Remittances, Output, and Exchange Rate Regimes: Theory with an Application to Latin America

Abstract: Immigrant remittances have a broad effect on the receiving economies. We show this impact on the main macroeconomic aggregates are dependent on the policy arrangements in place that manage capital flows. We look at remittance inflows in a small open economy to examine their influence on output under alternative exchange rate regimes. Using a simple stochastic limited participation model, we are able to reproduce dynamics consistent with the empirical literature. We find that the dynamics of labor, inflation, and output are dependent on the parameterization of the utility function and on the monetary rule governing the evolution of the interest rate, and in particular with respect to the response of interest rates to exchange rate movements. We find that the initial drop of output resulting from a remittances shock is similar under alternative exchange rate regimes, but the subsequent recovery of output is faster and stronger under more flexible exchange rate regimes. We provide suggestive empirical evidence from a panel Vector Autoregression specification for 17 Latin American countries that corroborates our results.