



## Role of remittances and banking sector development in Nepal

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### ABSTRACT

The paper investigates the interaction among foreign remittance, banking sector development and GDP in four South Asian nations that export huge pools of labour abroad. Multivariate Granger causality tests, based on error correction models, are employed with data spanning from 1990 to 2010. A key finding of the paper is that remittances and banking sector development influence per capita income in all four South Asian nations. In addition, interactions among the variables are also examined in a panel setting. As in individual country analyses, both remittance and banking sector development have positive and significant influences on the national income of Nepal. On the other hand, neither domestic products nor advancement in banking sector have significant impact on the remittance flows. This is new findings of the linkage between remittances and economic development, which may also be evident for countries exporting labour pools. Remittance as a major source of foreign currency to the developing nation has become a substantial component of making current account surplus in the balance of payments. It is argued that many workers from Nepal going abroad for employment are no doubt young, energetic, laborious and enthusiastic. They do hard work for earning large remittance income to support their families. However, the downside of remittances reflects the view that remaining young generation for long time outside without family may increase their vulnerability and ultimately it will have a tendency to leave their homeland. Thus, in order to recover the loss of economically active labor force to the domestic economy, they should be encouraged to come back again with skilled knowledge for utilizing their savings and working experience for development to the productive areas in accordance with the priority of the national development plans.

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### Introduction

Nepal, a landlocked and predominantly an agrarian economy, is one of the least developing countries in the South Asian region and is classified as one of the poorest countries in the world.

The population growth in the country has averaged around 2 percent with a total population close to 30 million people, and per capita income of USD 524 in 2010. The economy's GDP is growing at a rate of 4.5 percent on an annual basis over the last decade and inflation in 2010 was 10 percent (World Bank, 2010). The government debt comprises close to 50 percent of the GDP. The economy has just come out of severe current account deficit which prevailed over the last two decades. Foreign direct investment remains very low and aid per capita has been growing. Nepal faces political conflict, unfavourable climate for agriculture and reduction in export of readymade garments (Gaudel, 2006) Poverty has remained rampant and deprivation widespread but there is a definite shift in the economy with pronounced growth in the secondary sector. Centralization in the capital Kathmandu of both government and private structures, over dependence on foreign aid, widespread corruption and abuse of authority by bureaucrats and politicians, exclusion of large sections of population from devising policy and programs for development and failure of donors to ensure proper use of funds have adversely impacted the pro-poor growth prospects (Sharma, 2007; ADB, 2009). There are signs of growth in some critical (services) sectors of the economy.

These includes growth in financial services, (growth in domestic credit to private sectors), trade and exports of goods and services, ICT (telecommunications and mobile phone services) and remittance inflows as a result of increase in migration and employment demand abroad for close to 1.6 million (unskilled and semi-skilled) Nepalese in close to 107 countries around the globe (ADB, 2010; Gaudel, 2006). Besides, the large inflow of remittances has also supplemented the domestic savings in meeting the country's investment requirements. The major destination of the Nepalese labour force are Malaysia, Qatar, Saudi Arabia and United Arab Emirates which absorb more than 93 percent of the labour force migrated from Nepal (Pant, Pandey and Rahut, 2011). Nepal began to move towards an open, market oriented economy in the mid-1980s with the adoption of policies involving greater liberalization of the domestic economy and trade. The interest rate spread in Nepal has been among the lowest in the South Asian region in order to support growth in investment through lowering the cost of borrowings. Moreover, the country has under taken substantial reforms in the financial sector, which led to more than three-fold increase in the credit to GDP ratio since 1985 (ADB, 2009). In light of these developments, this paper looks at the nexus between technology diffusion, financial development, export orientation and remittance inflows vis-à-vis per worker income in Nepal. The study is of interest in at least three folds. First, we look at the nexus between these contemporary economic drivers which has been neglected if not studied in isolation. Second, we

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provide a formal approach – the augmented Solow model to estimate, besides capital per worker, the effects of shift factors (exports, remittances, financial development and ICT). Thirdly, we outline some of the contemporary issues which have a bearing on policy discourse as far as Nepal's development and effort towards speeding up growth is concerned. Migrant remittances into the developing economies have increased by 526% from US\$ 31,058million to US\$ 194,349 over the 1990-2005 period (World Bank 2009) accounting for the second largest source of international inflows next to foreign direct investment. A financial system channels funds from savers to borrowers, thereby playing a vital role in an economy's growth process. Migrant remittances can promote financial development in the recipient countries by increasing the volume of deposits with financial institutions. By increasing the availability of credit and banking services to the public such as savings accounts and small scale loans, remittances can also bring a larger proportion of a country's 'unbanked' population in contact with the formal financial system (IMF 2005). Remittance inflows into the low and middle income economies have been found to reduce poverty (Adams and Page 2003), promote economic growth (Mundaca 2009), provide capital for micro enterprises (Woodruff and Zenteno 2001), reduce output volatility (Chami *et al.* 2009) and lead to exchange appreciation (Rajan and Subramanian 2005, and Lopez, Molina and Bussolo 2007). Barajas *et al.* (2009) however, find no evidence of a relation between workers' remittances and economic growth, while Abih *et al.* (2008) show that remittance inflows can lead to a decline in institutional quality. The relation between remittances and the financial sector has been examined in the studies of Giuliano and

Ruiz-Arranz (2009), Aggarwal, Demircuc-Kunt and Martinez Peria (2006), Orozco and Fedewa (2005), Munduca (2009), Gupta, Pattillo and Wagh (2009) among others. Giuliano and Ruiz-Arranz (2009) conclude that remittances can promote economic growth in the developing economies by enhancing financial sector development, particularly in financially less developed economies. Aggarwal *et al.* (2006) find that migrant remittances lead to financial sector development in the developing economies by leading to increases in the aggregate volume of deposits and credit intermediated by the banking sector. In a case study of nine financial institutions in South America, Orozco and Fedewa (2005) show that financial institutions' distribution of transfers, and financial services provided depend on the resources of the institution and its existing presence in the community. Monaca using a panel dataset from Latin America shows that remittances can further promote economic growth in economies with well developed financial markets. Modeling the entry of banks into the remittance market, Alberola and Salvado (2006) observe that banks as opposed to smaller money transmitter operators, have the ability to offer lower remittance transmission fees thereby increasing the volume of remittances into recipient countries. Freund and Spatafora (2008) on the other hand, argue that formal transmission channels such as banks are more expensive compared to informal transmission channels. In a panel dataset covering 104 countries, they show that remittances are transmitted through formal channels in countries which have well developed financial systems. The informal sector is large in countries in which exchange rate spreads are large, in particular, Sub-Saharan Africa, Eastern Europe and Central Asia. Examining the effect of remittances on poverty and financial

development in Sub-Saharan Africa, Gupta *et al.* (2009) find that remittances have a positive effect on both poverty and financial development. Acosta *et al.* (2009) investigating the effects of remittances on the exchange rate on 109 developing and transition economies find that the upward pressure on exchange rates brought about by the increase in remittances, are lower in countries with well developed financial markets. This study is closely related to the literature that investigates the relation between remittance flows and the financial sector. The studies hereto have explored the effects of remittance inflows on financial sector size. The majority of studies undertaken on the impact of remittances on financial sector size as measured by the ratio of deposits/GDP, private credit/GDP and liquid assets/GDP, show that migrant remittances have a positive influence on financial sector size. This study differs from the previous literature in that it not only examines the effect of migrant remittances on financial sector size, but also *efficiency*. In addition, the present study investigates if the impact of remittances on financial sector size and efficiency are conditional on the degree of government ownership of banks. The impact of remittance inflows on financial sector efficiency as measured by overhead costs and net interest margins is unknown. If remittances lead to an increase in efficiency this would benefit the public due to reduced overhead costs and net interest margins. Increases in overhead costs and net interest margins on the other hand, would lead a fall in financial sector efficiency. A related issue that has not been explored is, the role played by government owned banks, in determining the magnitude and efficiency of remittances. In the developing economies, the government plays a major role in setting up banks in rural areas providing access to finance. The political view argues that the government, by pursuing its own political objectives is subject to conflicting interests which can lead to inefficient outcomes, primarily in economies with weak property rights. This could lead to increased interest margins and overhead costs. The development view on the other hand, argues that the government can help overcome market failures and promote development through lower costs and increased access to finance, particularly in the developing economies. Government ownership can also play an important role in retaining savings within a financial system where regulations not of high quality (Shortland 2009). Consequently the contribution of this study is threefold: one, to investigate the effects of migrant remittances on financial sector size; two, to examine the effect of remittances on financial sector efficiency; and three, to explore the relation between migrant remittances and financial sector development through the government ownership of banks channel. In the context of global labor market several millions people are now living and working in another countries, far away from their countries of birth. These people regularly remit a substantial portion of their earnings to their home countries. The financial flows generated by these migrants by way of remittances are very substantial. Although accurate figures are extremely hard to get, it was estimated that in 2004, remittances to developing countries from developed countries exceeded US\$126 billion, which was up by nearly 48.7 percent as compared to 2001. Actual amounts were probably much larger because flows through informal channels such as hawala were not included in official data collection. The Nepal has become one of the major labor exporting country in recent years. The history of foreign employment in Nepal dates back to the early nineteenth century when Nepalese soldiers began to work for the

British army. In the ensuing decades, hundreds of thousands of Nepalese have worked in British and Indian army. Currently, over 60 thousand Nepalese are working in the Indian Army and other government institutions in India. As the border between India and Nepal is open, hundreds of thousands of Nepali goes to India for labor works. The pace of the foreign employment increased dramatically after 1996 and the consequent of shrinking economic opportunities back home compelled Nepalese youths to look for alternatives elsewhere. The massive unemployment inside the country is the main reason behind this upsurge in venturing out to distant lands. As per the government data among the total population of 23.2 million, 47 percent are underemployed. According to one estimate, every year 300,000 to 350,000 new Nepalese enter the labor market. Out of these new entrants, 30 to 40 thousand find jobs within the country; 100,000 to 150,000 go abroad and the rest remain in the country with no job. According to the National Planning Commission (NPC), the number of overseas workers has grown, on average, by 30 percent in the last couple of years. There are now an estimated 1.2 million Nepalese working in 40 countries, excluding India. In the Gulf region alone, about 700,000 Nepalese are working in Bahrain, Kuwait, Saudi Arabia, Qatar and the United Arab Emirates (UAE). The demand was so high that Nepal had to open a consulate in Qatar to supplement the efforts of the embassy in Saudi Arabia, where there are over 200,000 Nepalese. Malaysia first opened its domestic job market to Nepalese in 2001, and it is estimated that about 150,000 workers have legally entered the country since then. Around 70,000 more are estimated to work in Hong Kong. Large numbers are also illegally employed in the rest of Southeast Asia. There are huge number of Nepalese in UK, Gulf countries and USA. They went to those countries as a student but their returning to Nepal is rare. They are remitting their earnings through unofficial channels since the commission charge in official channels is very high. Remittances to-day, the process of money transfer to Nepal from abroad through banking channel has become efficient and easy. It is now possible to measure the amount repatriated by the Nepalese migrant from abroad to Nepal every year through formal channel. However, it is estimated that only around 40 percent of Nepalese migrant workers use formal channel to send their earning back home. The rest still rely on the informal channel like hundi that is believed to be fast and economic. Now, there are 26 recognized remittance companies including Western Union, operating to transfers money from all over the world to all the part of Nepal. Since 2001, the flow of remittance to the country has grown at an annual pace of 15-20 percent. It is expected to grow more as number of people going abroad is increasing day by day. Remittance market study shows that around 40 percent of the total inward remittance volume to Nepal is paid within Kathmandu valley. On the basis of data provided by the Department of Foreign Employment, the number of workers going abroad for employment increased by 35.4 percent to 294,094 people in 2009/10 compared to 217,164 people in 2008/09.9 With the increase in the number of workers, the inflow of remittances should have taken an upswing. However, this did happen.

#### **Remittances Data**

Migrant workers' remittance is a strong source of foreign exchange earnings for Nepal. It is estimated that in 2004 money transferred from migrant Nepalese have crossed Rs 100 billion—making it a bigger source of foreign exchange than

tourism and all exports combined. Workers remittance is now consider as a backbone of our economy. According to a study by David Seddon for the DFID, the value of foreign remittance from migrant laborers could be equivalent to 25 percent of official gross domestic product (GDP). Since last few years remittance income is playing a vital role for the foreign currency earnings and favorable impact on balance of payment situation, to reduce the number of people in the country below poverty line and ultimately to the economic growth of the nation. The upsurge in remittances had led to a surplus in the current account, thereby strengthening the overall BoP position. The share of remittances in total current account receipts, for instance, soared from 38.2 percent in 2004/05 to 56.7 percent in 2008/09 (Table 1). This in turn had enabled Nepal to maintain a very comfortable level of foreign exchange reserves. Mainly the remittance in Nepal from Gulf countries comes through Exchange Houses, Western Union Money Transfer, Money Gram, Himal Remit, and Nabil Speed Remit of which, Western Union Money Transfer and Money Gram are the international brand whereas Himal Remit and Nabil Speed Remit are the local brand. Himalayan Bank Ltd. is the sole agent of Money Gram. Himal Remit was mainly confined to the Gulf countries but now it has extended its service to Europe also. Similarly, Nabil Speed Remit is focusing its business in Doha, Qatar. The remittance from Gulf countries mainly comes through Exchange Houses. For this, Exchange Houses from Gulf countries maintain their accounts in Nepalese banks and issue either drafts or send the payment instructions through telex/e-mail/fax messages to remit the fund to the concerned beneficiary. The exchange houses in the Gulf are depending on these channels since they are not authorized to use SWIFT yet. Recently they have started using web based programme to transfer funds to Nepal, which has became easy and fast.

#### **Major Players in the Market:**

Major players of remittance business in Nepalese market are Himalayan Bank, International Money Express, NABIL Bank and Bank of Kathmandu. Himalayan Bank brings almost USD 20 million per month. It has deputed its staff in Gulf countries and in Malaysia and provided excellent delivery system to capture the major share. International Money Express (IME) is in second position in the market and brings almost USD 12 million per month mostly from Malaysia that comes to USD 10 million per month. It transfers money through remittance system and has branches in UK and Malaysia. Similarly, Nabil Bank is also entering the remittance in Nepal through Nabil Speed Remit. Another company, which is global and major player in the market, is Western Union. Currently Western Union is doing 18,000 remittance transactions per month with the record of 30% increment p.a. and an average amount of USD 700 per transaction. The four existing agents of Western Unions are Annapurna Travel, CG FINCO, SITA Travel & NABIL and they hold 40%, 30%, 20% & 10% business share respectively. Recently Hulas Remittance, a remittance company promoted by Golcha group has received the 5th principal membership of Western Union in Nepal. Hulas Remittance is expecting to capture 15% of the Western Union's remittance volume in the first year of its operation. It is expected that their market share will further increase since they are pioneer in consumer product and have good market reputation.

#### **Remittance in Nepal Bank Ltd:**

Having a large network inside the country and correspondence relationship with the banks around the world,

we could have tap large portion of remittance business in Nepal. But due to several factors we never thought of making inward remittance as a profitable product in the bank. Whatever Vostro accounts were opened and remittance came in was automatic, without any effort from our side. For your information, Nepal Bank Limited has the agency relationship with the following exchange houses

Nepal Bank Limited is presently receiving around USD 1.45 million per month as remittance from Gulf countries and Malaysia. In 2004, this amount was almost USD 2 million. Alrajhi Banking and Investment, IME, Alfardan Exchange Company, UAE Exchange Company and Eastern Exchange Company are the main agents of NBL. Habib Qatar International, Alrajhi Trading Est., Habib Exchange Company, Al Ansari Exchange Est., Lari Exchange Est., Dalil Exchange and Asian Tours and Travels (ATT) have not made any transaction in year 2005. Similarly, National Exchange Company, Redha Al Ansari and Handan Exchange made very nominal transaction in 2005. The main reason behind this is that their paper remittance is replaced by computer-based programme of HBL, NABIL, Western Union etc. in which we are lagging behind. Normally, NBL is receiving two kinds of remittance; one is beneficiary relating to NBL and second is beneficiary relating to Rastriya Banijya Bank (RBB) and other commercial Banks.

#### **Beneficiary relating to NBL:**

Under beneficiary relating to NBL, we are receiving two kinds of instrument, Telex Payment Order (TPO) and Draft. Under our existing settlement system, when we receive TPO, we credit beneficiary's account if the beneficiary has maintained his/her account in our Kathmandu Banking Office (KBO). If beneficiary's account is in different NBL branches, KBO draws a draft and sends it by courier and where courier services are not available, sends by post. Thus this system is taking around 2 to 7 days, depending on the distance of the branch, for settlement. In case of the NBL branches with fax facility, KBO sends the payment through fax to the branches and it takes around 2/3 days for settlement. When beneficiary receives the draft, presents it to their concerned NBL branches, where they have maintained their account and that branch sends it to KBO for collection. As KBO receive the same, it sends payment to concerned branch by means of courier service where available, or by post. Actually, this system is taking more than one month for settlement. If beneficiary has account in KBO and presents draft for deposit, KBO credits beneficiary account same day debiting draft in to concerned account.

#### **Beneficiary relating to RBB and other commercial Banks**

NBL is receiving TPO for beneficiary of RBB and other commercial banks also from finance companies of gulf countries, which have relationship with NBL. As NBL receives the TPO, KBO draws NRB cheque and sends it to RBB, Kathmandu Main Branch and then this bank collects amount from NRB and sends payment to concerned RBB branch by their internal means of fund transfer. NBL applies similar process for the beneficiary related to other commercial banks also. Thus, settlement of the remittance related to beneficiaries of RBB and other commercial banks are taking one to two months. In case of the draft, all the processes are similar to NBL draft case. The main difference is that the concerned ranches of the RBB or other commercial banks send draft for collection. When NBL receives the same it sends payment to concerned main branch of the bank and they settle it by their

means. Thus, the settlement of the remittances relating to beneficiaries of RBB and other commercial banks are taking too long period of time compare to beneficiaries related to NBL, but our beneficiaries are not also satisfied with our settlement system as they are facing problem.

#### **Commission Rate:**

NBL does not charge any commission if the beneficiary has account in KBO. But if the beneficiary's account is in NBL branches, NBL flatly charges Rs. 200 per draft/fax. Similarly, if beneficiary's account is in other commercial banks, NBL charges a minimum of Rs. 150 to 0.20% for Nepalese Rupees and a minimum of Rs. 1,500 to 0.40% for USD. If NBL receives the payment order from Nepalese commercial banks and the beneficiary's account is in KBO, no commission will be charged but if the beneficiary's account is in NBL branches, Rs. 1,000 commission is being charged. Other commercial banks are also not charging commission for their own account holder beneficiaries but if the beneficiary has account in other banks they charge Rs. 500 per transaction. But IME is charging 1% of the total remittance value as commission. Regarding workers remittance most of them are to be paid under identification and they are charged Rs. 500 by banks and 1% by IME. Another type of income remittance generates is the exchange income. Banks are buying FCY from the customer at the buying rate and selling at minimum of mid rate. But the exchange risk is there as USD is depreciating against INR.

#### **Modes and Instruments used in Remittance Business**

- i. Swift (Society for Worldwide Interbank Financial Telecommunication)
- ii. Telex
- iii. Demand Drafts
- iv. Fax Transfer
- v. Tested Email
- vi. Online Remittance
- vii. Cash Card etc.

#### **Online Remittance: Western Union Money Transfer**

Western Union is recognized for sending money quickly, reliably, and conveniently with more than 150 years experience and 245,000 agent locations in over 200 countries and territories. Currently there are 5 main agents of Western Union viz. CG FINCO, SITA World Travel, Annapurna Travel, NABIL Bank Ltd. and Hulas Remittance. We had received proposal from all the agents except Annapurna Travel for sub agency, Hulas Remittance being the latest to offer the sub-agency. Likewise, Hulas Remittance offered us the exclusive sub agent in banking sector and all USD remittance through us. After analyzing the proposals of the above four agents, we joined hand with Hulas Remittance on 22 December 2005. After joining hands with Hulas Remittance, it has selected our 25 branches in the first phase for Western Union's services from different region. All the concerned staffs from these branches have already been provided basic orientation programme about the Western Union's services in NBL's Training Centre. After the completion of the first phase programme, it has selected another 35 branches in the second phase for this business from different region and the regional level training has already been provided to the concerned staffs of these branches. Now, Nepal bank Limited is providing Western Union's services through its 60 branches covering all the regions of the country and we are in the process of adding the rest branches in this network in the near future. Although it is online software, NBL is using it through faxed

based system to minimize the total cost associated with the service.

#### **A brief literature survey**

In a recent book on modern economic growth, Acemoglu (2009) has provided a comprehensive view on economic growth and development. Under the modern growth paradigm, he provides a theoretical justification of the role of various instrumental factors which support growth. Therefore, besides the crucial role of labour and capital stock in the production function, other contemporary variables describing the structural changes and transformations include, inter-alia, changes in the composition of production and consumption, that is, the shift from agriculture to industry and to services, urbanization, financial development, changes in inequality of income and inequality of opportunity, the transformation of social and living arrangements, technological diffusion, financial institutions, changes in internal organization of firms and the demographic transitions, can be crucial drivers of productivity and growth in an economy.

#### **Remittances**

Remittance inflows are one of the financial flows referring to the private income or savings from income earned that are transferred from one or more family members living and working abroad back to the family members in the home country (Chami, Cosimano, and Gapen 2006). Over the last four decades, remittances have surpassed official development assistance (ODA) of developing countries (World Bank 2011). In reference to developing and low income countries, contributions of remittance income towards poverty reduction, improving human capital (education), health, consumption and human welfare, freedom of choice and empowerment, developing productive capacity, besides supporting entrepreneurial expedition, savings and (capital) investment, and providing emerge Migrants use a number of services to remit money to their relatives back home. Among the most commonly used formal means of sending remittances are the: automated teller machines (ATM), Western Union money transfer services and bank draft facilities. However, in many developing countries, particularly where the financial services and basic infrastructure are not well developed to support efficient and reliable transactions, the cost of transferring money is high and risky (Ratha and Riedberg 2005). According to Irving, Mohapatra and Ratha (2010), the factors influencing remittance transfer includes: the number of competitors (service providers), which depends on the size of that particular remittance corridor and legal regulations; the cost of remittance providers, which depends on the method and technology available to them for use; the needs and preferences of customers; and the extent to which consumers are aware of the various choices of services available to them. Further, the preferences of customers are equally funds in times of crisis are widely acknowledged in a number of studies (Browne dependent on the availability and accessibility of existing remittance-transfer services, the selection of which are largely based on the speed, the needs at the destination, and the sender's legal status). Remittances in Nepal have affected consumption patterns differently for lower class or poor households than the middle or rich ones. The poor households use remittance income to fulfill their basic needs (consumption, housing, education, health care and paying off debts) while the rich ones spend on travelling abroad, capital projects and entrepreneurial activities (Gaudel, 2006). The flow of remittances in Nepal has not only increased in size but also

has a poverty reducing effect (Riester, 2010; Sharma, 2007). In a broader context, Gaudel finds that remittance inflows have equally improved the nominal GDP in Nepal besides providing a stable source of foreign exchange earnings. Srivastava and Chaudhary (2007) argue that in Nepal, the contribution of remittance to the national economy is much larger than what is reflected by official data. They argue that since remittances have welfare enhancing effect (improvement in livelihood, health and education and savings), a more effective use of remittances is needed to scale-up the benefits. The remittance sending approach used by migrant workers in Nepal is characteristically better relative to other developing countries. As described by Gaudel, remittance transaction companies cannot receive cash directly from the Nepalese workers working abroad. The workers have to deposit their remittances in a commercial bank account and then the transaction company through its account delivers the remittances to the recipient at the cheapest cost (about 1 percent of remittance income). There is also the Hundi system facilitating Nepalese migrants in Japan and Korea. Remittance transfer services are also provided by Western Union, IME and PrabhuMoney Transfers companies in Nepal (Gaudel, 2006). Moreover, Gaudel highlights that of these agencies, more than 200 sub-agent including banks, finance companies, trading concerns, and enterprises have been opened in five Development Regions of Nepal to facilitate remittance transfers and that some migrants who do not have bank accounts use the option of group sending where they send money to a single account and split the money when they return home.

#### **Financial development**

A substantial body of literature exists in support of the role of financial development as critical contributor to economic growth (King and Levine 1993; Beck, Levine and Loyaza 2000; and (Levine, Loayza and Beck 2000). Kar, Peker, and Kaplan (2008), using Turkey as case study find trade liberalization, financial development and the interaction between the two have positively contributed to economic growth in the long term. Hassan, Sanchez and Yu (2011) find two-way causality relationship between finance and growth for most regions and one-way causality from growth to finance for the two poorest regions. Some recent studies also attempted to link remittances, aid and foreign direct investment to financial development and income while arguing that although remittances have a marginal contribution to economic progress, it is a reliable source of capital inflow for many small and developing countries for countries like India,

#### **Significance of Remittances**

Remittances are typically helpful to meet specific needs of the respondents' family members and thus tend to increase their standard of living. In lower class or poor households, they may finance their remittances to fulfill their basic needs, such as in consumption, housing, children education and health care and to pay for loan. In middle class or rich households, they may provide either loan for individuals going abroad or capital for businesses and entrepreneurial activities. From macroeconomic point of view, this source maybe more stable than capital flows. It is said that remittances has represented more than 10 percent of GDP in Nepal in the late 1990s. Moreover, it would be highly beneficial to the country, where there is natural calamities, political conflict, people war, low investment in entrepreneurial activities and economic recession. Minimizing transaction costs would significantly help recipients' families. The cost of remittance service does not really depend on the amount of

principal. Indeed, the real cost of a remittance transaction include labor charges, house rent, technology, networks etc. It is also known that greater competition among banks and money transfer operators (MTO) brings down the cost of transaction. Furthermore, remittance fees can be reduced significantly if they were converted to a flat fee instead of a percentage of the principal transferred (Ratha 2005). In addition, some commercial banks have recently started providing remittance services than money transfer operators. Both sending and receiving countries can increase banking access for migrants by facilitating participation of financial institutions and credit unions in the remittance market. Keeping these facts into consideration, this paper has raised some issues regarding the flow of remittance income and its role in economic development of Nepal. The basic issues are: How is money transferred under the process of remittances? Why are remittances helpful for economic development? How these sources of finance are utilized? What is the relationship between remittances and GDP? What are their socio-economic implications? With these issues, this paper has set some specific objectives.

### Objectives

The specific objectives are:

- i) To describe the role of remittance income for economic development of Nepal.
- ii) To analyze the socio-economic implications of remittances in Nepal.
- iii) To compare the relationship between remittance income and foreign direct investment in Nepal.
- iv) To measure the statistical relationship of GDP among workers' remittances, grants and pensions in Nepal

### Remittances and Economic Growth

There are a number of potential costs associated with remittances. If remittances are large, the recipient country could face an appreciation of the real exchange rate that may make its economy less competitive internationally. In this regard, some argue that remittance can also create dependency, reduction in recipients' incentives to work and thus slowing economic growth. But others argue that remittance may also have human costs. Migrants sometimes make significant sacrifices, family separation and incur risks to find works in another country. Consequently, they may have to work hard for saving enough to send remittances. Basically, remittances are private funds that should be treated like other sources of households' income. In terms of asset formation, larger number of remittance receivers uses their funds to purchase land or buildings in town areas. Someone purchase means of transportations a part of their investment. Very rare is found in promoting agriculture and tourism. In short, it could be asserted that the productive use of remittance income is yet to be sought though it forms a significant part of GNP. Furthermore, in order to channel remittances in productive areas for economic growth, the government should offer incentive to increase remittance flows. Tax incentives like rebates or concession may attract remittances, but they may also encourage tax evasion. The government has to assess prospective growth rates, potential for exports, revenue elasticity and composition of existing debt. Besides, the government may choose to increase either external borrowing or to raise remittances for economic growth (Heller 2005). If we observe the economic growth rates of some SAARC countries in 2006, we find the highest growth rate (8.2 percent) of India and the lowest growth rate (1.9 percent) of Nepal. Sri Lanka has received the second position (7.0 percent) then

Bangladesh (6.7 percent) and Pakistan (6.6 percent) (Annapurna Post, Dec.15, 2006). In such a circumstances, Nepal has reached the insignificant growth rate because of prevalence of the political conflict, unfavorable climate for agriculture and reduction in export of readymade garments. However, Bangladesh has received the third position in economic growth rate mainly by increasing the flow of remittances and maintaining strong production sector. Thus, remittance as a major source of foreign exchange earnings can improve a country's creditworthiness and enhance its access to international capital markets

### Remittance Income in Nepal

Initially, remittance in Nepal was introduced with Gurkha remittances. The Gurkhas were renowned for good qualities of soldiers. That is why British India formally recruited Nepalese youth as a regular army, which later divided into British and Indian army. Now-a-days, Nepalese going abroad are not only for armies but also spread all over the world for work and mostly they are concentrated in Gulf areas in civilian front (Kshetry 2003). Any Nepali to go for work legally, he/she needs to get permission from the Department of Labor under the Ministry of Labor and Transport of the Government of Nepal. From the official report of the Labor Department it is known that 107 countries are at the government list where Nepalese are allowed to go for work (Annex B). But still some people are found going abroad without permission and working in the government restricted areas too. Because of this trend, data on foreign employed workers are not available in exact form. Majority of those who have left home for overseas job are eager to earn foreign currency by hard working to support their families. With regard to the delivery of remittances, the World Bank has expressed the view that the procedure of receiving remittance in Nepal is the best one in compare to others. Remittance Transaction Company cannot receive cash directly from the Nepalese workers remaining outside. The workers have to deposit their remittances in foreign commercial banks account and the transaction company through its account delivers the remittance services to the recipients at the cheapest cost (about 1 percent of remittance income) (Annapurna Post, March 15, 2005). Moreover, the Hundi system is almost closed due to the establishment of Remittance Company in Malaysian and Gulf countries. However, the system of Hundi is still working in Japan and Korea where most Nepali workers are living even if their visa date is expired. Over the past 15 years from 1991, international migrants' remittances have become increasingly prominent in our country. The amount of remittances reflects only transfer record in the balance of payments. Unrecorded flows through informal channels are believed to be more than the recorded flows. Regarding the transfer of remittances in Nepal, the record of banking sector showed that Rs.15.9 billion was received in FY.2000/01. However, Hundi operators or money transferring agencies handled the bulk part of remittances. Considering the increasing number of workers, assuming four lakh per year going outside the country in this perspective, remittance received was estimated at Rs.50 billion in FY.2001/02, (Kshetry 2003). In this regard, it is also estimated that more than 500 people per day are going abroad for foreign employment. From such migrants, about Rs.100 billion per year is expected to enter into the country through remittance income only (Annapurna Post, Oct.28, 2006). In order to provide access for transferring remittances, Western Union, ME and Prabhu Money Transfers are found active in

Nepal. Of these agencies, more than 200 sub-agents of single Hulas remittance including banks, finance companies, trading concerns, enterprises etc. under the province of Western Union, have been opened in five Development Regions of Nepal. These agents deliver remittances to the recipients of local areas within a short span of time.

#### Contribution of Remittance to GNP

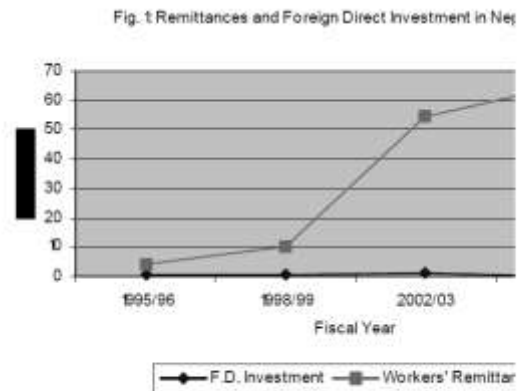
Remittance as major component of current account<sup>1</sup> plays a vital role in increasing current transfers in balance of payments. The basic factors of determining current transfers are grants, workers remittances, pensions and others including excise refund also. This is clear from Table 1. Initially, the share of remittance to GNP was found 1.74 percent in mid-July 1991. This share increased sharply (9.38 percent) after the period of mid-July 1999 and eventually reached to 12.03 percent in mid-July 2005. On average, the share of remittance to GNP was 11.03 percent during the review period from mid-July 2000 to 2005. Under the transfer category of BOP, remittance income increased by 11.65 percent totaling Rs.65.42 billion in 2005 due to the increasing trend of Nepali workers going to Malaysia and Gulf countries for employment (MOF 2006). During that period, the grants and pension also increased by 7.72 percent and 58.06 percent respectively. Thus, from this analysis it is clear that the remittance income has become an important contributor (64.72 percent) to the current transfers in balance of payments of Nepal.

#### Socio-Economic Implications of Remittances

The income of migrants from the foreign employment has not only increased their personal income but also their social prestige. The rural people lying below the poverty level have succeeded to uplift their economic standard receiving the opportunity of foreign employment. Moreover, the downside of remittance reflects the view that the shortage of labor due to emigration has not only compelled to keep barren land in rural areas but also hamper agricultural productivity and ultimately the country would be liable to import the large quantity of food grains. Despite these, remaining young generation from the families for long time may affect their reproductive age and their vulnerability may be subject to communicable diseases. It is also possible that if they come back with good skills and earnings, they may not normally cope with the environment of the homeland and consequently they will have a tendency to leave the country again. Thus, the remittances from foreign employment on the one hand, has played an important role to increase their personal income and thereby improve standard of living and a risk of diseases like HIV/AIDS through migrants on the other may enter into the country. More specifically, this type of communicable disease may be due to poverty, illiteracy, gender discrimination, women exploitation, insecurity, and the lack of legal advice as well as proper treatment. Thus, to minimize this problem, especially rural people should be made aware of the communicable diseases through mass media, education, health care and training cum workshops. Furthermore, a part of remittance income should set aside by the government through welfare scheme that may become the long run solution to the problem of communicable diseases. Recently, the decision made by British government has provided the permission for the permanent residence in U.K. to the ex-army of Nepal retired before 1997. From this decision, remittance as a major source of the Nepalese economy will have negative impact in the long run.

#### Comparisons of Remittances and Foreign Direct Investment

Over the past ten years, emigrant remittances have become prominent exceeding Rs.65 billion in FY. 2004/05. This analysis of ten years (FY. 1995/96 to FY. 2004/05) has recorded that remittances are the major sources of financing compared to the foreign direct investment. This will be clear from Table 2 and Fig.1.



#### Conclusion

From the foregoing analysis, it can be concluded that remittances and grants are claimed as an important sources of increasing foreign exchange earnings in Nepal. Moreover, remittances may be a dependable source of national income for economic development if there is job guarantee for the workers with the wage level equivalent to the residence of the foreign country. Furthermore, the young and energetic generation remaining outside should be attracted to come back again with skilled knowledge and experience and to provide the way for utilizing their remittances in productive sector. Thus, remittance received so far taken by the country is considered as boon, and the government should pay attention to make workers confident to deal with whatever anomalies arise in working places. Besides, the policy of providing permanent residence in outside for retired workers should be amended to continue the source of increasing remittance flow in Nepal.

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| Heading  | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10p |
|--|---------|---------|---------|---------|---------|----------|
| Total remittances (in Rs. billion)                                   | 65.54   | 97.69   | 100.14  | 142.68  | 209.70  | 231.73   |
| Share of remittances to current a/c receipts excluding grants (in %) | 38.2    | 46.7    | 45.3    | 51.1    | 56.7    | 59.3     |
| Ratio of remittances to GDP (in %)                                   | 11.1    | 14.9    | 13.8    | 17.5    | 21.2    | 19.6     |

p - provisional

Source: Nepal Rastra Bank.

|   |
|---|
| Habib Qatar International Exchange, Qtr |
| Eastern Exchange Establishment, Qtr     |
| National Exchange Company, Qtr          |
| Alfardan Exchange Company, Qtr          |
| Gulf Exchange Company, Qtr              |
| Arabian Exchange Company, Qtr           |
| Alrajhi Banking & Investment, KSA       |
| Alrajhi Trading Est., KSA               |
| UAE Exchange Centre, UAE                |
| Alfardan Exchange, UAE                  |
| Habib Exchange Company, UAE             |
| Al Ansari Exchange Est., UAE            |
| Lari Exchange Establishment, UAE        |
| Redha Al Ansari Exchange Est., UAE      |
| Hamdan Exchange, Oman                   |
| Dalil Exchange, Baharain                |
| IME                                     |
| ATT                                     |



**Table: 2 Comparisons of Remittances and Foreign Direct Investment**  
(Rs. in Billion)

| Fiscal Year | Foreign Direct Investment | Workers' Remittances |
|-------------|---------------------------|----------------------|
| 1995/96     | 0.39                      | 4.28                 |
| 1998/99     | 0.58                      | 10.31                |
| 2002/03     | 0.96                      | 54.2                 |
| 2004/05     | 0.14                      | 65.42                |

Source: Government of Nepal, Economic Survey (various issues).

## 8. Regression Results and Economic Interpretation

**Table: 3 Regression Results**

| Eq <sup>a</sup> | Depend. Variable | Independent Variables   | Statistic      |                    |          |       |
|-----------------|------------------|---|----------------|--------------------|----------|-------|
|                 |                  |   | R <sup>2</sup> | Adj.R <sup>2</sup> | F        | DW    |
| 1               | GDP              | 202374.3 + 5.174 Rem<br>(11.109)*** (9.493)***                      | .874           | .864               | 90.1***  | 0.459 |
| 2               | GDP              | 133463.2 + 2.138Rem + 14.302Gr<br>(10.029)*** (4.144)*** (6.793)*** | .974           | .970               | 224.6*** | 1.166 |
| 3               | GDP              | 132492.5 + 15.431Gr + 8.972PO<br>(8.184)*** (6.160)*** (2.960)**    | .963           | .957               | 158.1*** | 1.218 |

Source: Annex (A)

*GDP=Gross Domestic Product, Rem=Remittances, Gr=Grants, PO= Pensions & Others*

Note: Figures in parenthesis are t values, \* denotes 10% level of significance, \*\* denotes 5% level of significance, \*\*\* denotes 1% level of significance. R<sup>2</sup> = degree of explanation of the dependent variable  
Adj.R<sup>2</sup> = Proportion of variation adjusted to the degrees of freedom F= F statistic for the joint significance of all coefficients, DW= Durbin-Watson statistics for the presence of autocorrelation

**Annex A: Remittance, Grants and Nominal GDP**

| Year<br>Mid-July | Grants   | W/Remittance | Pensions &<br>Others | Nominal GDP |
|------------------|----------|--------------|----------------------|-------------|
| 1991             | 1694.00  | 2128.30      | 218.20               | 122517.0    |
| 1992             | 1689.50  | 2316.50      | 483.90               | 152202.0    |
| 1993             | 3498.50  | 2994.30      | 582.70               | 174705.0    |
| 1994             | 3039.90  | 3469.10      | 494.90               | 203135.0    |
| 1995             | 5339.10  | 5063.60      | 824.50               | 223992.0    |
| 1996             | 7582.80  | 4283.60      | 899.90               | 252479.0    |
| 1997             | 9743.20  | 5595.00      | 1009.10              | 285173.0    |
| 1998             | 10919.70 | 6987.80      | 1157.80              | 306870.0    |
| 1999             | 11648.30 | 10314.60     | 1204.60              | 352917.0    |
| 2000             | 12874.80 | 36818.10     | 7259.90              | 392613.0    |
| 2001             | 12046.40 | 47216.10     | 7765.20              | 427447.0    |
| 2002             | 12650.50 | 47536.30     | 9970.50              | 441182.0    |
| 2003             | 13842.20 | 54203.30     | 9719.60              | 472869.0    |
| 2004             | 19557.80 | 58587.60     | 11016.40             | 509700.0    |
| 2005             | 21067.20 | 65416.00     | 14601.20             | 543902.0    |

Sources: *Economic Survey* (various issues), Ministry of Finance, Government of Nepal. Main Economic Indicators (May-July), 2005, Monthly Report, NRB, Research Department, Kathmandu.

**Annex B: List of Countries Opened for Foreign Employment**

Government of Nepal has formally opened the following 107 countries on institutional basis for sending laborers in foreign employment. But now-a days, the government has also restricted to go Nepali workers in some foreign countries including Iraq\* due to massacre of 12 Nepali laborers in Iraq.

| S.N. | Country     | S.N. | Country    | S.N. | Country               | S.N. | Country              |
|------|-------------|------|------------|------|-----------------------|------|----------------------|
| 1    | France      | 28   | Belgium    | 55   | Iceland               | 82   | Ireland              |
| 2    | China       | 29   | Iran       | 56   | Holy see <sup>1</sup> | 83   | Bosnia Herzegovina   |
| 3    | Russia      | 30   | Canada     | 57   | Malta                 | 84   | United Arab Emirates |
| 4    | Japan       | 31   | Denmark    | 58   | Panama                | 85   | Qatar                |
| 5    | Sri Lanka   | 32   | Bulgaria   | 59   | Tunisia               | 86   | Saudi Arabia         |
| 6    | Egypt       | 33   | Romania    | 60   | Fiji                  | 87   | Kuwait               |
| 7    | Germany     | 34   | Algeria    | 61   | Zambia                | 88   | Iraq*                |
| 8    | Austria     | 35   | Spain      | 62   | Mozambique            | 89   | Bahrain              |
| 9    | Italy       | 36   | Bangladesh | 63   | Nicaragua             | 90   | Oman                 |
| 10   | Switzerland | 37   | Albania    | 64   | Venezuela             | 91   | Hong Kong            |
| 11   | Poland      | 38   | Norway     | 65   | Colombia              | 92   | Malaysia             |
| 12   | Greece      | 39   | Finland    | 66   | Bolivia               | 93   | Singapore            |
| 13   | Philippines | 40   | Tanzania   | 67   | Estonia               | 94   | Brunei               |
| 14   | Australia   | 41   | Morocco    | 68   | Ukraine               | 95   | South Korea          |
| 15   | Myanmar     | 42   | Cuba       | 69   | Armenia               | 96   | Saipan <sup>4</sup>  |
| 16   | Pakistan    | 43   | Cambodia   | 70   | Kazakhstan            | 97   | Kosovo <sup>5</sup>  |
| 17   | Netherlands | 44   | Vietnam    | 71   | Byelorussia           | 98   | Latvia               |
| 18   | Laos        | 45   | Kenya      | 72   | Moldavia              | 99   | South Africa         |

Source: Labor Market Information Bulletin, Year 4(11), Annual Publication, 2062,P.28

Website: [www.moltn.gov.np](http://www.moltn.gov.np)

1.Vatican City, Italy.2.South-West Africa-Namibia.3.Island country in the Western Indian Ocean, north of Madagascar.4. Island of Western Pacific Ocean. 5.Region of Southern Serbia.6.North African Island-It was changed from Seychelles in 1756 in honor of French Minister of Finance.