005) finds in a sample of selected Central America countries that financial development tends to increase the responsiveness of growth to remittances. However, the works of Giuliano and Ruiz-Arranz (2009) and Fayissa and Nsiah (2008) suggest that remittances boost growth in countries with an underdeveloped financial sector. In other words, in countries where the financial sector is unable to extend credit to the private sector, remittance receipts are a vital source of capital relative to financially developed societies. These conflicting empirical findings invite further research of these issues.

The existing literature also points out that nonfinancial institutions affect the development of the financial markets (Levine, 1997; Roe & Siegel, 2008) and the economy as a whole (Rodrik et al., 2004; Acemoglu et al 2003; and Acemoglu et al 2006). It has been shown that developing countries characterized by sound general institutional frameworks attract comparatively more private capital in the form of FDI (Harms and Ursprung, 2002; Jensen, 2003; Busse, 2004; Hess 2004; and Busse and Hefeker, 2005). It is not farfetched to argue that migrant transfers meant for investment purposes could be severely limited in the presence of acute political instability, corruption and *go-slow* bureaucracies. In a recent paper, Catrinescu, Leon-Ledesma, Piracha and Quillin (2009) examine the premise that the remittances-growth relation is conditioned on the non-financial institutional setting. They provide empirical evidence which suggests that non-financial institutions such as law and order, government stability, democratic accountability etc, affect the growth-effect of remittances positively.

A crucial point made in this paper is that both financial and nonfinancial institutions are needed to induce investments. A country may have respectable nonfinancial institutions, say a functioning democracy, but it requires vibrant financial markets to mobilize both local and international capital, and channel them into productive usage. In the same way, no matter how competent a country's financial institutions appear to be, political stability, less corruption and efficient bureaucracy and avenues of redress are paramount in bolstering investor confidence. Our study differs from earlier works by focusing on investment and investigating how the institutional framework and the financial infrastructure influence both investments as such and how remittances impact investment.

In view of the importance of financial development and institutions in the development literature, it is equally important to analyse their moderating effects together. We take up these concerns by simultaneously examining the role of financial development and institutional quality in the remittance-investment nexus. A recent paper closely related to ours in that aspect is Bettin and Zazzaro (2008). They are studying how both financial development and institutional quality affect the impact of remittances on growth. Our paper differs from theirs in the view of financial development and choice of dependent variable. We focus on the effect on investment and see bank assets and credit provided by the banking sector as signs of financial development. Bettin and Zazzaro (2008) study growth and have a measure of what they call the efficiency of the financial intermediaries as a proxy of financial development. We deal on the activities of financial intermediaries.

The rest of the paper is organized as follows: the next Section outlines the hypotheses. Data and methodology models are presented in Sections 3 and 4. In Section 5 the empirical results are reported. Conclusions are offered in Section 6.

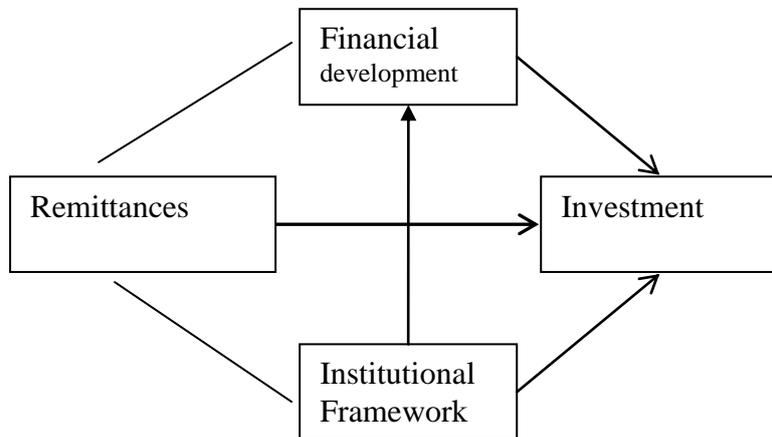
2 Hypotheses

In a number of articles it has been shown how financial development is associated with greater growth (King & Levine, 1993; Levine & Zervos, 1998 and Beck, Levine & Loayza, 2000). We are concentrating on the investment component of growth. As funds provided through remittances can go to investment in an indirect fashion through financial intermediation, financial development has to be accounted for in an analysis of remittances and investment. Another important variable is the institutional framework of a country. A number of studies have shown that institutions matter for growth (for an overview see Acemoglu et al 2006). Institutions must guarantee that fruits of the investment are reaped by no one other than the investor. Without such a guarantee the incentives to provide equity and loans to new projects will be hampered. One way that institutions enter into the picture is through boosting financial development. Another way is in a more direct way to make returns from investment more secure for the investor in the sense that the returns will not be appropriated by others. In a third way, good institutions are likely to make using remittances for investment more interesting (desirable). In addition, remittances are likely to be disclosed and thereby officially recorded if institutions are supportive.

Hence, the extent to which remittances will stimulate investment and thereby also growth in developing countries is dependent on a number of circumstances. These circumstances will influence the use of remittances for consumption, savings or investment. They will also have an effect on the choice of transferring funds through channels of a formal transparent character rather than channels of an informal character that is not recorded in official statistics. We are highlighting the circumstances that can be put under the headings 'financial development and

institutional framework’. Figure 1 illustrates in a simplified univariate fashion how the institutional framework and financial development are important for the impact of remittances on investment.

Figure 1 Factors that determine the impact of remittances on investment



A number of testable hypotheses can be formulated against the described relationships between remittances, institutional framework, financial development and investments.

To begin with, parts of remittances are not used for consumption by the receiver. In a review of the global evidence, Adams (2007) documents that remittance receiving households invest more on the average than households without remittance receipts. Adams (2007) also shows that remittance receiving households tend to save more than the average households. The ability of financial intermediaries to expand credit to the private sector and thus give additional impetus to investment is thereby increased. Finally, there are effects of remittances on investment from the multiplier effect of remittance-induced expenses. Several studies have found the multiplier effect to be quite large (see Lucas 2005). All these considered, it can be expected that:

Hypothesis 1 *An inflow of remittances increases investment.*

Institutional regimes characterized by transparency, contract enforcement, as well as protection of property rights are crucial for the development of capital markets as well as for the willingness to invest (see eg. North, 1990; Williamson, 2000; and La Porta et al, 1997; 1999; 2000; and 2002). Hence we expect that:

Hypothesis 2 *Investment is positively affected by the quality of the institutional framework of a country.*

We add to earlier research by studying whether institutional quality has a complementary or substitution effect on the use of remittances for investment. The nature of the moderating effect of institutional quality on the investment impact of remittances is unclear. On the one hand, in the presence of poor institutional quality, remittances could be the only external capital available to entrepreneurs. In that sense, we expect the institutional effect to be substitutive. On the other

hand, the effect of institutional environments may transcend access to external finance. Poor institutional quality may result in weak incentives to invest. For instance, in an institutional environment characterised by political instability, inefficient bureaucracies, a lack of just and fair legal recourse, entrepreneurs may find it difficult to identify safe and secure profitable opportunities. Conversely, sound institutional frameworks are more likely to create the appropriate incentive structure for investment from remittance proceeds. On balance, we expect the complementary effect to dominate. Hence a hypothesis 3 is that:

Hypothesis 3 *A high quality institutional framework increases the use of remittances for investment.*

With a higher quality institutional framework it is expected that firms can to a larger degree rely on debt financing of new projects at the same time as saving at banks and other financial intermediaries becomes more important. It is a well known fact that firms in developing countries to a larger extent use equity in financing projects than developed countries.²

The stock market is not examined in this paper. Hence the financial sectors studied are those that make credits available in form of loans to investments (like the banking sector). The hypothesis of the impact of financial development on investment is that:

Hypothesis 4 *Investment is positively affected by the development of the financial sector.*

Hypothesis 4 is based on several studies (see e.g. Levine, 1997; Kilpatrick, 2005; and Jalilian and Kilpatrick, 2005) that have shown the importance of financial institutions for economic growth.

We also want to examine whether financial development has a complementary or substitution effect on the use of remittances for investment. Inspired by Aggarwal et al (2006), who explore the impact of remittances on bank deposits and credit to the private sector, we state the following hypothesis:

Hypothesis 5 *A more developed financial sector channels more of the remittances to investments*

Aggarwal et al (2006) find a significant positive influence of remittances on financial development in developing countries. Remittances contribute to the development of the financial sector by increasing the aggregate level of deposits and/or the amount of credit to the private sector extended by the local banking sector. Providing remittances, services allow banks to “get to know” and reach out to unbanked recipients or recipients with limited financial intermediation. Banks become more willing to extend credit to remittance recipients because the transfers they receive from abroad are perceived as significant and stable and to increase during periods of economic downturns and natural disasters.

With hypothesis 5 we add to the findings of Aggarwal et al (2006) by also investigating whether there is a positive relation between financial development in terms of more use of credit in the economy and the use of remittances for investment. The differing results in studies of among others Mundaca (2005) and Giuliano and Ruiz-Arranz (2009) motivate why this hypothesis is included.

² See eg Singh (1997) and Glen & Singh (2003) who find in studies of listed companies around the world that companies in developing countries depend more heavily on equity in financing new investment.

We are aware fact that the arrows in Figure 1 can be reversed. Investment can influence financial development and institutional framework which, in turn, can influence remittance flow. These possible endogeneity problems are in our statistical analysis handled by using Generalized Method of Moments regressions following Arellano and Bond (1991).

3. Data

This study focuses on the impact of remittances on investment since 1995. The sample includes annual data on over 70 countries for which data is available for at least five consecutive years. In its simplest form, outlays intended to increase future output or income could be considered *investment*. At the national level, such expenses include the purchase of plants, machinery Equipment, the construction of roads, railways, schools, hospitals and residential, commercial and industrial buildings. It also includes expenditure on land quality improvement such as fences, irrigation channels and the like. In this context, additions to inventories are excluded from the concept of investment employed in this paper. Along these lines, we use the World Bank's gross fixed capital formation to gross domestic product (*Investment/GDP*) as the principal measure of investment's share of aggregate output.

We report the all variables, their proxies and sources in Table 1A of the Appendix. According to the descriptive statistics, the representative country invests, on average, 22% of total output over the period. There is a considerable spread, however. For instance, Sierra Leone invests only 8% of total output as compared to China, which invests close to 36% of GDP over 1995-2005. One of the core questions of this paper is how remittance *per se* explains such variability in investment. Furthermore, we seek to investigate the nature of the moderating effects, if any, of the institutional quality and financial development in the investment and remittances relationship.

Table 1: Descriptive Statistics

	Mean	Median	Std Error	Min	Max	Skewness	N
Investment/GDP	21.63%	21.20%	5.14	8.09%	35.55%	0.26	79
Remittances/GDP	3.69%	1.54%	4.74	0%	21.45%	1.789	79
Trade/GDP	86.57%	79.91%	46.27	24.67%	303.62%	1.824	79
GDP per capita Growth Rate	4.36%	4.00%	1.96	0.8%	12.37%	1.33	79
Lending Rate	18.61%	17.29%	9.66	6.36%	66.11%	1.786	79
Asset/GDP	46.50%	34.90%	39.53	6.27%	169.5%	1.772	73
Credit/GDP	35.28%	24.35%	33.89	2.18%	153.62%	1.825	73
Institutions	65.38	65.47	8.59	44.55	85.18	-0.23	79

The conception of remittances adopted here relates to international migrations. It refers to the financial resources migrants transfer to their countries of origin. This remittance inflow is constructed as the sum workers' remittances, compensation of employees and migrant transfer. These series are obtained from the World Bank's World Development Indicators (2008). One important shortcoming of the remittances measure is that it does not adequately capture money

transfers through informal channels such as friends, drivers, traders and the *hawala* service providers. In a survey conducted by Martiez (2005), only 1 out of every 4 countries made efforts to record remittance flows through informal channels. As such the remittance variable here could best be seen as “recorded” remittance inflows. Averaged over 1995-2005, remittance inflows as measured above, constitutes over 3.7% of GDP in a typical country within our sample. They constitute even larger shares of GDP in some of the poor countries such as Yemen (14.34%), Lebanon (14.68%), Haiti (15.24%), Albania (16.05%), Moldova (18.78%) and Jordan (21%).

The extant literature proposes various indicators of financial development (see e.g. Beck Demirgüç-Kunt & Levine. 2000). These indicators range from broad money supply (M2) to credits. For our purposes, we are interested in an indicator that most appropriately proxies the extent to which financial intermediaries channelled savings to investors. The prime measure of financial development employed in this paper is *private credit*. Private credit represents the claims of financial intermediaries on the private sector as a share of GDP. It includes credits extended to the private sector by deposit money banks as well as non-deposit banks. It however excludes loans originating from the central banks. Thus *private credit* is a comparatively more appropriate measure of financial development in the current context. In particular, it captures the activities of financial institutions with regard to mobilizing savings from private entities to private firms³. That said, we also recognised that in some of the economies under consideration, state-owned enterprises play a major role in the economy. As a result we also employ *assets* – the total claims on the private and public enterprises as well as the claims on the government sector – as an alternative measure that captures credit to both private and state-owned enterprises. We retrieve both measures of financial development from the 2008 version of Beck Demirgüç-Kunt & Levine (2000) database.

North (1990) refers to institutions as the humanly devised constraints that shape human interactions. It is no gainsaying that different institutional settings provide different opportunity sets as well as incentive structures that define the actions of economic agents. Unlike most of the variables discussed thus far, institutions do not lend themselves to direct measurements. However, they manifest in the general political stability, law and order, bureaucratic quality, corruption, among others. International Country Risk Guide (ICRG) provides an assessment of the institutional development of various countries under the caption ‘political risk’. It comprises 12 separate institutional risk indicators – government stability, socioeconomic conditions, investment profile, internal conflicts, external conflicts, corruption, the military in politics, religion in politics, law and order, ethnic tensions, democratic accountability and bureaucratic quality. The index assigns higher values for lower risks. Conversely, ICRG assigns higher values to better institutional quality. This index is our primary measure of institutional development.

As a standard practice, we also include a set of control variables in order to isolate the effects of the variables at the core of this investigation. The first of these relates to the view that investment outlays respond to economic growth. Intuitively, one could conceive growth of total output as an increase in purchasing power and hence demand. On the aggregate such demand is an invitation to expand the productive capacity as outlined in the Keynesian economics thinking. Accordingly, we attempt to control for the accelerator by the growth rate of gross domestic product – *GDP growth*. It goes without saying that the financial resources required to undertake

³ For a fairly detailed discussion on the comparative advantages of private credit over the alternative measures of financial development, see Beck Demirgüç-Kunt & Levine (2007).

the necessary investment is scarce and costly. This is likely to constrain the optimum investment, *ceteris paribus*. We control for this effect using the *lending rate*.

The third issue we control for is the *access* to the international market. Whilst the importance of domestic market cannot be overemphasized, access to the international market is an increasingly important factor considering where to invest and at what scale. The share of trade (exports plus imports) in GDP is used to proxy access to both input and output international markets. As evident from the descriptive statistics, the mean (median) openness to trade is 86% (79%) of GDP. However the sum of export and import is only 24% of GDP in the least open economy as compared to over 300% in the most open country in the sample.

Table 2 presents the pair wise correlation coefficients among the variables. As could be seen from the second column, investment is positively and significantly correlated with the economic growth rate and access to the international market but negatively correlated with the prevailing lending rate. Of particular interest, remittances inflows, the two measures of financial development and institutional development are positively and significantly correlated with investment outlays. Whilst acknowledging that correlations do not necessarily imply causality, the significance and the signs of the correlation coefficients between investment and the covariates are consistent with the discussions thus far. The correlation coefficients also show that there is a significant inverse relationship between the remittance share of GDP and the level of financial development and the quality of the general institutional framework. This inverse correlation seems to indicate that in countries with relatively more developed financial and general institutional framework the share of remittances in domestic national is comparatively small.

Table 2: Bivariate Correlation of the variables of Interest

	Investment/ GDP	Remittances/GDP	Trade/ GDP	GDP Growth	Lending Rate	Assets/ GDP	Credit/ GDP
Investment/ GDP	1						
Remittances/GDP	0.10*	1					
Trade/ GDP	0.29*	0.03	1				
GDP Growth	0.22*	0.03	0.04	1			
Lending Rate	-0.24*	-0.02	-0.25*	-0.22*	1		
Assets/ GDP	0.21*	-0.08*	0.43*	-0.05	-0.34*	1	
Credit/ GDP	0.21*	-0.10*	0.45*	-0.05	-0.34*	0.97*	1
Institutions	0.19*	-0.11*	0.42*	0.05	-0.23*	0.43*	0.45*

In line with the previous studies, we also find a significant and positive correlation between financial and institutional development which, in turn, underscores the need to examine the separate moderating effects of financial and institutional development simultaneously. Finally, the table also reports that the two measures of financial development are highly correlated (97%). This should not be surprising since each of these indicators are supposed to be capturing the extent of financial development.

4 Methodology

Our task is to examine the relationship between remittances and investment, and the moderating role of institutional quality and financial development in such remittances-investment relation. More specifically, we seek to find out whether remittance inflows in country i from 1995 to 2005 have any causal effect on investment expenditure over the same period. We have in hand a dataset that consists of 11 annual observations per 79 countries. The first consideration therefore pertains to estimation techniques suitable for such a short unbalanced panel. In addition, the discussion from the hypotheses section suggests a web of interrelations among the variables of interest. As such, our second consideration relates to an estimation strategy that is capable of sorting out endogeneity and autocorrelation concerns as well as complications emanating from heteroscedasticity. The Arellano-Bond (1991) dynamic panel estimator and its variants such as Arellano-Bover (1995) and Blundell-Bond (1998) address these concerns. Thus our preferred specification is the dynamic panel approach.

To fix ideas, we proceed with the standard static approaches. First, we pooled the observations across countries over the years such that

$$INV_{it} = \beta_0 + \beta_1 Rem_{it} + \beta_2 INST_{it} + \beta_3 FD_{it} + \beta_4 Rem_{it} * INST_{it} + \beta_5 Rem_{it} * FD_{it} + X'_{it}\beta_6 + \varepsilon_{it} \quad (1)$$

where INV_{it} refers to investment over GDP of country i as of time t . and Rem is remittances/GDP. $INST$ is a measure of institutional quality, and FD is a proxy for financial development. X is a set of control variables as discussed above in addition to year dummies. First of all, we test the implication of hypothesis 1 which postulates that the marginal impact of remittances⁴ on investment is significantly different from zero. In addition, we test whether there is a complementarity or substitutive relationship between the level of financial development and remittance inflows on the one hand, and institutional quality and remittances on the other. A positive and significant coefficient of the interaction term between institutional quality and remittances β_4 would imply that remittances are more effective in inducing investment in sound institutional environments. In that case, higher institutional quality would be deemed as complimenting remittance inflows to boost investment according to hypothesis 3. The converse would suggest that remittances are life line to investment in institutionally difficult settings. An analogous interpretation is given to β_5 , where $\beta_5 < 0$ would lead to the rejection of hypothesis 5. β_2 and β_3 pertain to hypotheses 2 and 4 respectively.

In the first instance, we estimate the parameters of equation (1) by the Ordinary Least Square (OLS). Before we take the OLS estimates too seriously, however, we ought to assure ourselves that the assumptions underlying ε_{it} are reasonably realistic. For instance, equation (1) assumes that the error terms are independent across countries. However ε_{it} can be decomposed into μ_i (a country specific effect such as the state of technology, geography and the like) and v_{it} (the classical standard error with the usual assumptions). As a second step in the static domain, we obtain the parameter estimates of equation (1) using the random effect (RE) with the assumption that the country specific effects are uncorrelated with the regressors in equation (1). Of course, it is not settled that the covariates are uncorrelated with μ_i . Hence we also run the fixed effects (FE) which allows for such correlations. As is customary in static panel analyses, we employ the restricted F-statistics, Breuch-Pagan LM and the Hausman (1978) specification tests to discriminate among these three estimators.

⁴ $\left(\frac{\partial INV}{\partial Rem} = \beta_1 + \beta_4 INST + \beta_5 FD\right)$

As might be apparent, the OLS, the fixed effect and the random effect estimators side step several issues such as autocorrelation and endogeneity problems. First of all, the vast literature on investment models suggests that investment outlays are autocorrelated. Innovations in current investment outlays may only decay with lags. The main explanation lies in the business cycles effects. Several studies try to get around the autocorrelation menace by averaging observations over 5-year periods (see for example: Giuliano and Ruiz-Arranz; 2009). Apart from the fact that such an approach leads to excessive loss of information, it seems arbitrary. For instance, it amounts to assuming that the waves of contractions and expansions of economic activities are of regular 5-year intervals. An alternative we pursue here includes among the right hand side variables lag (p) realisations of INV_{it} such that

$$INV_{it} = \beta_0 + \sum_{s=1}^p \gamma_s INV_{it-s} + \beta_1 Rem_{it} + \beta_2 INST_{it} + \beta_3 FD_{it} + \beta_4 Rem_{it} * FD_{it} + \beta_5 Rem_{it} * INST_{it} + X'_{it} \beta_6 + \varepsilon_{it} \quad (2)$$

where $\varepsilon_{it} = \mu_i + \delta_t + v_{it}$ and $\delta_t \sim IID(0, \sigma_\delta^2)$, $\mu_i \sim IID(0, \sigma_\mu^2)$ and $v_{it} \sim IID(0, \sigma_v^2)$ are independent of each other and among themselves⁵.

The inclusion of the lag dependent variable does render pooled OLS and the RE estimators bias and this bias does not necessarily decay with the sample size. This is evident in the fact that the country specific effects μ_i are correlated with INV_{it} and its lagged realisations even in the absence of serial correlation of v_{it} . Certainly, one cannot rule out the possibility of correlation between INV_{it} and δ_t . The current global crisis is an uncompromising reminder of this possibility. At first glance, the FE estimator seems to be a way around the problem. But the within estimator is also biased and potentially inconsistent in view of the fairly large number of countries and short period sample we have at hand (Nickell 1981)⁶.

Perhaps, the critical issue borders on the bias induced by reverse causality. Whilst we are interested in examining whether remittance inflows lead to increased investment, it is however theoretically plausible that increasing investment in the country of origin could induce migrants to increase remittances to finance investment opportunities. India and China, two of the leading recipients of remittances (in absolute terms), seem to provide some anecdotal evidence in this respect. In the same vein, financial sector development may emerge in reaction to the demand from the business sector. Take for example private credit, the primary measure of financial sector development in this paper. Private credit may actually increase in response to demand for such credits. In other words, financial sector development is as much a supply side issue as a demand side phenomenon. In many countries, developed and less developed, business groups such as the Chamber of Commerce, Association of Industrialists and the like are known to advocate for improved government policies and institutional quality in general. Thus even in the case of institutional quality we cannot claim strict exogeneity.

Starting with Anderson and Hsiao (1981), various dynamic panel solutions have been suggested in the literature. The main feature of this family of panel estimators is that they rely on internal instruments. Essentially, the approach involves taking the first difference of equation (2) which wipes out the unobserved time invariant country effects and then instrument the covariates in the transformed expression with the levels of the lagged realization of the respective variables.

⁵ μ_i and δ_t are country and year specific effects. v_{it} is the standard error term.

⁶ Nickell (1981) shows that the FE estimator is biased of $O(1/T)$ which means that the bias only vanishes with the length of the time period.

5 Results

We start by running the pooled OLS, the fixed-effect and the random effect versions of equation (1) within a static framework. The *F-test* and the Hausman (1978) tests suggest that among these static specifications, the fixed effect specification with time dummies is superior. In order to conserve space, we report only estimates from the fixed-effect models. The fixed-effect estimates are presented in the first three columns of Table 3. They show that economic growth (*GDP Growth*) and access to the international market (*Trade/GDP*) positively induce investment. As expected, the *lending rate* adversely impacts on investment expenditure. The estimates in column 1 suggest that without any consideration for the institutional and financial development, remittance inflows have statistically insignificant impact on investment outlays.

This result is consistent with the view that remittances are not meant for capital accumulation (Martin 1991) but are directed primarily towards consumption. It is also in line with the findings of the IMF (2005) that remittance receipts have no growth effects. However, there is emerging evidence that a significant fraction of remittances is invested (see Amuedo-Dorantes and Pozo. 2006; and Adams. 2007). In the case of rural Pakistan, Adams (1998) finds that the propensity to acquire irrigated farmland is significantly greater among households receiving remittances than those without. Even in urban Mexico, Woodruff and Zenteno (2001) report that about 27 per cent of small businesses depend on remittance inflows from the USA. In his survey of the global evidence on the uses of remittances, Adams (2007) finds that remittance receiving households spend more on investment goods and invest more on entrepreneurial activities than households without.

Moreover, households receiving remittances are not necessarily the best entrepreneurs in town. In countries where the financial market is fairly developed, such households could conveniently put aside some of their remittance receipts in the banks, for instance. Thus a portion of purely altruistic motivated remittances can in this fashion find its way via financial intermediation into the business sector. Furthermore, migrants can remit to their home countries in search of fair returns by taking advantage of the intermediation provided by the financial institutions. Institutional quality also makes a difference. Poor institutional quality of a receiving country increases the risk of expropriation, distorts the investment opportunities and increases the return required on investments. The implication is that the impact of remittances on investment outlay is potentially conditioned on both financial and non-financial institutional qualities and these ought to be examined together.

Table 3: Institutional and Financial Development in the Investment-Remittances Nexus

Dependent Variable: Investment/GDP (Gross Fixed Capital Formation to GDP)

	Static Panel: FE			Dynamic Panel: GMM		
	1	2	3	4	5	6
Investment/GDP(1)				0.545*** (0.023)	0.613*** (0.025)	0.529*** (0.030)
Investment/GDP(2)				-0.233*** (0.022)	-0.190*** (0.020)	-0.188*** (0.023)
GDP Growth	0.120*** (0.039)	0.140*** (0.038)	0.118*** (0.035)	0.078*** (0.021)	0.154*** (0.020)	0.113*** (0.017)
Lending Rate	-0.032 (0.021)	-0.044** (0.021)	-0.041** (0.019)	-0.024** (0.012)	0.016 (0.022)	-0.004 (-0.019)
Trade/GDP	0.037*** (0.013)	0.028** (0.012)	0.056*** (0.011)	0.039*** (0.007)	0.015* (0.008)	0.042*** (0.006)
Remittances/GDP	0.078 (0.055)	0.818** (0.370)	0.945*** (0.340)	0.019 (0.036)	0.599*** (0.156)	0.808*** (0.235)
Credit/GDP		0.093*** (0.018)			0.037** (0.016)	
Remittances *Credit		-0.008*** (0.003)			-0.004*** (0.001)	
Assets/GDP			0.230*** (0.021)			0.128*** (0.015)
Remittances *Asset			-0.002*** (0.000)			-0.001*** (0.000)
Institution		0.060* (0.034)	0.106*** (0.031)		0.095** (0.042)	0.153*** (0.033)
Remittances *Institutions		-0.007 (0.006)	-0.013** (0.005)		-0.006* (0.003)	-0.012*** (0.004)
Constant	18.336*** (1.323)	11.536*** (2.621)	5.165** (2.508)	12.614*** (0.851)	3.413 (3.475)	-1.586 (2.370)
No. of Obs.	753	689	689	500	461	461
No. of Countries	79	73	73	77	70	70
R Square	0.100	0.168	0.301			
F-Stats.	5.251	6.707	14.314			
Chi Square				5068.16	62459.875	37909.442
[p-value]				[0.0000]	[0.0000]	[0.0000]
AR(1) test				-3.546	-3.882	-3.880
[p-value]				[0.0004]	[0.0001]	[0.0001]
AR(2) test				0.387	0.663	0.870
[p-value]				[0.6987]	[0.5071]	[0.3845]

Sargan	63.331	54.247	44.359
[p-value]	[1.0000]	[1.0000]	[1.0000]

note: *** p<0.01. ** p<0.05. * p<0.1. Year dummies are included in all the specifications

Consequently, we re-estimate equation (1) by taking these into consideration. The results seem to lend credence to the view that in examining the remittances-investment nexus, one has to simultaneously investigate the moderating role of both financial development and institutional quality. From columns 2 and 3 of the table, we observe that remittances, financial development and institutional quality *per se* induce investment expenditure. Furthermore, the results seem to suggest that remittance inflows do not complement institutional quality and/or financial development as postulated in hypotheses 4 and 5. On the contrary, remittance inflows are potentially more important for investment outlays in institutionally and financially under-developed economies.

The question at this stage though is whether these results are robust in a dynamic setting. Columns 4, 5 and 6 of Table 4 summarises results of the dynamic panel estimations. In all the 3 specifications, we take the first-difference of equation (2), and then instruments with the lag realisations of the respective variables in the spirit of Arrelano and Bond (1991)⁷. We then perform the Sargan test for over-identifying restrictions. In each of the 3 cases, we could not reject the null hypothesis that the over-identifying restrictions are valid. The statistics of the Arellano-Bond tests of first- and second-order autocorrelations in the first-difference errors suggest that the idiosyncratic errors are independently and identically distributed in all the specifications.

With regard to the parameter estimates, we find strong evidence of dynamic dependence. Investment expenditure tends to increase significantly with its first lag but declines with the second lag. Whilst this may raise concern about the quantitative implications of the estimates obtained from the static approach, the qualitative implications are identical. In addition to Arrelano and Bond (1991), we also estimate the dynamic panel using system generalised moment method (SGMM) proposed by Blundell and Bond (1998). The implications of the SGMM estimates are essentially similar to those reported in Table 3 except that SGMM estimates are generally bigger in magnitude. The SGMM results could be found in Table 2A of the Appendix.

As in the static case, we observe that without controlling for the effects of financial and institutional development, the impact of remittance on investment is statistically negligible. However, the estimates from columns 5 and 6 show that the impact of remittances on investment is significant, and that it varies with the level of institutional and financial development. Thus, the estimates from the dynamic approach reiterate the need to examine the effect of remittances on investment within the context of the financial and institutional environment. In general we find evidence in support of the hypothesis that remittance receipts increase the investment expenditure. Contrary to hypotheses 3 and 5, the financial and institutional environments do not complement remittance inflows. Rather, the evidence suggests that the institutional framework and the level of financial intermediation are substitutes to remittance receipts with regard to investment expenditure.

⁷ We use the same dataset as the in the static case but with fewer observations owing to the first-difference and the lag structure involved.

Specifically, the coefficient estimates on the interaction terms indicate that the impact of remittances on investment varies inversely with the level of financial development and the quality of the economy's institutions. Figure 1 shows the marginal effects of remittances at the 25th, 50th and 75th per centiles of institutional and financial development (with the *t*-statistics in the brackets). Figure 1a is constructed at the 25th, 50th and the 75th per centiles of institutional quality whilst holding financial development (*credit/GDP*) at the median level. In general, Figure 1a gives a pictorial impression of the reported inverse relationship between the marginal effects and the institutional quality. For instance, at the 25th per centile of overall institutional development, the marginal effect of remittance inflows on investment is 0.18. This implies that under a poor institutional environment, when remittance inflows are doubled, investment share of gross domestic product increases by 18 per cent at the margin. However, the corresponding increase in investment is 11 per cent in respect of institutions qualities above the 75th per centile. This finding does not support the hypothesis that high quality institutional framework increases the use of remittances for investment.

This substitutive relation between remittances and institutions does not concur with Catrinescu et al's (2009) report that the GDP per capita growth effect of remittances is significantly greater in the presence of sound institutions relative to weak institutional environments. One possible interpretation is that the moderating effect of institutional quality on the impact of remittances investment and growth differ. A closer examination of empirical results of Catrinescu et al (2009) suggests a potential error in their reading of the ICRG data and hence misinterpretation of the results. Our reading of their results suggests a substitutive effect similar our findings.

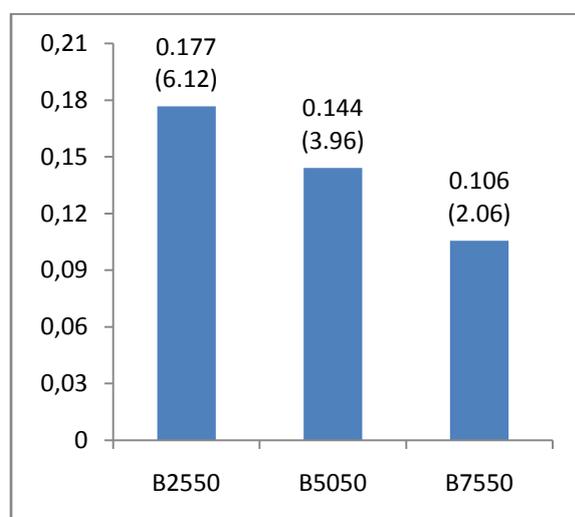


Figure 1a: The Marginal Effects of Remittances on Investment by the Levels of Institutional Quality

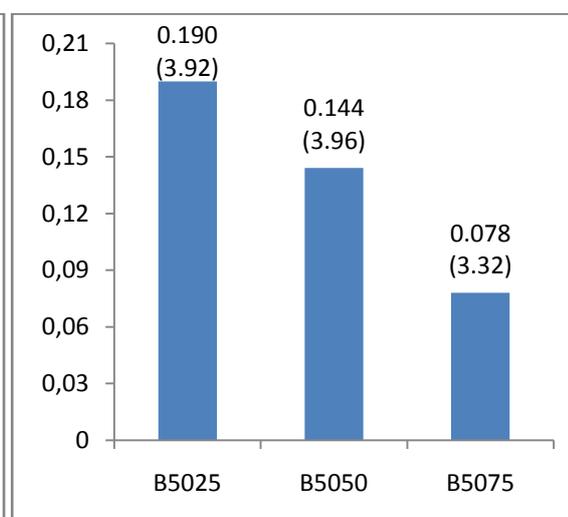


Figure 1b: The Marginal Effects of Remittances on Investment by Levels of Financial Development

These findings have to be put into the wider picture of the role of institutions in order to grasp the essence. The extant literature suggests that, to a large extent, the failure of attempts to foster economic performance by promoting official development assistance and foreign direct investment could be explained by poor institutional quality (Acemoglu et al., 2006; Easterly, 2001 & 2006; Dollar & Kraay, 2003; Burnside & Dollar, 2000 and North, 1990). Poor institutional quality does not only fail to properly define the individual and collective constraints of the game (North, 1990) but most importantly it creates perverse incentive systems which are inimical to any capitalist society (Easterly, 2001 & 2006). In such perverse settings, capital is "dead" (Soto, 2000). Phrased differently, when the institutions that could secure the interest of third parties are virtually non-existent, entrepreneurs are only taken seriously by their immediate

circles. Hence, funds needed to undertake investment projects are limited to self-finance, and whatever entrepreneurs could be raised from close associates of which transfers from friends and relatives abroad can be a major component. Within these settings, our finding suggests that remittance inflows are lifeline to investment where the very institutions that give life to capital are non-existent.

Turning attention to financial development, Bettin and Zazzaro (2008) argue for the need to distinguish between quantity and efficiency based measures of financial development. Their empirical results show that bank efficiency (cost to income ratio) complements the impact of remittances on growth. We focus on financial development as measured by the amount of credit granted to the private sector by the bank sector. Figure 1b shows a pattern of substitution between remittances and financial development. Holding the level of institutional quality at the median, the marginal effect of remittances increases as one migrates from financially developed (above 75th per centile) to moderately (median) and then ultimately to financially underdeveloped (below 25th per centile) environments. For the typical financially underdeveloped economy (25th per centile and below), 100 per cent increase in remittance receipts is associated with 19 per cent increase in investment outlays. In the case of more financially development economies (75th per centile and above), the marginal effect of remittances on investment falls to 8 per cent. This implies that in economies where the level of financial intermediation is developed, the importance of remittance receipts as a source of capital falls by close to 60 per cent as compared to economies characterised by low levels of financial intermediation. This finding is inconsistent with hypothesis 5 which implies a complementarity between remittances and the level of financial development. The result thus suggests that remittance receipts and financial development are substitutes with regard to investment expenditure.

Our finding is reminiscent of Giuliano and Ruiz-Arranz (2009), and Fayissa and Nsiah (2008) who study the moderating effect of financial development on the remittance-growth relation. In the parlance of Giuliano and Ruiz-Arranz (2009), remittances are substitutes for the lack of financial depth. Similarly, Fayissa and Nsiah (2008) conclude "... remittances boost growth in countries where the financial system is less developed by providing an alternative way to finance investment and helping overcome liquidity constraints". A potential criticism against the estimates of both Giuliano and Ruiz-Arranz (2009) and Fayissa and Nsiah (2008) is that none of them controlled for the effects of institutional development and how it might impact on their findings. Given the apparent consensus among financial and political economists that the institutional framework affects the level of financial intermediation (see Levine. 1997 and Roe and Siegel. 2007), this concern does hold some bite. Indeed, Giuliano and Ruiz-Arranz (2009) write, "... we cannot eliminate the possibility that omitted variables drive some of the results." Our findings demonstrate that the lack of reinforcement effect between remittance inflows and financial development persists even when one simultaneously examined the moderating effects of financial and institutional development on the promise of remittances.

6 Conclusions

Financial constraint has been identified as one of the main impediments that keep the poor from getting foothold on the development ladder (Domar, 1946; Swan, 1956; Solow, 1956; Harrod, 1959; Rowstow, 1960; Sachs, 2005). One question that emerged recently following the increasing inflow of remittances to developing countries is whether remittances could be considered as capital – do they relax the financial constraints facing the receiving countries? Earlier studies (see Chami, Fullenkampl and Jahjah, 2005; and IMF, 2005) cast doubt on the role of remittances in easing the financing gap. We make a case for institutional quality and the level of financial development in modifying the motive to remit, the resultant mix of remittances, and the effectiveness of remittances in promoting investment and hence economic progress. We therefore investigate the relationship between remittances and investment expenditure and the moderating effects of the prevailing institutional environment and depth of financial intermediation.

The main insight from this study is that the use of remittances for investment depends on the institutional quality and the depth of financial intermediation. Our Dynamic Panel Data approach, which accounts for the potential endogeneity of remittance inflows, yields positive and significant estimates of the effects of remittances on investment outlay across several specifications.

Consistent with the literature the role of institutional quality on economic performance (see Acemoglu et al. 2006), we find that the quality of the prevailing formal institutions impacts positively on investment outlays. From an investment risk point of view, sound institutions ameliorate the risk of expropriation, political and economic instability, and hence the required rate of return. Furthermore, it makes it relatively easy for entrepreneurs to identify investment opportunities and secure the interests of outside investors to exploit such opportunities. Our finding thus implies that sound institutions give life to (third party) capital and accordingly impact positively on investment among the remittance receiving countries. As documented by the economics of financial development literature, (see eg. Hermes & Lensink, 2003; and Beck, Levine & Loayza, 2000) we also find that financial development has significantly positive impacts on investment. This suggests that by mobilising and channelling financial resources for investment purposes, the level of financial development eases the financial constraints on investment.

Given the positive role of institutional quality and financial development in providing the enabling environment for identification and marshalling of the needed financial resources to exploit such investment opportunities, we expect sound institutions and financial development to boost the effect of remittances on investment. Contrary to hypotheses 3 and 5, the results reveal that institutional quality and the level of financial development interact inversely with remittance receipts. In particular, the coefficient estimates indicate that the marginal impact of remittance inflows under weak (lower quartile) institutional environment is about 40 per cent more than its impact under sound (upper quartile) institutional settings. Similarly, the marginal impact of remittances in financially underdeveloped settings is more than twice the marginal effects observed among financially more developed countries.

A plausible explanation of these substitutive relationships lies in the ease with which entrepreneurs could raise external funds under varying degrees of institutional quality and financial development. Weak institutions undermine all formal checks on expropriation and thus make, *ex ante*, commitments of entrepreneurs to secure the interest of impersonal investors less credible. Under such environments, entrepreneurs can hardly raise funds beyond their relatives.

Our finding thus indicates that the absence of sound institutions increases the marginal importance of such family based transfers as a remittance for investment by close to 40 per cent.

In the same vein, the observed substitutive relationship between financial development and remittances points to use of remittances for investment when the credit market is malfunctioning. In addition, it indicates that remittance inflows are neither channelled via financial intermediaries nor leveraged (i.e. use as collaterals) for investment purposes. Hence, a policy regime that encourages domestic financial institutions to actively engage in the money transfer market may change this relationship between remittance, credit market and investment. This will weaken the current monopoly enjoyed by the major money transfer companies and thus lower the cost of money transfers (Alberola and Salvado, 2006). Most importantly, it would enable financial intermediaries to re-package such remittances towards the productive sectors, and thereby foster complementarity (as opposed to the current substitutive) between the financial development and the remittance inflows.

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Table 1A: Definition and Source of the Variables

<i>Variables</i>	<i>Description</i>	<i>Sources</i>
<i>Investment/GDP</i>	Gross Fixed Capital Formation: It includes land improvements such as fences, ditches, and drains; plant, machinery and equipment purchases; and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings.	
<i>Growth per capita</i>	The growth rate of gross domestic product	
<i>Trade/GDP</i>	The sum of exports and imports of goods and services as a share of the gross domestic product.	
<i>Remittances/GDP</i>	Workers' remittances and compensation of employees comprise current transfers by migrant workers and wages and salaries earned by non-resident workers. Workers' remittances are classified as current private transfers from migrant workers who are residents of the host country to recipients in their country of origin. They include only transfers made by workers who have been living in the host country for more than a year, irrespective of their immigration status. Compensation of employees is the income of migrants who have lived in the host country for less than a year. Migrants' transfers are defined as the net worth of migrants who are expected to remain in the host country for more than one year that is transferred from one country to another at the time of migration.	World Development Indicators (2008)
<i>Lending rate</i>	The rate charged by banks on loans to prime customers	
<i>Assets/GDP</i>	Assets are the claims of the deposit money banks and other financial institutions on the whole nonfinancial real sector, including government, public enterprises and the private sector.	
<i>Credit/GDP</i>	Claims on the private sector by the deposit money banks and other financial institutions as a share of gross domestic product. Unlike <i>assets</i> , it does not include credits to government and public enterprises.	The 2008 version of Beck.,Demirgüç_Kunt & Levine (2000)
<i>Institutions</i>	It is an index of overall political risk. Countries with the low risk are assigned the high points. Conversely, countries with better institutions (low risk) receive higher rating and vice versa. The minimum point is 0 and the maximum is 100	International Country Risk Guide

Table 2A: GMM2 and SGMM estimates

Dependent Variable: Investment/GDP (Gross Fixed Capital Formation to GDP)				
	GMM2		SGMM	
	1	2	3	4
Investment/GDP(1)	0.613*** (0.025)	0.529*** (0.030)	0.734*** (0.024)	0.745*** (0.028)
Investment/GDP(2)	-0.190*** (0.020)	-0.188*** (0.023)	-0.118*** (0.016)	-0.135*** (0.016)
GDP Growth	0.154*** (0.020)	0.113*** (0.017)	0.136*** (0.015)	0.132*** (0.027)
Lending Rate	0.016 (0.022)	-0.004 (0.019)	-0.002 (0.019)	0.009 (0.014)
Trade/GDP	0.015* (0.008)	0.042*** (0.006)	0.023*** (0.005)	0.014*** (0.003)
Remittances /GDP	0.599*** (0.156)	0.808*** (0.235)	1.564*** (0.281)	0.680*** (0.162)
Credit/GDP		0.128*** (0.015)	0.015** (0.006)	
Remittances *Credit		-0.001*** (0.000)	-0.000*** (0.000)	
Institution	0.095** (0.042)	0.153*** (0.033)	0.071** (0.028)	0.103*** (0.030)
Remittances *Institutions	-0.006* (0.003)	-0.012*** (0.004)	-0.024*** (0.004)	-0.008*** (0.003)
Assets/GDP	0.037** (0.016)			0.019* (0.011)
Remittances *Asset	-0.004*** (0.001)			-0.002** (0.001)
Constant	3.413 (3.475)	-1.586 (2.370)	1.998 (2.470)	-0.616 (2.043)
No. of Obs.	461	461	536	536
No. of Countries	70.000	70.000	73.000	73.000
Chi Square	62 459.875	37 909.442	355 921.190	17 634.083
[p-value]	[0.0000]	[0.0000]	[0.0000]	[0.0000]
AR(1) test	-3.882	-3.880	-3.899	-4.038
[p-value]	[0.0001]	[0.0001]	[0.0001]	[0.0001]
AR(2) test	0.663	0.870	0.153	0.066
[p-value]	[0.5071]	[0.3845]	[0.9473]	[0.8782]
Sargan	54.247	44.359	46.174	47.133
[p-value]	[1.0000]	[1.0000]	[1.0000]	[1.0000]