ECONOMICS OF LESS DEVELOPED COUNTRIES

EC3141
Spring 2019

Lecture Notes 6

Michael King
Course Outline

1. Contemporary Theories of Economic Development
2. Policymaking: What Role for the State in Development?
3. The Role of Institutions in Development
4. Aid: Does it Work?
5. Trade: Engine of Growth or Obstacle to Development?
6. Domestic and International Finance: Opportunities and Instability
7. Economic Growth and Environmental Sustainability
Lecture Structure

1. Balance of Payments: Financing and Reducing Deficits
2. The 1980’s Debt Crisis: Attempts at Alleviation
3. Private Foreign Direct Investment (FDI) and MNCs
4. Remittances
Readings

Required

Supplementary Reading
The Balance of Payments (BofP)

- BofP summarises a nation and its residents' financial transactions with the rest of the world.
- Current account (CA) focuses on export and import of goods and services, investment income, debt service payments and private and public new remittances and transfers.
- Capital account (KA) records the value of private foreign direct investment, foreign loans by private banks and multilateral agencies minus capital outflow.
- Official reserve transactions by the central bank (cash account) including foreign hard currency, gold, deposits with the IMF.

\[ \text{BoP = CA + KA} = \Delta \cdot \text{IR} \]
## Balance of Payments

Exports of goods and services  
Imports of goods and services  
Investment income  
Debt-service payments  
Net remittances and transfers  
  Total current account balance \((A - B + C - D + E)\)  
Direct private investment  
Foreign loans (private and public), minus amortization  
Increase in foreign assets of domestic banking system  
Resident capital outflow  
  Total capital account balance \((G + H - I - J)\)  
Increase (or decrease) in cash reserve account  
Errors and omissions \((L - F - K)\)

\[
A - B + C - D + E + G + H - I - J + L - F - K = 0
\]

### Credits and Debits in the Balance of Payments Account

**“Positive” Effects (Credits)**
1. Any sale of goods or services abroad (export)
2. Any earning on an investment in a foreign country
3. Any receipt of foreign money
4. Any gift or aid from a foreign country
5. Any foreign sale of stocks or bonds

**“Negative” Effects (Debits)**
1. Any purchase of goods and services abroad (import)
2. Any investment in a foreign country
3. Any payment to a foreign country
4. Any gift or aid given abroad
5. Any purchase of stocks or bonds from abroad

Balance of Payments

- Balance of Payments:
  - Current Account - Financial Account – Official Reserve Transactions = 0

- Current account deficit: CA < 0 → Country borrows from the rest of the world or reduces cash position.
- Current account surplus: CA > 0 → Country lends to the rest of the world or increases cash position.
- On average, better to have a current account surplus and an increasing net asset position.
EU Crisis: Evidence from CAs

- Current Account Deficit: May lead to trouble
- It may just as easily occur because investments in the home country are secure and profitable
- It may be a response to excessive inflation, to productivity differentials, or to inadequate saving.

![Graph showing current account as % of GDP for Ireland and Spain from 2000 to 2011.]
Cumulative CA Balances: 1980-2009
Current Account Balances (1980-2006)

<table>
<thead>
<tr>
<th>TABLE 13.5  Summary of LDC Payments Balances on Current Account, 1980-2006 (billions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All developing countries</td>
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<tr>
<td>By region</td>
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<tr>
<td>Africa</td>
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<tr>
<td>Developing Asia</td>
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<td>Middle East</td>
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<tr>
<td>Latin America</td>
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</tbody>
</table>

| 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
| All developing countries | 88.1 | 37.9 | 77.3 | 147.6 | 212.6 | 428.0 | 544.2 |
| By region | | | | | | | |
| Africa | 5.4 | -1.5 | -7.5 | -2.2 | 0.6 | 14.6 | 19.9 |
| Developing Asia | 45.4 | 38.1 | 64.6 | 82.5 | 88.5 | 165.2 | 253.1 |
| Middle East | 69.6 | 38.1 | 30.0 | 59.5 | 99.2 | 189.0 | 212.4 |
| Latin America | -47.0 | -54.5 | -16.1 | 7.7 | 20.4 | 34.6 | 48.7 |
Financing and Reducing Payments Deficits

• International reserves can decline if there is a BofP deficit.

• Policy options in the face of a BofP deficit
  – Promote export expansion
  – Limit imports (through quotas, tariffs, import substitution)
  – Currency devaluation
  – Restrictive fiscal policies or monetary policies (reduce demand and inflationary pressures)
  – Encourage more FDI or portfolio flows
  – Seek public foreign assistance
  – Borrow from international commercial banks (can delay the problem)
Trends in LDC Balance of Payments

• Pre-1980 conventional development strategy encouraged large current account deficits (imports of capital and intermediate good). Made possible by large resource transfers:
  – Foreign Aid
  – FDI
  – Loans from International Banks
  – Loans from Multilateral Organisations
Debt Crisis of the 1980s: Background

• Debt service is defined as the paying off of the principal and accumulated interest.
• Debt service can be met from export earnings, curtailed imports, further external borrowing or economic growth.
• Debt service payments are likely to be in foreign currency.
• Debt service difficulties will arise if:
  – Exports earning decline
  – Interest rates rise
  – Local currency devalues against the currency of the debt “Original Sin”
  – And of course if growth is poor
Mechanics of Petrodollar Recycling in 1970s

OPEC countries export oil

Europe, Japan, and the United States send dollars to OPEC countries to pay for imported oil

OPEC countries deposit dollars in U.S. and European banks

Europe and U.S. banks lend OPEC’s petrodollars to developing country borrowers, leading to debt expansion

Developing-country debtors pay debt service (interest and principal)

1980s Debt Crisis: Alleviation Attempts

1. Stabilization Policies (IMF)
2. Debt Relief
3. Odious Debt
4. The Case of Mexico
IMF and World Bank: Crisis Resolution

• Crisis stabilization (debt, fiscal, balance of payments crises) have led to IMF and World Bank stabilisation and structural adjustment programmes (SAPs)

• The stabilisation and structural adjustment programmes (SAPs) were heavily informed by the Washington Consensus
Attempts at Alleviation: Stabilization Policies

- Typical elements included:
  1. Fiscal Correction - often involving the cutting of social expenditures and wage reduction to achieve balanced budgets
  2. Stringent domestic anti-inflation programme
  3. Devaluation of currency to make exports still more competitive
  4. Reorienting the economy toward exports in order to earn the foreign exchange required for servicing the debt (Trade Liberalisation and reduction in import restrictions)
  5. Deregulation of industries and privatisation of state enterprises (opening up to foreign investors)
  6. Improving governance and fighting corruption.
Attempts at Alleviation: Stabilization Policies

• The IMF stabilization program
  – Such policies can be politically unpopular because they hurt the lower- and middle-income groups.
  – “The IMF in many ways is like a medieval doctor where no matter what the ailment, you apply leeches and bleed the patient. My experience is that IMF policies are successful in steering countries’ resources towards paying debts to commercial banks, but are disastrous in terms of the long term economic health of these countries.” – John Cavanagh
  – Less radical observers view the IMF as neither a developmental nor an anti-developmental institution.
Attempts at Alleviation: Stabilization Policies

• Tactics for debt relief:
  – Debtors’ cartel
  – Restructuring (Toronto Options: Partial cancellation, reduced interest rates, extended payment schedule)
  – Brady Plan (Linked to IMF conditionalities)
  – Debt for equity swaps
  – Debt for nature swaps
  – Debt repudiation (hurt borrowers and lenders)

• Most proposals only postpone the day when debts become due
### Dimensions of the LDC Debt Burden, 1970–2007

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<tbody>
<tr>
<td>Total external debt (billions of dollars)</td>
<td>68.4</td>
<td>180.0</td>
<td>635.8</td>
<td>949.0</td>
<td>1,182.3</td>
<td>1,808.9</td>
<td>2,367.6</td>
<td>3,022.6</td>
<td>3,715.1</td>
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<td>Of which Africa</td>
<td>—</td>
<td>14.9</td>
<td>55.6</td>
<td>64.7</td>
<td>283.3</td>
<td>304.1</td>
<td>286.8</td>
<td>298.8</td>
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<td>Debt service payments (billions of dollars)</td>
<td>11.0</td>
<td>25.8</td>
<td>102.4</td>
<td>128.0</td>
<td>140.5</td>
<td>237.5</td>
<td>446.7</td>
<td>593.7</td>
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<td>Of which Africa</td>
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<td>1.3</td>
<td>4.1</td>
<td>27.6</td>
<td>31.1</td>
<td>33.1</td>
<td>26.8</td>
<td>34.7</td>
<td>26.5</td>
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<tr>
<td>Debt-to-export ratio (percent)</td>
<td>99.4</td>
<td>76.4</td>
<td>81.9</td>
<td>154.5</td>
<td>178.6</td>
<td>136.9</td>
<td>122.1</td>
<td>75.8</td>
<td>62.6</td>
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<tr>
<td>Of which Africa</td>
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<td>—</td>
<td>92.5</td>
<td>189.0</td>
<td>230.7</td>
<td>228.5</td>
<td>182.0</td>
<td>94.5</td>
<td>61.9</td>
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<tr>
<td>Debt service ratio (percent of exports)</td>
<td>13.5</td>
<td>9.5</td>
<td>13.2</td>
<td>20.9</td>
<td>9.4</td>
<td>27.5</td>
<td>23.0</td>
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<tr>
<td>Of which Africa</td>
<td>5.7</td>
<td>—</td>
<td>14.4</td>
<td>27.6</td>
<td>11.3</td>
<td>32.8</td>
<td>17.0</td>
<td>11.0</td>
<td>6.1</td>
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<tr>
<td>Debt-to-GDP ratio (percent)</td>
<td>13.3</td>
<td>15.4</td>
<td>24.4</td>
<td>36.4</td>
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<td>40.5</td>
<td>37.3</td>
<td>28.7</td>
<td>24.4</td>
</tr>
<tr>
<td>Of which Africa</td>
<td>20.9</td>
<td>—</td>
<td>28.3</td>
<td>46.6</td>
<td>61.4</td>
<td>74.2</td>
<td>64.1</td>
<td>37.0</td>
<td>23.2</td>
</tr>
</tbody>
</table>


*aActual payments of interest on total debt plus actual amortization payments on long-term debt.

bRatio of external debt to exports of goods and services, expressed as a percentage.

cDebt service as a percentage of exports of goods and services. Excludes service payments to the IMF.

dRatio of external debt to gross domestic product (GDP), expressed as a percentage.
“Odious Debt” and its Prevention

• What is odious debt?
  – Sovereign debt used by an undemocratic government in a manner contrary to the interests of its people should be deemed invalid
  – Examples include Mobutu Sese Seko (Congo), Jean-Claude Duvailier (Haiti) and Ferdinand Macros (Philippines)
“Odious Debt” and its Prevention

- Jayachandran and Kremer: Proposal for an independent commission to declare regimes illegitimate and certain debt odious
  - Reduce the ability of illegitimate regimes to borrow
  - Lower interest rates for legitimate governments

- HIPC debt reduction programme launched by the G8 in 1996 – good progress was made

- But highly indebted poor countries (HIPC)s remain a phenomenon
Public Debt as a % of GDP

Gross public debt, percent of GDP

Source: IMF - 2015
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The Case of Mexico in the 1980s

• 1973:
  – Mexico’s external debt was relatively small.
  – Citibank Chairman: “Sovereign countries do not default” as petrodollars flowed into Latin America in the form of loans.

• 1973-1980:
  – Value of outstanding loans to Mexico grew 10 fold.
  – Investment as a share of GDP hardly increased.
  – No added capacity to generate foreign exchange to repay the loans without a fall in living standards.
  – Greater production of oil, encouraged further borrowing.
  – Dutch Disease: Non-oil exporters were hurt by currency appreciation.
The Case of Mexico in the 1980s

• 1979:
  – Second oil price shock – increase in interest rates, lower demand for exports, high debt levels made borrowing more difficult.

• 1982:
  – Mexico triggered a debt crisis by announcing that it could not service its debt.
  – International banking system was in peril.
  – IMF Stabilisation Agreement reached (public sector deficit fell from 17% to 8% of GDP but GDP fell and real income fell from 1982 to 1985.

• 1984:
  – Agreement to stretch out the repayment period
The Case of Mexico in the 1980s

• 1985:
  – Baker Plan: New lending to inspire growth conditional on further market reforms.
  – Only a small proportion of the commercial loans envisioned under the Baker plan materialised.
  – Fall in oil prices hurt Mexico further.
  – Pioneering of debt-for-equity swaps (tended to be inflationary and political pressures grew to limit foreign ownership).

• 1989:
  – Eventually everyone agreed that growth would not resume until Mexico's debt burden was reduced not simply rescheduled.
  – Under a new Brady Plan, Banks were given three options 1) agree to a 35% reduction but with more certainty of repayment 2) agree to a lower interest rate or 3) lend new money to help Mexico meet repayments.
  – Saved Mexico $1.3bn a year.
The International Flow of Financial Resources

• Four sources:
  – Private direct (mostly MNC)
  – Portfolio investment (not considered)
  – Remittances of earnings by international migrants
  – Public and private development assistance (covered already)
Total Net Resource Flows to Developing Countries, 1990–2005


Note: Total net resource flows are defined as net liability transactions or original maturity of greater than one year. Note that the World Bank's classification of developing countries is used here. It differs from UNCTAD's classification in that it includes new EU member states from central and eastern Europe and excludes high-income countries such as the Republic of Korea and Singapore.
FDI Inflows to Developing Countries vs Domestic Investment, 1990–2003

Evolution of FDI in Irish Aid Countries

Source: Barry & King 2009
How important is FDI to LDCs?

• 1914: More than 80% of global foreign capital stock located in developing economies.
  – Importance of railway building, the extractive industries and the colonial control of international trade at that time.

• Today: Vast bulk of the global FDI stock is located in the developed world.
  – Associated with activities which are intensive in the use of knowledge capital.
How important is FDI to LDCs?

• Today FDI represents a small proportion of domestic investment in developing countries.

• But a high proportion of all resource flows to developing countries (72% in 2003).
  – Compares to the late 1980s and early 1990s when ODA and FDI were equally important.
Irish Aid Countries: Aid v’s FDI

FDI and Aid Flows - Irish Aid Programme Countries

Sources: WDI (2009), UNCTAD (2009), Roodman (2009).
Timor Leste is excluded because the average aid inflow 04-07 is 61% with FDI of 0.37%.
FDI Inflows, 1980–2005

LDC Poor FDI Performance due to?

- Same factors that have contributed to a generally low rate of private investment to GDP
- While gross returns on investment can be very high in Africa, the effect is more than counterbalanced by high taxes and a significant risk of capital losses. Risk factors include:
  - macroeconomic instability
  - loss of assets due to non-enforceability of contracts
  - physical destruction caused by armed conflicts.
Benefits of MNCs in LDCs?

• Few areas of economics are subject to so much controversy

• Often controversy hinges on different ideological and value judgments about the meaning of economic development
  – Free market v’s importance of national control and the minimization of relationships of domination
  – Bearers of employment and higher earnings v’s modern incarnation of colonial exploitation
Benefits of FDI and MNCs: Growth

• FDI influences growth by raising TFP and efficient resource use through three channels:
  – Linkages between FDI and foreign trade flows
  – Spillovers and other externalities vis-à-vis the host country business sectors
  – Direct impact on structural factors in the host economy

• Emanating from the traditional and new growth theories
  – Fills saving gaps (Harrod-Domar Model)
  – Fills foreign exchange or trade gap
  – Provides much needed government revenue
  – Introduce higher levels of human capital (raise the return to education)
Role of FDI and MNCs in LDCs

• Dynamic and diversified exporting base central to achieving long run sustainable growth and poverty reduction in developing countries

• Attraction of FDI and its associated technologies in a diverse range of sectors central ingredient to develop exporting industries in low-income countries
Pros and Cons of FDI and MNCs in LDCs

1. Management, knowledge of international markets gaps overcome through FDI
   - The entrepreneurial, management skills, ideas, technology may have little impact on the local economy
     Technological Spillovers
   - Rodrik – little evidence of technological spillovers to local producers of the same goods
   - Case of Indonesia: evidence of significant transfers of technology to local vendors so that MNC can purchase inputs at low cost. The spillovers may be vertical rather than horizontal

2. Impact of FDI on human capital has been found to be indirect via government education policies
Pros and Cons of FDI and MNCs in LDCs

3. Normally FDI improves the current and capital accounts
   – However, permitting MNCs to operate behind protection can worsen current and capital accounts by increasing imports of intermediate and capital goods and the repatriation of profits

4. MNCs and FDI may reduce domestic savings and investment by stifling competition via exclusive agreements
   – In a survey of 11 developing countries higher FDI was accompanied by lower domestic investment, larger current account deficits and lower economic growth rates – suggesting crowding out
Pros and Cons of FDI and MNCs in LDCs

5. Tax concessions, excessive investment allowances and subsidies reduce the level of government revenue collected
   - Transfer pricing can reduce level of revenues recorded in LDC depending on relative corporation tax rates

6. Domestic Competition
   - MNCs may encourage domestic competition and thereby leading eventually to higher productivity, lower prices and more efficient resource allocation
   - Conversely, the entry of MNCs can raise the levels of concentration in host-country markets, which can hurt competition
Pros and Cons of FDI and MNCs in LDCs

7. Power of multinationals (any five of the top 10 MNCs recorded more sales than the entire GNI of sub-Saharan Africa) that have oligopolist market positions

– The power of multinationals can mean that concessions that reduce the benefits to the local economy are extracted from LDC governments when there are many LDC competing for the investment
Pros and Cons of FDI and MNCs in LDCs

8. Can divert resources away from local food production
9. Can encourage the consumption of expensive consumption patterns to the detriment of household investment
10. Can promote urbanization and an increase in inequality between urban and rural areas, and the associated tension that accompanies such inequality
11. Can inhibit the development of local industry – no self discovery
Pros and Cons of FDI and MNCs in LDCs

12. FDI has potential to bring social and environmental benefits to host economies

- Dissemination of good practices and technologies within MNCs and subsequent spillovers to domestic enterprises.
- Risk of a lowering or a freezing of regulatory standards as countries compete for FDI
- Environmental degradation and poor labour conditions can result from poor regulation
Disputed Issues about the Role and Impact of Multinational Corporations in Developing Countries

1. International capital movements (income flows and balance of payments)
   - Do they bring in much capital (savings)?
   - Do they improve the balance of payments?
   - Do they remit “excessive” profits?
   - Do they employ transfer pricing and disguise capital outflows?
   - Do they establish few linkages to the local economy?
   - Do they generate significant tax revenues?

2. Displacement of indigenous production
   - Do they buy out existing import-competing industries?
   - Do they use their competitive advantages to drive local competitors out of business?

3. Extent of technology transfer
   - Do they keep all R&D in home countries?
   - Do they retain monopoly power over their technology?

4. Appropriateness of technology transfer
   - Do they use only capital-intensive technologies?
   - Do they adapt technology to local factor endowments or leave it unchanged?
Disputed Issues about the Role and Impact of Multinational Corporations in Developing Countries

5. Patterns of consumption
   - Do they encourage inappropriate patterns of consumption through elite orientation, advertising, and superior marketing techniques?
   - Do they increase consumption of their products at the expense of other (perhaps more needed) goods?

6. Social structure and stratification
   - Do they develop allied local groups through higher wage payments, hiring (displacing) the best of the local entrepreneurs, and fostering elite loyalty and socialization through pressures for conformity?
   - Do they foster alien values, images, and lifestyles incompatible with local customs and beliefs?

7. Income distribution and dualistic development
   - Do they contribute to the widening gap between rich and poor?
   - Do they exacerbate urban bias and widen urban-rural differentials?

Role of Developed Countries: Promotion of pro-development FDI in Developing Countries

1. Tax sparing agreements to preserve LDC tax benefits
2. Reduce bribery and corruption in MNCs
3. Improve Environmental and Labour Norms in MNCs
4. Better industrial policy: Support for investment in developing Countries
Role of Developed Countries: Promotion of FDI in Developing Countries

- Tax sparing agreements
  - Used as a tool to promote economic development in numerous developing countries over the last 50 years.
  - Definition bilateral agreement where developed countries, such as Ireland, preserve the benefits of tax incentives offered by developing countries to foreign investors.
  - Tax incentives used by developing countries have included generous tax treatment of investment expenditure, tax holidays and the provision of public goods at below market prices.
  - Developed country “spares” the tax it would normally impose on the low or untaxed income generated in the developing country as a result of the tax incentive.
Role of Developed Countries: Promotion of FDI in Developing Countries

• Reduce corruption in MNCs.
• Evidence that countries that tackle bribery and corruption can improve growth performances and reduce the effects of poverty.
• Developed countries should eradicate bribery and corruption in own companies by:
  – holding them to account in domestic legal systems.
  – signing up to more advanced anti-corruption treaties.
Role of Developed Countries: Promotion of FDI in Developing Countries

• Through domestic regulations or international agreements developed countries can hold MNCs to a higher standard of environmental protection.

• International aid can focus on developing the capacity of developing world governments and stimulating local civil society to improve the dividend for the local economy and environment from agreements with MNCs.
Role of Developed Countries: Promotion of FDI in Developing Countries

• Support for LDC industrial policy
  – Promote competition and preserve industrial policy space for LDCs.
  – The IDA has in the past been involved in helping design Costa Rica’s strategy to attract FDI and in establishing the highly-rated Costa Rican Investment Promotion Agency, CINDE.
Remittances

Potential Benefits to Open Migration
• Allowing workers to move until real wages are equal worldwide would lead to a doubling of world GDP, with LDCs receiving disproportionate share of income growth (Hamilton & Whalley, 1984)
• More recent studies, where developing country workers have lower human capital/productivity – benefits: 10 percent of world GDP.
• Migration had a much larger impact on 19th century convergence of per capita incomes across countries than either trade or capital flows (O’ Rourke and Williamson, 1999).

Other Issues
• Importance of “Brain Drain”
• Uneven flow of remittances (not necessarily to the poorest countries)
Resource Flows to Developing Countries, 1990–2005

Top 20 Remittance Recipient Countries, 2004

<table>
<thead>
<tr>
<th>Country</th>
<th>Billions of U.S. dollars</th>
<th>Share of GDP</th>
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<tbody>
<tr>
<td>India</td>
<td>21.7</td>
<td>31.1</td>
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<td>China</td>
<td>21.3</td>
<td>27.1</td>
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<tr>
<td>Mexico</td>
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<td>France</td>
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<td>Nigeria</td>
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Options to Support Remittances

• Competition and price transparency in remittances services should be encouraged
• Incentives to increase the flow of remittances to developing countries such as “salary sacrifice” or social security refunds
• Stealing Africa Documentary
• http://www.youtube.com/watch?v=WNYem uiAOfU