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# Effects of Remittances on Economic Growth in Indonesia

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**Abstract**

*Nowadays, the amounts of remittances in Indonesia have increased dramatically. It is reported that Indonesia received approximately USD9.2 billion of remittances. Remittances refer to money transferred by worker to the home country. Because the significant trend of remittances was sent to migrants' household immensely, many people can fulfil their basic need and resulting to increased their income and quality of life as well. This study tried to analyse the effects of remittances on economic growth in Indonesia by using an Ordinary Least Square (OLS) method during the period 1983 to 2016. The other variables considered include foreign aid, short-term debt and trade openness. The study found that remittance is significantly affecting economic growth as well as the other variables. All variables positively affect economic growth except trade openness which has negative effect on growth. Thus, to increase economic growth effectively, government needs to evaluate the policy regarding remittance inflows by improving financial institution in both Indonesia. Then, educating the migrants and households to manage remittances efficiently, may result on economic growth.*

**Keywords:** *Remittances, Economic growth, Indonesia, OLS.*

## 1. Introduction

Many Indonesian workers migrate abroad in order to improve their quality of life. Lack of job availability and rise of poverty in Indonesia exemplify the reasons that reveal migration (Balderas & Edward Blackburne, 2013). The data shows that more than 430,000 workers are living at overseas which is equal to 0.4 percent of Indonesian population in 2014 (ILO, 2015).

Malaysia is the most destination country for Indonesian workers with more than 130,000 migrants. While the other countries, such as Taiwan, Saudi Arabia and Hong Kong are only attracting Indonesian migrants between 83,000 to 35,000 people. The least destination countries are located in South Africa with near to 587 of Indonesian migrants (BNP2TKI, 2015). Thus, because the significant trend of Indonesian migrants was sending abroad immensely, the amount of remittance might increase gradually.

Many workers would send their money to their migrants' household in home country. It is reported that Indonesia received approximately USD9.2 billion of remittances in 2016 which is contributing to 1.1 percent of national GDP (GPFI, 2017). Remittances refer to money transferred by worker to the home country through official channel (Rivera-Batiz, 1987; Jawaid & Raza, 2012). According to Akter (2016), remittances are an important source of external funding for many developing countries. The flows are more stable and countercyclical compare to other private inflows (World Bank, 2008). In addition, remittances are considered as second-largest foreign source of finance after Foreign Direct

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Investment (FDI) (Asian Development Bank, 1992), though sometimes the number of remittances are greater than FDI flows (Shera & Meyer, 2013). As a result, it is expected that larger size of remittance might significantly affect macroeconomic variables in economy. Hence, understanding the relationship between remittance and economic growth would probably help government to boost up the economic welfare, since there have been limited studies reported on this issue.

There are many studies related to remittances and economic growth all over the world. Shera and Meyer (2013) have examined the impact of remittance to macroeconomic aspects in 21 developing countries. The study found that remittances are positively affecting economic growth, one percent increase in remittance contributed to a 0.14 percent increase in GDP per capita income for Albanian country. However, huge numbers of migrants would be a defining issue for labour markets since high competitiveness would beat the unskilled worker. Then, improving skill is needed to increase the number of high-skilled workers and it might indirectly help government to raise economic growth through remittance inflows.

While Giuliano and Ruiz-Arranz (2009) found that remittances increase economic growth in 100 developing countries, particularly in country which has less developed financial system. Remittances often claimed as an alternative way to solving liquidity problem in financial investment. However, investment is not the only way to promote growth, another channel, such as consumption and investment in the form of education, health and insurance might promote growth as well. In addition, it is interesting yet challenging since many government only focused on how to reduce cost of remittances instead of how to settle economic growth through remittances. The fact that countries which have good financial system in the form of credit markets does not seems to raise the growth very well.

Furthermore, research from Akter (2016) in Bangladesh, found that remittances are an essential element of private capital flow for improving the economic development of Bangladesh. There have been multiplier effects from remittances to any macro-economic indicators. It means that remittances could indirectly reduce poverty, elevate investment and trigger savings. While in Morocco, Tabit and Moussir (2017) found that remittances are representing economic growth determination, particularly in short term with 35 percent of elasticity. Although, remittances are claimed as steadier and low volatility, those number is quite lower compare to the long term period with about 88 percent. The possible justification might happen due to focusing on consumption purposes instead of investment purposes.

Moreover, in case of Nepal, Sharma (2017) examined about socio-economic problems due to remittances. It has been reported that Nepal remains one of poorest countries over the world, yet Nepal country is becoming one of top countries which received remittances. The role of remittances in economic growth is substantial to be implemented since consumption and GDP growth would affect the most in this case. However, remittances lead to moral hazard, the Dutch diseases[2], trade deficit due to distribution of imported luxury goods and others. Thus, in order to eliminate the negative effects, evaluating policy is necessary to be done, such as creating meaningful labour force opportunity. In addition, government also need to ensure that Nepalese workers are qualified enough to compete with other workers from outside Nepal country. Another research from Nepal was conducted by Kunwar (2015), this study proposed another policy since there have been socio-economic impacts to this country, particularly due to discrimination aspect. Many workers do not have good skill and

[2] The apparent causal relationship between the increase in the economic development of a specific sector (Krugman, 1987)

low educational background. It even expected that remittances number would be in trouble and considered as low percentage.

Gupta, Pattillo and Wagh (2007) studied the effect of remittances to economic growth in Sub-Saharan Africa from 1995 to 2006. This research showed that the level of remittances effects to economic growth was depending on migrants' household. If the families of worker used more remittances for consumption purposes instead of investment, it would cut off the access of remittances as a means of investment and resulting to not boosting economic growth. However, this study suggested that increasing remittances would be a matter compares to focus on how recipient of remittances used it. Remittances through financial services, such as saving product can stimulate economic growth immensely. Hence, lowering remittances cost might significantly help government to collect as many as remittances, since banks are not interesting to handle small remittances market.

On the other hand, according to Ratha and Mohapatra (2007), even though remittances might increase consumption and do not promote the growth, the number of poverty and inequality would probably reduce due to increased income per capita from remittance flows. In addition, this research also mentioned that skilled worker could reduce growth in home country. Nahar and Arshad (2017) reported that high-skilled workers bring along their family to the destination country. The worker did not remit money since they did not pay attention anymore to people in countries of origin. Although high-skilled worker might reduce growth, indeed by investing remittances of shares in physical and human capital, it would enhance financial development and contributing to increase growth in the future.

## 2. Method

The empirical analysis in this study examines the effects of remittances to the economic growth in Indonesia by considering other variables, such as foreign aid, short-term debt and trade openness. The model can be denoted as follows:

$$GDP_t = \alpha_0 + \alpha_1 LnRMT_t + \alpha_2 FA_t + \alpha_3 SD_t + \alpha_4 TO_t + \varepsilon_t$$

GDP : Economic growth (GDP growth)
RMT : Remittances
FA : Foreign Aid
SD : Short-term Debts
TO : Trade Openness
C : Constant
ε : Error term

All variables in this model represent percentage data except remittances that need to be transformed into log. Remittances, foreign aid, short-term debts and trade openness are expected to have positive effects. Thus, the expected signs; $\alpha_1, \alpha_2, \alpha_3$ and $\alpha_4$ are all positives. The dependent variable is GDP as proxy from economic growth whilst remittances, foreign aid, short-term debts and trade openness are independent variables.

Data in this study were collected from World Bank's reports and the coverage data is from the year of 1983 to 2016 of annually time series data. Hence, there are 33 total of observation. In this study, empirical work based on time series must first be confirmed to be stationary. A test of the stationary can be employed using the unit root test. Afterwards, if the unit root test is already stationary for all variables, OLS can proceed with the condition that all variables have fulfilled the requirement of the OLS properties.

### 3. Results

After proceeding to the regression, it is found that all variables are stationary and satisfy classical assumption test. From Figure 1 and 2, it can be seen that the p value of Obs*R-Squared are 0.6533 and 0.1087 respectively which is greater than the level of significance (0.05). It can be concluded that there is no autocorrelation and heteroskedasticity problem Moreover, all of the VIF scores for each auxiliary regression are less than 10. This means that there is no problem of multicollinearity for all independent variables (see figure 3). Hence, the OLS is the proper method for this paper and the result can be seen in table 1.

Breusch-Godfrey LM test for autocorrelation

| lags(*p*) | chi2 | df | Prob > chi2 |
|---|---|---|---|
| 1 | 0.202 | 1 | 0.6533 |

H0: no serial correlation

Source: Data Processed

**Figure 1:** Auto Correlation Test for OLS

| | | |
|---|---|---|
| chi2(1) | = | 2.57 |
| Prob > chi2 | = | 0.1087 |

Source: Data Processed

**Figure 2:** Heteroskedasticity Test for OLS

| Variable | VIF | 1/VIF |
|---|---|---|
| dremit1 | 3.36 | 0.297968 |
| dshort | 3.22 | 0.311023 |
| dnet | 1.53 | 0.654534 |
| TO | 1.42 | 0.705721 |
| Mean VIF | 2.38 | |

Source: Data Processed

**Figure 3:** Multicollinearity test for OLS

**Table 1:** Estimation Result of Regression Analysis
(Dependent Variable is economic growth)

Linear regression

| | | |
|---|---|---|
| Number of obs | = | 32 |
| F( 4, 27) | = | 13.23 |
| Prob > F | = | 0.0000 |
| R-squared | = | 0.8109 |
| Root MSE | = | 1.7676 |

| gdpgrowth | Coef. | Robust Std. Err. | t | P>\|t\| | [95% Conf. | Interval] |
|---|---|---|---|---|---|---|
| dremit1 | 4.523718 | 2.134036 | 2.12 | 0.043 | .1450381 | 8.902398 |
| TO | -.1906955 | .0428868 | -4.45 | 0.000 | -.2786919 | -.1026991 |
| dshort | .8064174 | .1810036 | 4.46 | 0.000 | .4350288 | 1.177806 |
| dnet | .8614032 | .4011953 | 2.15 | 0.041 | .0382184 | 1.684588 |
| _cons | 15.0223 | 2.193218 | 6.85 | 0.000 | 10.52219 | 19.52241 |

Source: Data Processed (1983-2016)

**4. Discussion and Conclusion**

The result (table 1) shows that ln RMT has a positive sign and significant at the 5 percent level of significance. A one percent change in remittance will increase economic growth by 4.52 percent. As well as foreign aid and short-term debts, both variables are having positive signs and significant at 5 percent level. According to estimation, one percent change in foreign aid and short-term debts lead to raise economic growth for about 0.86 percent and 0.80 percent respectively. On the other hand, trade openness has a negative sign, which means that one percent increase in trade openness caused a growth reduction of 1.90 percent.

Remittances are mainly seen as a significant mechanism to boost up economic growth. Based on the result, it is shows that remittances tend to promote growth indirectly. According to Nisar and Tufail (2013), increases remittances led to gain income for migrant's household in home country. The increased incomes allow household to increase their lifestyle in the form of good and services preferences (Snyder & S.Chern, 2008). The more remittances received by household, the more economic status of household is improved. At first, they can fulfil their daily consumption needs. Once the consumption satisfaction is increased, household can pay more attention to the investment purposes, for instance: education and business orientation. Education is better investment for migrant's generations in future which resulting to improve quality of life. Meanwhile, business activity is an additional income that the migrant can earn as backup savings in case of emergency, crisis, or if the migrant returns back to the home country permanently. Thus, remitted fund either for consumption or investment purposes lead to stimulate economic growth in the future.

From researchers' point of views, it is believed that remittances might stimulate economic growth in long-term period by using remittances for consumption activity first and followed by investment purposes. World Bank (2018) pointed out more than 28 million people in Indonesia are suffering due to living below poverty line. It is equivalent to 40 percent of whole Indonesian population. It means that consumption through remittances is more crucial to be solved at that moment compared to using remittances for investment activity. Although, Mohamoud and Formson-lorist (2014) argued that remittances which mostly used for daily consumption rather than productive activity, would affect economic growth directly in short-term period. However, it might be different result for Indonesian cases. No matter what remittance used for, remittances have the potential to become an important tool for improving economic development, particularly in developing countries (World Bank, 2013).

In addition, the result stated that remittances led to raise economic growth in Indonesia for about 4.52 percent. This number is considered as high percentage compared to other countries, such as Pakistan, Korea and Bangladesh which only earn small number of GDP from remittances. In the case of Pakistan, Tahir, Khan, and Shah (2015) reported that most workers remit money due to altruism motives which indirectly contribute to raise economic growth. One percent of remittances lead to increased 0.72 percent of GDP. While in Korea (Jawaid & Raza, 2012) and Bangladesh (Akter, 2016), increase in remittances may lead to raise economic growth for about a 0.080 and a 0.030 percent respectively. The small magnitude of remittances to economic growth might happen in Korea due to some reasons. One of possible reasons is Korea does not provide good policies regarding remittances inflow. Thus, it is advocated that the Korea's government need to form friendly policies and utilize the remittance efficiently.

There is possible explanation regarding high percentage of growth caused by larger remittances inflows. Indonesian government have understood that remittances from migrants is important tool to fight poverty and improve economic development, hence governance has released the new law regarding migrant's protection. The law no 18 year 2017 stated that government obligate to protect migrants through remittances management by involving bank institution and non-bank institution in both Indonesia or destination country *(Presiden Republik Indonesia*, 2017). Surprisingly, before the law of protection of migrant is updated in 2017, the survey from Bank Indonesia in 2009 found that 79 percent of workers remit money via banking institution whiles the rest via Money Remittance Operator (MRO), particularly Western Union. It means that government just need to maintain the remittances inflow from worker through formal financial institution which result on raise of economic growth as well as poverty reduction (Bank Indonesia, 2009). In addition, government also needs to educate migrants on how to arrange remittances properly. Sometimes, migrants spend much money by ignoring the impact on future, such as did not invest the money to productive activity or consuming without spare the money to saving.

Foreign aid and short-term debts have positive sign and statistically significant to economic growth. According to estimation, one percent change in foreign aid lead to raise economic growth for about 0.86 percent. Ustubici and Irdam (2012) defined foreign aid as one of foreign currency inflows toward a country. Foreign aid might help country to boost up the economic growth (Moreira, 1998). Galiani, Knack, Xu and Zou (2016) stated that one percent increase in the aid might affect economic growth for about 0.35 percent of GDP. However, the significant effects of remittances to the growth depend on some consideration which related to the governance of eah country. The aid would effectively stimulate the growth in countries with stronger macroeconomic policy framework and lower coruption (Durbarry, Gemmell, & Greenaway, 1998). Although Veiderpass and Andersson (2007) argued that Indonesia would experience less effect to the growth due to remittances, the estimation of this study stated that foreign aid could boost the growth in Indonesia for about 0.86 percent. It means that foreign aid can be succesfully used to boost economic growth in Indonesia.

Moreover, this study found that short-term debts contributed to raise economic growth for about 0.80 percent. Short-term debts are considered as government debt that has short maturity date, less than one year (Guin, 2011 as cited in Fosberg, 2012). Mainly, government borrowing was used for investment purposes, such as building infrastructure, increasing education and health services and improving agriculture production (Das, 2016). Investing the external debts to productive factors led to an increase of country’s real production and raise on economic growth (Korkmaz, 2015). However, economic growth might occur as long as that country stops to lend more money (Swastika, Dewandaru, & Masih, 2014). Borrowing more debts would probably increase the return due to high interest rate. Government cannot make an effort to return the money and resulting to the worst case, just like Turkey’s incident with high debt 85.9 percent of GDP (Mousa & Shawawreh, 2017).

Trade openness is estimated to have a negative sign, which causes a growth reduction of 1.90 percent. Trade openness is defined as the ratio of exports plus imports to GDP (Fujii, 2017) which aimed to determine the effect of trade and capture the openness of the economic on the growth (Meyer and Shera, 2016). However, this study found that trade openness is likely to reduce growth in Indonesia. The possible reason is Indonesia cannot make an effort to send huge export abroad which resulting to reduce the growth. High competitiveness among seller in both Indonesia and overseas, expensive tax, less capital are the reasons that trigger Indonesia do not ready yet to face trade openness. According to Chang, Kaltani and Loayza (2009), trade openness might successfully affect the growth as long as government fully understands how to respect the rule that enhances the effectiveness of the trade openness’ impact on economic growth. Then, larger exports might increase economic growth immensely (Dung, 2004; Berg and Krueger, 2003 as cited by Akoum, 2008).

From the result, it is found that all variables are significantly affecting economic growth though only one variable which has different expected sign, trade openness. Remittances, foreign aid, short-term debts have positive relationship to economic growth while trade openness has negative relationship to economic growth. Since remittances are the main focus variable in this study, more discussion regarding remittances were presented in detail compared to others variables. The finding shows that Indonesia government is full ready to protect migrants since remittances are considered as the main reason for massive economic growth in many countries, particularly in developing countries. Remittances would stimulate growth and has a potential to develop the economy of a poor-country. Migrants, as an agent of change, will send large scale remittances in the form of capital transfer. The larger the amount of remittances received, the more rapid and modern the economic development of worker's origin country in many countries.

Based on this study, it is advocate for educate the migrant worker through standardized the training, such as by providing qualified teacher and trainer, so they can ready enough to compete with other workers from foreign countries. In addition, the most important thing is Indonesian government should have strong policy to protect migrants in abroad, particularly for women and children and building migrants' protection centres in destination countries.

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