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# IMPROVING THE DEVELOPMENT IMPACT OF REMITTANCES*

PEDRO DE VASCONCELOS**

*The views expressed in the paper do not imply the expression of any opinion on the part of the United Nations Secretariat.
**Inter-American Development Bank.

# Improving the Development Impact of Remittances

**Donald F. Terry / Steven Wilson / Pedro De Vasconcelos**[1]

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## Hidden in Plain Sight

Call it the case of the missing billions. For decades, millions of migrant workers have been sending billions of dollars back to their home countries to support their families. Yet the impact of these huge international flows of both money and workers is only now beginning to be understood.[2]

More than $45 billion flowed from the rest of the world to Latin American and the Caribbean (LAC) alone in 2004—exceeding the *combined total* of foreign direct investment and foreign aid once again for the entire region (see map 1). And these figures undoubtedly underestimate the actual totals, because of problems in counting and tracking these flows—known as remittances.[3]

**[see Table 1 annex]**

Moreover, these totals are cash amounts. They do not include periodic transfers of goods such as computers and household appliances. These can also serve as investment goods, especially in informal microenterprises—a major economic sector unit in all developing countries. These so-called in-kind remittances can amount to more than a quarter of the value of monetary transfers in some households and communities.

Money and goods are one side of this international equation. Workers are the other. Workers leave their home countries for higher paid jobs abroad and, through a combination of hard work and thrift, send a portion of their earnings back home to support their families. Today, 1 in 10 people around the world are directly involved with remittances. Approximately 125 million workers send money to support another 500 million family members living in households back home.[4]

But these huge sums of money and flows of workers have been hidden in plain sight for decades. Why?

First of all, remitters to Latin America and the Caribbean usually send money in small amounts: $200 to $300 each month is most typical. In other parts of the world, monthly amounts can be much less, often ranging from as little as $50 to $100.

Moreover, workers often send remittances in ways that lie outside of any formal financial system. Some is still hand-carried. Unlike some other regions of world, where banks play a more prominent role in sending money home, migrants from Latin America and the Caribbean mostly rely on international money transfer companies or local neighborhood operators for their remittance transactions. Since the vast majority of these remitters and their families do not use banks, they have not traditionally been counted in the financial statistics collected to track international financial flows.

As a result, the main organization that tracks international financial flows, the International Monetary Fund, for years literally relegated billions of dollars of remittances to the “errors and omissions” category of its accounts. As central banks in Latin America are beginning to track remittances more thoroughly, they are revising their estimates upward by 200 to 300 percent for some countries. For this reason it is difficult to determine exactly how much of the recent “increase” in remittances is due to improved reporting and how much to increasing volumes—although 2004 figures now provide a much more accurate baseline for future comparisons.

There is another, even more basic reason why remittances have been undercounted: because the people who send them figuratively “do not count.” They are typically poor and largely invisible—both at home and in the country where they migrate to work. Many come from poor areas in their home countries, where their extended families still reside. Many work in low-skill, low profile jobs—jobs that nevertheless are in high demand in their new countries. And they save a far higher percentage of their income than average households in rich countries do, and these savings translate into widening flows of remittances.

**Redrawing the Map of Global Labor Markets**

Migrants are redrawing the map of global labor markets. More than 25 million Latin American and Caribbean migrants form part of a large and growing global diaspora. Of these, approximately 22 million are in the developed economies of North America, Europe, and Japan, while another 3 to 5 million work in neighboring countries of Latin America or the Caribbean.

For example, there are now significant concentrations of Bolivians in Argentina, Nicaraguans in Costa Rica, Guatemalans in Mexico, Haitians in the Dominican Republic, Colombians in Venezuela, and Peruvians in Chile.

Although, the fastest growing increase in the percentage of remittances to Latin America and the Caribbean is from Western Europe (Spain, Italy, and Portugal), the United States remains by far the foremost destination for migrant workers from LAC. At least 12 million adults from Latin America and the Caribbean—over 60 percent of the total living in the United States are sending money home to their relatives on a regular basis, typically once a month.[5] This ongoing process results in almost $35 billion a year in remittances to this region from the United States.

Within the United States, the map of foreign workers is also being redrawn. In fact, significant amounts (over $50 million) are sent annually from 37 states and the District of Columbia, demonstrating that the absorption of this workforce extends far beyond traditional border states. Migrants in the most recent destinations for Latino workers (Georgia, North Carolina, Virginia, Colorado, Massachusetts, Maryland, Nevada, and Washington) tend to send money home more often than migrants living in other states (see map 2 annex ).

As a result, Latin America and the Caribbean comprise the highest volume remittance market in the world. Indeed, the Western Hemisphere as a whole is increasingly functioning as an integrated labor market. The driving force behind this process is a fundamentally human connection: workers move abroad to support family members and protect their futures at home. While decisions to send money home are a mix of both altruism and harder-nosed motives, the commitment to family remains at the core of these flows. In this sense, remittances can be truly characterized as the human face of globalization.

Remitters and their families are forging a new kind of family—the transnational family—living in and contributing to two cultures, two countries, and two economies at the same time. This pattern, and this new wave of labor mobility, differs from previous types. In the not too distant past, leaving the home country meant severing virtually all ties. Today, cheap air travel, long-distance communication, e-mail and computers, and a multitude of other links (including the growing potential for the electronic transfer of funds) are allowing families to convey money, information, and even affection relatively quickly and easily across borders. As a result, these families are surmounting traditional geographic boundaries, creating new forms of social and economic interconnections.

**The Economic Power of the Poor: Leveraging the Impact of Remittances**

If individual remitters and their families are too often invisible, the economic power of millions of the poor is increasingly evident. In fact, the dividing line between the poor and the non-poor is less about the existence of assets than about the *use of these assets*. Peruvian economist Hernando de Soto's observations on the poor and property are equally germane to remittances:

"For poor countries to develop, the poor and lower middle classes must be allowed to use their assets in the same way that wealthier citizens do…[these assets] can become more productive and generate capital for their owners, growth for the nation, and markets for industry" (de Soto, 2001, p. 1).

In a similar vein, Professor C.K. Prahalad, author of *The Fortune at the Bottom of the Pyramid: Eradicating Poverty Through Profits*, observes: "If we stop thinking of the poor as victims or as a burden and start recognizing them as resilient and creative entrepreneurs and value-conscious consumers, a whole new world of opportunity will open up" (Prahalad, 2004, p.1).

At the household level, remittances often average half or more of household income. Many migrants send money to more than one household, and 20 million families in Latin America and the Caribbean benefit from these flows. The bulk of remittances—about 80 to 85 percent—are used to cover basic everyday necessities such as food, housing, and utilities. For millions of these families, many living on a few thousand dollars a year, regular remittances and periodic transfers of goods make a huge difference in their standards of living. Yet this channel remains largely undeveloped with respect to providing the poor with more options in using their own resources to benefit their families and their local communities.

Unlike foreign aid, remittances go directly to families in places that are the most difficult to reach with development assistance—such as those living in remote rural areas. Compared to foreign direct investment and other capital flows, remittances also show remarkable staying power—partly because they support household survival back home

Besides their direct impact on current family incomes, remittances provide an essential development impact for another reason: they are also being used to fund investments in the future.

Families use them to pay school fees for children in the home country, thereby investing in human capital for the next generation. Some remittances are funneled into investment goods, such as tools or as a source of operating capital for small businesses.

Indeed, for many poor households with severely limited access to credit, remittances may be their *only* source of finance. Moreover, remittances are used to purchase land or homes, as well as to repair and upgrade homes. Such outlays are beyond ordinary consumption, given the primary importance of housing, as well as the fact that many productive activities take place in the home.

While the percent of remittances going to such uses may be relatively small, given the total size of these flows, these cumulative amounts are significant. At the country level, remittances serve as an important source of foreign exchange, facilitating imports that cannot be funded from domestic sources. At the same time that official development assistance and foreign direct investment has slowed or fallen in many developing countries, remittance provide a reliable alternative source of foreign exchange that can compensate for diminishing inflows.

Remittances also act as a cushion against shocks, such as hurricanes, earthquakes and other natural disasters.  Remittances are also a buffer against economic meltdowns caused by significant financial sector problems, or political instability. For low-income migrants and their families, remittances act as a kind of safety net and as a form of insurance.

Given the magnitudes of these flows, remittances represent an enormous range of potential opportunities not only for individual families, but also for local communities and national economies. At the macroeconomic level, remittances can have a powerful impact through the multiplier effect—on GDP, job creation, consumption, income, and investment. In a study sponsored by the Multilateral Investment Fund (MIF) of the Inter-American Development Bank (IDB) it was found that mainstreaming remittances into the financial systems of recipient countries can significantly increase the income multipliers of these flows (Hinojosa Ojeda 2003).

**The Next Challenge: Financial Democracy**

Five years ago, very little was known about remittances beyond anecdotal information. Five years later, we now have a much more accurate accounting and understanding of LAC remittances flows and their development potential.[6]

Indeed, in 2004 the issue of remittances was front and center at three major international forums: The Summit of the Americas (January), the European Union/Latin American and Caribbean Summit (May), and the G-8 Summit (June). In 2005, numerous efforts are underway around the world to better understand remittances and to improve their development impact. The World Bank is taking the lead on improving data collection, through work with central banks, and numerous bilateral donors are involved with various aspects of remittances, as well as several non-governmental organizations, foundations and universities.

Five years ago, the average cost of sending remittances to Latin America was more than 15 percent of the value of each transaction, underscoring the reality that it is indeed expensive to be poor. Five years later, competition, technology, and improved awareness, have cut the cost of sending money in half, making an additional $3.5 billion available for families each year.

The huge scale of remittances to Latin America and the Caribbean can be a powerful lever to open up financial systems, mobilize savings, generate small business loans, and multiply economies impact for millions upon millions of individual families and the communities where they live.

But unleashing this potential will require fixing historic inequities in the financial systems of Latin America and the Caribbean and other developing regions. Currently, the great majority of families do not have access to savings accounts, loans, or mortgages, and small enterprises find it very hard to get credit or other financial services they need to grow their businesses. The resulting "intermediation gap" helps to perpetuate inequality.

Meanwhile, remitters are generating billions of dollars through hundreds of millions of individuals as "cash-to-cash" transactions totally outside of the financial system.

These remittances remain financial flows in search of financial products. Yet few financial institutions are meeting the needs of theses transnational families, and few public authorities are creating enabling environments to leverage these flows. Remittances present an enormous opportunity for millions of families to enter the world's financial system: to open a savings account, or obtain a loan or mortgage. This is a critical first step to entering the financial mainstream for individual families and reaching the goal of financial democracy for a country.

Remittances can be the point of entry for many remitters and their families to the formal financial system. Most remittances families are either "unbanked" or have only limited dealings with financial institutions. This represents an important business opportunity for banks, credit unions, microfinance institutions, and cooperatives—in both developed and developing countries—to introduce new customers to a range of financial services. A recent study published by the North American Integration Department (NAID) at UCLA indicates a significant in development impact if there is an increase in remittances moving through the financial system, such as banks or credit unions (Hinojosa Ojeda, 2003).

Financial democracy also requires new partnerships: with civil society, nongovernmental organizations, microfinance institutions, and others close to remitters and their families. One promising avenue is partnerships with Home Town Associations (HTAs). These are informal associations of emigrants who come from the same town or region in home countries. In recent years, they have spread across the United States, and have enjoyed some success in the channeling of remittances, building productive networks with home towns and ex patriot investors, and collaborating on the resolution of practical issues with home governments.

Financial democracy requires not only new partnerships and new initiatives to leverage the money; it requires new approaches and new attitudes toward handling it. Public authorities are used to regulating and taxing money. Development institutions such as the World Bank, the IMF, and the Inter-American Development Bank (IDB) are used to putting conditions on the money they lend.

Remittances are different. They are private transactions between private parties. The money is family money: earned by work hard and at considerable sacrifice. These family transfers represent the ultimate in family values: hard work, thrift, sacrifice, and hope for a better future. Underlying all of them is one basic fact: *It's their money*. The money rightly belongs to them and their families.

**Recognizing Reality and Moving Ahead**

Remittance flows, a major consequence of migration, are now a fixture of the international economic and financial landscape. Between 1975 and 2000 the world's population increased by 50 percent, while the number of migrants almost doubled. Today, the number of people having migrated for economic reasons would alone constitute the sixth most populous country in the world (Martin, 2004). While only 15 percent of the world's population live in developed countries, 60 percent of migrant workers reside there.

Migration, as part of a process of global integration, spawns new interrelated labor markets and transnational networks comprised of families and individuals, including migrants who return home, businesses and investors who continue to forge connections across borders These networks benefit from liberalization and technology and their growth creates markets for goods and services. This process is well underway in the Americas.

The emergence of remittances as an important issue for development policy has generated some backlash and confusion among politicians and academics regarding the nature of remittances. Remittances have been cited by some as encouraging migration from poor countries, and thus leading to reduced labor pools, lower per capita incomes, increased income inequality, and negative "demonstration effects" (such as visible household expenditure on housing, satellite dishes, imported equipment, and so on).

Others have equated remittances with so-called "Dutch Disease" – named for the economic impact on the Netherlands resulting from the discovery of natural gas in the North Sea. This term has been loosely used to diagnose the exchange rate volatility, inflation, loss of competitiveness on international markets, and other effects, such as real estate appreciation, caused by an influx of foreign exchange (including remittances) into a country. Some argue that remittances enable governments to avoid reforms, to overspend on the bet of growing future inflows.[7]

Still other researchers suspect that geographic distance and asymmetric information between remittance senders and receivers leads to problems of moral hazard, whereby recipients may engage in activities contrary to the wishes or interests of senders (Chami, Fullenkamp, and Jahajah 2003).

There is related confusion at the political level. For instance, the issue of money laundering for terrorist financing or other illegal activities often surfaces in policy discussions involving migrant remittances. The U.S. Patriot Act, through its various provisions urges banks and other institutions to "Know Your Customer" (see Bair, 2005).

While there is clearly a compelling and legitimate interest in depriving illegal activities of their means of financing, it strains credulity to suggest that migrant remittances play any meaningful role in these efforts. It should be understood that while remittances to Latin America and the Caribbean are large in the aggregate, individually these are very small amounts by standards of international transfers--averaging only $240 per transfer in

2004 (Bendixen and Associates, 2005). Pooling and coordinating such small amounts for illegal uses would be a highly inefficient way to direct or accumulate funds for such purposes.

Another confusion at the political level involves the suggestion by some that remittance flows justify the reduction or elimination of foreign assistance to those countries receiving significant remittances. Here again, it needs to be understood that these flows are neither charity nor foreign assistance. Remittances are derived from the payment for services rendered by migrant workers.

However, many of the studies that question the benefits of remittances tend to minimize several basic issues. First, while remittances are *no cause for celebration, they are not the cause of underdevelopment*. The hard reality is that remittances exist because many countries cannot provide adequate employment and income for their citizens. Hence, people move "North" by the millions, and money moves "South" by the billions. These flows have become a major source of income for millions of families. Indeed, it is impossible to envision social conditions in the absence of these resources.

Secondly, remittances do not typically produce optimal economic outcomes in recipient countries – but neither do other flows and economic activities in environments where *poor economic incentives and weak institutions discourage households, businesses, and investors from saving, investing, and undertaking risks.* Even sophisticated international investors, armed with the best market intelligence and deep resources, often avoid projects in developing countries. Indeed, given the economic environment in many countries of origin, it is remarkable that remittances support as much productive activity as they do.

With remittances, as with other economic flows, incentives matter. The way remittance senders and their families use money reflects in large part local incentives and economic realities. For instance, the major "investment returns" for many recipient households are the remittances they receive from family members who they have helped to migrate successfully. Given low household incomes and poor alternative uses for money, many families will spend most of their remittances, quite rationally, on consumption. In the same vein, remitting via relatively expensive "cash-to-cash" transactions may make sense for families that have few or no secure or liquid alternatives in which to send or store their money.

Let's be clear: the development impact of remittances has historically been limited. While these flows offer vital support for millions of households, remittances cannot be equated with any kind of grassroots "development model." On the contrary, these flows are symptomatic of systemic development failures afflicting millions of families across the developing world.

However, the subject has become something of a "mantra" for some governments and groups who assign great hope to remittances. But realizing this hope demands more than programs aimed at convincing migrants to send money home or encouraging home town associations to engage in development works in their homelands. What is required is a change in market incentives and in the capacities of migrants and families to respond to incentives. Short of this, most remittances will continue to flow into household expenditures and remain outside of the formal financial system.

As Jeffrey Sachs notes in his recent book *The End of Poverty*, when the basic conditions are in place for any economic activity, including technical and regulatory infrastructure and human capital – then the market can be a powerful engine of development (Sachs, 2005). This will be the case with improving the economic impact of remittances.

The technology is already available; what is needed are entrepreneurial business plans, appropriate regulatory frameworks, and financial literacy. With more people into the financial system, and more choices available to migrants and their families, remittances will be leveraged by linking flows to local microfinance institutions, home mortgages, and even the securitization of bonds for on-lending to local small businesses.

Changes in the market will occur when banks and other financial institutions, money-transfer companies, and other businesses recognize what Prahalad calls "the fortune at the bottom of the pyramid": the largely untapped market in lower-income households in developing countries. As the power of this market is better understood, a range of new competitive products and services aimed at migrants and their families will emerge in both host countries and countries of origin.

For families, increased capacities in the form of higher financial literacy will be needed to respond to new incentives that arise from reforms in the regulatory and institutional framework. A challenge for governments and civil society will be to improve financial literacy among transnational families while at the same time undertaking the institutional changes necessary for lowering the risks and costs (in time and money) facing these families when they choose to spend, save, or invest their remittances.

Every party involved in the remittance process needs to be involved in provide more and better options for remittance families to use their own money. To this end, the MIF has crafted a set of principles for remittance institutions, public authorities, and civil society, and is actively collaborating with other international organizations to improve the quality of remittances data and improve the impact of these flows on the lives of millions.

Drawing from an extensive network of stakeholders in the area of remittances, the MIF formed a Remittance Advisory Committee for Latin America and the Caribbean, comprised of leading representatives of international and regional financial institutions and money-transfer companies.[8] The Committee recognized that improving the development impact of remittances will require ambitious action in three areas: the practices of remittance institutions,[9] public authorities,[10] and civil society.[11]

After a broad process of consultation with the Task Force, the MIF devised the following recommendations, called Core Principles, to help organize and focus priorities on the collective effort to improve the potential of these flows (MIF-IDB 2004b). Each principle is a worthy subject for further research, and all have been discussed to some extent in various chapters of this book. These Principles address deficiencies, barriers, and bottlenecks in the three major areas that are critical to leveraging the huge scale of remittances: remittances institutions, public authorities, and civil society.

## Core Principles for the Remittance Market in Latin America and the Caribbean

### REMITTANCE INSTITUTIONS:

- ***IMPROVE TRANSPARENCY***

Remittance institutions should disclose in a fully transparent manner, complete information on total costs and transfer conditions, including all commissions and fees, foreign exchange rates applied, and execution time.

- ***PROMOTE FAIR COMPETITION AND PRICING***

Remittance institutions should compete on the basis of fair and non-discriminatory contractual arrangements. They should refrain from unfair pricing and the use of high exchange rate margins.

- ***APPLY APPROPRIATE TECHNOLOGY***

Remittance institutions should apply cost effective technology and deploy innovative platforms to cut costs, improve speed and security, and create new products. Such systems can also help to reduce money-laundering and other illicit activities.

- ***SEEK PARTNERSHIPS AND ALLIANCES***

Remittance institutions should seek partnerships and alliances, including linkages between money transfer companies and financial institutions, in order to leverage capabilities and promote “cash to accounts” services, and other forms of financial intermediation.

- ***EXPAND FINANCIAL SERVICES***

Financial institutions should deepen financial markets through inclusive and integrated services for remittance customers, such as current account services, savings, credit, and mortgage products, among others.

## PUBLIC AUTHORITIES:

- ***DO NO HARM***

Public authorities should facilitate remittance markets, and avoid attempts to tax, overregulate or otherwise take actions that impede the flow of remittances.

- ***IMPROVE DATA***

Public authorities should improve systems for collecting and reporting remittance market data, and help to develop international standards for measuring such data.

- ***ENCOURAGE FINANCIAL INTERMEDIATION***

Public authorities should facilitate the mainstreaming of remittances into financial institutions by improving regulatory and financial sector frameworks.

- ***PROMOTE FINANCIAL LITERACY***

Public authorities should raise awareness of the benefits of savings and other financial products, and inform consumers of their rights involving remittance transactions.

## CIVIL SOCIETY:

- ***LEVERAGE DEVELOPMENT IMPACT***

Civil society and private sector organizations should systematically identify obstacles to leveraging the development impact of remittances, and engage with all relevant stakeholders to address and remove such obstacles.

- ***SUPPORT SOCIAL AND FINANCIAL INCLUSION***

Civil society and private sector organizations should support the social and financial inclusion of transnational families into their communities, and develop innovative partnerships to promote training and local productive opportunities.

Over the past five years, remittances have undergone dramatic changes. Over the next five years the system can be entirely transformed. Progress on any of these Principles will improve the lives of many migrants and their families, but transforming the economic and social potential of remittances in developing countries will require concerted effort on all. While these Principles are directed at the remittances market in Latin America and the Caribbean, they are sufficiently general to be relevant to remittance markets in other regions.

While the growth in remittances appears assured over the medium term, the longer term outlook will hinge on economic growth in countries of origin, the rate of migrant family unification in host countries, the average age of migrants, and migrants' decisions to remain in host countries, among other variables. Significant changes in these can lead to declines in remittance volumes, such as occurred after many Turkish families were reunited in Germany in the late 1990s.

Moreover, remittances are not a substitute for pro-growth policies, investment in education, or skills formation in labor-exporting countries. However, by changing incentives, governments can improve the economic impact of remittances. The time to enact such changes is while these flows remain robust.

In particular, governments must avoid the temptation to tax or divert these flows for any reason. These amounts are usually sent in relatively small amounts – far smaller than concerns border or monetary authorities in virtually all countries. Moreover, any taxes or levies would prove highly regressive because of the low incomes of most senders. In addition, this could serve to drive some portion of these flows back into informal channels.

More importantly, countries stand to gain far greater economic and social gains from remittances by making the regulatory and institutional changes needed to allow more viable options for people when spending, saving, investing, or otherwise leveraging their money. Improving economic frameworks to permit the greatest number of recipients more economic outlets for their remittances will deliver broader economic multipliers – thereby expanding the tax base. It is simply better tax policy to provide incentives to promote greater economic activity than to tax (and thus impede) the financial flows that could generate that activity.

Quite simply and profoundly, when it comes to remittance senders and receivers: it's their money. Remittances represent far more than simple financial transactions; they are the outcome of the separation of families, the disruption of national economies, and the exodus of creative and hard-working adults from poor to richer countries. These flows deliver high financial benefits – but at very high human cost.

Yet remittances remain private flows in search public opportunity. Action on the part of public authorities, remittance institutions, and civil society can do much to provide the incentives and capacities needed to enable people to put their money to use for their families and their futures. Remittances, for so long the sign of a broad problem, now have potential to be part of a far-reaching solution.

In sum, it is time to turn cash into change.

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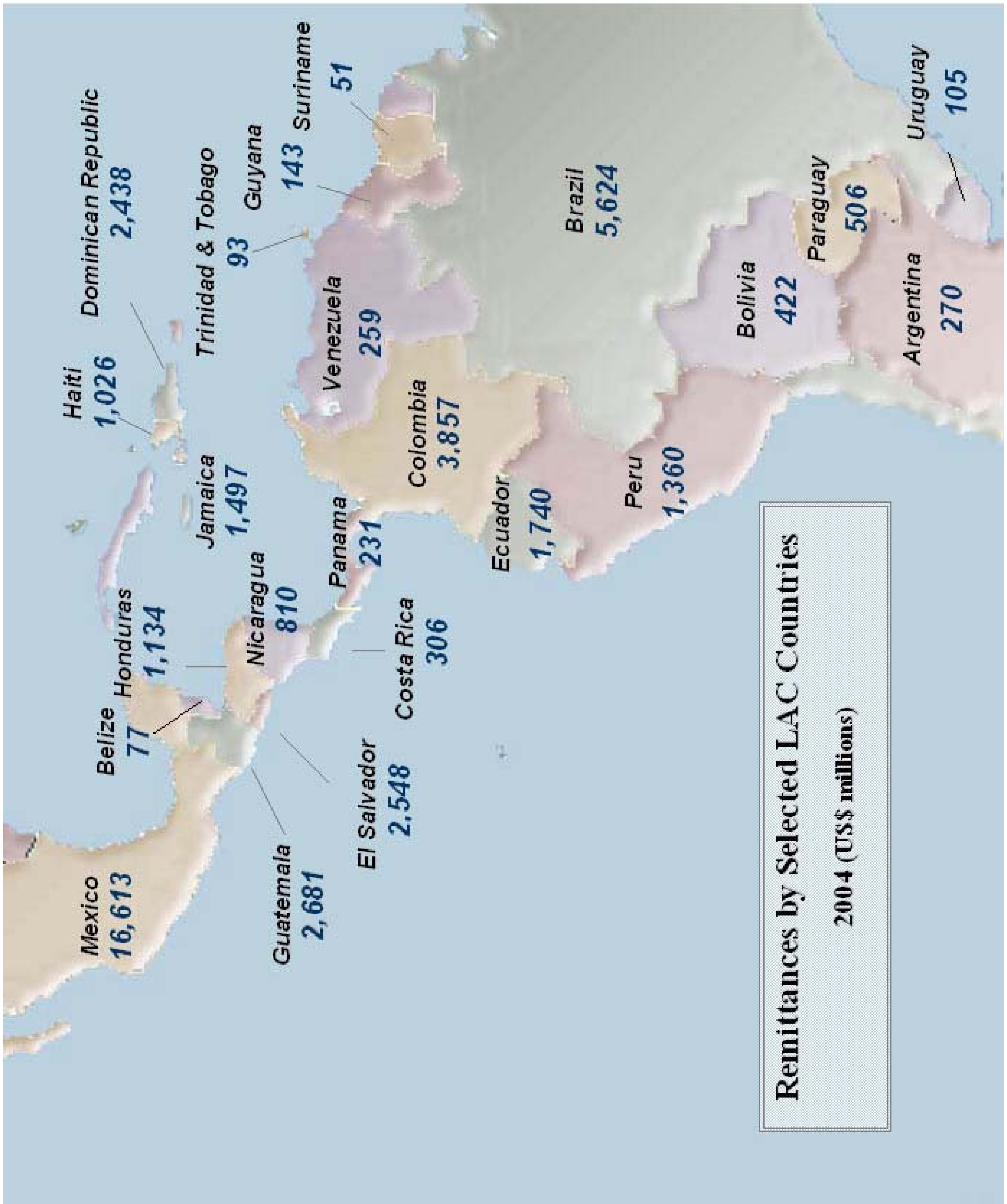
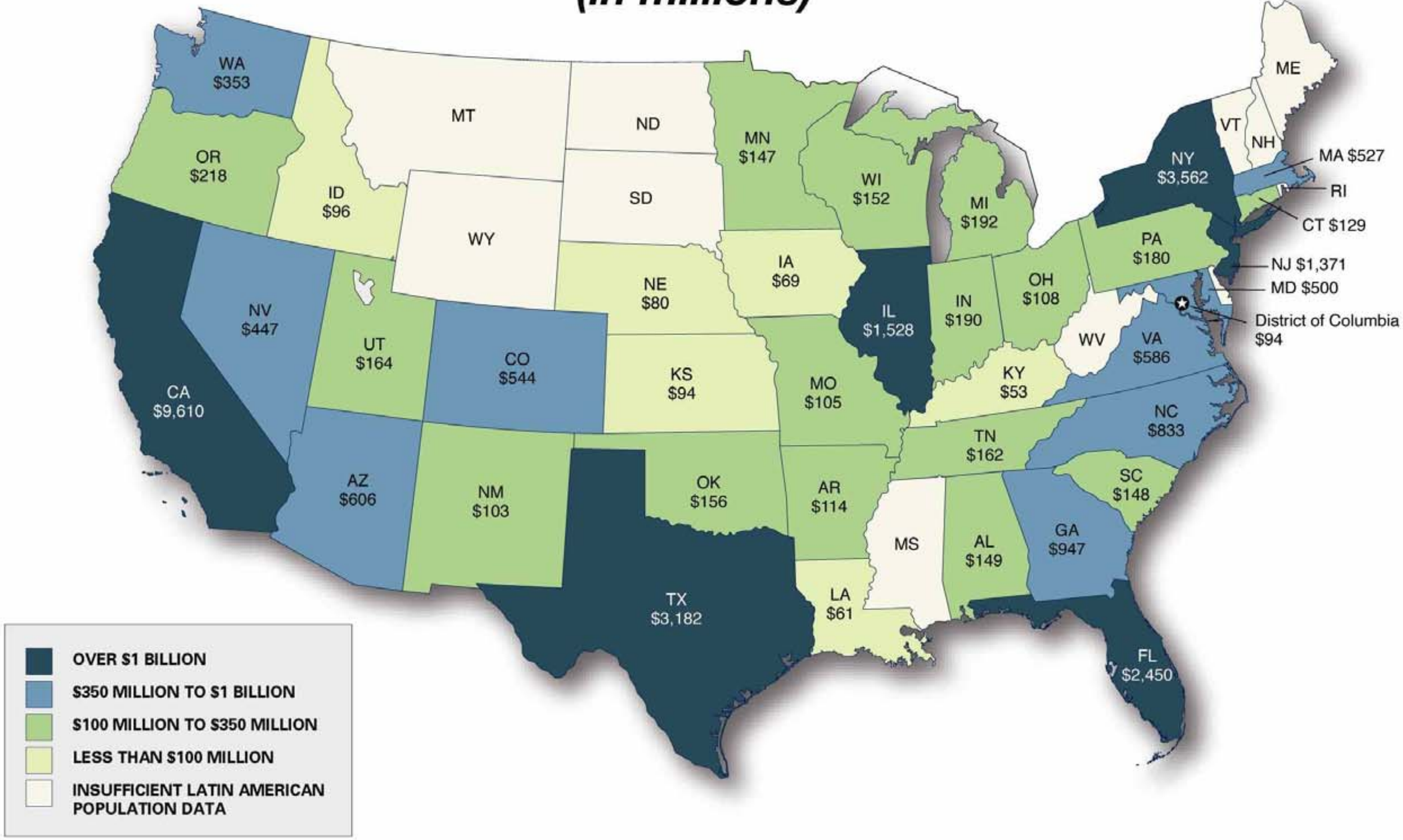
Annex


Remittances by Selected LAC Countries
2004 (US$ millions)
Mexico
16,613
Belize
77
Guatemala
2,681
Honduras
1,134
El Salvador
2,548
Nicaragua
810
Costa Rica
306
Panama
231
Jamaica
1,497
Haiti
1,026
Dominican Republic
2,438
Trinidad & Tobago
93
Guyana
143
Suriname
51
Venezuela
259
Colombia
3,857
Ecuador
1,740
Peru
1,360
Brazil
5,624
Bolivia
422
Paraguay
506
Argentina
270
Uruguay
105

# Remittances to Latin America from the US—2004

*(in millions)*



1

*Beyond Small Change: Making Migrant Remittances Count*

*Ecuador* *Colombia*
*Ecuador*
*Mexico* *Brazil ,*
*Domnican Republic* *Portugal* *Spain)*
*USA* *microfinance investment company,*
*Germany* *USA* *money-transfer organization* *money-transfer organization* *USA*
*payment card ,* *money-transfer organization*
*WOCCU, USA* *WSBI, Brussels*
*Spain*