Understanding The Influence of Remittances on Household Consumption and Investment Trends in Pakistan

Muhammad Zaman
Relationship Associate, Islamic Corporate Credits, Bank Al Habib Ltd. Karachi, Pakistan
muhammad.zaman2712@gmail.com

Aizaz Ahmed
Intern Finance, Research Development Foundation (RDF), Hyderabad, Pakistan

Dr. Saima Tabassum
Associate Professor, IBA, University of Sindh, Jamshoro, Pakistan
saima.tabassum@usindh.edu.pk

Imdad Hussain
PhD Scholar, IBA, University of Sindh, Jamshoro, Pakistan
is.mpa.hr@gmail.com

Abstract

The effect of remittance inflows on Pakistan's economy, in relation to household consumption and investment behavior, is the subject matter of this research. With monthly observations starting from 2005, data from the World Bank is used in this analysis, where a Vector Autoregression (VAR) model in R Studio is employed to explore the remittances-GDP growth-investment-consumption-CPI relationship. The impulse response function enables short-run responses to shocks in remittances to be depicted, and the variance decomposition calculates the proportion of variations in reference economic indicators due to remittances. The results validate that remittances have a critical, if transitory, function to fulfill in stimulating GDP growth, triggering investment, and enhancing domestic consumption in Pakistan. Of note is that their temporary effect on inflation (on the CPI basis) is mildly adverse but fleeting. The most probable reason is that the initial boost in investment and spending temporarily relieves pressures on the price's downward movement while this effect recedes subsequently. This research provides crucial insights to policymakers and planners of the economy, emphasizing the importance of developing well-informed policy responses that capitalize on remittance development potential to its fullest. It thus contributes fresh perspectives to ongoing academic discussions regarding remittance-fostered economic change in developing nations such as Pakistan and bridges significant gaps in literature.

Keywords: *Remittances, Consumption, Investment (GFCF), GDP Growth, CPI*

Introduction

Remittances have been the pillar of Pakistan's economic backbone over the last two decades. With billions of dollars poured into the country every year by overseas Pakistanis, often pegged at about $22 billion in a single year, like 2022, these remittances not only sustained families but also served to stabilize the macroeconomic situation when times were tough.But beyond being employed for near-term family purposes, an even bigger question lingers: To what extent do remittances impact macroeconomic variables like consumption levels, investment activity, and economic growth? While past research has provided mixed findings—some with a readily apparent positive relationship between remittances and growth, others finding little or no evidence, the picture still remains incomplete.

As Pakistan's financial sector matures slowly, it is experiencing a shift in how remittances are utilized. Originally going towards consumption spending, remittances are being more and more invested in savings and productive uses, particularly when there are good financial instruments. A well-established banking system has been instrumental in channeling remittance flows into growth-oriented sectors. World experience, as that of Albania, indicates remittances as important in influencing household consumption and helping reduce income inequality. These lessons reinforce the power of remittance not merely as a source of complementary income, but as agents of economic development. Though remittances make a huge contribution to Pakistan's economy, there is not much available on what effect remittances have on domestic investment back home. This study attempts to fill the gap. Based on full-month data and a good VAR model, this paper examines empirically the dynamic relationships between remittance inflows and their implications on consumption and investment after controlling for CPI and GDP growth as background variables. These relations must be understood. Strategically optimized, remittances could prove a viable economic growth trajectory. This study not only brings existing literature up to date with the most recent econometric methods and statistics but also provides policy recommendations that can be acted upon for country planning.

Research Objective

The main aim of this research is to examine the impact of remittances on household investment and consumption level in Pakistan. Consumption and investment are dependent variables, while remittances are the independent variable.

Research Questions

1. What is the impact of remittance inflows on consumption in Pakistan?
2. What is the effect of remittances on domestic investment patterns in Pakistan?

Research Hypotheses

- H1: Remittance inflows have a substantial impact on household consumption in Pakistan.
- H2: Remittance inflows have considerable impact on investment patterns in Pakistan.

Literature Review

Realization of the impact of remittances on household behavior and growth is natural to garner considerable scholarship. Literature in Pakistan is no exception, with a wide variety of findings, both the beneficial and potential negative effects of remittances on consumption behavior and investment behavior. Carling (2008) reveals that remittance-receiving households have more conservative consumption and saving habits, directing funds to longer-term well-being. Adams (2005) also discovered a highly positive relationship between remittances and consumption and investment. The research observed that the latter has a greater likelihood of giving families the economic buffer to raise consumption levels and finance small-scale investments.

Not all of these impacts are harmless, though. Ali et al. (2011) contend that in some settings, remittances will promote overconsumption, create social pressure to consume to display wealth (demonstration effect), and induce currency appreciation, harming export competitiveness. These impacts can effectively skew economic equilibrium if not managed. Easterly (2003), concentrating on foreign aid, noted the same phenomena—describing how outside money moves, e.g., remittances, realign household spending habits and investment intentions. Încalţărău et al. (2012) further noted that households prefer to invest rather than spend remittances if redirected by formal financial institutions, suggesting that access facility and transfer mode are significant in use.

Castaldo and Reilly, working with the 2002 Albania Living Standards Measurement Survey, distinguished between households with domestic remittances, foreign remittances, or neither. Internationally transferred households had a more significant effect on consumption. Surprisingly, internally transferred households varied hardly at all in consumption from non-remittance provision ones. In a Bangladesh study, Stahl and Habib contrasted the way remittances affected small-scale industries such as livestock and agriculture. Comparing findings from a World Bank survey based on a computable general equilibrium model, they concluded that capital investment represented just a portion of remittances. Yet their study indicated that even small investments such as these would prove important in their contribution to aggregate economic activity when combined with productive sectors.

Claessens et al. (2001) discovered that in more advanced financial systems, remittances ultimately become redirected towards less productive or speculative uses unless well-developed financial instruments exist. Acosta et al. (2009) reinforced this warning by stating that more advanced banking infrastructure is required for purposes of mobilizing remittances into productive investment. Their study references the important overlap of financial literacy, institutional capacity, and economic development. Adams (1991) further contributed that the international remittances provide a significant but limited contribution to the reduction of poverty via better income distribution. His work concluded that even small percentages of remitted income can contribute significantly to the standard of living when invested in housing, education, and healthcare.

León, Ledesma, and Piracha (2004) experimented with the effect of remittances in Central and Eastern European nations and discovered remunerative inputs to employment generation and productivity of working time. Manic (2017) also discovered remittances are more likely to grow urban investments than rural investments, which could result in regional imbalances if not contained by policy inclusive. The World Bank (2007) also identified that growth in the banking industry increases the developmental effect of remittances because it provides tools to channel funds into development-oriented activities. Quisumbing and McNiven (2010) analyzed household asset building using remittances and established that they promoted more expenditure on durable goods, housing, and education—enhancing physical and human capital of remittance-receiving households.

Combes and Ebeke (2011) contributed to this factor as well by defining remittances as economic insurance. They deduced in their research that remittances smooth consumption at the household level when faced with shocks such as natural disasters, crop loss, or financial crises. In periods of exchange rate volatility and global uncertainty, remittances have repeatedly acted as a stabilizer, especially in financially excluded areas (Dhakal & Oli, 2020). Partly due to the sheer amount of literature, there remains no consensus. While substantially agree that remittances can be beneficial to consumption and investment, their magnitude and even orientation differ with context, channel, and household response. In Pakistan, where remittance flows make a significant contribution to foreign exchange, it is necessary to examine their role with accuracy.

This research synthesizes such disparate findings to provide a rigorous examination of the influence of remittances on Pakistani consumption and investment patterns, seeking to fill gaps in existing scholarship and provide context-appropriate suggestions.

Research Methodology

In developing an insight into how remittances push consumption and investment behaviors in Pakistan, this study employs quantitative analysis via econometric analysis. Expenditure at household level, remittance received, Gross Fixed Capital Formation (GFCF), Consumer Price Index (CPI), and Gross Domestic Product (GDP) growth rates rank as the most critical indicators being contested for quite a number of years under monthly data set by the World Bank.

Data preparation was the first process within the research. The data set was cleaned accordingly to remove aberrations as well as missing values to achieve reliability as well as consistency of findings. The data were next imported into R Studio, a robust statistical package for analysis, that enabled effective as well as complex modeling of the economic interdependence. The first analytical method used was the Vector Autoregression (VAR) technique that was selected on account of its ability to run interdependence tests for a sequence of time series variables without making pre-supposed assumptions concerning endogenous or exogenous variables. The VAR model best fits to analyze dynamic interrelated relationships between remittances, consumption, GFCF, CPI, and GDP growth over time.

During VAR model estimation, the "vars" package in R Studio was employed. It is through this model that the study estimated how other variables would behave in subsequent periods when an effect or a surprise alteration in remittances occurs. The data covered a wide time span and had probabilities for both instantaneous as well as lag effects. The second methodology component essential for the study was Impulse Response Functions (IRF), which provide a graphical representation of the response of one variable to an exogenous shock in another one. IRFs, for example, were used on the end to describe how consumption or investment reacts over a period of time to a remittance shock. This was helpful for the sake of uncovering whether the effects were temporary or long-lasting.

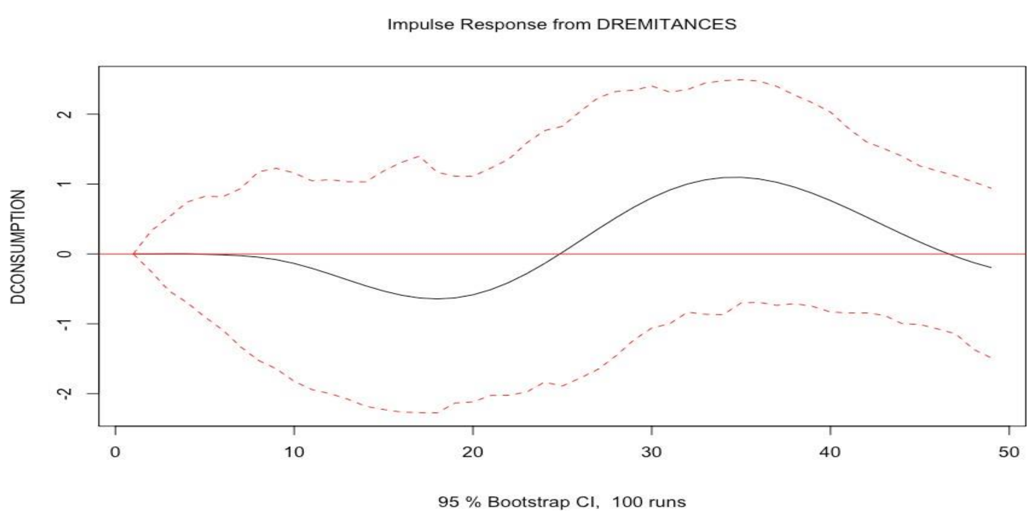
Apart from that, Variance Decomposition (VDC) was also employed to examine the extent to which the shifts in remittance inflows, CPI, and GDP growth could explain consumption and investment variation. This helped in determining the relative significance of remittances as a key driver in the case of Pakistan's economy. To make sure that the data was aligned to VAR modeling specification, the Augmented Dickey-Fuller (ADF) test was carried out to verify stationarity. Data must be stationary to be analyzed in terms of time series because non-stationary variables will yield spurious results. ADF test made sure that the dataset was stationary.

The findings of VAR analysis confirmed that remittances have a statistically significant and positive impact on consumption and GFCF in Pakistan. In addition, inflation (CPI) and economic growth (GDP) also found to have a positive impact on these dependent variables, which supports a greater macroeconomic environment within which remittances function.

In general, the method has a quantitative and empiric assessment of the causal relationship between remittances, consumption, investment, inflation, and growth. Utilizing the application of monthly data and dynamic modeling techniques, the study makes sound empirical contributions to ongoing debate on remittance-driven growth in Pakistan.

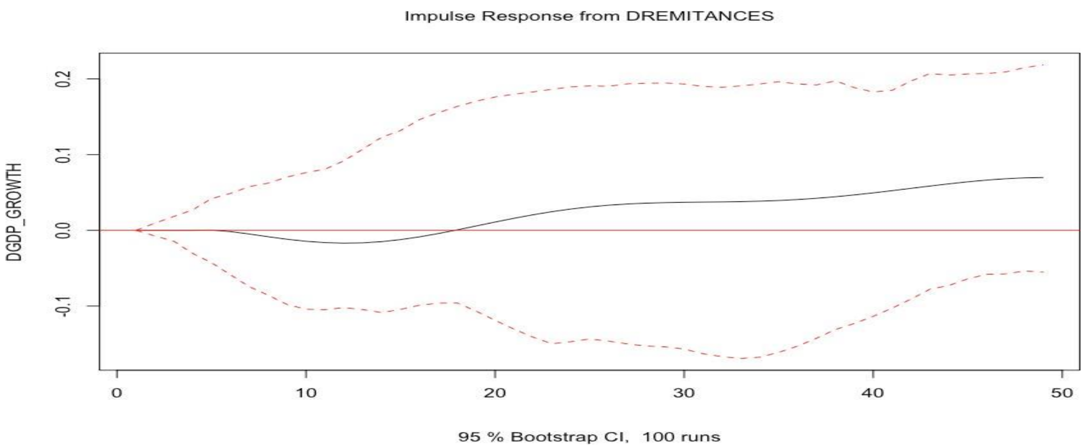
Discussion and Analysis

Figure 1



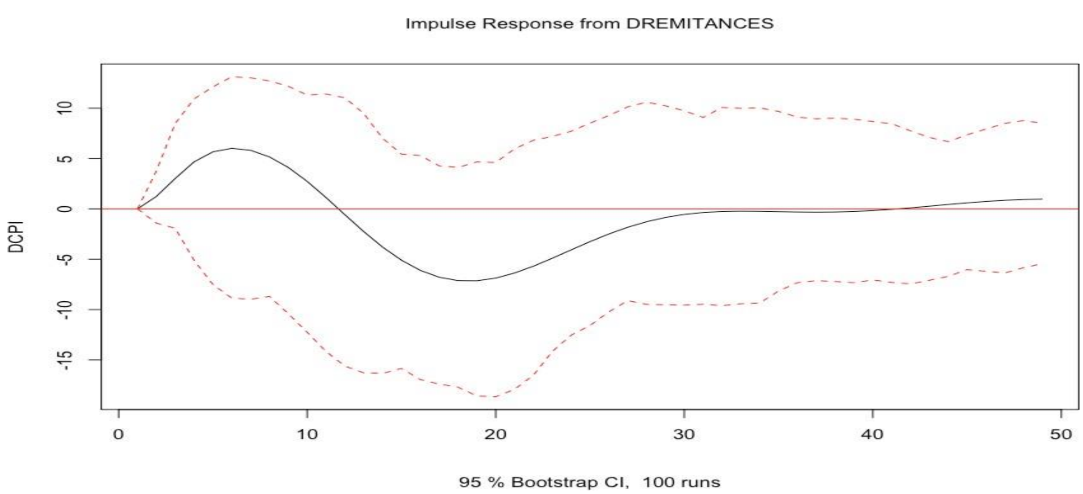
The short-run effect of a remittance shock on consumption is achieved from the impulse response figure for the relationship between remittances and consumption for Pakistan. From the figure, it is clear that consumption decreases somewhat because of an increase in remittances. Perhaps recipients of remittances save part of the amount received initially and don't spend all at once, which would account for decreasing consumption. However, the graph does reveal that consumption is rising more and more as time passes, peaking at around the 12th month. Consumption again declines consistently after the 12th month.

Figure 2



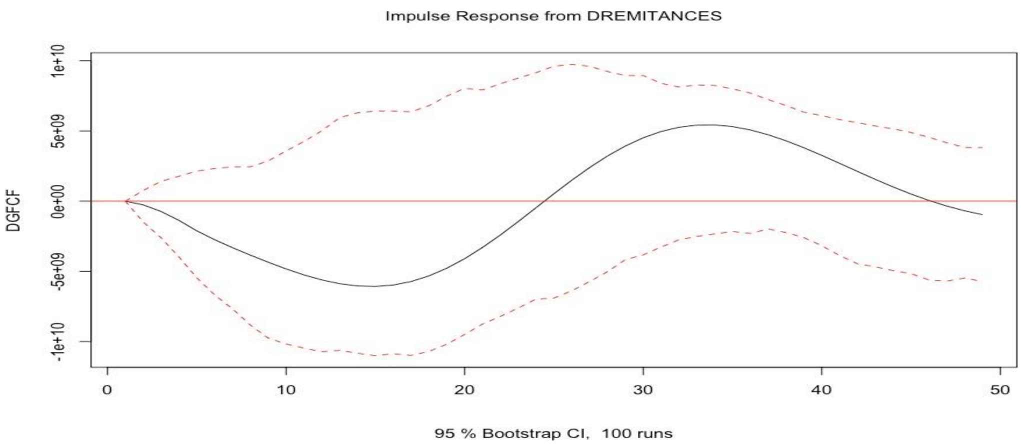
The remittance shock short-run response is illustrated in the impulse response graph of Pakistan remittances and GDP growth. It has been proven from the impulse response graph that there is a rise in GDP growth in the short term after a rise in remittances. This slight increase in GDP could have been caused by the fact that remittances can also be an alternative source of income for businesses and individuals alike, thus resulting in greater investment and spending, both of which are causes of economic growth.

Figure 3



Short-run impact of remittance shock on CPI is presented in impulse response graph of remittances dynamics and Pakistan Consumer Price Index (CPI). According to the graph, there is a short-run decrease (small) in CPI with an increase in remittances. Remittances act as an additional source of income for the firms and households, resulting in increased consumption and investment, and help in price stabilization, an explanation of this small decrease in the CPI.

Figure 4



The slope of the impulse response of the relationship between remittances and investment in Pakistan is also identical. From the figures, there is a decrease in investment following a rise in remittances in the short run. But with the passage of time, the figure indicates that investment steadily rises, reaching its maximum level at around the 12th month. Investment steadily returns after the 12th month. The other alternative, that remittance receipts might initially save the funds rather than spend or invest it in directly may be one reason behind this trend. Recipients might consume and invest after some time period with ease, having confidence in the increased financial resources. The remittances' advantages might begin to wear off due to the effect of time and curtail investment and consumption. Overall, the graph of the impulse response shows remittances will have a positive but temporary effect on Pakistani consumption and investment. The recipient of the remittance can first hold the funds as savings, but over time they will spend more and invest more, which increases before decreasing. More studies must be conducted in order to more fully understand how remittances and the Pakistan economy are connected.

Implication, Recommendation and Conclusion

Implications of the research are that remittances positively affect consumption and investment in Pakistan. This aligns with research regarding the effect of remittances on economic growth and development. The fact that remittances provide individuals and firms with a sum of money that they can utilize for consumption and investment is one reason why remittances positively affect consumption and investment.

The IRF does verify that a remittance shock has a positive and significant consumption and investment response. That implies the increase in remittances results in consumption and investment increases in Pakistan. The study also observed that consumption and investment were positively and significantly influenced by economic growth, as well as CPI, which were being employed as control variables. This means that growth and inflation have a very significant influence on shaping the level of Pakistan's consumption and investment.

The study finds that overseas workers' remittance promotion policies and facilitation policies have the capacity to significantly augment Pakistan's domestic investment and consumption. This can be made real through reducing the cost of the transaction or simplifying remittance transfer mechanisms to make the process attractive and convenient to the senders.

Besides that, policies for generating economic growth and stability, i.e., maintaining low inflation rates, investments in capital and infrastructure, and private investment concessions, may be put into place by the government. The study concludes that remittances are positively affecting Pakistan's consumption and inve stment. The study also concludes that consumption, investment, and remittances have a positive relationship in a feedback relationship for Pakistan. The study has implications for policy formulation for Pakistan. The study concludes that the policies that promote remittances and encourage the easy repatriation of money back home by migrant workers can have a positive effect on Pakistan's investment and consumption.

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