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# NRB Working Paper

## **Mobilizing Remittances for Productive Use: A Policy-oriented Approach**

*Bhubanesh Pant*

**NEPAL RASTRA BANK, RESEARCH DEPARTMENT  
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**Mobilizing Remittances for Productive Use:  
A Policy-oriented Approach**

Prepared by Bhubanesh Pant\*

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**Abstract**

The potential for remittances to reduce poverty and economic vulnerability, improve family welfare and stimulate economic development has been of special interest to the governments everywhere. For this to take place, the formulation and implementation of effective remittance-augmenting policies and strategies is the core. This paper thus looks at the different policies initiated by some countries. Policy alternatives for Nepal are then suggested for mobilizing remittances for productive use.

Key words: Remittances, Migration, Balance of Payments, Current Account, Poverty

For comments and suggestions, author's e-mail address: [bppant@nrb.org.np](mailto:bppant@nrb.org.np)

\*The author is with the Research Department, Nepal Rastra Bank.

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## I. BACKGROUND

Migrant remittances represent the most direct, immediate and far reaching benefit to migrants and their countries of origin. They are a more constant source of income to developing countries than official development assistance, foreign direct investment and other private flows. Moreover, the emergence of remittances as a new strategy for poverty alleviation in developing countries has spurred multilateral institutions, international organizations, and national governments, among others, to seriously study, identify and implement measures on how these inflows could be maximized and then harnessed for the development of migrants' countries of origin.

The term "remittances" basically refer to the transfers, in cash or in kind, from a migrant to household residents in the country of origin. The IMF considers a wider definition and incorporates three categories, that is, a) workers' remittances or transfers in cash or in kind from migrants to resident households in the country of origin, b) compensation to employees or the wages, salaries and other remuneration, in cash or in kind, paid to individuals who work in a country other than where they legally reside and c) migrant transfers which denote capital transfers of financial assets made by migrants as they move from one country to another and stay for more than one year. As stated in the BOP Manual (5th edition, 1993): "Workers' remittances covers current transfers by migrants who are employed in new economies and considered residents there. (A migrant is a person who comes to an economy and stays, or is expected to stay, for a year or more). Workers' remittances often involve related persons. Persons who work for and stay in new economies for less than a year are considered non-residents; their transactions are appropriate mainly to the component for compensation of employees."<sup>1</sup> The Nepal Rastra Bank (NRB), the country's central banking authority, follows the IMF Manual in recording remittances or migrant transfers in its BOP computation.

Since the end of the 1990s, there has been a renewed interest in the financial resources that migrants send back to their countries of origin due to the potential contribution to the economic development of the receiving regions. It is generally acknowledged that foreign remittances, whether channeled through formal or informal modes from host countries to receiving countries, contribute positively towards the economic development both at the household level and country level, although remittances through formal channels are more amenable to policy interventions and are generally believed to have greater developmental impacts.

The rest of this paper is planned as follows. The next section examines the recent trends in global remittances followed by the impact on the economy of migrants' home countries. Some general policy measures for employing remittances into productive use are adumbrated followed by the case of South Asia. Part V discusses the impact of remittances on the Nepalese economy and the policy arrangements initiated so far for attracting more remittances through the official channel while Part VI spells out some policy alternatives for mobilizing remittances and using them productively.

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<sup>1</sup> For details, see IMF (1993), p. 75.

## II. TRENDS AND IMPACT

International migrant remittances have become an important source of external finance in developing countries. In nominal dollar terms, recorded remittances sent home by migrants from developing countries are expected to reach \$283 billion in 2008, a rise by 6.7 percent from \$265 billion in 2007.<sup>2</sup> This amount, however, reflects only transfers through official channels. Econometric analysis and available household surveys suggest that unrecorded flows through informal channels may add 50 percent or more to recorded flows. Including these unrecorded flows, the true size of remittances is larger than foreign direct investment flows and more than twice as large as official aid received by developing countries.

Remittances can generate a positive effect on the economy through various channels such as savings, investment, growth, consumption, and poverty and income distribution. At the national level, remittances contribute significantly to GDP. Remittances can also contribute to stability by lowering the probability of current account reversals. Since they are a cheap and stable source of foreign currencies, remittances are likely to stem investor panic when international reserves are taking a downward trend or external debt is rising.<sup>3</sup>

At the community level, remittances create multiplier effects in the domestic economy, producing employment opportunities and spurring new economic and social infrastructure and services, especially where effective structures and institutions have been set up to pool and direct remittances. Where these have been set up and encouraged, and where the state is cooperative, remittances can bring about a change, especially in remote rural areas.

Remittances have been found to rise when the recipient economy incurs a downturn in activity or macroeconomic shocks owing to financial crisis, natural disaster, or political conflict. By making up for foreign exchange losses due to these shocks, remittances may smooth consumption and thus play a part in maintaining the economic stability of recipient countries.<sup>4</sup>

The poverty reducing and income distribution effect of remittances is also significant. This case is based on the fact that the recipients of remittances are often low-income families whose offspring left the country to work abroad.

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<sup>2</sup> In real terms, however, remittance flows to developing countries are expected to fall from 2 percent of GDP in 2007 to 1.8 percent in 2008. After many years of strong growth, remittance flows to developing countries began to slow down in the third quarter of 2008. This slowdown is expected to deepen further in 2009 owing to the global financial crisis, though the exact magnitude of the growth moderation is hard to estimate largely due to the uncertainties about global growth, commodity prices and exchange rates. For details, see Ratha *et. al* (2008)

<sup>3</sup> These beneficial impacts are particularly strong for countries where remittances are above 3 percent of GDP as illustrated by Bugamelli and Paterno (2006).

<sup>4</sup> The benefits of remittances in terms of providing a cushion to the economy in the perspective of macroeconomic shocks are highlighted in Agunias (2006).

Remittances assist in augmenting national income by providing foreign exchange and raising national savings and investment as well as by providing hard currency to finance essential imports hence curtailing any BOP crisis.<sup>5</sup> Since they bear no interest, do not have to be repaid, and their utilization is not tied to specific investment projects with high import content, they have a more positive effect on BOP than other monetary flows such as direct investments or loans.

In many countries, a large portion of remittances are invested in real estate, demonstrating both a desire of migrants to provide housing to families left behind and a paucity of other investment instruments in the recipient. Whether remittances are utilized for consumption or purchasing houses, or other investments, they produce positive impact on the economy by stimulating demand for other goods and services.

Some studies have illustrated that remittances can have a deleterious impact on national economic growth in the medium and longer term.<sup>6</sup> Remittances can fuel inflation, disadvantage the tradable sector by appreciating the real exchange rate, and reduce labor market participation rates as receiving households opt to live off of migrants' transfers rather than by working. Moreover, remittances' contribution to growth and poverty might reduce the incentives for implementing sound macroeconomic policy or to institute any needed structural reforms.

Some also argue that remittances do little to stimulate development in the countries of origin. A few studies undertaken relating to the uses of remittances show that savings produced by remittances are frequently directed to purchases of non-productive assets.<sup>7</sup> Remittances were also seen to increase dependency. These inflows are quite volatile since countries that depend too much on them may face economic shocks when the flow is disrupted.<sup>8</sup>

### **III. GENERAL POLICY MEASURES**

There are many policy instruments the government can use to improve development impact of remittances and enhance the flow of remittances through the formal channel. Which policy instruments the government selects depends on the desired goal it intends to achieve. First, if the government's objective is to capture a portion of remittances for development purposes, then the policy instrument will be to impose taxes or levies on remittance transfers, or to explore voluntary check-off for charitable purposes. But, taxing remittances may be counterproductive.<sup>9</sup> Second, if the government's objective is to stimulate transfers through formal channels and to stimulate capital availability, then the

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<sup>5</sup> This aspect is delineated in Buch *et. al* (2002).

<sup>6</sup> For details, see Oxfam Novib (2006).

<sup>7</sup> Evidences from microeconomic surveys demonstrate that purchases of land, housing and other real assets, are the most common uses of remittances in the country of origin. In some instances this led to ballooning prices of these real assets.

<sup>8</sup> The Gulf war, for instance, put Jordan, Sudan and Yemen, among others, in difficulty owing to the massive return of emigrants. For details, see El-Sakka (1997).

<sup>9</sup> Taxing remittances may be counterproductive from an economic standpoint as this could redirect remittances from the formal channels to the informal channels, thus, worsening the balance of payments.

policy instruments should focus on the sale of remittance bonds, opening of foreign currency accounts, premium interest rate accounts, promoting transfers through microfinance institutions, promoting financial literacy, and banking the unbanked. Foreign currency accounts and bonds have proven to be viable means of raising funds. This should be targeted at the diasporas' middle-to-upper income members.<sup>10</sup>

Moreover, if the goal is to stimulate investment of remittances then the government needs to reach out to remittance receivers through micro finance infrastructures. The government could also reach out to its migrants abroad through migrants' service bureaus, and tax breaks on imported capital goods by migrants.

Since a long time, governments of migrants' home countries have employed a large variety of policy measures that target different elements in the system. Multilateral agencies such as the World Bank and the IMF and bilateral development agencies such as the DFID of the UK have also examined different policy options and recommendations. A list of policy measures based on this array of experiences is delineated in Table 1.

Table 1  
**Policy Measures to Enhance the Development Impact of Remittances**

<b>Objective</b>	<b>Measure</b>
Capturing a share of remittances for development purposes	<i>Taxation of emigrants</i> <i>Duties or levies on remittance transfers</i> <i>Voluntary check-off for charitable purposes (or transfer forms)</i>
Stimulating transfers through formal channels and/or stimulating capita availability	<i>Remittance bonds</i> <i>Foreign currency accounts</i> <i>Premium interest rate accounts</i> <i>Promoting/enabling transfers through microfinance institutions (MFIs)</i> <i>Promoting financial literacy/banking the unbanked</i>
Stimulating investment of remittances	<i>Outreach through MFI infrastructure</i> <i>Outreach through migrants' service bureaus</i> <i>Tax breaks on imported capital goods</i> <i>SME schemes (financial, infrastructural, or innovative)</i> <i>Training programs</i>
Outreach to migrant collectives/Hometown associations (HTAs)	<i>Matched funding</i> <i>Public-private ventures</i> <i>Competitive bidding for development projects</i>
Influencing consumption patterns	<i>Promoting consumption of local goods &amp; services</i> <i>Enabling migrants to spend on their relatives' behalf</i>

Source: Carling (2004).

<sup>10</sup> For example, India and Pakistan maintain interest rates on foreign currency accounts that are higher than domestic or Euro-currency deposits.

#### IV. POLICIES IN SOUTH ASIA

It is growingly acknowledged in South Asia that foreign labor migration helps promote national economic growth, eases the pressure of unemployment, brings in much-needed foreign exchange through remittances and increases consumption, savings and investment at both the household and macro levels.

The Governments of Bangladesh, India, Pakistan and Sri Lanka have devised a legal framework encouraging their citizens to send foreign remittances into their countries of origin. Generally, the non-resident citizens of these countries are granted the following facilities, among others: a) maintenance of bank accounts in both foreign and local currencies without tax implications; b) investments in securities/shares, and deposits with local firms/companies; and c) investments in immovable properties in the respective countries.

Because of these and other facilities provided to their respective non-resident citizens, these countries have been able to attract enormous remittances from their respective non-resident citizens. A case in point is India where it was the largest recipient in 2006 with \$24.5 billion, followed by Mexico at \$24.2 billion and China with \$21bn.<sup>11</sup>

Migrant workers, particularly from India and Pakistan, have introduced products, especially food items, in the host countries. These products are now regularly exported to these countries and have become a permanent source of revenue for local exporters.

The Government of India has devised better incentives for its expatriates abroad to send and invest money in India's growing economy. It has also eased regulations and controls, and eliminated the black-market premium on the rupee and has created convenient remittances services. The Indian and international banks have systematically shifted some remittances from the informal "hawala" channels to formal channels. Indians abroad have also responded to several attractive deposit schemes and bonds offered at home.

To attract investment from remittances, different types of bonds have been issued by the Government of Bangladesh. These include Wage Earners' Development Bond, US Dollar Investment Bond and US Dollar Premium Bond.<sup>12</sup>

In Sri Lanka, on the other hand, the Government has attempted to encourage investment and long-term financial planning by return migrant workers by offering different types of credit schemes. The credit schemes do not focus solely on investment but also cater to other identified needs of migrant workers, making them more realistic in application. Most of the South Asian Governments have established special institutions such as migrant workers welfare funds and appointed community welfare officers/attaché in embassies in the receiving countries to promote and protect the interest of migrant workers.

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<sup>11</sup> These data are taken from Yee (2007) based on a report from the International Fund for Agricultural Development (IFAD) and the Inter-American Development Bank (IDB).

<sup>12</sup> For details on the functioning of these bonds, refer to IOM (date not given).

## V. NEPAL'S EXPERIENCES

While Nepal has a long tradition of overseas employment, other factors have contributed to an increase in labor migration in recent years. Starting in the early 19th century, Nepalese have served in various armies in pre-colonial and colonial India. This tradition continues and Nepalese are employed in the Indian and British armed forces. Earnings and pensions from these soldiers form a sizeable portion of remittances. However, with rapid population and labor force expansion and inadequate growth, the absorptive capacity of the domestic economy has been stretched. With limited arable land, landlessness is pervasive and the number of landless households has steadily increased in the agricultural sector. In the nonagricultural sector, the slowdown in growth, especially since 2000/01, due to the insurgency and exogenous shocks has further retarded the pace of employment creation. The armed conflict has also created difficult living and security conditions, especially in the rural areas.<sup>13</sup>

India has been a traditional destination for Nepalese migrants. The main reasons for this are geographical proximity, historical and cultural links, and a large and open porous border. The 1950 Treaty of Peace and Friendship between India and Nepal formalized free border movement of people. The bulk of these migrants are employed in the private, informal sector. These migrants hold semi-skilled and unskilled jobs in restaurants and factories or are employed as domestic workers, security guards, and maids. However, the lion's share of the remittances from India are not recorded in the BOP as they are brought in by the migrants themselves or sent through relatives and friends.

An increasingly larger share of remittances now comes from countries other than India, reflecting changing migration patterns and higher earnings in these locations. Moreover, the composition of skills of the labor flows is different among these destinations. While migrants to the Middle East are employed mostly as security personnel, chauffeurs, and construction workers, the demand from South East Asian countries is more for employment in industrial enterprises. Monthly earnings for these workers are higher than those in India.

The analysis pertaining to the impact of remittances can vary depending on the analytical approach adopted. In Nepal's case, there has been a positive impact of remittances on poverty as illustrated by the *Nepal Living Standards Survey (2003-2004)* that showed that the poverty level, defined in terms of absolute head counts, declined from 42 percent in 1995/96 to 31 percent in 2003/04.<sup>14</sup> Other studies have also supported the government's findings on the significance of remittances.<sup>15</sup>

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<sup>13</sup> This is given in IMF (2006).

<sup>14</sup> Besides remittances, the other factors responsible for the decline in poverty included, among others, rise in agriculture wages, rise in non-agriculture wages and income, rise in urbanization and a drop in dependency ratio owing to a decline in fertility.

<sup>15</sup> For instance according to the Asian Development Bank (ADB), in 2003/04, the economic recovery was led by remittance-driven consumption expenditure. For details, see ADB (2005).

Owing to the widespread conflict in the country until recently, many workers viewed foreign employment as their only viable option. Again, paucity of economic opportunities at home and rising employment prospects abroad have also tempted Nepalese to seek employment abroad.<sup>16</sup> On the basis of data provided by the Department of Labor and Employment Promotion, the number of workers going abroad for employment has increased by almost 13 percent in 2007/08 as compared to 2006/07.<sup>17</sup> With the increase in the number of workers, the inflow of remittances has also taken an upswing. Remittances rose from Rs. 47.5 billion in 2001/02 to Rs. 142.7 billion in 2007/08. Moreover, the share of remittances incoming through the official channel has been going up. For instance, while in 2001/02, out of total remittance income, just about 27 percent flowed into the country through the official channel as against 73 percent through the unofficial channel, in 2007/08, on the other hand, about 91 percent entered through the official channel and the rest through the unofficial channel.

The upsurge in remittances has led to a surplus in the current account, thereby strengthening the overall balance of payments position. The share of remittances in total current account receipts, for instance, soared from 33.6 percent in 2001/02 to 50.8 percent in 2007/08 (Table 1).

**Table 1**  
**Remittances Data**

Heading	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08 <sup>P</sup>
Total remittances (in Rs. million)	47536.3	54203.3	58587.6	65541.2	97688.5	100144.8	142682.7
Share of remittances to current a/c receipts excluding grants (in %)	33.6	37.8	36.6	38.2	46.7	45.3	50.8
Ratio of remittances to GDP (in %)	10.3	11.0	10.9	11.1	14.9	13.8	17.4

P = provisional

Source: Nepal Rastra Bank.

Similarly, the remittances to GDP ratio increased from 10.3 percent in 2001/02 to 17.4 percent in 2007/08. These figures clearly indicate that any significant decline in receipts from remittances could disturb the structure of the economy from the macro level.

Because of the potential positive effect of remittances, the country has accorded priority in promoting overseas employment and mobilizing remittances so as to maximize the benefits from these transfers. In this respect, effective March 29, 2002, the Nepal Rastra Bank (NRB) had begun granting licenses to private sector organizations interested in remittance-transfer business. As of mid-July 2008, 29 firms besides the commercial banks are undertaking money transfer businesses.

<sup>16</sup>These causes have been discussed at length by Seddon (2005).

<sup>17</sup> The number of persons granted institutional permission for foreign employment was 182,043 and 214,094, respectively, in 2005/06 and 2006/07. The major destinations have been Malaysia, followed by Qatar, Saudi Arabia and United Arab Emirates.

Other policy initiatives have also been undertaken so that remittances could be directed through the banking channel. For instance, the NRB has arranged to provide 15 paisa per US dollar as commission to licensed private firms in addition to the prevailing buying rate. Moreover, permission was granted to manpower agencies, engaged in sending Nepalese nationals to work overseas, to open foreign currency account in the Nepalese commercial banks out of the foreign currency income that they earned under the existing rules.

A policy arrangement was also introduced whereby if a Nepal-based licensed agent/representative of a money transfer company situated overseas required bank guarantee for receiving advance payment from the principal company, such facility, within the stipulated limits, would be made available directly from the commercial banks.

## **VI. POLICY ALTERNATIVES**

Policies need to be developed to encourage the use of remittances for promoting longer-term growth and income security. Nepal needs to formulate policies that (i) send more remittances through official rather than unofficial channel; (ii) increase the levels of remittances by encouraging migrants to hold their savings in financial assets in the country rather than holding them abroad (or spending their savings on consumer goods); or (iii) encourage migrants to become investor in productive assets in the country.<sup>18</sup>

A favorable interest rate policy, a market-determined and realistic exchange rate and limited restrictions on withdrawals are also important. In building these products, policymakers should keep in mind that migrants and their families form a diverse group, ranging from white-collar workers to the illiterate and poor.

The opportunity to promote self-employment and small business formation amongst returning migrants and their relations back home should be acknowledged by the government and schemes must be targeted to support investment in business activities. In this light, microfinance is well-placed to address the demand for remittance-linked financial services, particularly among poor and/or geographically isolated populations. Where formal financial markets have traditionally been unsuccessful at the low end in developing countries, microfinance institutions (MFIs) have revealed a competitive advantage based on a host of techniques that reduce the high transaction costs of outreach to poorer clients. By broadening the remittance-linked services to the ‘unbanked’, MFIs have the potential to promote broad-based development, as well as expanding the volume of remittance flows mediated through the financial system. Hence, micro-finance institutions in Nepal could also expand their micro and small business portfolio, while the government and NGOs could provide services such as training, business advice and

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<sup>18</sup> Elsewhere, governments of labor-exporting countries have introduced a variety of schemes with these policy objectives in mind, namely (a) repatriable foreign exchange accounts to encourage the greater use of official channels, (b) foreign currency denominated bonds to encourage more use of financial assets in the home country, and (c) self-employment investment schemes to stimulate more direct investment in productive assets.

marketing assistance for micro and small entrepreneurs to facilitate matching of funds for development projects.

An increasingly recognized policy route is to provide matching funds to the collective remittances sent by migrant organizations abroad, commonly referred to as Hometown Associations or HTAs. Most frequent examples are from Mexico and El Salvador. The local or federal governments in these two countries allocate \$2 or more for every dollar migrant organizations remit back in their communities. The pooled funds are normally used to finance infrastructure and social projects, such as remodeling churches and schools.<sup>19</sup>

The banking system of Nepal has not been adequately developed in terms of coverage and efficiency. Many villages of rural Nepal are devoid of any financial institution and a large proportion of the people in these regions are illiterate and ignorant about the operations of the banking system. Furthermore, the absence of transport facilities has isolated such villages from other parts of the country. Against this perspective, it is crucial to expand the banking network in the rural areas. At the same time, as it might not be economically feasible for the commercial banks to establish their branches in the remote areas, commercial banks can be encouraged to initiate collaboration with cooperatives and other rural institutions in those areas for conducting the remittance business.

One of the biggest hurdles to private sector growth in Nepal is the paucity of credit for seed capital and working capital for enterprises, especially small and medium-size enterprises. Pooled remittances can provide such credit, thus supporting the growth of enterprises. Although residing abroad, many Nepalese migrants want to invest in enterprises in their home country, either to employ family members at home, earn additional income or to prepare for their retirement or eventual return. These types of investments on the part of remitters can lower poverty by expanding businesses in their home communities and generating jobs and income that would not otherwise exist.

Pre-departure training for labor migrants is not only important to reduce the human and economic costs of migration; it can also be a powerful tool in raising awareness about remittance methods and utilization. The involvement of a variety of actors (migrant associations, NGOs and governmental bodies) is instrumental in the success of these initiatives.

The government must understand that remittances cannot be a panacea to our structural economic problems. Remittances do not automatically contribute to national development. To carry out effective and efficient public policies to channel remittances into productive projects, the government has to look at what motivate Nepalis to send money home particularly beyond individual family remittances, and craft its policies to take advantage of it. The government must therefore use its embassies abroad to foster a sense of solidarity and community identity among Nepalis abroad.

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<sup>19</sup> For further elaboration, see Agunias, *op.cit.*

The workers will be inclined to use the banking channel only if the services provided are quick, reliable and efficient. Hence, new technologies that are constantly changing in the international banking system should be introduced in order to make the payment process quick, simple and hassle-free. Help desk, just relating to remittances and workers seeking loans for going overseas for employment, should be set up at all the financial institutions.

A national policy of remittances could build up the framework under which the endeavors of the NRB, Department of Labor and Employment Promotion, poverty alleviation agencies and the Ministry of Foreign Affairs, could be aggregated and coordinated towards the attainment of common goals. Again, a national policy on remittances could support in placing the topic of remittances on the national development agenda, particularly in a country like Nepal where remittances to GDP ratio is quite high.

A critical challenge facing Nepal with huge remittance receipts is to find ways in which these payments can be used to benefit the wider society. The governments of Brazil, Mexico, India and the Philippines had employed an array of inducements to attract these funds to specific saving and investment vehicles, including migrant pension plans, preferential loans or grants for business ventures, preferential access to capital goods and raw material imports for recent returnees, and investment and advisory services for business start-ups.<sup>20</sup> Nepal can learn a great deal from the experiences of these countries.

## VII. CONCLUSIONS

Remittance flows are a crucial policy concern since they are very large in size, are relatively stable and provide a cushion for economic shocks, and are unique in providing direct benefits for households.

Bringing recipient households into the formal financial sector is only the first step in using remittances more effectively. Country surveys indicate that, although households typically spend a large proportion of their remittances, their propensity to save can be as high as 40 percent. For policymakers in Nepal, the challenge is to channel these savings into productive uses.

The bottom line, however, is that remittances cannot be a substitute for a sustained, domestically engineered development effort. Moreover, large-scale migration may hurt domestic labor markets in specific sectors, particularly when those leaving are mostly skilled workers. Still, migrant transfers can help ease the immediate budget constraints of recipient households.

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<sup>20</sup> These mechanisms of different countries are cited in Sander (2003).

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