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# International migration and development: the socioeconomic impact of remittances in Colombia

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**R**emittances to Colombia have grown rapidly over the last few years, and their economic significance is increasing apace. This article provides a detailed analysis of the economic and social effects of these currency flows and draws attention to the potential long-term risks involved. Accordingly, it analyses trends in remittances in Colombia over the last few years, paying special attention to their importance to the country's economy and the socioeconomic characteristics of their senders and recipients. This analysis is followed by an assessment of remittances in Colombia which indicates that, while they may help to improve the situation of the country, they also entail a number of costs that may, in the long term, be detrimental to its economy.

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# I

## Introduction

Over the past few years, remittances have become the Holy Grail of development studies. The massive amounts of capital sent by migrant workers to their countries of origin appear to bridge many gaps in developing countries, particularly with regard to financing problems that neither foreign direct investment nor development aid can address. There is no consensus, however, as to the actual impact of remittances on development. While optimists view them as the best way to spur economic growth and improve well-being in the world's poorest countries, pessimists regard them as yet another form of dependence which may make matters worse for receiving countries. As is always the case with such questions, the truth lies somewhere between these two extremes and largely depends on the social and economic situation of the receiving country, as well as the manner in which remittances are handled.

The Colombian experience offers particularly useful insights into the impact of remittances on development. The latter have increased rapidly over the last few years, and their economic importance is

also growing. Studies on the subject have multiplied as well, perhaps faster than remittances themselves. The issue remains surrounded by controversy, however. The purpose of this article is to provide a detailed analysis of the economic and social effects of remittances and to underscore the potential long-term risks these currency flows entail.

Accordingly, section II analyses trends in remittances in Colombia over the last few years, paying special attention to their importance to the country's economy. An effort is also made to understand the socioeconomic characteristics of those who send and receive remittances. Section III provides an assessment of remittances in Colombia which shows that, while they may help to improve the situation of the country, they also entail a number of costs that may, in the long term, be detrimental to its economy. Consequently, public policy should not focus solely on reducing the cost of sending remittances or channelling them towards investment in production. Rather, it must provide viable development alternatives to reduce the country's economic dependence on these flows.

# II

## An overview of remittances in Colombia

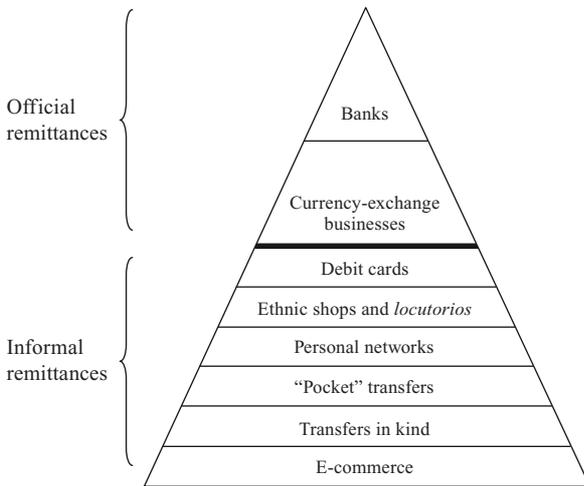
### 1. A classification of remittances

Remittances may be broadly defined as the portion of migrants' available income which they send back to their countries of origin. These funds can be transferred in a number of ways (see figure 1). In addition to official remittances, which are transferred through banks and currency-exchange businesses, migrants employ a variety of informal channels which enable them to lower the cost of international financial transfers. An informal remittance market dominated by ethnic shops and *locutorios* (migrant service businesses offering cheap international phone calls and other communication services) has thus arisen in the main urban centres that receive large inflows of migrants. In addition to their main business, the owners of these

shops also transfer funds for a lower fee than financial institutions charge.

Another informal channel is the creation of a bank account in the receiving country. An emigrant regularly transfers money to this account, and his or her relatives withdraw the desired amounts from an ATM, using a debit card supplied by the migrant. While these remittances do travel through the formal financial system, they are difficult to include in official statistics, since they are not recorded as interpersonal money transfers. Oftentimes, however, the best way to lower or even eliminate transaction costs is to use personal networks —friends or family members travelling to the country of origin who agree to carry cash back with them. Migrants themselves also carry a portion of their remittances with them when they go

FIGURE 1

**Classification of remittances**

Source: Independent research by the author.

on vacation or when they permanently resettle in their countries of origin.

While remittances are essentially monetary in nature, transfers in kind represent an additional means of transmitting part of a migrant's income. Trips to the country of origin are thus employed as an opportunity to bring gifts to family members. E-commerce has also become an increasingly common transfer mechanism. Migrants purchase goods for their families back home directly from the Internet.

The large number of channels through which remittances are conveyed makes the phenomenon difficult to measure. According to the World Bank, half of all remittances worldwide go unreported (Ratha, 2005), making it even more difficult to measure their impact on development in receiving countries. Notwithstanding these difficulties, this article will attempt to assess the possible economic and societal repercussions of the massive inflow of remittances into Colombia. In order to do so, trends in remittances in Colombia over the past few years must first be analysed.

## 2. The massive growth of remittances

Colombia has a long tradition of migration. After the country's participation in the Korean War, the United States opened its borders to Colombian workers through the Bracero Programme, and those workers then contributed to the economic expansion of the

United States during the 1950s and 1960s. During the 1970s and 1980s, about 500,000 Colombians settled in Venezuela, where labour demand had risen sharply following the oil boom of the 1970s. Migration also increased significantly during the 1990s as a result of both armed conflict and an economic crisis.

Armed conflict in the country has helped increase migration for three main reasons. Firstly, clashes between the participants in this conflict (guerrilla, paramilitary and regular forces) have compelled the civilian population—particularly *campesinos*—to flee combat zones and seek refuge in peaceful areas, either in the country's main cities or abroad. Secondly, the threats which many Colombian families have received from belligerents in the conflict have driven them into exile as a means of escaping their pursuers. Thirdly, this war against civil society has taken a high economic toll. Colombians are indirectly affected by political violence through the economic crisis and unemployment it has generated. The economic crisis worsened considerably during the second half of the 1990s, leading to a strong surge in migration.

As a result of this massive migration process, approximately 3.3 million Colombians—8% of the country's overall population—live abroad, according to 2005 census data (DANE, 2006).<sup>1</sup> Women make up 51.4% of the migrant population, and the median age of Colombians living abroad is 25.4 years. Migrants come mainly from the Valle del Cauca (24.1% of all Colombian migrants), Bogotá (18.7%), Antioquía (11.9%), Risaralda (7.8%) and Atlántico (6.6%). Their main destination countries are the United States (35.4% of all migrants), Spain (23.3%), Venezuela (18.5%), Ecuador (2.4%) and Canada (2.2%).

This strong upsurge in migration<sup>2</sup> has led to a sharp increase in remittances to Colombia over the last few years. Between 1995 and 2006, official remittances increased almost five-fold, from US\$ 809 million in 1995 to US\$ 3.89 billion in 2006. This makes Colombia the third-largest recipient of remittances in Latin America, after Mexico and Brazil (see table 1). In Colombia, however, remittances do not account for as high a share of GDP (3.3% in 2005) as they do in other countries

<sup>1</sup> The results of the 2005 census are available at the following website: <http://www.dane.gov.co/censo/>.

<sup>2</sup> According to estimates prepared by the National Administrative Department of Statistics (DANE), the number of Colombians living abroad was 1.7 million in 1990, 1.9 million in 1995 and 2.3 million in 2000.

in the region such as Jamaica (19.0%), Haiti (20.7%) and Honduras (21.2%). Measured as a share of GDP, the level of remittances is higher in Colombia than it is in Brazil, however (1.1%), or in Mexico (2.8%). It has also increased over time (see table 2). Remittances represented only 1% of the country's GDP and 6.9% of its exports in 1990; as of 2005, these figures had risen to 3.3% and 15.9%, respectively.

As of 2006, remittances were the second most important item in the country's current account, behind petroleum but before coal, coffee, ferronickel and emeralds (see figure 2). For three years, from 2002 to 2004, they also exceeded foreign direct investment (see

figure 3). The gap between the two was at its widest in 2003, when Colombia took in US\$ 3.06 billion in remittances, compared to only US\$ 1.758 billion in foreign direct investment. In 2005, on the other hand, foreign direct investment (US\$ 10.255 billion) far exceeded remittances (US\$ 3.314 billion). This was mainly a result of the sale of Bavaria group to the British-South-African company SABMiller for US\$ 8 billion. In 2006, foreign direct investment exceeded remittances, although the gap between the two shrank considerably. This reflects the highly cyclical nature of foreign direct investment. Remittances, in contrast, are much more stable.

TABLE 1

**Latin America: remittances, 2005**

Country	Millions of dollars	Percentage of GDP
1. Mexico	20 034	2.8
2. Brazil	6 411	1.1
<b>3. Colombia</b>	<b>3 314</b>	<b>3.3</b>
4. Guatemala	2 993	9.3
5. El Salvador	2 830	17.1
6. Dominican Republic	2 682	9.1
7. Peru	2 495	3.2
8. Ecuador	2 005	6.4
9. Honduras	1 763	21.2
10. Jamaica	1 651	19.0
11. Haiti	1 077	20.7
12. Bolivia	860	8.5
13. Nicaragua	850	16.9
14. Argentina	780	0.4
15. Paraguay	550	7.2
<i>Total, Latin America</i>	<i>52 608</i>	

Source: Inter-American Development Bank (IDB, 2006).

TABLE 2

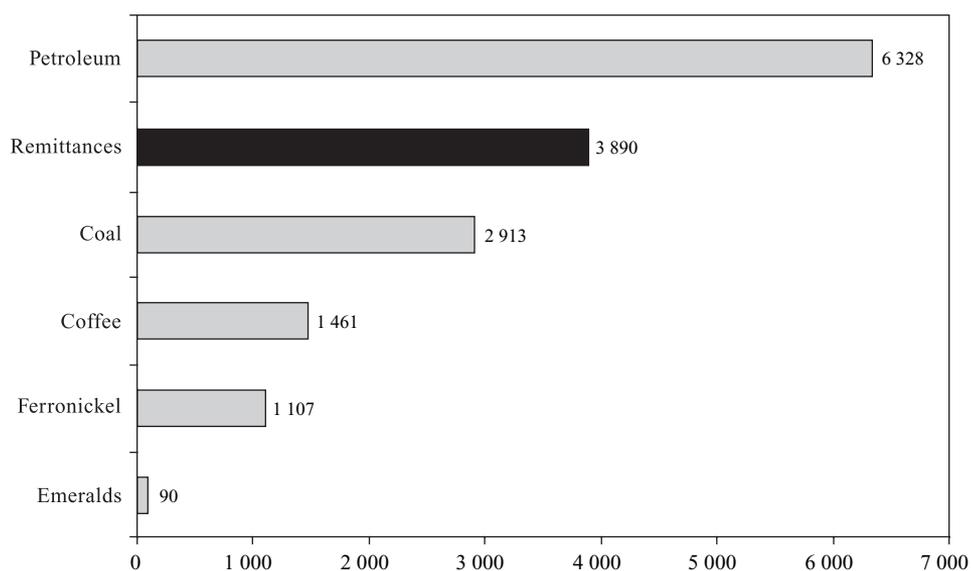
**Colombia: Economic importance of remittances**

	1990	1995	2000	2005
Remittances (millions of dollars)	488	809	1 578	3 314
Percentage of GDP	1.0	0.9	1.9	3.3
Percentage of exports	6.9	8.0	12.0	15.9

Source: Author's calculations, based on data from Banco de la República.

FIGURE 2

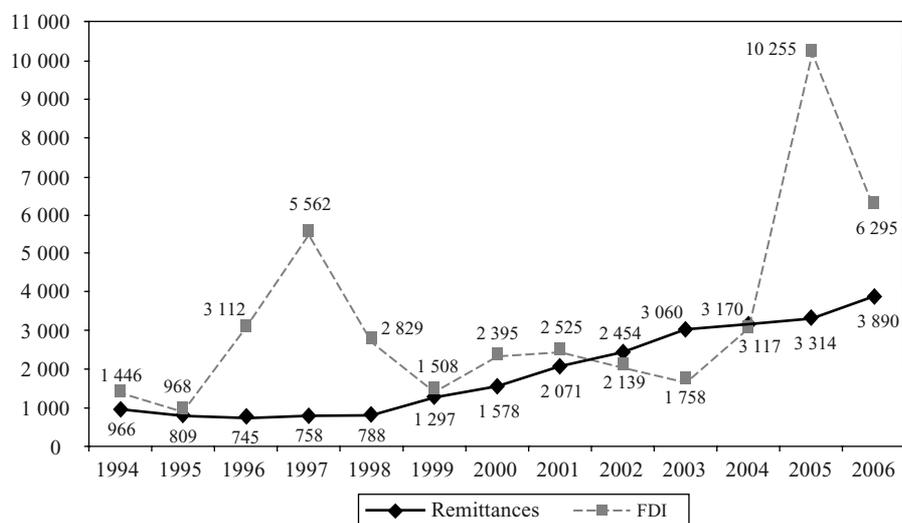
**Colombia: main items in current account, 2006**  
(Millions of dollars)



Source: Banco de la República.

FIGURE 3

**Colombia: remittances and foreign direct investment, 1994-2006**  
(Millions of dollars)



Source: Banco de la República.

### 3. Senders and receivers of remittances: Who are they?

Over the past few years, several studies have been carried out to develop profiles of those who send and receive remittances, as well as to determine the uses to which remittances are put. The most notable of these studies have been carried out by Garay and Rodríguez (2005) and Gaviria and Mejía (2005). The former received technical support from the National Administrative Department of Statistics (DANE), the Colombian Ministry of Foreign Affairs and the International Organization for Migration (IOM). The study focuses on households in the *Área Metropolitana Centro Occidente* ("Midwestern Metropolitan Area"), which comprises the municipalities of Pereira, Dosquebradas and La Virginia, in the province of Risaralda. The latter consists of an Internet survey which seeks to contribute to a better understanding of the behaviour of Colombians abroad.<sup>3</sup> Despite the limitations inherent in such exercises, these two studies are a useful source of data for the analysis of remittances in Colombia.

According to these surveys, half of total remittances come from the United States and one fourth from Spain. This roughly matches the geographic distribution of Colombian emigrants. About 75% of Colombians living abroad send remittances. Most of those who do so are recent emigrants. The average monthly remittance is somewhere between US\$ 240 and US\$ 300. Remittances tend to be higher during the first few years after migration, as migrants' finances improve; they begin to decline after about 10 years as families regroup, among other factors. Migrants send money to Colombia primarily because members of their family (spouse, children, parents) remain there.<sup>4</sup> It should be noted that a migrant's schooling affects the pattern of remittances in two opposite ways. On

the one hand, better-educated migrants (those who have attended university) are less inclined to send remittances than those who have only attended high school (probably because the families of the former have higher incomes). On the other hand, there is a positive correlation between the number of years a migrant has attended school and the average monthly remittance he or she sends home, since better-educated migrants tend to earn higher incomes.

The average age of remittance recipients is 40. The vast majority of them (76%) are women. Over half of them have no steady job and therefore depend on remittances as their main source of income. Most remittance recipients are, in fact, below the poverty line (64% in the Midwestern Metropolitan Area), which explains why most of the remittances they receive (between 61% and 68%) are spent on recurrent expenses, such as food, clothing, rent or utility bills. Remittances are also used to cover education and health-care costs (10% to 15% each), start businesses (4% to 7%), build up savings (4% to 6%) or buy a home (3% to 5%).

Generally speaking, the massive increase in remittances to Colombia over the past few years has helped to significantly improve living conditions for the families that receive them, increasing their purchasing power and affording them access to a wider range of consumer products and health and education services. In this respect, the impact of remittances has been undeniably positive for households which steadily receive this supplemental income. At the national level, however, their impact is not as clear. Can remittances help finance the development of Colombia? Can these capital flows help reduce inequality and improve living conditions for the overall population? Or do these flows bring with them a risk of dependency that might jeopardize the economy in the long run?

<sup>3</sup> Gaviria and Mejía (2005), in particular, have developed an index of "Colombianness" (or transnationality) which measures a migrant's ties to Colombia. The index consists of six binary variables: membership in a Colombian expatriates' association; sending of remittances; receipt of goods from Colombia; continued affiliation with a Colombian pension fund; telephone calls to Colombia at least twice a week; keeping apprised of events in Colombia via television.

<sup>4</sup> The literature on remittances usually draws a distinction between two types of motives. One is altruism, or a sense of obligation to one's family. In this case, migration is viewed as a family decision. The other motive is risk-sharing. In this case, remittances serve a more individualistic purpose, with migrants expecting help from their families if circumstances change (particularly if they lose their job). In fact, migrants probably send remittances for a mixture of altruistic and individualistic reasons.

### III

## The role of remittances in the Colombian economy

Remittances affect many different stakeholders (senders, recipients, intermediaries, public authorities and others) and therefore have many different implications for the economy and for society. In addition to influencing the traditional components of aggregate demand, a massive inflow of capital can have repercussions on prices, exchange rates, the formation of human and social capital and income redistribution. Remittances also represent a challenge for financial institutions seeking to attract those resources, as well as for public authorities striving to maximize the benefits and minimize the direct and indirect costs of such flows.

#### 1. Domestic demand

One of the main arguments against remittances is that they are spent mainly on goods to meet basic needs rather than on production. Advocates of this view assert that, since the recipients of remittances save very little and do not invest in business projects, they do not contribute to long-term economic development. It should be noted, however, that the spending patterns of families that receive remittances are similar to those of most other Colombian households; they have nothing to do with remittances *per se*, but are rather a result of the living conditions of the overall population. Furthermore, it is unreasonable to criticize the use that families make of remittances when the main reason why migrants send money is to cover their families' basic needs.

In addition, by contributing to an increase in consumption—that is, to aggregate demand—remittances have a multiplier effect on GDP. In fact, spending by recipient households spurs demand in several sectors of the economy, which then spend more. The initial momentum thus has more than a proportional impact on economic activity. Considering that Colombian households that receive remittances have a savings rate of approximately 5% (Garay and Rodríguez, 2005), this flow of money has a significant multiplier effect. To the extent that trade liberalization is already well under way, however, some demand is directed towards the consumption of imported

products, thereby reducing the multiplier effect of remittances.<sup>5</sup>

The construction industry has particularly benefited from remittances thanks, on the one hand, to home purchases by the families of migrants and, on the other, to direct investments in their country by Colombians living abroad. Between 1995 and 2005, homebuilding costs rose by 181%, while inflation fell by 75% (from 19.5% in 1995 to 4.9% in 2005), which suggests that demand was strong in that sector. Housing fairs in the main foreign cities where Colombians have settled, such as those held in September 2005 and October 2006 in New York, in April 2006 in Miami, and in March 2006 and April 2007 in Madrid,<sup>6</sup> have proven to be an effective way to connect migrants with the Colombian real estate market.

Remittances have also contributed to the creation of microenterprises in Colombia, as they have helped to mitigate the problems faced by low-income households in trying to gain access to loans. Remittances have been particularly useful for the purchase of investment goods, such as tools for the establishment of small businesses. Experience has shown, however, that most of these microenterprises are subsistence operations in the informal sector and are relatively short-lived. One of the main obstacles preventing recipients of

<sup>5</sup> The multiplier effect of remittances may be calculated as follows:

$$\Delta Y = \frac{1}{1 - c + m} \Delta R$$

where  $\Delta Y$  is the variation of the product generated by remittances,  $\Delta R$  is the change in the flow of remittances entering the economy,  $c$  is the marginal propensity to consume and  $m$  is the marginal propensity to import.

<sup>6</sup> Housing fairs, organized by the *Cámara Colombiana de la Construcción* (Colombian Chamber of Construction, or CAMACOL), are designed to steer remittances towards investment in construction and real estate. They bring together the Colombian communities residing in the area where the fair is held, on the one hand, and building and real estate promoters, as well as financial entities, on the other. These fairs are supported by IOM, the Ministry of Foreign Affairs and the Ministry for the Environment, Housing and Territorial Development. For further details, see: <http://www.camacol.org.co/htm/index.asp>

remittances from starting their own business is their lack of experience. The State should offer technical assistance, financial information and training. Training programmes could also be offered to migrants in order to encourage them to return.<sup>7</sup>

The massive inflow of remittances has also contributed to the growth of a number of activities that are related, directly or indirectly, to this phenomenon. The rapid growth of the money-transfer and exchange business, in particular, is clearly associated with migration. The number of branches established by Western Union as a commercial money-transfer agent rose from 8 in 1996 to 112 in 2006. Similarly, the air transport industry, including airlines and travel agencies, has experienced strong growth in recent years as a result of the increase in the number of Colombians living abroad. Many of the new migrants are able to travel thanks to the financial support of family members living abroad, who pay part or all of their travel costs and thus help set up a chain migration process.<sup>8</sup>

While it is true that remittances have a positive effect on economic activity, they also make the Colombian economy highly sensitive to migratory cycles. There is a strong correlation between emigration rates and the volume of remittances. Remittances therefore tend to have an anticyclical effect on economic activity: when the economy is in recession, emigration increases, as does the volume of remittances, helping to stimulate the national product. Conversely, a period of strong economic growth leads to a decrease in emigration flows and thus to a smaller inflow of remittances, thereby slowing economic activity. In the case of Colombia, there is a strong negative correlation (-0.76) between the cyclical deviations of GDP and those of remittances for the 1994-2005 period. This confirms the anticyclical nature of remittances. The current resurgence of economic activity in Colombia<sup>9</sup> has been

<sup>7</sup> In Brazil, for example, the *Corporación Oficial de Apoyo a la Pequeña Empresa* (State Microenterprise Corporation) and Banco do Sul implemented a programme to support enterprises established by Brazilian emigrants of Japanese descent who returned to Brazil after working for several years in Japan.

<sup>8</sup> Chain migration is a cumulative migration process based on family ties or ties to a common place of origin. Those who first attempt migration help feed migration flows by providing information on opportunities in the receiving country, sending money to cover the travel costs of future migrants, offering lodging and logistical support to new migrants and facilitating job contacts or access to social services.

<sup>9</sup> With a GDP growth rate of over 4% since 2003 (as of 2006 it was 6.0%), Colombia has achieved better results than its Latin American neighbours (5.3% on average in 2006). The country's unemployment rate fell from an average of 17.7% in 2002 to 12.6% in 2006.

accompanied by a decline in emigration, which may, over the medium term, lead to a drop in the volume of remittances, with the ensuing slowdown of growth.

## 2. Current account and exchange rate

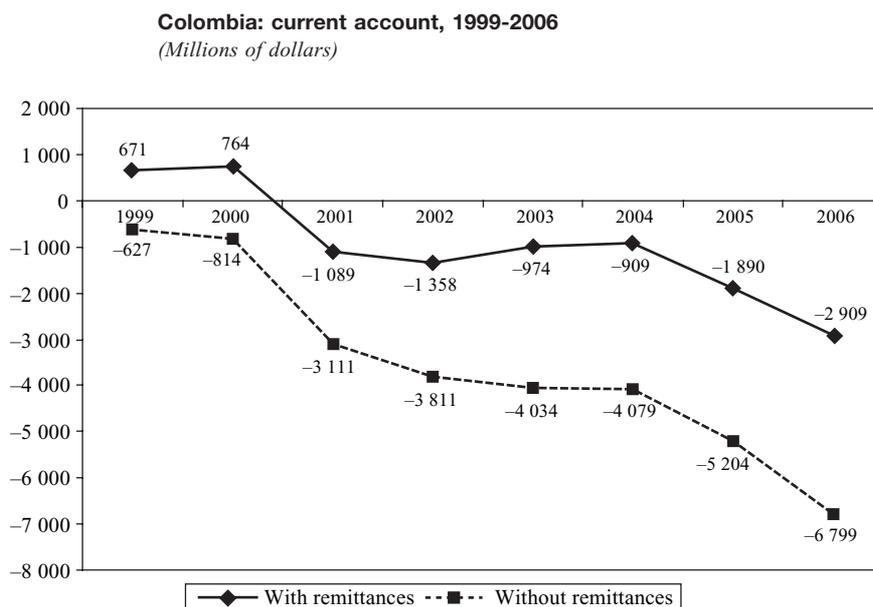
Remittances can affect the current account in three ways. Firstly, they have a direct impact on the balance of payments, as they improve the balance of invisibles, which is comprised mainly of money transfers. Thus, remittances have helped reduce the external imbalance of the Colombian economy over the last few years. As shown in figure 4, without the money sent by migrants, the current account deficit between 1999 and 2006 would have been worse. In fact, the improvement in the current account that occurred between 2002 and 2004 was basically due to an increase in remittances, without which it would have continued along its downward path. Similarly, remittances have helped curb the deterioration of the current account which has been occurring since 2004.

The second impact of remittances on the current account involves changes in consumer behaviour. Recipients of foreign currency usually adopt ostentatious consumption habits, as evidenced in their purchases of foreign products such as brand-name clothing or household appliances (Terry, 2005). This behaviour tends to spread to their neighbours, who do not receive remittances but who copy these consumption patterns. The effects of "ostentation" and "imitation" lead to an increase in imports, a trend that is encouraged by the openness of the Colombian economy to trade. Thus, between January 2000 and December 2005, imports of goods and services rose by 137.8%, while exports rose by only 91.2%.

Finally, remittances are likely to have repercussions on the current account through their effect on exchange rates (figure 5). A large inflow of money can be expected to lead to an appreciation of the national currency, which may be followed by a loss of competitiveness and a deterioration of the current account (Amuedo-Dorantes and Pozo, 2004). This, in turn, creates the risk of "Dutch disease"<sup>10</sup> (i.e., a shift of economic activity

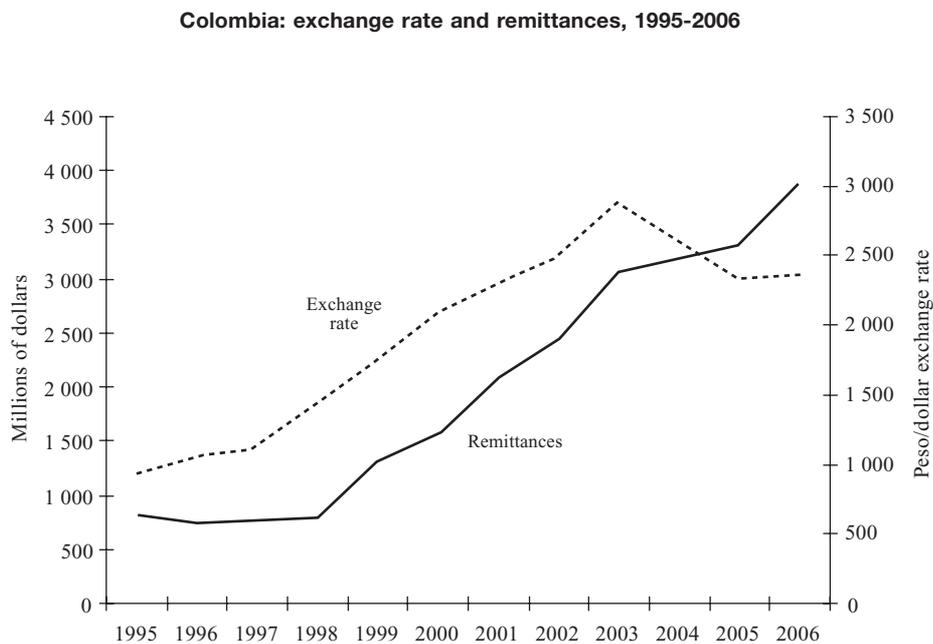
<sup>10</sup> "Dutch disease" takes its name from the negative consequences of the discovery and exploitation of natural gas in the Netherlands during the 1960s. A large inflow of capital leads to a strong trade surplus, which causes the real exchange rate to appreciate and thus hurts the competitiveness of the tradable goods sector. The economy becomes revenue-based, and the structure of production is distorted in favour of non-tradable goods.

FIGURE 4



Source: Author's calculations, based on data from the Banco de la República.

FIGURE 5



Source: Banco de la República.

towards non-tradable goods as exporters become discouraged). The massive flow of remittances into Colombia in recent years has probably contributed to the strong appreciation of its currency. Thus, between March 2003 and April 2007, the peso fell by 28% with respect to the dollar.

It is difficult, however, to establish a direct link between remittances and the exchange rate. In the first place, although the share of the current account represented by remittances has increased, oil is still the country's chief export, and the rise in prices of this raw material has had a greater impact on the exchange rate than remittances have. Similarly, the high level of foreign investment in Colombia in recent years, which is partly attributable to the acquisition of Colombian firms by large foreign groups, has contributed significantly to the appreciation of the peso. Furthermore, if remittances were the factor that was responsible for the appreciation of the Colombian currency, the peso would have appreciated many years ago. As shown in figure 5, remittances and the exchange rate both rose, side by side, until March 2003. This disproves the argument that remittances affect the exchange rate. On the contrary, it could be argued that the depreciation of the peso has encouraged migrants to send remittances, since every dollar or euro they send means more cash for recipient families. It would appear, therefore, that the idea of remittances causing Dutch disease in Colombia can be discarded, at least for the time being.

### 3. The labour market

The net impact of remittances on the labour market is ambiguous, as they may reduce the unemployment rate without necessarily improving the employment situation. Remittances can, in fact, have an income substitution effect since, by driving the reservation wage<sup>11</sup> up, they may discourage recipients from seeking work and thus reduce unemployment. In many cases, monthly remittances (which average between 585,000 and 680,000 pesos, at an exchange rate of 2,260 pesos to the dollar as of late 2006) actually exceed the minimum wage in Colombia (408,000 pesos as of 2006). In a way, this has created a "culture of idleness", particularly in regions —such as the coffee belt— that export the most labour. The fact that a growing number of remittance

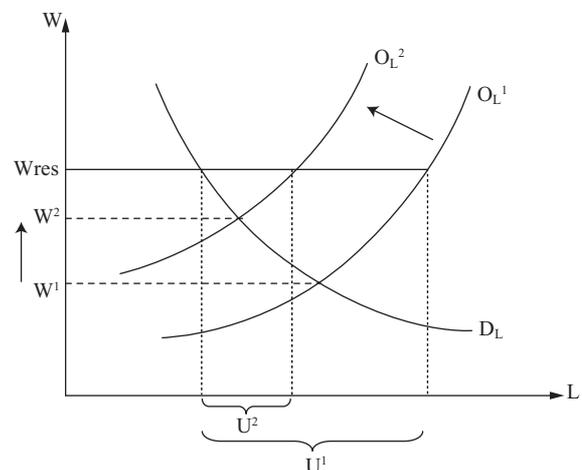
recipients are withdrawing from the labour market may lead to a drop in the unemployment rate.

Figure 6 illustrates the impact of remittances on the labour market.  $L$  represents labour, while  $W$  represents the real wage.  $O_L$  and  $D_L$  represent labour supply and demand, respectively.  $W^1$  represents the equilibrium wage without remittances. The reservation wage is assumed to equal  $W^1$ . What happens when remittances enter the equation? The reservation wage ( $W_{res}$ ) climbs above  $W^1$ , which means that a fraction of workers are failing to find work. This leads to increased unemployment (the difference between  $O_L^1$  and  $D_L$ , or  $U^1$ ). But remittances also help reduce the labour supply (as  $O_L^1$  shifts to  $O_L^2$ ), as they encourage idleness. The result is lower unemployment ( $U^1$  to  $U^2$ ) and higher wages ( $W^1$  to  $W^2$ ). While increased wages do improve living conditions for workers, they also raise production costs for businesses. This may have a negative impact on competitiveness.

The decline in the unemployment rate in Colombia since 2000 (from an average of 20.2% in the country's seven main metropolitan areas in 2000 to 12.6% in 2006) partially confirms the foregoing analysis. The massive exodus of migrants which began in the mid-1990s had, in fact, already helped to significantly reduce unemployment, either because a portion of the unemployed population left the country, or because those who were employed and left (due to safety concerns, or in search of better working conditions) created vacancies

FIGURE 6

#### Impact of remittances on the labour market



Source: Author's calculations.

<sup>11</sup> The reservation wage is the minimum wage an individual requires in order to participate in the labour market.

upon their departure. The withdrawal from work of some members of recipient families —particularly in the coffee belt (Garay and Rodríguez, 2005)— has also helped lower the country's unemployment rate. Notwithstanding the above, it is difficult to determine the precise extent to which lower unemployment is directly (migration of part of the active population) or indirectly (impact of remittances) attributable to migration. The recovery of the Colombian economy over the past few years has, of course, played a role in improving the labour market. Without migration, however, unemployment rates today would probably be higher.

#### 4. Prices

In terms of prices, remittances bring with them a high risk of inflation. A massive influx of capital has a direct impact on the money supply, driving prices upward. Since Colombian businesses are, as shown in figure 7, suffering the consequences of an increase in real wages, there is a temptation to raise the end prices of their products. This would entail a risk of supply-

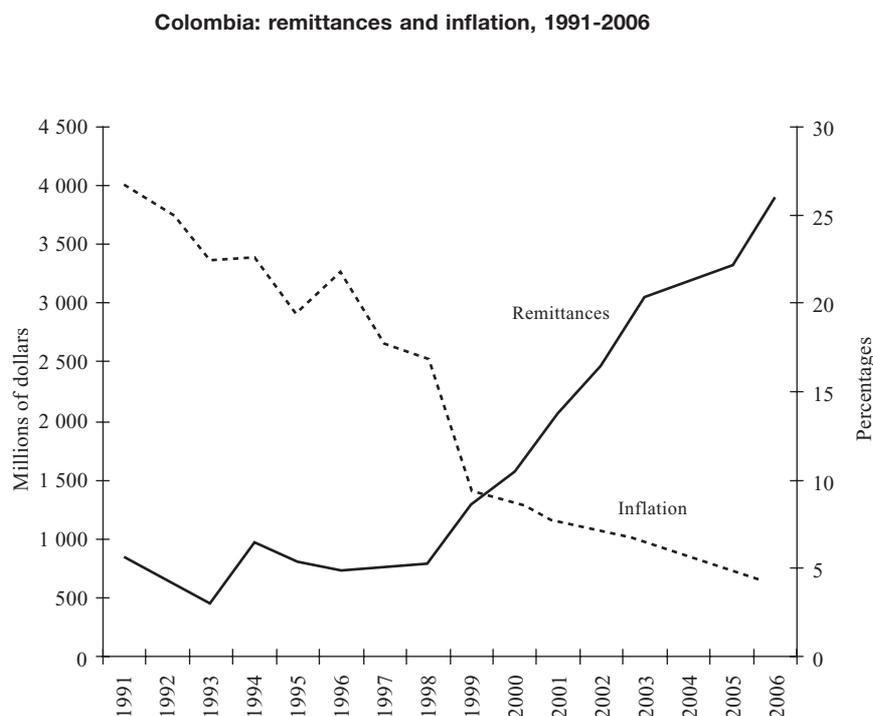
side inflation. Remittances also lead to an increased demand for non-tradable goods, which are free from international competition and are therefore more likely to rise in price in response to stronger demand. This, in turn, would fuel demand-side inflation.

It should be noted, however, that the appreciation of the Colombian peso, for which remittances are partly responsible, has made foreign imports cheaper, leading to a process of imported disinflation which partially offsets the inflationary effects of remittances. Most importantly, the Banco de la República has implemented a strict inflation-control policy based on an inflation targeting strategy. This may explain why the Colombian economy has been free of inflationary tensions over the last few years, despite renewed economic activity and a massive inflow of remittances (see figure 7).

#### 5. The financial system

The rapid increase in remittances in Colombia has drawn the interest of a growing number of financial institutions which are attracted by potential profits in

FIGURE 7



Source: Banco de la República.

TABLE 3

Colombia: cost of sending remittances from Spain<sup>a</sup>

Company name	March 2005	March 2006
Latinoenvíos	6.87	4.16
Giroexpress	7.95	4.73
Unigiros Express	6.99	4.73
Maccorp Exact Change	8.54	4.83
Uno Money Transfers	5.19	4.91
Changepoint	7.63	5.27
United Europhil	6.93	5.37
Master Envíos Unidos	6.27	5.79
Safe Money Transfer Spain	5.12	6.30
Envía Telecomunicaciones	6.69	6.78
Geomil Transfer	8.37	6.93
Foreign Exchange Company	8.30	7.32
Interenvíos Money Transfers	5.81	7.38
Telegiros	7.47	7.82
Cambios Sol	8.39	8.13
R.D. Money Transfer	6.88	1.60
<i>Average</i>	<i>7.09</i>	<i>6.32</i>

Source: www.remasas.org

<sup>a</sup> Remesas.org publishes an assessment of remittance costs twice a year. This assessment is based on a survey of remittance firms approved by the Banco de España. The survey consists of a telephone inquiry regarding the cost of sending 150 euros to northern Bogotá. Remittance costs correspond to the percentage of money withheld by the remittance firm.

this market. This has led to keener competition among money-exchange firms and banks seeking to capture emigrant capital. This, in turn, has helped to boost the competitiveness and functional efficiency<sup>12</sup> of financial intermediaries. Heightened competitiveness benefits the Colombian economy in two ways. Firstly, lower intermediation costs represent a net gain for households that receive remittances. Table 3 traces changes in remittance costs from Spain to Colombia through several different companies. In most cases (11 out of 16), costs fell considerably, and the average ratio between remittance costs and the sums remitted dropped from 7.09%, in March 2005, to 6.32% one year later. This is equivalent to a reduction of -10.9% over the course of one year. Secondly, the enhanced productivity of money-exchange firms and banks has increased the productivity of the Colombian financial system, which should help raise the rate of capital formation in Colombia.

Another way in which remittances have a significant effect on the financial system is by expanding

<sup>12</sup> Functional efficiency may be defined as the ability of financial intermediaries to perform their functions at the lowest possible cost.

Colombians' access to banking services. Table 4 lists several indicators of "bankarization" (expanded access to banking services for the population) in Colombia. While it is true that the number of bank accounts has not increased sharply over the last few years, more and more Colombians have acquired bank cards, which accounts for the rapid development of the country's ATM network (the number of ATMs in the country increased five-fold between 1993 and 2004). Since banks tend to be safer than other formal channels, recipient households' degree of bankarization appears to be on the rise.

Notwithstanding the above, "financial democracy", or increased popular access to financial services, remains quite limited (Terry, 2005). This is particularly true of banking services in Colombia,<sup>13</sup> especially among poorer families that receive remittances mainly through money-exchange businesses or other informal

<sup>13</sup> As of 2003, Colombia possessed 9.6 ATMs for every 100,000 inhabitants. By way of comparison, the ratio for Latin American countries was 5.9 in Peru, 6.3 in Ecuador, 12.8 in Costa Rica, 14.9 in Argentina, 16.6 in Mexico and Venezuela, 17.8 in Brazil, 20.2 in Guatemala and 24.0 in Chile. In industrialized countries, the ratio was 42.5 in the United Kingdom, 67.2 in Italy, 70.3 in France, 113.8 in Japan, 120.9 in the United States and 126.6 in Spain (Beck, Demirgüç-Kunt and Martínez Peria, 2005).

TABLE 4

**Colombia: bankarization indicators, 1993-2004**

	1993	2000	2004
Active current accounts	2 067 629	1 970 623	2 203 390
Active savings accounts	...	12 893 804	12 893 263
Active debit cards	3 500 000	7 925 022	10 277 353
Active credit cards	1 200 000	1 9442 17	2 812 228
Number of ATMs	1 207	3 874	5 520

Source: Caballero, Lizarazo and Urrutia (2005).

channels. The involvement of the Bank of the Republic in the remittance process, using an approach similar to that of the Banco de México, may help increase access to banking services and reduce remittance costs.<sup>14</sup> Financial education campaigns may also be required to make recipient families aware of the importance of employing formal banking services. Information regarding the remittance market should also be improved, in order to ensure that the agents involved are better acquainted with the relevant legislation, entities and services. Information must be developed to ensure greater transparency in the financial system, as well as greater trust in that system, which should increase access to banking services. Such access is essential if the savings derived from remittances are to be invested in production.

Finally, the massive influx of remittances into Colombia raises the delicate issue of money laundering. Drug traffickers have developed a laundering technique known as “smurfing”, whereby large sums of money are funnelled through transactions below the maximum authorized by the monetary authorities, in order to elude detection. International transfers are made to beneficiaries, who then receive a commission. It is

difficult, of course, to distinguish family remittances from smurfing operations. These transactions are probably limited, however, since they require coordinated action on the part of many accomplices, and beneficiaries must be changed regularly to avoid suspicion (Cadena and Cárdenas, 2004). The country’s monetary authorities (Bank of the Republic) and financial authorities (Office of the Bank Examiner), acting through the System for the Prevention and Control of Asset Laundering (SIPLA) and the Financial Information and Analysis Unit (UIAF), have implemented regulatory and supervisory measures that significantly reduce the risk of money laundering through international transfers.

## 6. Public finance

Despite the abolishment, in 2005, of the tax-at-source which had previously been levied on international transfers, remittances probably have a positive impact on public finance. They are, in fact, still subject to a number of taxes. The value added tax (VAT) is applied to currency exchange operations, increasing their cost. Financial movements in Colombia are also subject to a 0.4% tax, which must be paid by anyone receiving transfers from abroad. The same tax applies whenever an agent withdraws money from an account. Consequently, migrants sending money to their families through a bank must pay a transaction tax, in addition to the transaction costs and the 0.4% tax when the recipients make use of the funds. This has increased the volume of taxes collected by the State, thereby improving its revenue.

It should be noted that these taxes constitute a loss for households which receive remittances, and are partly responsible for keeping a fraction of those flows outside of the official financial system. In addition, the tax regime applied to remittances is regressive, since most of their recipients belong to lower social strata. Burdensome taxes come at a cost, both in terms of economic efficiency and social justice. A strong

<sup>14</sup> The FedACH system (Federal Reserve Automated Clearing House) is based on cooperation between the United States Federal Reserve and the Central Bank of Mexico. Emigrants send money to their families through a correspondent bank, which employs the services of the Federal Reserve, which in turn wires the funds to the Bank of Mexico. Recipients then retrieve their funds through local correspondent banks. This system offers several advantages (Collazos, Montes and Muñoz, 2005). The exchange rate employed is more advantageous than that offered by private intermediaries, and the remittance fee is lower. Transactions are more secure, since they are backed by both the Federal Reserve and the Bank of Mexico. The system also ensures a higher degree of transparency than would be possible if several private operators were involved. The concentration of transactions in the hands of the monetary authorities creates economies of scale which make recipients the ultimate winners of the process.

TABLE 5

## Colombia: public finances, 1996-2004

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Fiscal deficit (as % of GDP)									
- Central national government	-3.4	-3.7	-4.8	-6.1	-5.4	-5.3	-4.9	-4.7	-4.3
- Non-financial public sector	-1.7	-2.8	-3.7	-4.1	-4.0	-4.1	-3.5	-2.6	-0.9
Total gross external debt									
- In millions of dollars	31 114	34 409	36 681	36 733	36 130	39 109	37 336	38 065	39 460
- As % of exports	236	242	273	263	229	260	263	242	202

Source: ECLAC (2005).

argument can therefore be made for their abolishment, or at least for their reduction.

As mentioned above, the massive influx of remittances has increased both domestic demand and imports. Remittances have thus become a supplementary source of tax revenue, through the VAT, on the one hand, and customs duties, on the other. Insofar as migration reduces unemployment and remittances are a form of social protection, they benefit the State by easing the burden of social problems. Public spending is lower than it would be in the absence of migration, and the fiscal deficit is reduced as a result. Thus, between 1999 and 2004, the deficit of the national central government fell from -6.1% to -4.3% of GDP, and the deficit of the non-financial public sector fell from -4.1% to -0.9% of GDP (see table 5).

Recent IMF studies on the impact of remittances on development in receiving countries emphasize their possible risks for the financial system (Chami, Cosimano and Gopen, 2006). By raising the liquidity of the financial system, remittances expand access to foreign capital, reducing the cost of foreign indebtedness. At the same time, this increased liquidity raises moral hazard issues, since the terms of credit created by remittance flows may generate growing public debt. The Colombian economy may find itself affected by such forces in the future.

## 7. Human and social capital

One of the positive effects of remittances on development in Colombia has to do with human capital (Kugler, 2006). A significant portion of these funds are used to cover education and health-care costs. Many children are able to remain in school, and many poor families are able to afford health care, thanks to the financial support of a family member abroad. In addition,

collective remittances (funds raised by emigrant associations or channelled through Internet community networks) are used to finance large-scale initiatives, particularly infrastructure and educational projects. The experience of *Conexión Colombia*,<sup>15</sup> a non-governmental organization (NGO) which uses the Internet to channel money from Colombian emigrants into education, health or cultural programmes, is one example of the kind of impact that remittances can have in terms of social investment. Organizations of this type also contribute to the development of social capital<sup>16</sup> by encouraging the implementation of transnational networks (Guarnizo, 2003). It should be noted that there is no history of cooperation between the Colombian government and emigrant associations. In this regard, Colombia differs from Mexico, with its *Programa Iniciativa Ciudadana 3x1* (3x1 Citizen Initiative Programme),<sup>17</sup> and El

<sup>15</sup> *Conexión Colombia* operates through the following website: <http://conexioncolombia.terra.com.co/index.jsp>. The organization has two objectives: first, to strengthen the ties of expatriate Colombians to their country by publishing articles on current events in Colombia, allowing migrants to write about their experiences and hosting a discussion forum; second, to create a safe channel through non-profit foundations for migrants' contributions to the financing of development efforts in Colombia. Between December 2003 and December 2005, *Conexión Colombia* channelled US\$ 2 million to 22 foundations and other special projects.

<sup>16</sup> According to Coleman (1990), social capital is a public good that includes ties of trust between the members of society. It becomes manifest particularly through respect for collective commitments, which strengthens social cohesion. Social capital has a positive impact on other forms of capital, such as human or financial capital.

<sup>17</sup> *Programa Iniciativa Ciudadana 3x1* was created in Mexico in 2002. For every dollar invested in a local development project by associations of Mexicans living abroad, the Mexican government invests an additional three dollars. One dollar comes from the federal government, another from the State government and a third from the municipality where the project takes place. The 3x1 Programme has helped fund a wide range of initiatives (Vásquez Mota, 2005), including social projects (e.g., rest homes or homes for persons

Salvador, with its *Unidos por la Solidaridad* (United for Solidarity) programme.<sup>18</sup>

Remittances are the flip side of the costs associated with migration. The departure of millions of Colombians represents a net loss of human capital. It is not only a brain drain, but a “body drain” as well. Economic growth requires both skilled and unskilled labour, and Colombia is currently at a disadvantage on both counts. The brain drain is a more serious concern at present, since it reflects the removal of part of the country’s investment in education.<sup>19</sup> The loss is often permanent, since most of the students and professionals who leave Colombia settle in their destination country.<sup>20</sup> Incentives today are insufficient to persuade talented Colombians to return home.

Another problem associated with migration and remittances is that, in many cases, migrants are parents who have had to leave their children in the care of grandparents, aunts or uncles as they travel abroad in search of a better life. While the money they send their families is often used to finance their children’s schooling, those children cannot help but feel abandoned. Studies on this issue, particularly in the Colombian coffee belt (Garay and Rodríguez, 2005), have shown that children whose parents live abroad do not perform as well in school and tend to exhibit violent behaviour. They join gangs more frequently and may even become criminal offenders. It could thus be argued that one

of the collateral costs of remittances is an erosion of social capital. The family is responsible for initiating individuals into society and is therefore an essential component of social capital (Wilson, 1993). The break-up of families has a disruptive effect on children and may lead to increased criminal behaviour.

## 8. Poverty and inequality

Aside from their impact on aggregate demand, remittances play a social role. Many recipients are, in fact, below the poverty line, and the funds they receive allow them to improve their living conditions. Garay and Rodríguez (2005) have shown that, when remittances are factored out of the income of Colombians living in the Midwestern Metropolitan Area, poverty and indigence levels rise from 59.4% to 64.3% and from 30% to 34.9%, respectively. Remittances finance social protection for the poor and are often the only source of income for many retirees who are not covered by the national pension system. They also serve as an insurance policy of sorts against economic shocks (namely, unexpected drops in family income) since they tend to remain stable over time.

In this regard, remittances are much more effective at reducing poverty than development aid is, since they go directly to the families in greatest need, bypassing the intermediate channels usually employed by international assistance (Terry, 2005). Indeed, both the senders of remittances and their recipients have a greater stake in making optimal use of these funds than do public bodies. Moreover, unlike development aid, remittances from family members are untouched by corruption.

A regular inflow of transfers from abroad poses several problems, however. In the first place, remittances tend to create financial dependency, which may lead to difficulties for recipient households if family members abroad stop sending money, either temporarily or permanently. In addition, remittances can magnify social and geographic inequalities. Migration is essentially a lower-middle-class phenomenon; it does not extend to the poorest households, which lack the financial resources to travel abroad. The social gap between households that receive remittances and the rest of the population becomes wider as a result. Furthermore, migrants do not come from the poorest regions of the country, such as Chocó, Cauca or Nariño, but rather from industrialized areas such as Bogotá, Antioquía (Medellín) or the Valle del Cauca (Cali) (Khoudour-Castéras, 2007a). Remittances are concentrated in these areas, making geographic inequalities deeper.

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with disabilities, health-care centres), educational projects (schools, libraries), cultural projects (museums, cultural centres) and public works (road paving, electrification, sewerage).

<sup>18</sup> The Salvadoran programme *Unidos por la Solidaridad* was created to coordinate the anti-poverty efforts of the government, municipalities, the private sector and associations of Salvadorans living abroad. The funds provided by such contributors are administered by the *Fondo de Inversión Social para el Desarrollo Local en El Salvador* (Social Investment Fund for Local Development in El Salvador, or FISDL), which distributes available resources through open calls for grant proposals from local communities. The programme has channelled incoming remittances into local investment projects and has helped to increase the coverage of basic social services and infrastructure.

<sup>19</sup> Beine, Docquier and Rapoport (2001) argue that the brain drain may help to increase the level of human capital in countries of origin, as it creates an incentive to stay in school and take advantage of better employment opportunities abroad. Since only a fraction of the country’s skilled labour force ultimately migrates, the end result is a higher level of human capital than that which existed before the brain drain began. Notwithstanding the above, empirical studies show that a positive correlation between the departure of skilled workers and increased investment in education exists only in a limited number of cases (Schiff, 2006).

<sup>20</sup> The odds of encountering Latin Americans schooled at the secondary level or beyond are 2.5 times higher in the United States than they are in their countries of origin.

In the final analysis, the impact of remittances is mixed (see figure 6). While they can, under certain circumstances, strengthen economic activity and improve the social landscape, they also involve a number of risks that could have harmful long-term consequences for the development of Colombia. Despite their magnitude, the overall impact of remittances tends to be very limited. If one divides the overall sum of official remittances in 2005 (US\$ 3.314 billion) by the

country's population (41.2 million), the result is US\$ 0.22 per day, or one fifth of the amount which the World Bank has set as an indicator for extreme poverty (one dollar a day). Consequently, under no circumstances should a development model be based solely on the financial contributions of emigrants.

Of course, this does not mean that remittances cannot be used to spur development. On the contrary, the accrued experience of international good practices

TABLE 6

**Colombia: potential effects of remittances**

Affected sector	Positive effects	Negative effects
Domestic demand	<ul style="list-style-type: none"> <li>• Multiplier effect on GDP through consumption</li> <li>• Reactivation of construction sector</li> <li>• Development of remittance-related activities</li> <li>• Support for investment (particularly microenterprises)</li> </ul>	<ul style="list-style-type: none"> <li>• Demand is heavily focused on non-productive spending</li> <li>• Economic activity is sensitive to changes in migratory cycles</li> </ul>
Current account	<ul style="list-style-type: none"> <li>• Improvement in current account through balance of invisibles</li> </ul>	<ul style="list-style-type: none"> <li>• Increased imports as a result of ostentation and imitation</li> <li>• Loss of competitiveness as a result of currency appreciation (risk of Dutch disease)</li> </ul>
Labour market	<ul style="list-style-type: none"> <li>• Higher reservation wage</li> <li>• Higher real wages (due to reduced labour supply)</li> <li>• Lower unemployment (fewer people looking for work)</li> </ul>	<ul style="list-style-type: none"> <li>• No incentive to work (culture of idleness)</li> </ul>
Prices	<ul style="list-style-type: none"> <li>• Imported disinflation (due to appreciation of currency)</li> </ul>	<ul style="list-style-type: none"> <li>• Increase in money supply</li> <li>• Increased demand for non-tradable goods</li> <li>• Higher production costs (due to increase in real wages)</li> </ul>
Financial system	<ul style="list-style-type: none"> <li>• Increased functional efficiency (more competition between financial intermediaries)</li> <li>• Increased bankarization among remittance recipients</li> </ul>	<ul style="list-style-type: none"> <li>• Risk of money laundering</li> </ul>
Public finance	<ul style="list-style-type: none"> <li>• Increased tax revenue</li> <li>• Lower social expenditure</li> <li>• Lighter debt burden (greater access to international financing)</li> </ul>	<ul style="list-style-type: none"> <li>• Moral hazard (growing public debt)</li> </ul>
Human and social capital	<ul style="list-style-type: none"> <li>• Increased investment in education and health care</li> <li>• Organization of emigrant networks for the sending of collective remittances</li> </ul>	<ul style="list-style-type: none"> <li>• Collateral problems: brain drain and break-up of families</li> </ul>
Poverty and inequality	<ul style="list-style-type: none"> <li>• Reduced poverty</li> <li>• Steady income for retirees</li> <li>• Funding of social projects by emigrant associations</li> </ul>	<ul style="list-style-type: none"> <li>• Increased social and geographic inequality</li> <li>• Strong financial dependence on the part of recipient households</li> <li>• Risk of reduced social spending (remittances take its place)</li> </ul>

Source: Independent research by the author.

should be put to use in Colombia in order to adopt public policies that take advantage of this “financial manna”. The abolishment of the tax-at-source on international transfers, the creation of a consular identity card in the United States,<sup>21</sup> the organization of several housing fairs in the United States and Spain, and the development by the Colombian National Education System (SNE) of virtual training courses

for Colombians living abroad are all steps in the right direction. In any event, remittances should clearly not be an objective but rather an instrument of public policy. It should not be forgotten that remittances belong to migrants and their families; they are the result of much effort and sacrifice, and it would be a mistake to think that the State could take ownership of them.

## IV Conclusions

In Colombia today, there is a tendency to view migration as a public-policy tool. The departure of part of the country’s workforce is, in effect, a safety valve that allows the State to ignore its economic and social responsibilities. Migration does reduce unemployment, and remittances help to stimulate economic activity and improve the balance on current account. The government should not view it as a solution to the country’s problems, however. While there is reason to encourage migration (to export problems, so to speak), internal solutions must also be found. The reduction of unemployment should be the result of an active job-creation policy, not of the mass departure of the unemployed.

While the government should strive to reduce remittance costs, promote financial democracy and steer remittances towards investment in production, it should not be forgotten that the key to development lies in domestic structural reforms. The experience of other countries has shown that, generally speaking, migration is not a development solution. Some countries, such

as Morocco, Algeria and even Mexico, have received remittances for decades and yet have failed to offer their people viable development options. Migration has thus become a perverse process, creating “poverty traps” whereby flawed economic and social policies lead to increased migration to industrialized countries, which in turn makes it so governments do not feel the need to undertake the types of reforms required to overcome underdevelopment. In contrast, countries that have successfully jump-started their economies have all carried out profound reforms. The achievements of Ireland, Spain or the Republic of Korea cannot be attributed to the massive outflow of migrants they experienced at a given time in their history, but rather to sound development policies. As a result, these countries, which used to be exporters of manpower, are now net receivers of migrants.

Such a transformation calls for a reorientation of economic and social policy. Economic growth must be a priority for the Colombian government; this is a *sine qua non* if the country is to retain its workforce. Increased efforts are needed in terms of agricultural, industrial and employment policy, as well as investment in research and development and in human capital. Social expenditure must also be a priority, since there is an inverse relationship between social spending and the migration rate (Khoudour-Castéras, 2007b). This will require a redistributive policy, which will in turn entail tax reforms aimed at improving social justice. It is also time for Colombia to consider affirmative action policies for the benefit of the most vulnerable sectors of society.

(Original: Spanish)

<sup>21</sup> The consular identity card is issued by Colombian consular offices in the United States (Atlanta, Boston, Chicago, Houston, Los Angeles, Miami, New York, San Francisco and Washington, D.C.) and is recognized by numerous public and private entities in that country. The card, which includes several features designed to prevent forgery, is a bilingual document that includes a photograph of the bearer and lists his or her city of origin, age and address, as well as the consular office that issued the card, its date of issuance and expiry and its registration number. The main advantage of the card is that it contains no information on the bearer’s immigration status and allows migrants whose status is irregular to open a bank account at their place of residence.

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