

# The Positive and Negative Impact of Remittances on Economic Growth in MENA Countries

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## ABSTRACT

*In the worldwide economy, remittances represent one of the major international flows of financial resources. Sometimes the flows of remittances can exceed the flows of foreign direct investment (FDI). For centuries, economists have tried to recognize why some countries reflect strong economic growth, while others stand still at low levels of output. This effort led to a numerous of possible determinants of economic growth including financial development. This study aims to observe the impacts of remittances on economic growth, using panel data set of MENA countries, Algeria, Egypt, Jordan, Libya, Morocco, Oman, Syria, Lebanon and Tunisia, during the period 2000-1010. These countries have experienced a major increase in remittance inflows, and at this time accounts for the bulk of total remittance receipts, compared with other regions. Most countries, remittances represent the largest source of foreign exchange earnings and represent more than 10 per cent of GDP. Hence, it is worth noting that while some countries are net providers of remittances (the Gulf Cooperation Council Countries), others such as Jordan, Egypt, Morocco, Tunisia, Lebanon, and Syria are known to receive large amounts of workers' remittances. In other words, the econometric analysis will be based on those remittance receiving Arab countries. The paper is then to review the theoretical as well empirical literature devoted to remittances, in order, first, to select the arguments that can be applied to this region and, second, to identify empirically if there are significant relationships between remittances and growth in these countries*

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**Keywords:** Remittances, Economic Growth, Panel Data, MENA Countries.

## INTRODUCTION

The growth performance in the Middle East and North Africa (MENA) region has been fragile and unsatisfactory. For example, over the last two decades, “real per capita GDP in the MENA region stagnated, compared to average annual growth of 4.1 percent in east Asia and 0.3 percent in all other developing countries over the same period” (Hakura, 2004). Naturally, this lack of economic growth should be a challenging issue to policy-makers because it exacerbates the problems posed by the already existing high unemployment rates and the relatively strong growth in the labor force of the region<sup>1</sup>.

The argument that the development of well-functioning banks (financial development) is expected to positively affect economic growth is well supported by many cross-country, industry-level and firm-level research papers<sup>2</sup>. For example, Chuah and Thai (2004) examined this issue for a group of Arab Gulf Countries. Based on bank credit to the private sector (as a measure of financial development) and the ECM and VAR models, the results indicate that financial development has a role to play in the economic development of those countries<sup>3</sup>.

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<sup>1</sup>The empirical literature attributes the poor performance in the MENA region to myriad of factors (see, for example, Dasgupta et al. (2002); Sala-i-Martin and Artadi (2002); Chan and Gemayel (2004).

<sup>2</sup>Levine (2003) and Demetriades and Andrianova (2004) provide excellent overviews of this literature.

<sup>3</sup>Trabelsi and Boulila (2003) and Ben Naceur and Ghazouani (2003) examined the MENA region in terms of the causality issue in the finance and growth nexus

It is broadly acknowledged that international migration has become a global phenomenon. Indeed, about 3 percent of the world's population are counted as migrants (Harrison, 2004). Besides, while migrant remittances are recorded at US\$93 billion in 2003 (Ratha, 2004), they are estimated at US\$200 to US\$300 billion (Migrant Remittances, 2004). The sheer volume of remittances has captured the attention of academics, policy-makers, donor, international organizations, and others. Much of this research is devoted to three main questions. First, how large are the unofficial (unrecorded) remittances?<sup>4</sup> Second, what are the determinants of remittances?<sup>5</sup> Third, what is the developmental impact of remittances?<sup>6</sup>

The importance of this paper stems from two observations. First, the “limited” empirical evidence shows that controlling for financial development enhances the positive impact of remittances on growth (Mundaca, 2005). Second, as far as we are aware, the impact of remittances on financial development has been examined by one recent paper only (Aggarwal et al., 2005). Based on their analysis, which included a total of 99 countries, they state that “remittances have a significant and positive impact on bank deposits to GDP, suggesting that these flows do find their way into the formal financial system and get deposited in banks” (Aggarwal et al. 2005: 19). However, this analysis relied on a rather heterogeneous set of countries whose financial systems are at very different stages of development.

## **THE POSITIVE ASPECTS AND THE NEGATIVE ASPECTS FROM THE CONSEQUENCES OF THESE TRANSFERS**

### **The positive effects of remittances in terms of economic development**

The spread channels by which the funds of remittances of the emigrated workers can have positive effects on the growth of their home country; The transmitted funds can fund the dynamic investment, moreover, when these funds are deposited in financial institutions whether local or intentional in terms of savings, this will imply a significant increasing and raising in the financial resources of these financial institutions, hence it will encourage

these institutions to expand its performance by granting more credit to the companies in their markets for short or long term loans, and granted by non banking financial institutions to companies or households; on the other hand, when the families of the emigrated workers encounter difficulties of credit rationing, the remittances enable them to get out of these difficulties and are able to finance their needs for consumption or their capital expenditures. Of course, in order this effect takes place, it is necessary that the families which receive these funds, be driven to do that.

At macroeconomic level, increasing the total capacity of financing of the investments that brings this saving coming from abroad, plays a pro-cyclic role if the migrant workers abroad trust the local economic situation and if the financial system of the country encourages them to invest. But one could also observe that remittances, for certain countries and in certain circumstances, play a counter-cyclic role: it is the case if, when the country of origin of the migrant workers is a poor country which knows a period of economic crisis, these workers send more remittances to help their families to overcome these difficulties more easily. Studies like Bobeva's (2005) or Chami et alii's (2003) ones analyze different aspects of this question to turn remittances into investment or to verify if remittance flows are an actual source of physical capital improvement. And the answer to this question is not always positive (cf. Chami et alii, 2003).

Despite the fact that remittances can have to somehow pro-cyclic effect, and sometimes counter-cyclic. Sayan (2006) shows, the way in which the migrant workers answer the cyclic movements of the GDP in their home country. In his study, he develops at the same time theoretical and empirical analysis on the evolution of flows of remittances in twelve developing countries over the period 1976-2003, and on their business cycle characteristics, the remittances receipts follow a compound secular dynamics, either pro-cyclic, or counter-cyclic, which must encourage with prudence in the analysis of their implications according to the considered country's economic situation.

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<sup>4</sup> For example, see Freund and Spatafora (2005).

<sup>5</sup> For example, see Aggarwal and Spatafora (2005).

<sup>6</sup> For example, see Chami et al. (2003) and Aggarwal and Spatafora (2005), and Giuliano and Ruiz-Arranz (2005).

In addition, remittances can make effective contribute to develop the financing capacities of the financial system, particularly in banking sector. Many studies shown in numerous endogenous growth models, that the enhancing of the financial system in developing or emerging countries is an important factor of growth. If we take in our consideration as an example the US and Mexico, the importance of flows of remittances encourages the banks to intervene in the routing of these flows, which is also desirable from the point of view of the State. Study by Taparia (2005) shows; in the case of several countries like Morocco, the surge of the remittances involves a liquidity increasing of the banks, a point which can be considered that if banks use these funds to lend more easily credits to small and medium-sized enterprises, however, banks would preferring to buy Treasury bonds in spite of financing small private companies.

The fact that this effect is more or less obvious according to the degree of financial development has been reached in the country. Bugamelli and Paterno (2006) underline that remittances can have a beneficial effect if they reduce the probability that foreign investors suddenly flee out of emerging markets or developing economies; they consider that there is a threshold effect of remittances: if remittances are over three percent of GDP, they can be considered as cheap inflows of foreign currencies which gives guarantees to the foreign investors present in the country.

One of the key and most important roles of remittances is their significant and powerful contribution to fight positively against poverty. remittances are besides constructive to the economic development when part of these funds contributes, in the families of the emigrated workers, to support the building of human capital while allowing to pay expenditure for education and training for the young people living in these families. As a consequence, in certain countries, remittances can in reality contribute to the accumulation of human capital, and then to the growth of total factor productivity of the local economy (Chami and alii, 2008).

However, besides these positive aspects of the links between remittances and growth, one can find, in the appropriate literature, a fairly vast number of theoretical analysis and empirical studies which depict the negative aspects of the remittances for the home countries of the migrant workers as we shall explain it now.

### **The negative impacts of remittances on growth**

In the literacy on remittances, one finds a number of theoretical as well empirical papers in which the impacts of the remittances on the macroeconomic performance of the recipient countries are estimated to be rather negative. Among the empirical studies above mentioned, the majority of them concerns migrants' countries located outside of MENA or Mediterranean region, but the same negative impacts should certainly be observed in this area also. These negative effects can be gathered and analyzed around three analytical topics: first, the insensible monetary penalty of the entry of foreign currencies in a low developed country open to the movements of capital, this throughout their sound effects on the exchange rate level of the home currency and on the domestic price level. Second, the uses of these funds, either within the family of the migrant worker or by the worker himself who chooses to spend his savings through real estate investment. Finally, the effect of the remittances can be also negative in terms of lacking among the members of the family remained in home country. These types of risk are considered as critical from a macroeconomic point.

The common consequences of the remittances flows on the exchange rate of the local currency and on the domestic price level is a rise of both, the exchange rate being defined as the price in terms of the local currency, of the foreign currencies of the countries where live the migrant people for each increase of foreign currencies rises on average the central bank reserves, therefore, grow which obliges the bank to issue new local money entailing mechanically inflation. Many authors consider that this increase of the real exchange rate produce a so called "Dutch Disease Effect" in the local country, in Mexico for example, see the PhD thesis from Vargas-Silva (2006) and for Cape Verde, see Bourdet and Falck (2006). nevertheless to conclude in support of a "Dutch Disease Effect", it is necessary to remind that such an effect is only possible if the country receiving remittances, and suffering a rise of its real exchange rate and it is an industrialized country at a certain level and exporting some manufactured . Otherwise, the country has to be a country exporting some commodities or services whose cost of production and selling prices will increase due to the entry of remittances.

The remittances, in some beneficiary countries or families, can stimulate members of the family who profit from these incomes, living in the country of migrants' origin, to be satisfied to live with this "manna falling from heaven" without working or by withdrawing from the local labor market; one observes also scenarios in which these recipients

use remittances while launching themselves in showy consumptions or of luxury goods often imported from abroad, certain expenditure in projects not very relevant or in badly studied investments can lead to the wasting of these funds.

The impact of workers' remittances may have also a negative impact on the local income distribution inequality as shown in Adams' and Richard's (1989) paper and these inequalities among families with or without emigrate members abroad, lead to two types of further inequalities and negative incentives. Nowadays the same story happens: Van Dalen, Groenewald and Fokkema (2005) in an empirical study for Egypt, Turkey and Morocco, show also that the receipt of remittances in the home country of emigrants has an attractive effect on emigration intentions of household members living home; this trigger-effect is a truly negative effect in terms of labor force disposal for economic development in the home country. This contribution of the receipt of remittances to new flows of migration seems to be particularly high in Morocco.

Land and housing property being, in many developing countries, the best opportunity compared to the poor masses, in many countries migrants' remittances go up to this kind of unproductive uses, which fetch huge prices in these specific sphere. This kind of expenses act for another set of negative effects of remittances because these funds coming from abroad are leading to price inflation. This kind of unproductive investment is obviously the case in Tunisia as well in Morocco, but the amounts of money spent through these speculative uses are hard to be known, due to fact that an important part of remittances utilized in that way, are transferred from abroad to the migrants' home countries through non official money circuits.

The different positive or negative effects of remittances on macroeconomic performance analyzed above showed that these specific financial funds, contrary to FDI and portfolio inflows, do not insure economic growth. In the following sections, I shall study the contribution of remittances to the global process of convergence among a set of MENA and Mediterranean countries, for which, till now, no such a global study has been done.

### MODEL

This study will examine the relationship between financial development and remittances in the remittance-receiving Arab countries, by estimating the following model:

$$Y_{it} = \beta_{0i} + \beta_1 Y_{it-1} + \beta_2 Remit_{it} + \beta_3 FDev_{it} + \beta_4 Ins_{it} + \beta_5 X_{it} + \eta_i + \varepsilon_i \quad (1)$$

Where  $Y_{it}$  is the annual percentage growth of real per capita GDP in country  $i$  in the ten year period,  $Y_{it-1}$  is the logarithm of the initial GDP per capita in country  $i$  in time  $t-1$ .  $Remit_{it}$  is the logarithm of worker remittances to GDP ratio,  $FDev_{it}$  is a vector of financial development variables;  $Ins_{it}$  is a vector of institutional quality variables; and  $X_{it}$  is a set of exogenous variables.  $\eta$  is an unobserved country-specific effect and  $\varepsilon$  it is the error term. Basing on Barro (1996), Barro and Sala-i-Martin (1995) and Giuliano and Ruiz- Arranz (2005), the other variables includes investment (log of gross fixed capital formation to GDP), human capital (HC), government consumption (GOV), and inflation (INF). In addition to the ratio of remittances to GDP (Rem), the model includes a set of direct variables that the empirical literature has found to affect financial development and these include inflation, openness and the log of GDP.

Equation (1) is first estimated by running ordinary least squares (OLS), fixed effects and random effects regressions. Generalized Method of Moments (GMM) a regression has been used to address the issue of remittances' endogeneity, using lags of the independent variable as instruments for the regressors. By following Arellano-Bond model estimators are obtained by differencing both sides of model 2 and by using the lagged dependent variable and other regressors in the resulting model 3 with lagged explanatory variables.

$$FDev_{i,t} = \alpha + \gamma FDev_{i,t-1} + \beta_1 Rem_{i,t} + \beta_2 X_{i,t} + \mu_{i,t} + \varepsilon_{i,t} \quad (2)$$

$$FDev_{i,t} - FDev_{i,t-1} = \gamma(FDev_{i,t-1} - FDev_{i,t-2}) + \beta_1 (Rem_{i,t} - Rem_{i,t-1}) + \beta_2 (X_{i,t} - X_{i,t-1}) + \varepsilon_{i,t} - \varepsilon_{i,t-1} \quad (3)$$

In other words, the Arellano-Bond estimators propose the following moment conditions :

$$E [ FDev_{i,t-s} (\varepsilon_{i,t} - \varepsilon_{i,t-1}) ] = 0 \text{ for } s \geq 2; t = 3, \dots, T \quad (4)$$

$$E [ Rem_{i,t-s} (\varepsilon_{i,t} - \varepsilon_{i,t-1}) ] = 0 \text{ for } s \geq 2; t = 3, \dots, T \quad (5)$$

## DATA

The panel data analysis focuses on the sample of 13 MENA (Middle East & North Africa) and Mediterranean countries : Algeria (ALG), Egypt (EGY), Jordan (JOR), Lebanon (LBN), Morocco (MOR), Oman (OMN), Syrian Arab Republic (SYR), Tunisia (TUN), variables are observed over the period from 2000 to 2010 (source: World Development Indicators, The World Bank Group, 2010). Annual percentage growth rate of GDP at market prices based on constant local currency. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Workers' remittances and compensation of employees comprise current transfers by migrant workers and wages and salaries earned by nonresident workers. Data are the sum of three items defined in the the IMF's Balance of Payments Manual: workers' remittances, compensation of employees, and migrants' transfers. Remittances are classified as current private transfers from migrant workers resident in the host country for more than a year, irrespective of their immigration status, to recipients in their country of origin. Migrants' transfers are defined as the net worth of migrants who are expected to remain in the host country for more than one year that is transferred from one country to another at the time of migration. Compensation of employees is the income of migrants who have lived in the host country for less than a year. Data are in current U.S. dollars. Foreign direct investment is the net inflows of investment. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital.

Population is based on the definition of population, which counts all residents regardless of legal status or citizenship - except for refugees not permanently settled in the country of asylum.

## EMPIRICAL RESULTS

The panel analyses using the fixed-effects method conducted in accordance with a modified version of the Giuliano and Ruiz-Arranz (2005) model. Results indicates that remittance are found to be positively and significantly correlated with growth. A three specifications has been added, the financial development variables besides other independent variables. In these specifications, remittances also show evidence of positive and significant sign.

The result is consistent with the findings of Giuliano and Ruiz-Arranz (2005). The sign of the interaction term between financial development index and remittances is also negative and significant indicating the substitutability of remittance for financial systems. The coefficient on liquid liability (M3/GDP) times remittances exhibit significant and positive sign, suggesting that remittances can complement total liquidity in these countries to enhance growth. The investment rate show no influence on output and this result may reflect the weak correlation between domestic investment and the growth rate of MENA countries. Other controlling variables, i.e. human capital, government consumption and inflation, reach the theoretical expected sign and statistical significance.

## CONCLUSIONS

The findings of this paper are expected to be interesting and important for many reasons. First, this study has examined the impact of remittance on economic growth in a sample of 7 MENA countries. The study, gives insights on two important channels through which remittances affect growth i.e. institutions and financial development. Using fixed effects approach the empirical analysis points to the fact that institutions and financial development play an important role in how remittances affect economic growth. Through the financial development channel remittances are found to play a mixed role in MENA labor exporting countries. Through their negative interaction with credit they promote growth by substituting credit, thus improving the allocation of capital and hence accelerating economic growth. They

also, promote growth by complementing total liquidity. Second, greater understanding of the impact of remittances on financial development is useful given the numerous papers on the growth enhancing effects of financial development. Third, if the results of this paper show a positive relationship between remittances and financial development. This would imply that households are able to save at least part of their income. Finally, the implications of this paper are thought to be useful in terms of its recommendation for future research. For example, assuming that most of the remitted funds are in U.S. dollars, based on bank-level data, one can examine the impact of dollarization (ratio of dollar deposits to total bank deposits) on the performance of banks in terms of their credit extension and or net interest margin. This type of analysis will provide us with a greater understanding of remittances in the Arab countries.

In general, the evidence indicates a larger contribution of remittances flows to domestic resources. The inflow of these resources has financed consumption demand and reduced pressures on the current account. Moreover, these inflows, by contributing to national savings, have financed domestic investment and supported output growth in the largest recipient countries of these inflows, Jordan. While the share of FDI flows remains very moderate, the evidence points to the potential positive effects of these flows on output growth. Moreover, sustaining FDI inflows may provide an incentive to improve domestic policies and strengthen macroeconomic fundamentals. This is in contrast to remittances flows that are likely to vary with cyclicity in host countries beyond the control of domestic policies. As countries continue to search for means to supplement domestic resources, maximizing FDI flows should top the policy priority towards expanding productive capacity via long-term investment that provides its own financing.

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## APPENDEX

**Table 1: Growth Effects of Workers' Remittances as a Share of GDP**

	Basic Regression	M3/GDP	INDEX
<i>Remittit /GDP</i>	6.45 (2.10)**	6.99 (2.03)**	24.98 (4.99)**
<i>Initial Income: Y<sub>i,t-1</sub></i>	-0.87 (-3.14)***	-0.70 (-3.76)**	-0.78 (-3.98)**
<i>Human capital (HC)</i>	0.007 (3.90)**	0.21 (2.89)**	0.08 (2.19)**
<i>Investment (GFCF)</i>		0.23	
FDevit		-1.99 (-1.20)	-189.09 (-5.90)**
Inst		1.67 (2.09)**	
R <sup>2</sup>	0.49	0.54	0.44

Note: Robust t-statistics in brackets. \* Significant at 10%; \*\* significant at 5%; and \*\*\* significant at 1%. Each specification was also run using random effects.

**Table 2:**

Code of Variable	Definition of Variables
<i>Dependent variable Y<sub>it</sub></i>	growth rate of real per capita GDP in constant U.S.dollar
<i>Remittit /GDP</i>	Defined as the sum of three components, compensation of employees, worker's remittances and migrants' transfer
<i>Financial Development, M3/GDP</i>	M3/GDP represents the liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of the financial intermediaries and non-bank financial intermediaries) divided by GDP
<i>Initial Income: Y<sub>i,t-1</sub></i>	Is the log level of real per capita GDP in constant dollars at the beginning of each five year block in the panel.
<i>INF/ GOV</i>	Annual Percentage Change in CPI level of government consumption in constant dollars as a share of GDP
<i>Human capital (HC)</i>	measured as the average years of secondary schooling into total population: Source: Barro and Lee (1996), See update version at: <a href="http://www.cid.harvard.edu/ciddata/ciddata.html">http://www.cid.harvard.edu/ciddata/ciddata.html</a>
<i>Investment (GFCF)</i>	Is the log level of gross fixed capital formation in constant dollars as a share of GDP Inflation
FDevit	vector of financial development variables;
Inst	Inst is a vector of institutional quality variables

**Table 3: Remittances Inflow to GDP**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
EGY	1.76	2.68	3.99	2.97	2.33	2.17	1.42	1.39	1.39	1.38	1.91
IRQ	2.06	0.01	0.01	0.00	0.00	0.13	0.01	0.04	0.01	0.02	0.09
JOR	2.18	1.77	1.61	2.24	1.09	1.16	1.19	1.12	1.26	4.11	3.08
ALG	1.89	1.88	1.92	1.34	1.81	1.83	4.60	3.11	3.89	4.44	3.10
LEB	6.70	2.35	2.79	2.99	1.30	9.69	16.13	1.30	1.06	1.16	1.39
LBY	1.88	-1.63	-5.27	0.53	1.59	0.72	1.22	1.20	1.90	3.43	3.45
MOR	5.86	1.26	2.85	1.51	2.00	3.24	1.25	3.63	1.76	1.98	2.97
OMN	0.04	1.41	1.01	2.96	25.30	2.23	1.90	1.38	1.12	0.59	6.90
SYR	3.01	1.58	2.06	5.46	1.53	1.37	1.76	1.60	2.04	1.53	2.85
TUN	1.90	1.82	5.46	1.64	1.52	2.30	1.62	1.46	2.00	2.97	2.51

Source: World Bank, World Development Indicators, 2010

**Table 4 Workers' remittances to MENA, 2000-2010 (US\$ billion)**

Country Name	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Arab World	11	13	16	10	13	15	17	33	38	35	33
MENA all income levels	12	13	16	21	24	26	27	33	34	35	34
MENA developing only	11	13	16	20	23	25	38	32	36	34	32

*Source: Global Economic Prospects, 2010.*