Financial Development as a Catalyst: Transforming Aid into Economic Growth in South Asia

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Abstract

South Asia relies considerably on foreign aid to ameliorate its economic development. The primary cause of this reliance on foreign aid is a lack of resources to enhance macroeconomic performance. This study investigated how foreign aid affects South Asia's macroeconomic performance. Additionally, the significance of financial development is emphasized to assess the aid growth relationship. The panel autoregressive distributed lag (P-ARDL) model is part of an advanced panel data method. The study concluded that foreign aid does not enhance South Asia's macroeconomic performance; however, it does have a favourable and noteworthy effect on economic growth related to financial development. Therefore, it is argued that a well-developed financial system can accelerate the effectiveness of foreign aid in South Asia.

Keywords: Macroeconomic Performance, Foreign Aid, South Asia, Financial Development.

Introduction

Official development assistance (ODA), also called foreign aid, is voluntarily transferred between countries, often in the form of gifts, grants, or loans to support development and combat poverty in emerging economies. Proponents of foreign assistance argued that foreign aid is necessary to achieve developmental goals in developing economies (Bowen, 1995; Kosack, 2003; Tiwari et al., 2011). Two gap models (Chenery & Strout, 1966), three gap Models (Bacha, 1990), and big push theory (Murphy et al., 1989; Rosenstein-Rodan, 1961) have provided a theoretical rationale for the aid-growth relationship. However, a large body of empirical research regrettably draws attention to the problem of aid inefficiency in poor nations (Ali et al., 2022; Asongu, 2013; Chatterjee et al., 2007; Levin & Dollar, 2005; Mouneer et al., 2022; Mouneer & Khan, 2019). Several research studies have found various factors contributing to uncertain or even adverse effects of foreign assistance on economic growth. These variables include the Dutch disease phenomena, governmental instability, aid fungibility, corruption, etc. By having deep insight into the aid-growth relationship, this study aims to explore this relationship with a different dimension. The core purpose is to investigate the aid-growth relationship by probing the role of financial development in South Asia. A practical, resilient, established financial framework is essential for promoting equitable and long-term growth. A collection of organizations, tools, marketplaces, and regulatory frameworks that facilitate transactions through credit extension make up the financial sector.

Financial development aims to reduce costs associated with procuring facts, enforcing contracts, and conducting transactions, leading to the occurrence of financial contracts, markets, and

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intermediaries. Financial development is important for economic progress because it encourages capital accumulation, lowers impoverishment, and makes risk management easier.

A healthy financial sector is essential for promoting real sector expansion, which spurs economic expansion (Schumpeter, 2008). Economic growth is also a consequence of financial development, which comes from financial liberalization (McKinnon, 1973; Shaw, 1973). According to the supply-leading theory, economic growth does not provide a feedback loop, and causality moves from finance to economic growth. Economic growth is contingent upon a robust financial sector (Patrick, 1966).

We hypothesized that if countries are more financially developed, they can utilize foreign assistance more effectively. This rationale is based on the idea that increased foreign assistance inflows push the real exchange rate higher, raising the cost of goods and services and eventually decreasing economic growth (Mouneer, 2023). A well-developed finance industry creates financial services that can successfully control the detrimental effects of foreign aid on the growth of the economy (Nkusu & Sayek, 2004). Ang (2010) also provides evidence that countries with more financial liberalization have beneficial impacts of foreign aid on economic growth. This research is focused explicitly on six South Asian economies. The selection of South Asia is based on the significant influx of foreign aid to this region. In 2022, South Asia received approximately $16.81 billion in net ODA, a substantial increase from $5.07 billion in 2000. However, empirical research has shown that even with massive aid, this region cannot meet its targets (Jena & Sethi, 2021; Rao et al., 2023; Shah et al., 2022). Therefore, it is necessary to investigate several factors that may enhance the efficacy of foreign aid. We have selected "financial development" as one of the key factors that can enhance the effects of foreign aid on economic growth. Moreover, the financial systems of South Asian nations have improved, although further financial development is still needed (Almekinders et al., 2023)**.** With an emphasis on South Asian countries, this research will add to the prevailing knowledge by probing a critical aspect that may have an advantageous moderating effect on the aid-growth link. The main research questions of the study are:

1. Does foreign aid benefit or adversely impact economic growth in South Asia?
2. Does financial development contribute to the effectiveness of foreign aid in South Asia?

Furthermore, this paper is designed as follows: Section 2 delivers the issue's theoretical and empirical underpinnings, while Section 3 provides data and methodology. Section 4 presents a discussion and empirical data; section 5 concludes the study and proposes a policy framework.

Literature Review

Foreign assistance is considered an essential resource for boosting the developing economy. Much literature has emphasized the aid-growth relationship, but the debate is still inconclusive. Foreign Aid improves the economic growth of a country with an appropriate policy framework (Burnside & Dollar, 2000; Islam, 2003). Foreign aid with good governance is effective, but numerous studies have identified the issue of foreign aid ineffectiveness. This section provides a deep insight into empirical literature to understand the theoretical relevance of the concerned matter.

The impact of foreign assistance on economic development represents a multifaceted and intricate dilemma, with empirical evidence indicating both advantageous and detrimental effects contingent upon many factors. Although international aid possesses the potential to catalyze economic growth, its efficacy is frequently tempered by the specific circumstances surrounding its implementation. Research has demonstrated that foreign aid exerts a modestly positive influence on the economic advancement of recipient countries, particularly within the contexts of low- and medium-development nations (Martinez, 2015). An analysis encompassing 26 deeply indebted

impoverished countries in Sub-Saharan Africa revealed a direct positive correlation between the intensity of aid and economic growth; however, it was noted that levels of investment and the scale of government exerted a more pronounced effect (Phiri & Tchereni, 2013).

Martinez (2015) studied foreign assistance's impact on economic growth in 104 LDCs and found that while aid positively influences growth, its magnitude is minimal due to factors like conflict and geographical conditions. The study also found that aid effects are observed quickly.

The study by Phiri and Tchereni (2013) found a positive correlation between aid intensity and economic growth, but this effect is less significant than investment and government size. The findings suggest that industrialization in Africa is crucial for the substantial growth effect of assistance.

Neanidis and Varvarigos (2005) explored the effect of assistance funds transfers on economic growth, focusing on productive and non-productive purposes. They propose a theoretical framework that differentiates between aid allocation for productive and non-productive purposes. They found that directing aid towards productive public expenditure leads to growth, while non-productive aid transfers negatively impact development. Fatima (2014) found that when assistance is directed towards needy sectors, it can generate significant gains. However, support is often associated with specific aims and pre-established sectors. Moreover, if aid is given autonomy, it can be directed towards areas of its own choice, potentially leading to better developmental outcomes. The effectiveness of foreign aid depends on its appropriate allocation, political landscape, and the recipient nation's financial resource management.

The link between foreign assistance and economic growth is notably affected by the financial development of recipients. Evidence suggests that the success of foreign aid in fostering growth relies on existing financial infrastructures. Enhanced financial development amplifies the beneficial effects of foreign aid on economic growth, especially in nations with strong financial frameworks (Appiah-Otoo et al., 2022). In lower-income Asian countries, foreign aid and financial development can promote growth, but this effect diminishes in the middle- and upper-income countries, where assistance may displace domestic investment (Patra & Sethi, 2024). Research indicates that financial development plays a role in human development and living standards, implying a broader influence on economic growth via enhanced credit access and investment opportunities (Gillani et al., 2023). Geographical difficulties and armed conflict are two variables that might reduce the efficiency of foreign aid and offset its advantages (Martinez, 2015). Despite significant foreign assistance, Kenya continues to experience poverty and slow economic growth, raising concerns about the efficacy of aid and the possibility that it may not always result in progress (Gitaru, 2015). Assistance distribution is crucial because it may either stimulate or impede growth. According to Neanidis and Varvarigos (2005), assistance channelled toward productive public spending tends to encourage growth. Abdul Wadud (2009) found a significant positive association between financial development and economic growth in South Asia.

Financial development plays a crucial role in enhancing the effectiveness of foreign aid on economic growth through various mechanisms. The literature identifies several key pathways through which this relationship operates. Financial development lowers costs associated with information and transactions, which increases the effectiveness of resource allocation and helps in identifying viable investment opportunities (Khan et al., 2006; Murinde, 2012). A well-developed financial system encourages domestic savings, which can be complemented by foreign aid, leading to increased investment and growth (Khan et al., 2006). Financial institutions facilitate risk diversification and management, making it easier for businesses to invest in growth-oriented projects, thereby amplifying the impact of aid (Khan et al., 2006; Murinde, 2012). Hussain et al.

(2024) indicate a significant positive long-term relationship between financial inclusion and economic growth, particularly in developing countries, where access to financial services can drive growth more efficiently than in advanced nations.

Aid effectiveness is significantly higher in countries with supportive financial and policy frameworks, suggesting that financial development can create a more favourable environment for aid to translate into growth (Doucouliagos & Paldam, 2005; Tsikata, 1998). However, financial development can enhance the effectiveness of foreign assistance; it is essential to note that the link is complex and context-dependent. Some studies indicate that aid may not always lead to growth, particularly in less developed financial systems, highlighting the need for tailored approaches to aid and financial development strategies (Doucouliagos & Paldam, 2005). There is minimal research on financial development in the assistance-growth nexus. Previous studies did not combine finance-growth and assistance-growth analyses. Furthermore, no literature exists to explore this nexus, particularly in South Asia.

Data and Methodology

The model formulation, data, procedures, and variable descriptions are covered in this section. We first discuss the data sources we employ to obtain our data. We discuss our estimation technique for this investigation in detail here. This research investigates the relevance of financial development and the relationship between foreign aid and economic growth through an empirical study of South Asian nations. This analysis uses annual panel data from 2001 to 2022. Table 1 presents variable description and data sources used in this study.

Table 1: Data Description

Variables/ Symbol	Unit of measurement	Variable Description	Data source
Economic Growth (GDP)	Annual	GDP is the annual percentage growth rate of GDP at market prices, based on 2015 prices in US dollars, and includes the gross value generated by all producers, product taxes, and subsidies.	WDI-WB
Gross capital formation (GCF)	% of GDP	Gross capital formation, previously known as gross domestic investment, is the net change in inventories and spending on fixed assets in an economy, such as land improvements, plant purchases, and infrastructure construction.	WDI-WB
General Government Expenditure (GEXP)	% of GDP	General government final consumption spending includes procurement costs, employee compensation, and military expenditure, including national security and defense, excluding military expenditure in capital creation.	WDI-WB
Foreign Direct Investment (FDI)	% of GDP	Net inflows of money to buy long-term management shares in a foreign company, including capital invested in equity, earnings reinvested, other long-term capital, and short-term capital, all split down by GDP, are referred to as foreign direct investment.	WDI-WB
Financial development (FD)	Index	The nine indicators that make up the Financial Development Index provide an overview of the depth, accessibility, as well as effectiveness of financial	IMF

		markets and financial institutions. An overall indicator of financial progress is created by combining these indexes.	
Inflation (INF)	Annual	The GDP implicit deflator, which shows the proportion of GDP in current local currency as opposed to constant local currency, is used to calculate inflation, which is the rate of price change in the economy.	WDI-WB
Foreign Aid (FA)	% of GNI	DAC members, multilateral organizations, and non-DAC governments collaborate to provide net official development aid (ODA) to countries on the DAC list of receivers, which includes loans with a minimum funding element of 25%, calculated with a 10% discount rate.	WDI-WB
Trade (TR)	% of GDP	Trade is the entire amount of goods and services that are imported and exported, represented as a share of the GDP.	WDI-WB

An empirical analysis for this study is divided into two dimensions: statistical analysis which includes descriptive analysis and correlation matrix while the second dimension is econometric analysis which includes cross dependence test, unit root test, and P-ARDL econometric technique. A descriptive statistic is a brief collection of illuminating coefficients that gives a general picture of a certain data set, which might be the entire population or just a sample. Descriptive statistics are assessments of central tendency and variability. A statistical link among two or more variables is known as correlation, and it can be either positive, negative, or zero.

The cross-sectional dependence test (CD test) is crucial in panel research, highlighting the durability and associated cross-sectional dependency over whole units. It reveals disruptions in one area that typical panel models may overlook, influencing other areas. Ignoring this condition can lead to large deviations and dimensional bias (Pesaran, 2004). Pesaran CD test is employed in this study to check cross-sectional dependence among South Asian countries.

Researchers use cointegration tests to determine safe long-run relationships between models in non-stationary time series. The panel co-integration test simultaneously characterizes long-term and short-term affiliations and defines a static effect that can be adjusted for multiple associations. Its heterogeneous properties allow for cross-sectional interdependency with unrelated separate holdings. Kao test is used to check cointegration among variables.

First-generation and second-generation unit root tests are applied to panel data. These tests take into consideration any potential cross-sectional dependency between the entities in the panel and are expansions of unit root tests for individual time series. First-generation tests include Levin-Lin-Chu (LLC) and Im-Pesaran-Shin (IPS) tests while second-generation tests include CIPS and CADF tests.

Econometric Modelling

The main focus of the study is to empirically probe whether financial development matters in connection to the affiliation among foreign aid and economic growth in South Asia. We have designed the following models that show the association between the autonomous and dependent variables to get better outcomes.

$$(GDPit) = \beta 0 + \beta 1(GCFit) + \beta 2(GEXPit) + \beta 3(FAit) + \beta 4(FDIit) + \beta 5(TRit) + \beta 6(INFit) + \varepsilon it$$

$$(GDPit) = \beta 0 + \beta 1(GCFit) + \beta 2(GEXPit) + \beta 3(FDit) + \beta 4(FDIit) + \beta 5(TRit) + \beta 6(INFit) + \varepsilon it$$

$$(GDPit) = \beta 0 + \beta 1(GCFit) + \beta 2(GEXPit) + \beta 3(FDit * FAit) + \beta 4(FDIit) + \beta 5(TRit) + \beta 6(INFit) + \varepsilon it$$

Where *GDP* stands for Gross domestic product, *GCF* for Gross capital formation, *GEXP* for general government final consumption expenditure, *FD* for financial development index, *FDI* for foreign direct investment, *TR* for trade, *INF* for inflation, *FA* for net ODA received and *FA*FD* for Interaction of foreign assistance and Financial Development. ε is a composite error term. "*i*" denotes cross-section (countries) and "*t*" represents the period.

In our analysis, we used the P-ARDL method to explore the short-run and long-run impacts of foreign aid on economic progress by exploring the role of financial development.

Empirical Methodology

To serve this purpose, a very advanced and suitable Panel Auto Regressive Distributive Lag (P-ARDL) estimation technique is utilized. The error correction model (ECM) is extracted using the P-ARDL technique, which also looks at the short- and long-term co-integration relationships among the determinants. Error correction models define short-term dynamics using panel characteristics. The P-ARDL method works well with models that have straightforward equations. P-ARDL is also helpful in assessing the parametric values of analysis, both short- and long-term. Even for small datasets, the P-ARDL model generates outcomes that are efficient and equitable. An essential step in determining the panel auto-regressive distributed lag model is the panel unit root test.

Most of the variables are stationer at many levels, such as initial difference I (1) and level I (0) in analysis. Concerning these coupled stationary extents, the P-ARDL model is useful. The first method for assessing the long-term connection between variables is the P-ARDL auto-regressive distributed lag model. It is also consumed to look at the relationships between variable values over both short and long terms. For this reason, the P-ARDL approach is working to monitor the correlation between foreign aid and economic growth in Asian countries.

A "short-run" is defined as a period in which the quantities of the remaining inputs can vary, but the volume of one or more inputs stays constant. Long-run, on the other hand, describes a period during which all input levels are subject to variation. A P-ARDL approach is used to perceive the short and long-term assessments of foreign aid, economic growth, and financial development in South Asia. Some elements may be shown to be significant and others to be irrelevant in a short-run analysis, suggesting that these variables may not represent economic progress. In long-term evaluations, however, the total coefficients are noteworthy and have broad implications for economic growth. The P-ARDL model separates the stationary levels I (0) and I (1), allowing for both short and long-term relationships.

Empirical Analysis

Statistical analysis is used to describe the model's variable values. There are two approaches for statistically estimating data. The first step is descriptive analysis, followed by the usage of a correlation matrix.

The features of the dataset are summarized and a quantitative description is presented using descriptive analysis. Table 2 delivers descriptive results for the data utilized in this study.

Table 2: Statistical Description

Variables	Mean	Maximum	Minimum	S.Dev.	JB-test	Probability	Obs.
GDP	3.781	16.91	-10.8	3.368	150.3	0.000	132
GCF	31.834	69.472	14.534	12.465	27.46	0.000	132
FDI	1.005	6.321	-0.638	0.906	685.83	0.000	132
FD	0.251	0.54	0.07	0.109	25.863	0.000	132
GEXP	11.3664	22.6722	4.8456	4.9033	16.6098	0.000	132
INF	7.373	48.847	0.922	5.679	3141.8	0.000	132
FA	2.753	12.344	-0.268	3.012	48.534	0.000	132
TR	50.793	116.5	23.129	23.276	41.636	0.000	132

Table 3 presents a correlation matrix for economic indicators used for empirical analysis. High correlation values indicate severe multicollinearity.

Table 3: Correlation Matrix

	GDP	GCF	FDI	FD	FA	GEXP	INF
GDP	1						
GCF	0.2291	1					
FDI	0.0845	0.5834	1				
FD	0.3491	0.0708	0.4252	1			
FA	-0.2839	-0.0307	-0.1647	-0.5971	1		
GEXP	-0.1973	-0.1073	0.1429	- 0.0970	0.6112	1	
INF	0.0447	0.6133	0.0176	-0.0587	-0.1148	-0.0687	1
TR	0.2262	0.7337	0.2365	- 0.2690	0.6935	0.777	-0.0267

The Cross-sectional Dependence Test is a diagnostic tool used for analyzing panel data, focusing on general cross-sectional dependence. It can be used to determine if there is or is no dependence between any two cross-sections. In 2004, Pesaran proposed the LM test for Cross-sectional Dependence (CDLM) and the upgraded CD to overcome the disadvantage of the cross-sectional dependent test. Table 4 provides results for the Pesaran CD test. All variables show cross-sectional dependence except GCF and GEXP.

Table 4: Results for Pesaran CD Test

Variables	Coefficient	p-value
GCF	0.432	0.666
GDP	7.173	0.000*
GEXP	0.914	0.361
TR	3.265	0.001*
FA	8.251	0.000*
FDI	2.234	0.025*
INF	4.261	0.000*
FD	3.186	0.002*
FD*FA	1.493	0.135

Note: Pesaran CD test with H_0: No cross-sectional dependence, furthermore * shows that there exists cross-sectional dependence for that particular variable.

Furthermore, the panel unit root test is applied to check the order of integration of each variable used in this study. The purpose of a stationery test is to regulate the variables assimilated. Since data integration is necessary for the P-ARDL model's implication, it is tested. Thus, the unit root

test is done to discover the stationary variables. Table 5 provides the results for 1st generation panel data unit root test while Table 6 provides the results for 2nd generation panel unit root test.

Table 5: Panel unit root test results (1st Generation)

Variables	Constant		Trend		Decision
	LLC	IPS	LLC	IPS	
FD	-0.067 (0.472)	0.541 (0.706)	-8.551 (0.000)	-8.035 (0.000)	I(1)
FDI	-1.516 (0.064)	-2.556 (0.005)			I(0)
GCF	-0.523 (0.300)	-0.353 (0.362)	-3.511 (0.000)	-4.063 (0.000)	I(1)
GDP	-3.742 (0.000)	-3.063 (0.001)			I(0)
INF	0.250 (0.599)	-1.621 (0.052)	-2.396 (0.008)	-4.837 (0.000)	I(1)
FA	-4.367 (0.000)	-2.947 (0.001)			I(0)
GEXP	-0.585 (0.279)	-1.212 (0.112)	-4.547 (0.000)	-4.092 (0.000)	I(1)
TR	-1.517 (0.064)	-1.587 (0.056)	-5.014 (0.000)	-4.338 (0.000)	I(1)

Table 6: Panel unit root test results (2nd Generation)

Variables	Constant		Trend		Decision
	CADF	CIPS	CADF	CIPS	
FD	-1.725 (0.535)	-1.961 >0.10	-3.775 (0.000)	-4.053 (0.000)	I(1)
FDI	-2.708 (0.008)	-3.417 (0.000)			I(0)
GCF	-1.575 (0.680)	-1.645 >0.10	-2.219 (0.594)	-2.980 >0.05	I(1)---CIPS
GDP	-2.430 (0.045)	-2.368 =0.05			I(0)
INF	-1.858 (0.402)	-4.202 (0.000)	-1.848 (0.888)		I(0)—CIPS
FA	-4.221 (0.000)	-3.304 (0.000)			I(0)
GEXP	-2.369 (0.062)	-2.461 <0.05			I(0)
TR	-2.056 (0.227)	-2.04 >0.1	-2.466 (0.340)	-2.724 <0.05	I(1)---CIPS

On the basis of results from cross-sectional dependence test, we have decided to apply both 1st and 2nd generation panel unit root tests to check the stationarity of the variables. To serve this purpose, LLC, and IPS for 1st generation unit root test while CADF and CIPS for 2nd generation unit root tests are applied. The level of stationary for all of the provided variable values for the model is shown in the above table. There are many degrees of stationary that approach at level I

(0) or at first difference I (1), for example, several variables are retracted at level and several are retracted at first difference. While FD (financial development), GCF (gross capital formation), INF (inflation), GEXP (general government final consumption expenditure), and TR (trade) are stationer at the first difference, GDP (gross domestic product), FDI (foreign direct investment), and FA (net ODA received) are stationer at a level. Therefore, different degrees of stationarity for certain variables are specified in the panel unit root test table. Panel autoregressive distributed lag (ARDL) model is utilized to confer such different stationarity extents. Kao test to check the cointegration relationship among variables is applied.

Table 7: Panel Cointegration KAO Test

Statistic	t-Stat	p-value
Panel ADF-test	-4.7992	0.000

Table 7 presents results for the Kao test with H_0: No long-run association among variables exists. The outcome supports the alternative hypothesis that co-integration between variables exists and rejects the null hypothesis that there is none.

The results of the connection between foreign aid and economic growth, as well as the financial development of six specific South Asian nations, are found using the P-ARDL technique. This method demonstrates both the short and long-period interactions between the explanatory and dependent variables. The short-run relationships between variables are identified using the error correction model (ECM) approach, which also supports the long-run relationships among the regressor and regressond. The following tables show the long-term and short-term results:

Table 8: Results of Long-run analysis through P-ARDL

Variable	Foreign Aid (FA)		Financial Development (FD)		FA*FD	
	Co-efficient	Prob.	Co-efficient	Prob.	Co-efficient	Prob.
FA	-0.2549 (-0.7295)	0.467			-1.7457 (-2.4261)	0.018
FDI	0.0973 (0.1879)	0.851	2.264 (4.0843)	0.000***	5.0478 (5.0177)	0.000***
GCF	0.13 (2.614)	0.01***	-0.5764 (-4.6848)	0.000***	-0.2403 (-2.6204)	0.011***
GEXP	0.7325 (4.7598)	0.000***	-0.2289 (-1.1171)	0.27	0.0099 (0.0634)	0.949
INF	0.0412 (0.7363)	0.463	0.9058 (9.931)	0.000***	0.0939 (1.2902)	0.202
TR	0.0496 (1.6502)	0.102*	0.0171 (0.4345)	0.666	-0.1605 (-2.7217)	0.008***
FD			103.365 (4.9395)	0.000***	44.642 (4.0456)	0.000***
FA*FD					11.766 (3.5323)	0.000***

Note: * and *** show the significance level at 10% and 1% respectively.

Table 8 presents the long-run relation between economic growth and all explanatory variables for all three models which are estimated by panel autoregressive distributed lag approach. The foreign

aid (FA) coefficient value is -0.2549 and the probability of FA is 0.467 which shows a negative and insignificant association between FA and GDP. The findings of the study support the argument of those groups of researchers who discussed the foreign aid ineffectiveness phenomenon (Asongu, 2013; Levin & Dollar, 2005; Mouneer & Khan, 2019). In certain developing nations, foreign aid significantly hampered economic growth. This supported the argument made by Knack (2001), that foreign aid degrades institutions and increases corruption and rent-seeking, all of which have a detrimental impact on economic growth. Furthermore, the coefficient of the financial development index has a positive and significant impact on economic growth. Numerous studies support these results (Abdul Wadud, 2009; Jalil & Feridun, 2011; Sharma & Kautish, 2020). Studies have also found an interactive effect of foreign aid and financial development and results explore the fact that economies that are more financially stable can utilize foreign aid more appropriately. Foreign aid can be more effective with a good financial system in South Asian developing economies. This study is supported by Nkusu and Sayek (2004) and Tsaurai (2018).

Estimated results for foreign direct investment (FDI) explore the fact that in the presence of financial development, FDI has a beneficial and significant impact on economic growth while with foreign aid, FDI effect is insignificant. Research has shown that financial development enriches the progressive effects of FDI on economic growth. Alfaro et al. (2004) found that countries with powerful financial markets benefited more from FDI in terms of GDP growth. On the other hand, the relationship between FDI and foreign aid is more complex. A study by Asiedu (2006) highlighted that in countries heavily reliant on foreign aid, FDI does not exhibit a significant positive impact on economic growth. This is because aid can lead to distortions in local markets and reduce the incentives for foreign investors to engage meaningfully with the local economy.

The result for gross capital formation shows a significant and positive connection with the gross domestic product (GDP) growth rate of an economy. Aghion et al. (2014) and Barro (1991) supported these findings. Similarly, coefficient values for general government final consumption expenditure (GEXP) and trade (TR) show extremely substantial and positive relations in economic growth for all three models. The study reveals the insignificant impact of inflation on economic growth.

Table 9: Results of short-run analysis through P-ARDL

Variable	Foreign Aid (FA)		Financial Development (FD)		FA*FD	
	Co-efficient	Prob.	Co-efficient	Prob.	Co-efficient	Prob.
COINTEQ01	-0.4166 (-1.9085)	0.063*	-0.2059 (-0.9599)	0.342	-0.5619 (-3.3249)	0.001***
D(GCF)	0.5451 (1.9804)	0.054**	0.7162 (1.277)	0.208	0.4738 (2.5042)	0.015***
D(FDI)	0.7334 (0.8833)	0.382	0.1535 (0.2815)	0.779	-2.3058 (-2.6234)	0.011***
D(GEXP)	-0.2184 (-0.1082)	0.914	0.4525 (0.2394)	0.811	-0.2275 (-0.1649)	0.869
D(INF)	-0.3731 (-1.4998)	0.141	-0.3251 (-2.6015)	0.012***	-0.1264 (-1.1214)	0.266
D(TR)	0.2841 (2.5454)	0.014***	0.2962 (1.6151)	0.113	0.2551 (2.4396)	0.017***
D(FA)	1.6623 (0.8137)	0.42			-69.621 (-1.0808)	0.284

D(FD)			59.837 (2.163)	0.036***	41.741 (0.5171)	0.607
D(FD*FA)					165.775 (1.0678)	0.29
C	-3.7735 (-1.8331)	0.073*	0.6118 (0.2938)	0.77	13.47 (3.1332)	0.002***

Note: *, **, and *** show the significance level at 10%, 5%, and 1% respectively.

Table 9 illustrates the outcomes of short-run analysis by applying the technique of Panel auto-regressive distributed lag (ARDL). Consequences of short-run analysis express affiliation between foreign relief and the economic evolution of South Asian states. Short-run results also have the same conclusion as in the long run. Foreign aid is insignificant to impact economic growth but with the financially stable environment, foreign aid becomes more beneficial and significantly impacts economic growth in South Asian economies.

A well-developed financial system enhances the effectiveness of foreign aid, leading to improved economic outcomes. Financial development facilitates efficient resource allocation, reducing transaction costs and enhancing investment opportunities (Khan et al., 2006). Countries with robust financial systems can better utilize foreign aid, which supplements domestic savings and fosters growth (Fayissa & El-Kaissy, 1999). Foreign aid generally has a positive impact on growth; its effectiveness is contingent upon the financial infrastructure of the recipient country, suggesting that enhancing financial development is crucial for maximizing the benefits of foreign aid (Tsaurai, 2018).

Conclusions and Recommendations

The primary objective of this paper is to evaluate empirically how financial development influences the association among aid and growth in six South Asian economies: Bangladesh, Bhutan, India, Nepal, Sri Lanka, and Pakistan. The association among assistance and growth and, finance and growth is clarified by empirical literature. However, there is a dearth of research on the interactions between aid and financing and economic growth (Tsaurai, 2018). To achieve this aim, the P-ARDL estimate technique is employed for data for the period of 2001 to 2022. Gross domestic product (GDP), net ODA received (FA), financial development index (FD), gross capital formation (GCF), foreign direct investment (FDI), inflation (INF), and trade (TR) are the variables used in this study.

South Asian nations are major recipients of aid. An empirical analysis concluded that aid is insufficient on its own to meet developmental objectives. However, a strong financial system has a favorable and substantial effect on economic expansion. Thus, the primary argument for improving the efficacy of foreign aid is financial development. Based on these results, certain strategies are suggested to improve the efficacy of foreign aid. For South Asian economies to benefit from foreign help, the financial sector must be improved. In addition, it is advised to consistently access foreign aid effectiveness to accomplish developmental objectives.

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