

Remittances and Financial Deepening in Nepal

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Abstract

In the case of remarkable remittance inflows, the impact of remittances on financial development in Nepal has not been adequately studied. Therefore, this paper investigates the effects of remittances on financial development, using Nepal as a case study for the period from 1975 to 2021. The study examines the impact of remittances on the broad money supply. Alongside remittances as the key explanatory variable, other control explanatory variables such as gross capital formation, total trade, real gross domestic product, the national consumer price index, and foreign aid were considered. Unit root analysis revealed that all variables were integrated at order one. Consequently, a cointegration test was conducted, indicating the presence of at least one cointegration equation. Subsequently, an ordinary least squares regression was performed using the first difference data. The results were subjected to various econometric diagnostic tests, including assessment for autocorrelation, heteroscedasticity, multicollinearity, normality, as well as the Durbin–Watson test, t-tests for coefficients, and the F-test. Both the coefficient of determination and the adjusted coefficient of determination confirmed that the models were well-fitted. The outcomes of the model suggest that remittances have a positive impact on the enhancement of the broad money supply. Based on these findings, the study recommends implementing policies aimed at boosting remittance inflows into the country to further financial development in Nepal, specifically promoting financial deepening.

Keywords: remittances, broad money supply, unit root test, cointegration

Introduction

Worker remittances have become an important source of income and foreign exchange and account for a significant share of GDP in most of the developing countries. Between 1974/75 and 1999/00, remittances ranged between 1.23 percent and 3.34 percent

of GDP. In 2000/01, it increased drastically to 10.69 percent of GDP, reflecting the large increase in the number of migrant workers (MOF, 2009, MOF, 2021). Remittances reached as high as 21.22 percent of GDP in 2008/09, which declined to 18.52 percent of GDP in 2010/11 because of the impact of global financial and economic crises on major employment destinations for Nepali workers (MOF, 2009, MOF, 2021). The size of remittances as a percentage of GDP was constantly increasing with a stable trend with the enactment of the Foreign Employment Act, 1985, particularly from the fiscal year 1994/95. According to the Nepal Living Standard Survey (2010/11), about 56 percent of households received remittances, both from internal as well as external sources, up from 32 percent in 2003/04 and 23 percent in 1995/96 (CBS, 2011).

Remittances to Nepal have grown dramatically in recent years from Rs. 204.3 million in 1975 close to Rs. 1007306.9 million in 2022 and it has 27.1 percent increment as compared to the previous fiscal year, according to details of seven months of the current fiscal year (MOF, 2022, NRB, 2023).

A defining characteristic of Nepal's labor migration since the early 2000s has been an unprecedented increase in the volume of workers headed to the Gulf Corporation Council (GCC) countries and Malaysia for temporary employment. In 1993/94, the number of labor approvals issued by the Department of Foreign Employment (DOFE) was just 3,605. A decade later, in 2003/2004, it reached 106,660 and in 2013/14, it peaked at 519,638. Since 2013/14, however, the volume of annual outmigration has been decreasing and reached 354,098 and 236,208 in 2017/18 and 2018/19 respectively. Labor migration from Nepal is predominantly male, with more than eighty percent of the total labor migrant population in 2017/18 and 2018/19 between the ages of 18 and 35 (Ministry of Labor, Employment and Social Security, 2020).

The migrant sender pays the remittance to the sending agent using cash, check, money order, credit card, debit card, or a debit instruction sent by e-mail, phone, or through the internet. Remittances are typically transfers from an individual or family member to another individual or household. Generally, banking and other financial institutions that have legal authority of monetary transactions are involved in remittance transfers as well as making deposits.

Sound banking and financial institution system both in the host and home country encourages low-cost and quicker remittance transfer systems. Such institutions should not only provide remittance transfer facilities but also offer other varieties of banking facilities such as bank account and credit to the remitted family members. Therefore, for less costly, safer, and faster transfer facilities along with other varieties of banking facilities, there should be a modernized internet-connected chain of banking and financial institutions that have a large number of branches that link all domains of people both urban and rural areas. Such services should have easier access to remitted households such that the transport cost of access is nil or very little. Hence, for the safe, quicker, and inexpensive transfer of remittances along with other varieties of banking services such as bank deposit and credit facilities nearby the residence, there should be a sufficient number of banking and financial institutions that are established and connected with modern internet webs and they must be evenly distributed all over the country so that every remitted family member has efficient banking and financial facilities at the door (Chowdhury, 2011).

A growing number of studies have analyzed the developmental impact of remittances along various dimensions. The extent of the impact of remittances includes poverty reduction, narrowing of the inequality gap, education, infant mortality, entrepreneurship, and finally growth (Giuliano & Ruiz-Arranz, 2009). According to Gupta, Pattillo, and Wagh (2009), one reason why remittances have attracted attention is that they are seen as more stable than other foreign currency flows to developing countries.

The recent empirical literature showed that remittances might induce financial development encouraging financial depth (Giuliano & Ruiz-Arranz, 2009; Gupta et al., 2009; Mundaca, 2009; Aggarwal et al., 2011; Agir et al., 2011; Chowdhury, 2011; Hassan, 2011; Cooray, 2012; Coulibaly, 2015; Bhattacharya et al., 2018; Fromentin, 2017, 2018; Azizi, 2019; Basnet et al., 2020; Donou-Adonsou et al., 2020; Keho, 2020 and Mustafa et al., 2020). These studies empirically examined the broad money supply channel (M2) as a financial development measure. They indicated that the aggregate level of deposits may increase if remittances are held in the banks. Such inflow incomes

upsurge broad money supply (M2) implying that a well-functioning financial market may play an important role in directing the remittances to the projects that yield the highest return and therefore enhance growth rates. Remittances may introduce new households to the banking system and, in turn, this familiarity may result in more deposits which further enhances financial deepening through monetization of an economy, i.e. M2 to GDP ratios would increase.

Apparently, on the one hand, inflows of remittances are mounting rapidly and bank and financial institutions along with saving and credit cooperatives are receiving such funds in the form of deposits and money transfers. Further, these institutions are advancing remittance transfer facilities as well as bank deposit and credit facilities to the remitted family members. On the other hand, it intensified monetization in the economy, or financial depth is widening rapidly. Along with the expansion of the numbers of financial institutions, their qualitative fast e-services, the key indicators of financial development such as financial deepening or M2 to GDP reached to 96.7 percent in mid-July 2022. Such ratio was 12.5 percent in mid-July 1975. The average growth rate of M2 to GDP was 18.6 percent (NRB, 2009, NRB 2022). In the scenarios of increasing both the remittances and the financial sector, it is not clear whether there is a causation between remittances and financial development in Nepal. In this background, this study attempts to investigate the connection between remittances and financial development measures for Nepal.

Research Methodology

This study applies the OLS technique of estimation with the dependent variable as financial development (FD) measured as broad money supply (M2) and the private sector's remittances (REMIT) as an independent variable. Therefore, the conceptual equation is:

$$\text{Financial Development} = f(\text{REMIT}) \quad (1.1)$$

Financial Development is also affected by a number of other macroeconomic variables such as gross capital formation, total trade, real GDP, inflation rate, foreign aid, etc. Therefore, the study introduced several control variables (CV) into the above

equation (1.1). The inclusion of CV helps control of variability. Thus, the modified financial development equation (1.1) is:

$$\text{Financial Development} = f(\text{REM}, \text{CV}) \quad (1.2)$$

The paper examines the following econometric models in natural logarithmic form to find out the relationship between financial development and remittances in Nepal.

$$\begin{aligned} \text{LNBM2}_t = & \alpha_0 + \alpha_1 \text{LNREMIT}_t + \alpha_2 \text{LNGCF}_t + \alpha_3 \text{LNTT}_t + \alpha_4 \text{LNRGDP}_t + \\ & \alpha_5 \text{LNINF}_t + \alpha_6 \text{LNFA}_t + \varepsilon_t \end{aligned} \quad (3.3)$$

Where,

M2 = Broad Money Supply (Rs. in million)

REMIT = Remittances (Rs. in million)

GCF = Gross Capital Formation (Rs. in million)

TT = Total Trade (Imports plus Exports) (Rs. in million)

RGDP = Real GDP (Rs. in million)

INF = Inflation Rate

FA = Gross Foreign Aid (Debts plus Grants) (Rs. in million)

t = Time

ε_t = Error term

The paper applies annual data of different variables from FY 1974/75 to 2020/21 comprising 47 observations of each. All the secondary data related to broad money supply, remittances, gross capital formation, total trade, real per capita GDP, and inflation rate measured by the National Consumer Price Index are taken from Economic Survey Reports, Ministry of Finance, Government of Nepal and Quarterly Economic Bulletin, Nepal Rastra Bank.

All variables of the model are converted into natural logarithms to facilitate the calculation of elasticity and to make it possible the transformation of the non-linear models into log-linear ones. Basic structures of the transformed variable regarding its central location (mean) and spread (standard deviation) can be presented as a summary statistics. A correlation matrix of estimating variables is estimated to know how the dependent variable is proportional to all explanatory variables for each model. The unit root is observed with the ADF test. Durbin-Watson (DW test) and Breusch-Godfrey

Serial Correlation test are applied to detect the problem and order of serial correlation in the error terms and the Cochrane-Orcutt method is used to correct the autocorrelation. If the serial correlation problem is not handled at the first step of the Cochrane-Orcutt procedure, then its iterative procedures are conducted. Breusch-Pagan test of error term is conducted to detect the problem of heteroscedasticity and the weighted least squares technique is used to minimize it. Variance Inflation Factor (VIF) test is conducted and from the highly collinear pair, one of the variables is deleted. The normality of error terms is tested by the Jarque-Bera (J-B) test. The overall explanatory power of all explanatory variables is gauged by R-squared and adjusted R-squared. The F-test is used to determine the overall goodness of models. The t-test is used to test individual coefficients of explanatory variables.

Data Analysis and Presentation

Under data analysis, descriptive statistics of the variables, partial correlation, unit root test, cointegration test, regression results, and econometric diagnostics tests are conducted. Then the results are interpreted.

Summary Statistics

The descriptive statistics comprises of the mean, minimum and maximum values, standard deviation, skewness, kurtosis, Jarque-Bera (J-B), and observations. The descriptive statistics of the variables are presented in Table 1.1 below.

Table 1.1

Summary Statistics of the Variables

Variables	M2	REMIT	GCF	TT	RGDP	NCPI	FA
Mean	697752.8	173648.2	231508.4	308883.1	692667.3	43.2	33952.3
Maximum	5154850.0	961054.6	1304902.0	1680900.0	2382708.	137.62	287746.0
Minimum	2064.4	204.3	2223.0	2704.2	131061.8	4.144	387.0
Std. Dev.	1212445.0	285637.8	361301.9	441769.8	735401.6	39.83761	54087.6
Skewness	2.165052	1.569881	1.778099	1.712075	1.292012	0.999843	2.91657
Kurtosis	6.980486	4.029830	4.877080	4.905654	2.989258	2.806803	6.5178
Jarque-Bera (JB)	7.74670	8.38236	6.66621	7.07280	8.07637	7.903968	9.0341
Prob. of (JB)	0.000000	0.000023	0.000000	0.000000	0.001447	0.019217	0.000000
Observations	47	47	47	47	47	47	47

Source: *Economic Survey Report (2022)*, Ministry of Finance, Government of Nepal and *Quarterly Economic Bulletin*, Mid-July (2021)

The results on summary statistics showed that mean value of M2, REMIT, GCF, TT, RGDP, NCPI and FA were Rs. 697752.8 million, Rs. 173648.2 million, Rs. 231508.4 million, Rs. 308883.1 million, Rs. 692667.3 million, 43.2 percent and Rs. 33952.3 million respectively for the whole study period. The higher values of standard deviations for the variables under the study indicated that variables were volatile during the study period. Further, the positive value of skewness indicated that variables were positively skewed and the values of kurtosis suggested that more variables had peak ness. Finally, JB statistics and respective probability showed that all variables were normal.

Correlation Matrix between Dependent and Independent Variables

Before moving into the cause and effect relationship between dependent and explanatory variables, it would be better to know about their association or strength of relationship. The high degree of association between the variables satisfies the necessary condition to test the cause and effect relationship of explanatory variables to dependent variables in regression analysis. Level forms of data are used for correlation analysis. The correlation coefficients between the variables are presented in Table 1.2 below.

Table 1.2

Correlation between the Variables

Correlation	LNM2	LNREMIT	LNGCF	LNTT	LNRGDP	LNNCPI	LNFA
LNM2	1.000	-	-	-	-	-	-
LNREMIT	0.986	1.000	-	-	-	-	-
LNGCF	0.998	0.982	1.000	-	-	-	-
LNTT	0.995	0.977	0.995	1.000	-	-	-
LNRGDP	0.956	0.950	0.960	0.938	1.000	-	-
LNNCPI	0.997	0.979	0.996	0.998	0.943	1.000	-
LNFA	0.987	0.956	0.987	0.986	0.933	0.987	1.000

Source: Researcher's Calculations

The results on correlation confirmed that there was a high degree of correlation between dependent and independent variables. The value of correlation coefficients greater than 0.80 indicated that variables are positively and strongly associated with each other. The high degree of correlation between the independent variables might create suspicion that there might be multicollinearity among the independent which is tested under the multicollinearity heading.

Unit Root Test Results

Individual time series data must be stationary before running regression analysis. Otherwise, the regression results will be spurious. Therefore, it is better to determine the order of integration of the variables under the study. The Augmented Dickey Fuller (ADF) test is used for this purpose both at level and first difference (at once intercept and then intercept and trend). Log level forms of data were applied in testing the unit root. The results from log level forms of data are presented in Table 1.3 below.

Table 1.3

ADF Unit Root Results at Log Level Form

Variables	Intercept		Intercept and Trend	
	τ - statistics	p-value	τ - statistics	p-value
LNM2	-0.516094	0.8784	-2.266398	0.4429
LNREMIT	-0.138182	0.9388	-2.226631	0.4641
LNGCF	-0.599525	0.8606	-2.241584	0.4557
LNTT	-0.954270	0.7616	-1.244592	0.8889
LNRGDP	0.314412	0.9766	-1.920087	0.6280
LNNCPI	-1.926025	0.3178	-1.130512	0.9122
LNFA	-1.802656	0.3747	-2.861653	0.1840

Source: Researcher's Calculations

The unit root results showed that all variables were suffered unit root at level both at intercept and intercept and trend form. The test statistics and their respective probability clearly indicated that the log level forms of individual series were spurious with unit root. Thus, the first difference data were employed to test the unit root. The unit root results are reported in Table 1.4 below:

Table 1.4

ADF Unit Root Results at First Difference

Variables	Intercept		Intercept and Trend		Order of Integration
	τ - statistics	p-value	τ - statistics	p-value	
DLNM2	-4.733056	(0.0004)*	-4.691904	(0.0025)	I(1)

Variables	Intercept		Intercept and Trend		Order of Integration
	$\hat{\alpha}$ - statistics	p-value	$\hat{\alpha}$ - statistics	p-value	
DLNREMIT	-7.648249	(0.0000)*	-7.558854	(0.0000)*	I(1)
DLNGCF	-6.941295	(0.0000)*	-6.040508	(0.0000)*	I(1)
DLNNTT	-6.294611	(0.0000)*	-6.298608	(0.0000)*	I(1)
DLNRGDP	-6.691706	(0.0000)*	-6.739428	(0.0000)*	I(1)
DLNNCPI	-4.894379	(0.0002)*	-5.244790	(0.0005)*	I(1)
DLNFA	-6.159357	(0.0000)*	-6.270306	(0.0000)*	I(1)

Note: An asterisk denotes significant below 5 percent level.

Source: Researcher's Calculations.

The results showed that the log level forms of data at first difference both at intercept and intercept and trend form were completely unit root free and all series were integrated of orders 1. Thus, log level forms of data at first difference were appeared appropriate in employing empirical analysis, particularly empirical model to examine the impact of remittances on financial deepening.

Cointegration Test Results

After testing the stationary of the variables, the study looked at the cointegration among the variables where the Johannsen cointegration test was applied with log level forms of data. Lags are automatically selected by eviews 10. The results of the test are presented in Table 1.5 below.

Table 1.5

Cointegration Test Results

Unrestricted Cointegration Rank Test (Maximum Eigenvalue)				
Hypothesized		Max-Eigen	0.05	Prob.
No. of CE(s)	Eigenvalue	Statistic	Critical Value	
None *	0.648240	47.01622	46.23142	0.0311
At most 1	0.574069	38.40647	40.07757	0.1262
At most 2	0.400807	23.04769	33.87687	0.5268
At most 3	0.305322	16.39381	27.58434	0.1322
At most 4	0.241754	12.45366	21.13162	0.5036
At most 5	0.143655	6.978679	14.26460	0.4917
At most 6	0.015227	0.690498	3.841466	0.4060

Max-eigenvalue test indicates 1 cointegrating equations at the 0.05 level.

* denotes rejection of the hypothesis at the 0.05 level.

Source: Researcher's Calculations

The study looked at the max Eigen value and the corresponding p-value to confirm the cointegration results. The results established that there is one cointegration equation, suggesting that, in the long run the financial deepening and overall explanatory variables move together. Therefore, financial deepening and other study variables have long run relationship and it directed to run regression at first difference data.

Regression Results

The empirical results on the nexus between financial deepening and remittances along with other control variables are presented in Table 1.6.

Table 1.6

Regression Results DLNM2 as Dependent Variable

Variable	Coefficients	Standard Error	t-Statistics	Prob.
DLNREMIT	0.170767	0.025993	6.569811	(0.0009)*
DLNGCF	0.250501	0.040927	6.120678	(0.0003)*
DLNNTT	0.035157	0.103022	0.341254	0.7347
DLNRGDP	0.150352	0.036716	4.094999	(0.0009)*
DLNNCPI	0.110453	0.054119	2.040928	(0.0003)*
DLNFA	0.178586	0.030912	5.777238	(0.0056)*
C	1.062472	0.768280	1.382923	0.1746
R ² = 0.86 Adjusted R ² = 0.84		DW = 1.87 N = 46 after adjustments F= 5735.4 Probability of F statistics = (0.000)*		

Note: An asterisk denotes significant below 5 percent level.

Source: Researcher's Calculations.

The explanatory variables DLNREMIT, DLNGCF, DLNRGDP, DLNNCPI, and DLNFA are statistically significant below the 5 percent level whereas the constant term and DLNNTT are insignificant. The coefficient of determination and adjusted coefficient of determination are 0.86 and 0.84 respectively. It indicated that the model is best fit and explanatory variables explain the dependent variable by 84.0 percent. The F-statistics, which shows the overall fitness of the model, is also statistically significant below 5 percent level of significance.

The coefficient of DLNREMIT is 0.17 and it depicts that one percent increase in the growth rate of remittances increases broad money supply by 0.17 percent. The

coefficient of DLNREMIT is positive and significant, meaning that increase in the growth rate of the volume of remittances stimulates broad money supply or financial deepening in Nepal.

The coefficient of DLNGCF is 0.25 and it depicts that one percent increase in the growth rate of gross capital formation increases broad money supply by 0.25 percent. The coefficient of DLNGCF is positive and significant, meaning that an increase in the growth rate of the volume of gross capital formation increases financial deepening in Nepal.

The coefficient of DLNRGDP is 0.15 and it depicts that one percent increase in the growth rate of real gross domestic product increases broad money supply by 0.15 percent. The coefficient of DLNRGDP is positive and significant, meaning that increase in the growth rate of the real gross domestic product increases financial deepening in Nepal.

The coefficient of DLNNCPI is 0.11 and it depicts that one percent increase in the growth rate of National Consumer Price Index increases broad money supply by 0.11 percent. The coefficient of DLNNCPI is positive and significant, meaning that increase in the growth rate of the National Consumer Price Index increases financial deepening in Nepal.

The coefficient of DLNFA is 0.18 and it depicts that one percent increase in the growth rate of real foreign official assistance increases broad money supply by 0.18 percent. The coefficient of DLNFA is positive and significant, meaning that increase in the growth rate of the foreign official assistance increases financial deepening in Nepal.

The DW statistics is very near to 2 (1.87) indicating that the equation may be free from autocorrelation. However, Breusch Pagan-Godfrey Serial Correlation LM Test is conducted to test the autocorrelation as well as its order. The results are presented in Table 1.7 below.

Table 1.7

Breusch Pagan-Godfrey Serial Correlation LM Test for OLS Regression

Lags	Chi2 value	Df	Prob> Chi2
1	6.98	1	0.394
2	8.15	1	0.516

Source: Researcher's Calculations

The observed R-squared statistics at lag 1 and lag 2 are 6.98 and 8.15 with the probability of 39.4 percent and 51.6 percent respectively. The LM statistics showed that there is no autocorrelation in the residuals. Hence, the residuals are not serially correlated.

Breusch-Pagan-Godfrey test of heteroscedasticity of the variance of error terms from the economic growth equation shows that the observed R squared statics is 9.38 with the probability of 46.7 percent. This result indicates that the residuals are homoscedastic.

The result of the Jarque-Bera (J-B) statistics showed that J-B is 4.317 having probability value of 49.04 percent. As the probability value is reasonably high, the residuals are normally distributed because the null hypothesis cannot be rejected. The coefficients of Variance Inflation Factor (VIF) are less than 5 and it conforms that there is no multicollinearity among explanatory variables.

Conclusions

From the empirical results, it was evident that remittances play a vital role in enhancing financial development via a surge in the broad money supply. The study concluded therefore that, the official private remittances inflows positively and significantly affect the financial development in Nepal. Hence, there is a positive nexus between broad money supply and remittances.

The positive effect of the remittances on the broad money supply could be due to reasons like increasing monetary balances of the remittance-receiving households, and their purchasing power is increased due to an increase in remitted monetary incomes. Such income might be in cash or kept in different types of deposits. Such deposits might be demand deposits or time deposits. An increase in the volume of broad money supply monetizes the economy. This process increases financial intermediation. Hence, remittances stimulate financial deepening or broad money supply.

The positive effect of the remittances on the broad money supply could be also due to reasons like official remittances mostly transit through the banking system, where they are likely to increase bank deposits hence easing the liquidity constraints for banks through the creation of loanable credit funds by banks. This feeds into the financial intermediation process within the banking industry thus facilitating financial

development. Nevertheless, remittances enhance financial inclusion whereby they expose a large number of recipients and people who were previously not banked to the financial system, where they can access financial products like bank accounts, debit cards, which result in financial inclusion. Consequently, where remittance volumes are high, they create a need for the recipients to demand bank accounts for their safekeeping.

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