Remittances, Output, and Exchange Rate Regimes

Abstract: This study explicitly incorporates remittances in a small open economy and examines the behavior of the main macroeconomic aggregates in response to a remittances shock under alternative exchange rate regimes. Using a simple stochastic limited participation model we are able to reproduce dynamics consistent with the empirical literature, but find that the dynamics of labor, inflation, and output are dependent on the parameterization of the utility function and the monetary rule governing the evolution of the interest rate. We find that a more flexible exchange rate regime exacerbates the initial drop of output resulting from a remittances shock, but while the subsequent recovery of output is slower in the more flexible exchange rate regimes, it ends up being much stronger. These results are corroborated by the empirical evidence from a basic growth specification for 11 Latin American countries.