Monetary and Structural Determinants of Inflation in Nepal

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Abstract

Inflation is a macroeconomic phenomena that affects the overall performance of the economy. In Nepal, inflation challenges the macroeconomic stability, alarming the need for understanding its determinants and formulating appropriate policies to manage it tactfully. With a high concentration on studies about the demand dynamics of Inflation in Nepal, the study from the supply-side perspective is a pressing need. This study explores the short-run and long-run determinants of inflation in Nepal using both demand-side and supply-side factors. Using the Auto Regressive Distributed Lag Model (ARDL) and Error Correction Model (ECM), the long-run and short-run relationship between Nepalese Inflation and variables: Indian Inflation, Growth in Money Supply, Growth in Agricultural Production, Growth in Petroleum Prices, and GDP Growth Rate is explored. The model is finalized with confidence from the residual and stability tests. Results show the long-run positive relationship of Nepalese inflation with growth in money supply and Indian inflation. Aligning with the inferences, the study finds that the increase in agricultural production has a short-term and significant negative impact on Nepalese inflation.

Keywords: *ARDL, co-integration, ECM, RESET, CUSUM, CUSUM square, inflation, fiscal policy, inflation*

Introduction

Inflation is the persistent rise in the general prices of goods and services over a period of time causing a reduction in value of money. It is measured through the use of price indices. The Consumer Price Index (CPI) is the widely used price index to measure inflation all around the world. In Nepal, inflation is measured through three major indices Consumer Price Index (CPI), Wholesale Price Index (WPI), and Salary and Wage Rate Index (SWRI), which helps to study the price changes of consumer goods, wholesale prices, and wage respectively.

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Understanding the price movements is a must for any economy as this has direct effects on altering the purchasing power, allocation of resources, and economic stability. Price level guides both the demand and supply and is a key factor that influences the decisions of both producers and consumers. It helps to distribute scarce resources efficiently and is a factor that drives the economy toward an equilibrium where demand and supply meet. Smith (1776) in his book Wealth of the Nations, introduced the concept of the invisible hand, which defines how an individual behavior for their personal gain is beneficial to the society, at large. Price is considered as an invisible hand that helps to clear out the market naturally, as per the classical economists.

It is believed that a moderate level of inflation is necessary for an economy to be healthy. This level of inflation gives a positive outlook to the producers, encourage the investment decision, and ultimately boost the business confidence. However, high inflation with high variability creates uncertainties in income and expenditure decisions: hindering economic growth and affecting capital formation through low savings. High inflation erodes the real wealth of the people, adversely affects the poor, is unfavorable for the people with a fixed level of income, and further widens the income inequality. Nepal Rastra Bank (2007)

According to the International Monetary Fund (IMF), and the Bank for International Settlements (BIS), most countries around the world mandate their central bank to manage inflation by maintaining price stability.

"The overriding objective of most central banks is to maintain price stability." International Monetary Fund (2021). A large number of countries follow *inflation targeting* as their monetary framework: "*Most central banks consider an inflation rate of around 2% per year to be consistent with price stability and sustainable economic growth."* Mankiw (2016)

As per the International Monetary Fund (2020) *"For developing economies, an inflation rate between 4% to 6% is generally considered acceptable, provided it remains predictable and manageable."*

Like other countries, managing inflation and keeping it within a predictable range is a mere requirement for Nepal to build business confidence and ensure smooth economic growth in the economy. Nepal Rastra Bank (NRB), the central bank of Nepal, is the sole responsible agency to manage the price level and create price stability in the country. One of the prime objectives of NRB is:

"To formulate necessary monetary and foreign exchange policies to maintain the stability of price and balance of payments for economic stability and sustainable development of the economy, and to implement or cause to implement such policies." Nepal Rastra Bank Act (2002)

Therefore, understanding the main drivers of inflation along with the recognition of determinants of inflation is important to understand the price dynamics and develop policies to stabilize it.

The objective of this research is to understand how Indian Inflation, growth in Money Supply, growth in Agricultural Production, growth in Government Expenditure, growth in Real GDP, and growth in International Petroleum Prices affect inflation in Nepal (in both short and long term).

Literature Review

There are diverse schools of economic thought that have explained the causes of inflation and its dynamics. Summarizing the theory and its relevance in Nepal:

The Quantity Theory of Money, developed by classical economists, defines inflation as a monetary phenomenon, which occurs through excessive growth in the money supply relative to the output. The Fishers Equation, Fisher (1911) defines the theory as:

MV=PT

where, M= Money Supply, V=Velocity of Money, P=Price Level and T=Transaction

This theory suggests that inflation occurs when the money growth by the central bank is higher than the GDP growth.

Studies by Byanjankar (2020), Chhetri (2023) showed the inflation of Nepal linked to the money supply in consistent to the classical assumption.

Keynesian economists, Keynes (1936) defined inflation from a demand perspective, where inflation occurs when demand exceeds the production capacity. He emphasized demand management through fiscal policy tools like government spending or taxation.

Kunwar & Jnawali (2022) resonates the Keynesian hypothesis of demand-pull inflation concluding the budget deficit having significant impact on inflation of Nepal.

The Monetarists, Friedman (1963) argued that *"inflation is always and everywhere a monetary phenomenon",* and advocated to the rule based monetary policy required to manage inflation.

Structural Economists, Furtado (1961), emphasized the causes of inflation in developing countries are structural factors that create supply-side bottlenecks from agricultural shortages, lack of infrastructure, weak institutions, and import dependency causing pressure on foreign exchange reserves. This creates cost-push pressure resulting the unpredictability in the inflation.

Rational Expectation, Lucas (1972), says that forward-looking expectation plays an important role to shape the inflation in an economy. It suggests that the people and firm adjust their behavior based on the anticipation of loosening or tightening of the monetary policy, hence central banks transparency plays a critical role on managing inflation and its expectations.

The summary of the theories, their key drivers, and the variable that can be studied in the context of Nepal is given in the table below:

Summary of the Theories of Inflation and its Relevancy for Nepal

Theory	**Key Driver**	**Nepal's Context**
Classical	Money supply	M2 Growth
Keynesian	Aggregate demand	Remittance-driven consumption, fiscal deficits, Government Expenditure
Structuralist	Supply bottlenecks	Agricultural dependency, Indian Inflation
Rational Expectation	Inflation expectation	Central Bank Transparency, Communication
New Keynesian	Cost-push shocks	Global oil prices, exchange rate volatility

Some of the empirical research conducted related to the determinants of Inflation in Nepal are:

Chaudhary and Xiumin (2018) analyzed the effect of real GDP, Indian prices, and the broad money in Nepal's inflation, using the annual data from 1975 to 2016, with the use of Ordinary Least Square regression model. The findings indicated that every element taken into account is significant over the long term, suggesting that these factors are what determine inflation in Nepal. The findings align with the principles of monetary theory and concluded inflation is caused over time by the money supply and Indian prices.

By using the ARDL approach to cointegration, Byanjankar (2020) investigated the link between the price level and the macroeconomic variables-the Indian CPI, government deficit, broad money supply, nominal effective exchange rate, crude oil price, and real GDP-from 1975 to 2018. To ascertain whether there was a long-term link between variables, the bounds test (F-version) was used. According to empirical findings, real income (0.347), the exchange rate (0.224), and Indian inflation (0.453) were the main long-term drivers of inflation in Nepal. Furthermore, the short-term impacts of the Indian government deficit (0.039), exchange rate (0.141), and inflation (0.286) were found to be noteworthy. Lastly, it was discovered that the error correction term was statistically significant and negative, indicating that the short-run disequilibrium would be corrected within two years.

Dahal, Adhikari, Chaudhary, and Bista (2019) using the time series data from 1975 to 2018, studied the relationship between the remittance and Nepalese inflation using the Error Correction Model. Along with the remittances, which supposedly increase demand and ultimate put pressure on price, other variables like narrow money supply, GDP, and Indian CPI were included in the study. Remittance was found to have the short term and long term impact on the inflation of Nepal. The study highlights on the use of remittance for import led consumption, majority of the time, making it easy for pass-through of Indian price to Nepal through imports. In this case, rising imports cause the domestic market to produce an aggregate supply, reducing domestic inflation pressures. The study concludes that the narrow money supply, gross domestic product, and Indian inflation has positive significant effect on Nepalese inflation.

Joshi (2021) investigated the short-term and long-term relationships between inflation and money supply using annual data from 1964-2018. ARDL Bounds test is employed for the cointegration test where inflation is the dependent variable and the money supply and Indian inflation are the independent variables. The long-term relationship between the variables is revealed by the long-term cointegration of the variables, and the error correction term is determined to be significant ($p=0.02$) and negative (-0.98). It satisfies the monetarist view of the effect of money supply on inflation.

Amongst the national empirical studies related to the determinants of inflation, Studies by Joshi (2021), Khanal and Paudel (2024), Byanjankar (2020), and Chettri (2023) have concluded on the acceptance of Monetarist and Keynesian inflation hypotheses for Nepal. Likewise, there are numerous studies Joshi (2021), Ginting (2007), and Humagai (2023) concluding the positive effect of Indian Inflation in Nepal. The results regarding the effect of the remittance on inflation of Nepal, however, were mixed as per the studies of Maskey, Steinkamp, and Westermann (2015), and Dahal, Adhikari, Chaudhary, and Bista (2019).

Majority of the studies on inflation in Nepal have focused on analyzing the monetary approach and demand-driven approach to inflation. There exists a significant gap in analyzing the supply-side factors, which can be a major reason for domestic inflation. Though a few studies have been conducted on supply-side factors like exchange rate and price of petroleum, very few studies have analysed the impact of agricultural production on inflation. Therefore, to address this gap, the agricultural production of the five major food crops of Nepal: Maize, Wheat, Paddy, Barley, and Millets is taken as a supply-side variable in the study.

Methodology

The study uses the Auto Regressive Distributed Lag Model (ARDL) and Error Correction Model (ECM) to analyze the short-run and long-run effects of the independent variables on the Nepalese Inflation. The dependent and independent variables in the study are:

Dependent Variable:

Nepalese Inflation (CPI)

Inflation, measured through the annual change in the Consumer Price Index of Nepal, is used as the dependent variable of the study. Nepal Rastra Bank publishes CPI on a monthly basis. Data of CPI is taken, and the yearly inflation rate is compiled. This variable is transformed in a percentage change format.

Independent Variables:

i. Indian Inflation (ICPI)

   It is the annual rate of Change in Indian CPI. Published by Ministry of Statistics, in monthly basis. The data of inflation is taken from the database of the World Bank. Like, CPI, this variable is also transformed into a percentage change format.

ii. Growth in Broad Money Supply (GM2)

   The annual change in the broad money supply taken from the NRB data depository is used to compute the Growth in Broad Money Supply. This data is also in the percentage change format.

iii. Growth in Agricultural Production of Major Food Crops (GAP)

   Yearly production of five major food crops: wheat, maize, paddy, barley, and millets are computed and from which the year-on-year change in those yields is computed. This growth rate is taken as one of the independent variables for the study. It is in percentage change format. The data is compiled from the macroeconomic database of NRB.

iv. Growth in Government Expenditure (GGE)

   The sum of Capital and Recurrent Expenditure is taken as a proxy of government expenditure to measure the effect of such expenditure in inflation. The annual growth rate is computed to understand the growth dynamics of expenditure on domestic inflation. This variable is also computed in percentage change format. The data is compiled from the macroeconomic database of NRB.

v. Growth in Real GDP (GRGDP)

   Nominal GDP is converted to the real GDP with the use of its corresponding annual inflation rate. Further, the growth rate of the nominal GDP is computed for the

analysis. This data is also in percentage change format. The data source is the macroeconomic database of NRB.

vi. Growth in Oil Prices (GOP)

The retail price of Gasoline ($/barrel) in the USA is taken as a proxy of the international petroleum price. The growth rate of such prices is taken as the variable under study. The data source for the series is the US Department of Energy. This data is also in percentage change format.

Secondary annual time-series data from 1975 to 2023 are used for the study. The summary about the variables, symbols used, and data sources is tabulated below:

Data Sources

Variables	**Form**	**Symbol**	**Data Source**
Nepalese Inflation	%change	CPI	NRB
Indian Inflation Growth Rate of Production of Major Food Crops	%change %change	ICPI GAP	WB NRB
Growth in Government Expenditure	%change	GGE	NRB
Growth in Broad Money Growth in Retail Price of Gasoline ($/barrel)	%change %change	GM2 GOP	NRB US Department of Energy

Model Specification

Introduced by Pesaran, Shin, and Smith (2001), ARDL model is a robust econometric model that can be used to analyze both the short-run and long-run effects of variables. Byanjankar (2020), acknowledged the features of this model which would be advantageous to the study are:

i. It has mixed integration flexibility

ii. Bound testing for cointegration helps to find the cointegration among variables

iii. The Error Correction Model helps to quantify the speed of adjustment for short-term disequilibrium towards the long run.

iv. It is statistically more significant to use on small samples

v. Allows variable to have different lags

vi. Provides unbiased estimates for the long run even when some regressors are endogenous.

The general ARDL Model for the study would be:

$$\mathrm{CPI}_t = \alpha + \sum_{i=1}^{p} \phi_i \mathrm{CPI}_{t-i} + \sum_{j=0}^{q_1} \beta_j \mathrm{ICPI}_{t-j} + \sum_{k=0}^{q_2} \gamma_k \mathrm{GM2}_{t-k} + \sum_{l=0}^{q_3} \delta_l \mathrm{GAP}_{t-l} + \sum_{m=0}^{q_4} \theta_m \mathrm{GRGDP}_{t-m} + \sum_{n=0}^{q_5} \lambda_n \mathrm{GOP}_{t-n} + \sum_{r=0}^{q_6} \pi_r \mathrm{GGE}_{t-r} + \varepsilon_t$$

where,

p, q_1, q_2, q_3, q_4, q_5, q_6 are lags of CPI, ICPI, GM2, GAP, GRGDP, GOP, and GGE respectively: determined in the lag selection in the model later using AIC.

ϕ, β, γ, δ, θ, λ, are the Coefficients.

ε_t: Error term.

The ECM model for the study would be:

$$\Delta\mathrm{CPI}_t = \alpha + \sum_{i=1}^{p} \phi_i \Delta\mathrm{CPI}_{t-i} + \sum_{j=0}^{q_1} \beta_j \Delta\mathrm{ICPI}_{t-j} + \sum_{k=0}^{q_2} \gamma_k \Delta\mathrm{GM2}_{t-k} + \sum_{l=0}^{q_3} \delta_l \Delta\mathrm{GAP}_{t-l} + \sum_{m=0}^{q_4} \theta_m \Delta\mathrm{GRGDP}_{t-m} + \sum_{n=0}^{q_5} \lambda_n \Delta\mathrm{GOP}_{t-n} + \sum_{r=0}^{q_6} \pi_r \Delta\mathrm{GGE}_{t-r} + \kappa \mathrm{ECT}_{t-1} + \varepsilon_t$$

where,

is the first difference of the variables

p, q_1, q_2, q_3, q_4, q_5, q_6. lags of difference of CPI, ICPI, GM2, GAP, GRGDP, GOP, and GGE respectively: determined in the lag selection in the model later using AIC.

ϕ, β, γ, δ, θ, λ, , are the Coefficients.

ε_t: Error term.

ECT= Error Correction Term

The F- bound test is used to analyze the long-term correlation among the variables.

Results

ARDL model requires each variable to be stationary at level or at their first difference: I(0) or I(1). Unit Root tests in all the variables were performed before running the model.

It suggested all the dependent and independent variables are stationary at level, i.e. I(0). All the variables under study are taken in a percentage change term, or as annual growth rate, therefore it was found to be stationary at level. This makes us eligible to use the ARDL model to meet our objective. The Auto Regressive Distributed Lag Model for our study is ARDL (1,2,0,1,0,0,0). Eviews-12 was used to define the model with automatic lag selection using the Akaike Information Criterion (AIC). Out of 62,500 numbers of models formed, this model had the lowest AIC value. F-bounds Test is conducted to confirm if there exists a long-run co-integration among the variables. Since, the F-statistic i.e. 11.81509 does not lies inside the range of critical values I(0) and I(1), at all three level of significance, 1%, 5%, and 10%; the null hypothesis is rejected, meaning there exists a long run relationship amongst the variables.

The long run relationship of each independent variable with inflation of Nepal, obtained from the ARDL model is summarized in the table below:

ARDL Summary

Variables	Coefficient	p-value	Significance
GAP	-0.0238	0.836	No
GGE	0.0485	0.301	No
GM2	0.2918	0.021	Yes
GOP	0.0056	0.827	No
GRGPD	-0.0956	0.241	No
ICPI	0.6390	0.0001	Yes
C (Constant)	-0.3414	0.820	No

It was found that growth in broad money supply and Indian inflation have a positive and significant relationship with the inflation of Nepal. However, other variables were found to be insignificant in long term. The results is consistent with the monetarist theory. The model suggests 1% increase in the growth of broad money supply (M2) will increase inflation by 0.29%, in the long run.

As the findings of other studies, the strong positive significance of Indian inflation to Nepal shows the strong pass-through of price from Indian imports. The study found 1% increase in ICPI would raise Nepalese inflation by 0.64%.

Error Correction form of the model is:

Error Correction

ARDL Error Correction Regression
Dependent Variable: D(CPI)
Selected Model: ARDL(1, 2, 0, 1, 0, 0, 0)
Case 2: Restricted Constant and No Trend
Date: 04/11/25 Time: 18:59
Sample: 1975 2023
Included observations: 47

ECM Regression
Case 2: Restricted Constant and No Trend

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(GAP)	-0.099179	0.032454	-3.055995	0.0042
D(GAP(-1))	-0.110885	0.032403	-3.422034	0.0016
D(GM2)	0.152177	0.066146	2.300635	0.0273
CointEq(-1)*	-1.099659	0.103493	-10.62543	0.0000

R-squared	0.759221	Mean dependent var	0.058225
Adjusted R-squared	0.742422	S.D. dependent var	4.468206
S.E. of regression	2.267710	Akaike info criterion	4.556683
Sum squared resid	221.1278	Schwarz criterion	4.714142
Log likelihood	-103.0821	Hannan-Quinn criter.	4.615936
Durbin-Watson stat	2.146402		

* p-value incompatible with t-Bounds distribution.

The Error Correction shows the short-run dynamics of the model, it shows growth in agricultural production of major five food crops (both at current and lagged) have a significant negative relationship with Nepalese inflation. With 1% increase in agricultural production growth reduces inflation by 0.099% in the first period followed by 0.111% in the next period. This suggests, higher food production/supply drives the price of food down, and ultimately tames the inflation in Nepal. Similarly, it shows the growth in broad money supply has short term effect, owing a significant positive relationship with Nepalese inflation. The coefficient of 0.152 suggests, 1% increase in broad money supply growth would raise inflation by 0.152%. This supports the monetarist view, exhibiting Nepalese inflation caused by increase in money supply.

Furthermore, the error term was diagnosed to ensure that the error from the model is normally distributed, has no autocorrelation, and is homoskedastic. Jarque-Bera test is used to test the normality, Breusch-Godfrey LM test is used for autocorrelation, and Breusch-Pagan test is used to analyse the presence of heteroskedasticity in the model. The results of the diagnostic tests reveal that the error term satisfies the BLUE properties of the regression analysis.

Ramsay RESET test is performed to test if the model is functional and is free from the omitted variable bias. The p-value of all three test statistics; t, f, and likelihood ratio fails to reject the null hypothesis, making the model empirically appropriate.

Ramsey RESET Test

Ramsey RESET Test
Equation: EQ01
Omitted Variables: Squares of fitted values
Specification: CPI CPI(-1) GAP GAP(-1) GAP(-2) GGE GM2 GM2(-1) GOP GRGPD ICPI C

	Value	df	Probability
t-statistic	1.541097	35	0.1323
F-statistic	2.374980	(1, 35)	0.1323
Likelihood ratio	3.085711	1	0.0790

F-test summary:

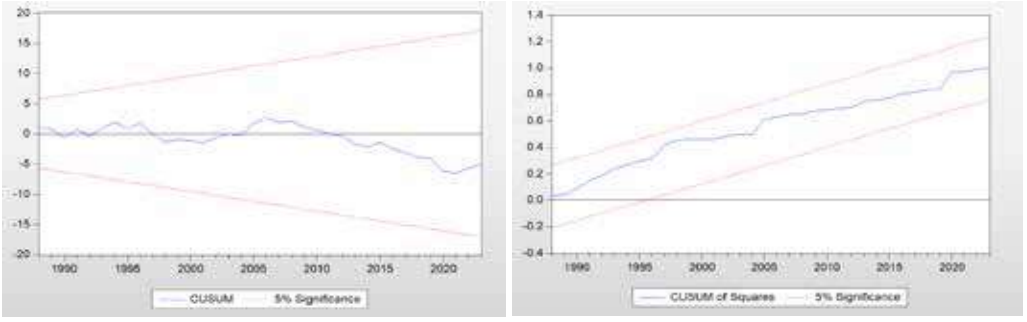
	Sum of Sq.	df	Mean Squares
Test SSR	14.05149	1	14.05149
Restricted SSR	221.1278	36	6.142439
Unrestricted SSR	207.0763	35	5.916466

LR test summary:

	Value
Restricted LogL	-103.0821
Unrestricted LogL	-101.5392

For the model stability, CUSUM and CUSUM of squares tests were performed. Both the stability tests are within the 5% critical bounds, suggesting the model is stable in the long run.

CUSUM and CUSUM Square Test



Conclusion and Policy Recommendation

Inflation, one of the major macroeconomic variables, has a great influence in the economy from the individual household level to the broad national and international level. Analyzing, the inflation of Nepal, it is seen that there is a great volatility in its rate of change, suggesting the need for policies to stabilize these price fluctuations, which would bring certainty to the business environment and growth prospect of the country.

With wide effect on economic growth to poverty and inequality, stabilizing the price is of utmost importance.

This study tries to understand the dynamics of inflation in Nepal over the last five decades and tries to look at the determinants of the inflation from both the demand side and supply side factors. The key findings of the research are summarized as:

Long-term Determinants of Inflation

i. Growth in broad money supply increases the inflation in Nepal, in long run. With 1 percent increase in GM2, the Nepalese inflation rise by 0.29 percent. This support the monetarist approach of Inflation.

ii. Growth of Indian inflation is also positively significant to the inflation of Nepal, showing the strong price pass-over effect through import from India, The relationship is stronger than that of money supply with coefficient of 0.64 suggesting 1 percentage increase in Indian inflation increases inflation in Nepal by 0.64 percentage. This defines one of the structural form of inflation of developing countries with pegged exchange rate system having high trade dependency. This makes the monetary policy tools of Nepal less powerful to contain the inflation, alone.

Short-term Determinants of Inflation

i. Growth in agricultural production of five major staple food crops have negative and significant relationship for up to one lag. The study suggest that 1% increase in growth rate of agricultural production decreases Nepalese inflation by 0.099% in first period and 0.111% in the following year. This shows the supply-side vulnerability of food supplies on Inflation of Nepal.

ii. Like the long-term effect, the growth in broad money supply has significant positive impact on Nepalese inflation for the short-term. The short-term effect is less strong than the long run, suggesting 1 percentage increase in growth of money supply increases the domestic inflation by 0.152 percentage. This holds monetarist theory in both short-run and long-run.

Summary of Empirical Findings

The empirical findings of the study have added value to the existing literatures, citing one more supply variable i.e. Agricultural Production's effect on the domestic inflation. Found to be negatively correlated matches with the intuition, of growth in agricultural production reducing the Nepalese inflation through reduction of food inflation. The study in consistent to the monetarist view on inflation, confirmed the positive relationship between the growth in money supply and domestic inflation.

The summary of the empirical findings and its comparison to the existing literatures are tabulated as:

Comparison of the Empirical Findings with Existing Literature

S.N.	Findings	Comparison to the pre-existing Empirical Literatures
1.	Broad Money has positive long term effect on Nepalese inflation	Consistent result with Chhetri (2023), Humagai (2023) Khanal and Paudel (2024)
2.	Indian inflation has positive long term effect on Nepalese inflation	Consistent result with Byanjankar (2020), Paudyal (2012), Neupane (2022), Chhetri (2023)
3.	Agricultural Production of major food crops have negative short term relationship with Nepalese inflation	New addition to the existing empirical works on the field of inflation determinants.
4.	Broad Money has positive short term relationship with Nepalese inflation	Consistent result with Neupane (2022) Paudyal (2012)

Policy Recommendations

i. The empirical research found out that agricultural production of five major food crops has a significant negative impact on Nepalese inflation in the short-term suggesting the government to address agricultural development prioritized in its fiscal policy.

ii. Furthermore, the positive short-run and long-run relationship of broad money supply with Nepalese inflation, suggests on the need a strong institutionalization of the Central Bank to control the money supply and contain the inflation in the desired level.

iii. The pass-through of Inflation from India to Nepal, suggests on the studying possibility in the revision on the pegged exchange rate with the Indian Rupee.

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