Analyzing the Key Determinants of Inflation in Nepal: An Empirical Investigation (2001-2021)

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Abstract

This study empirically examines the key determinants of inflation in Nepal from 2001 to 2021, focusing on both external and domestic macroeconomic factors. Using annual time-series data, the analysis employs Ordinary Least Squares (OLS) regression and Johansen cointegration tests to assess the impact of Indian inflation (INCPI), broad money supply (M2), remittance inflows (REM), government expenditure (GE), and imports (IMP) on Nepal's Consumer Price Index (CPI). The results reveal that Indian CPI, remittances, and money supply have statistically significant positive effects on inflation, with elasticities of 0.40 percent, 0.097 percent, and 0.142 percent, respectively. Government spending and imports, however, exhibit insignificant short-run effects, though cointegration tests confirm their long-run influence. The study underscores Nepal's vulnerability to imported inflation due to its fixed exchange rate regime and heavy trade dependence on India, while also highlighting demand-side pressures from remittance-fueled consumption and monetary expansion. Policy recommendations include tighter liquidity management, diversification of import sources, and channeling remittances into productive investments to mitigate inflationary pressures.

Keywords*: Inflation, remittances, money supply, Indian CPI, exchange rate peg, cointegration*

JEL Codes*: E31, E51, F24, F41, O53*

Introduction

Inflation, defined as a sustained increase in the general price level of goods and services over time, represents one of the most critical macroeconomic challenges facing both developed and developing economies. As a monetary phenomenon, inflation erodes purchasing power, distorts economic decision-making, and creates uncertainty in financial markets, ultimately affecting economic growth, employment, and income distribution. While moderate inflation is often viewed as a natural byproduct of economic

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expansion, excessive inflation can destabilize economies, disproportionately burden low-income households, and discourage long-term investment. The adverse effects of high inflation are particularly severe in developing countries like Nepal, where a large segment of the population relies on fixed incomes and subsistence agriculture. Given its far-reaching consequences, inflation control remains a primary objective of monetary and fiscal policies worldwide. Central banks, Nepal Rastra Bank (NRB) in Nepal, employ various tools-such as interest rate adjustments, open market operations, and reserve requirements-to maintain price stability while fostering sustainable economic growth.

The dynamics of inflation vary across economies due to differences in structural characteristics, policy frameworks, and external dependencies. In Nepal's case, inflation is heavily influenced by external factors, particularly due to the country's open economy, pegged exchange rate with the Indian rupee, and high dependence on imports for essential goods such as fuel, food, and raw materials. Since Nepal maintains a fixed exchange rate regime with India, changes in Indian inflation are directly transmitted to the domestic economy, making monetary policy adjustments less effective in the long run. Additionally, Nepal's reliance on remittances-which contribute nearly 25 percent of GDP-further complicates inflation management, as increased remittance inflows boost domestic demand without a corresponding rise in productive capacity. Other contributing factors include expansionary fiscal policies, supply-side constraints, and global commodity price shocks, particularly fluctuations in petroleum prices. These multifaceted drivers make inflation a complex and persistent challenge for policymakers in Nepal.

Historically, Nepal has experienced fluctuating inflation rates, with periods of relative stability interspersed with sharp spikes due to external shocks. For instance, global oil price surges in 2008 and 2011-2013 led to significant inflationary pressures, while domestic supply disruptions-such as trade blockades and agricultural shortages-have also triggered price volatility. The Consumer Price Index (CPI), Nepal's primary inflation measure, has shown an upward trend over the past two decades, reflecting the cumulative impact of these factors. Between 2001 and 2021, Nepal's CPI more than tripled, rising from 37.21 to 137.62, underscoring the persistent nature of inflationary pressures. This trend aligns with broader patterns observed in South Asia, where inflation has remained elevated due to structural bottlenecks, currency depreciation, and rising global commodity prices. However, Nepal's inflation trajectory is distinct in its heavy dependence on Indian price movements, given the two countries' integrated markets and shared currency peg.

Theoretical frameworks on inflation highlight different causal mechanisms, including demand-pull factors (excessive aggregate demand), cost-push factors (rising production costs), and structural factors (supply-side inefficiencies). In Nepal, all three mechanisms play a role. Demand-pull inflation is driven by remittance-fueled consumption and government spending, while cost-push inflation stems from rising import prices and

wage pressures. Structural inflation, meanwhile, arises from agricultural supply constraints, inefficient distribution networks, and energy shortages. The interplay of these factors complicates inflation management, as traditional monetary policy tools may have limited effectiveness in addressing supply-side constraints. Moreover, Nepal's financial system remains underdeveloped, with a large informal economy and limited credit penetration, further restricting the central bank's ability to influence inflation through conventional channels.

Given these complexities, understanding the determinants of inflation in Nepal is crucial for designing effective stabilization policies. While previous studies have examined the role of money supply, Indian inflation, and fiscal deficits, few have comprehensively analyzed the combined impact of remittances, imports, and government expenditure in a single framework. This study seeks to fill that gap by investigating how these variables interact to shape inflation dynamics in Nepal. Using annual data from 2001 to 2021, the study employs econometric techniques to assess the relative importance of each factor, providing evidence-based insights for policymakers.

By analyzing the determinants of inflation over a two-decade period, this study aims to provide a nuanced understanding of its underlying causes, helping policymakers design more effective measures to achieve price stability and sustainable economic growth. The findings will help identify the most significant drivers of inflation, enabling targeted interventions to enhance price stability. Additionally, the study contributes to the broader literature on inflation in small, open economies with fixed exchange rate regimes, offering comparative insights for other developing nations facing similar challenges.

The subsequent sections of this paper present a detailed literature review, methodology, empirical analysis, and policy recommendations based on the findings.

Methods

This study adopts a quantitative approach to analyze the key macroeconomic determinants of inflation in the Nepal's economy. The methodology outlines the structured plan of inquiry to address the research problem and test the hypothesized relationships among variables. This section includes the conceptual framework, research design, data sources and characteristics, sample description, and the econometric strategy employed in the analysis. The selected econometric tools aim to ensure the validity, reliability, and robustness of the findings.

The conceptual framework underlying this study focuses on the interaction between inflation and several macroeconomic variables deemed influential in the Nepalese context. Specifically, the dependent variable is the Consumer Price Index (CPI) of Nepal, which serves as a proxy for inflation. The independent variables include Indian Consumer Price Index (INCPI), Broad Money Supply (M2), Government Expenditure (GE), Remittance Inflows (REM), and Imports (IMP). The CPI measures changes in the general price level experienced by households and is considered a reliable indicator

of inflation. Indian CPI is included due to Nepal's fixed exchange rate regime and significant trade dependence on India. Broad Money Supply captures the domestic liquidity effect, while Government Expenditure reflects fiscal policy stance. Remittance, a major component of national income in Nepal, is expected to influence consumption and inflationary pressures. Imports are incorporated to account for external price shocks, especially those transmitted through trading channels.

The research design of this study is descriptive and analytical in nature. Descriptive statistics are employed to explore patterns and summarize key characteristics of the macroeconomic variables over time, while econometric modeling is used to assess causal relationships. The study uses annual time-series data covering 21 years, from fiscal year 2000/01 to 2020/21. The sample period is chosen based on the availability of consistent and credible data for all selected variables. All data used in this study are secondary and sourced from reliable publications, including the annual reports and macroeconomic bulletins of the Nepal Rastra Bank (NRB), the Ministry of Finance's Economic Surveys, and various economic journals. Given the importance of ensuring data accuracy, the collected information was verified, cleaned, and transformed primarily by applying logarithmic transformations to normalize scale and stabilize variance.

The dependent and independent variables were transformed into natural logarithms to reduce heteroscedasticity and to allow the interpretation of coefficients as elasticities. The dataset was processed using Microsoft Excel for initial organization and EViews software for econometric modeling and diagnostic testing. The regression model specified for this analysis is a multiple linear regression of the form:

$$\mathbf{CPIt = \beta_0 + \beta_1 M2t + \beta_2 GEt + \beta_3 REMt + \beta_4 INCPIt + \beta_5 IMPt + \varepsilon t}$$

where *CPI* denotes the Consumer Price Index of Nepal (dependent variable), and the independent variables include *M2* (Broad Money Supply), *GE* (Government Expenditure), *REM* (Remittance), *INCPI* (Indian CPI), and *IMP* (Imports). β_0 is the intercept, β_1 through β_5 represent the slope coefficients for each independent variable, and εt is the stochastic error term. The time variable *t* spans from 2001 to 2021.

To validate the econometric model, a series of diagnostic and robustness checks were conducted. First, a serial correlation test (Breusch-Godfrey LM test) was used to detect autocorrelation in the residuals. Second, a heteroscedasticity test (such as White's or Breusch-Pagan test) was employed to examine variance consistency across observations. Third, a cointegration test (Johansen's approach) was carried out to assess whether a long-run equilibrium relationship exists among the variables. In addition, model stability was verified through the CUSUM and CUSUMQ tests, which analyze the constancy of regression parameters over time.

Data analysis began with descriptive statistics, followed by correlation analysis to examine the pairwise relationships between variables. The main empirical analysis was carried out using multiple regression techniques to estimate the effects of the selected macroeconomic indicators on inflation. The findings were interpreted within the context of Nepal's economic structure, policy environment, and regional dynamics.

In summary, this study applies a comprehensive and robust methodological framework to evaluate the macroeconomic determinants of inflation in Nepal. By combining theoretical rationale, data integrity, and sound econometric techniques, the research aims to generate policy-relevant insights into the drivers of price level changes in a small, open, and remittance-dependent economy.

Results

Trend of Selected Macroeconomic Variables

To understand the inflationary dynamics in Nepal, a trend analysis of key macroeconomic indicators was conducted over the period 2001–2021. The selected variables include the Consumer Price Index (CPI) as the dependent variable, and Indian CPI, broad money supply (M2), government expenditure, remittance inflow, and imports as independent variables.

The trend of CPI inflation reveals a steady rise from 37.21 points in 2001 to 137.62 points in 2021, attributed to rising petroleum prices, supply-side constraints, and inflationary pressures from India. Similarly, broad money supply (M2) shows exponential growth during the study period, likely due to increased economic activity, expansion of financial services, and higher government spending.

Remittance inflow, another critical factor, exhibited consistent growth until 2018/19, followed by a decline in 2019/20 due to COVID-19 disruptions, and a recovery in 2020/21. This pattern mirrors Nepal's increasing labor migration trends. Indian CPI showed a gradual upward trend across the years, reflecting regional price dynamics affecting Nepal due to open border trade and currency peg.

Government expenditure remained steady until 2006, after which it gradually increased, with a notable spike post-2015 due to earthquake reconstruction activities. A temporary dip was observed in 2019/20, again due to the pandemic. Finally, import values followed a rising trend throughout the period, except for a sharp decline in 2019/20, driven by trade disruptions during COVID-19, before rebounding in 2020/21. These trends underscore Nepal's heavy import dependency and limited domestic production base.

Descriptive Statistics

The summary statistics for the variables are reported to capture their central tendencies and variability. The average CPI stands at 78.33, ranging from 37.21 to 137.62. Indian CPI averaged 113.88 with a minimum of 56.39 and a maximum of 192.38. Government expenditure ranged between NPR 79,835.10 million and NPR 1,180,953 million, with a mean of NPR 437,570.2 million. Broad money supply (M2) varied significantly from NPR 214,454.2 million to NPR 5,154,853 million, averaging NPR 1,502,829 million. Imports recorded an average of NPR 569,048.4 million, while remittance inflow averaged NPR 385,443.3 million over the study period. These statistics reflect substantial growth and volatility in all variables, particularly in monetary aggregates and external sector components.

Table 1:

Summary Statistics

Variable	N	Mean	Std. Dev.	Min	Max
CPI	21	78.33	34.44	37.21	137.62
INCPI	21	113.88	45.88	56.39	192.38
GE	21	437,570.2	390,836.9	79,835.1	1,180,953
M2	21	1,502,829	1,462,942	214,454	5,154,853
IMP	21	569,048.4	466,626.4	107,389	1,539,837
REM	21	385,443.3	320,168.1	47,216.1	961,054.6

Correlation Analysis

The Pearson correlation matrix reveals a strong and positive linear relationship between CPI and all independent variables. CPI exhibits a very high correlation with Indian CPI (0.997), remittance (0.995), imports (0.974), government expenditure (0.963), and money supply (0.954). The high correlation coefficients suggest potential multicollinearity and reinforce the theoretical expectation that both domestic and external factors play a critical role in shaping inflationary trends in Nepal.

Table 2:

Correlation Analysis

Variables	CPI	GE	IMP	INCPI	M2	REM
CPI	1					
GE	0.962751	1				
IMP	00.973813	0.989939	1			
INCPI	0.996912	0.943632	0.961870	1		
M2	0.953661	0.976883	0.976334	0.937992	1	
REM	0.995496	0.967820	0.967820	0.990105	0.961639	1

Diagnostic Tests

Before proceeding with regression analysis, several diagnostic tests were conducted to ensure that the classical linear regression model (CLRM) assumptions were not violated. These diagnostic checks are crucial in validating the reliability and accuracy of the regression estimates. The results of the key diagnostic tests are discussed below.

Serial Autocorrelation LM Test Results

To detect the presence of serial autocorrelation in the residuals, the Breusch-Godfrey Serial Correlation LM test was performed. The test results are reported in Table 4.4. The

probability value associated with the Chi-square statistic is 0.4774, which is greater than the 5 percent significance level. Similarly, the F-statistic also shows a probability value of 0.6307. These results indicate that there is no evidence of serial correlation in the residuals of the estimated model. Therefore, the null hypothesis of no serial correlation cannot be rejected.

Heteroskedasticity Test Results

To examine whether the residuals exhibit constant variance (homoskedasticity), the Breusch-Pagan-Godfrey test was conducted. Table 4.5 presents the results, where the Chi-square probability value is 0.7929, which is also greater than the 5 percent level of significance. In addition, the F-statistic yields a p-value of 0.8541, confirming the same. Consequently, the null hypothesis of homoskedasticity cannot be rejected, suggesting that the residuals of the regression model are homoscedastic and there is no problem of heteroskedasticity.

Stability Test Results

The structural stability of the estimated regression model was assessed using the Regression Specification Error Test (RESET), as proposed by Ramsey (1969), and the Cumulative Sum (CUSUM) and Cumulative Sum of Squares (CUSUMSQ) tests, introduced by Brown, Durbin, and Evans (1975).

Regression Specification Error Test (RESET)

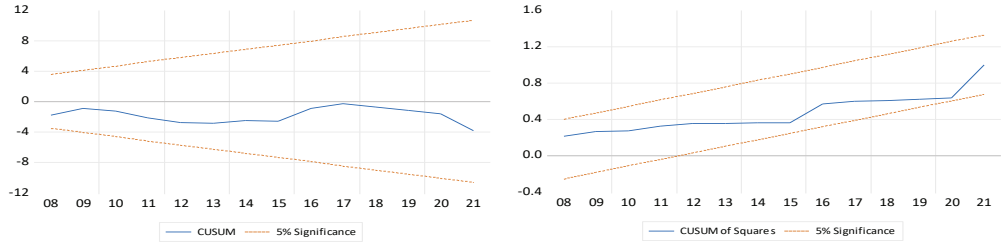
The RESET test evaluates whether the model suffers from specification errors, such as omitted variables or incorrect functional forms. The result, presented in Table 4.6, shows that the probability value for the omitted variables (squares of fitted values) is 0.6769, which is greater than 0.05. This indicates that the null hypothesis of correct model specification, therefore, the null hypothesis of correct model specification cannot b rejected. Hence, the model does not suffer from misspecification issues, and its functional form is deemed appropriate.

CUSUM and CUSUMSQ Tests

To assess the stability of the regression coefficients over time, the CUSUM and CUSUMSQ tests were employed. The graphical plots of these tests are illustrated in Figures 4.7 and 4.8, respectively. These plots display the cumulative sum of recursive residuals and squared recursive residuals against their corresponding critical bounds at the 5 percent, significance level. For both tests, the graphs show that the recursive residuals lie within the two critical lines throughout the sample period. This suggests that there is no significant structural change in the model, and the parameters remain stable over time. Therefore, it can be concluded that the estimated regression model is stable and appropriately specified.

Figure 1:

CUSUM and CUSUMSQ Tests



The results from diagnostic tests confirm that the assumptions of the classical linear regression model are not violated. There is no evidence of serial correlation or heteroskedasticity, and the model is both well-specified and stable, making it suitable for further econometric analysis.

Regression Analysis

Regression analysis was employed to assess the relationship between Nepal's Consumer Price Index (CPI) and selected macroeconomic variables: Indian CPI, Broad Money Supply (M2), Government Expenditure, Remittance, and Import. The model uses time series data from 2000/01 to 2020/21, applying the Ordinary Least Squares (OLS) method. The results indicate that lagged Indian CPI, remittance, and broad money supply have positive and statistically significant effects on Nepalese CPI. Specifically, a 1 percent increase in Indian CPI leads to a 0.40 percent rise in Nepalese CPI, while a 1 percent increase in remittance and broad money supply leads to 0.097 percent and 0.142 percent increases in CPI, respectively. Conversely, government expenditure and imports are found to be statistically insignificant, as their p-values exceed 0.05. The model demonstrates strong explanatory power, with an R-squared of 0.9994 and an adjusted R-squared of 0.9992, suggesting that 99.9 percent of the variance in Nepal's CPI is explained by the included variables. The Durbin-Watson statistic of 2.03 indicates no significant autocorrelation, affirming the model's reliability.

Table 3: Regression Analysis

Variable	Coefficient	Std. Error	t-value	Probability
LNGE	0.032747	0.032584	1.004985	0.3320
LNINCPI(-1)	0.400641	0.113390	3.533304	0.0033
LNIMP(-1)	-0.003544	0.035001	-0.101288	0.9208
LNM2	0.141643	0.045734	3.097087	0.0079
LNREM(-1)	0.097578	0.027897	3.497782	0.0036
C	-0.927335	0.130942	-7.082036	0.0000
R-squared= 0.9994 Adjusted R-squared= 0.9992				
F-value= 5229.827 Durbin-Watson stat= 2.0320				

Source: Researcher's own Calculation

This study suggest that inflation in Nepal is significantly influenced by Indian CPI, remittance inflows, and monetary expansion, while imports and government spending play a less direct role in the short run.

Co-integration Test Results

To investigate the long-run relationship among the variables, a co-integration test was conducted, the results of which are summarized in Table 4.8. The Johansen cointegration approach was used, with a lag length of one selected for the analysis. The test results show that four variables have p-values less than 0.05, suggesting rejection of the null hypothesis of no co-integration at the 5 percent significance level. This implies that there exists a statistically significant long-run equilibrium relationship among the selected variables-namely Indian CPI, government expenditure, imports, and broad money supply. Thus, despite some variables showing insignificant short-run effects, the co-integration test reveals that these variables are linked to Nepal's CPI in the long run, indicating their cumulative and sustained impact on inflation dynamics.

Table 4:

Cointegration test

Sample (adjusted): 2003 2021
Included observations: 19 after adjustments
Trend assumption: Linear deterministic trend
Series: LNCPI LNGE LNINCPI LNIMP LNM2 LNREM
Lags interval (in first differences): 1 to 1

Unrestricted Cointegration Rank Test (Trace)

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.967945	156.5816	95.75366	0.0000
At most 1 *	0.832426	91.21617	69.81889	0.0004
At most 2 *	0.716115	57.27594	47.85613	0.0051
At most 3 *	0.591356	33.35139	29.79707	0.0187
At most 4 *	0.561379	16.34809	15.49471	0.0371
At most 5	0.035655	0.689812	3.841465	0.4062

Trace test indicates 5 cointegrating eqn(s) at the 0.05 level
* denotes rejection of the hypothesis at the 0.05 level
**MacKinnon-Haug-Michelis (1999) p-values

Source: Researcher's own Calculation

Discussion

The empirical findings of this study highlight the multifaceted nature of inflation in Nepal, emphasizing the significant roles of external and domestic macroeconomic factors. The results confirm that Indian inflation (INCPI) exerts a strong and positive influence on Nepal's Consumer Price Index (CPI), with a 1 percent increase in Indian prices leading to a 0.40 percent rise in domestic inflation. This aligns with Nepal's fixed exchange rate regime, where the pegged currency system transmits inflationary pressures directly from India due to integrated trade and price pass-through effects.

Given that Nepal imports a substantial portion of its essential goods-including fuel, food, and manufactured products-from India, fluctuations in Indian prices inevitably spill over into the domestic economy. This finding is consistent with the Purchasing Power Parity (PPP) theory and corroborates earlier studies (Adhikari & Poudel, 2018; NRB, 2020), which identified Indian inflation as a dominant external driver of Nepal's price levels. The policy implication is clear: Nepal's monetary authorities must prioritize supply-side interventions, such as enhancing domestic production capacity and diversifying import sources, to mitigate imported inflation since exchange rate adjustments are constrained by the peg.

Another key determinant is remittance inflows (REM), which exhibit a positive and statistically significant relationship with inflation. A 1 percent increase in remittances leads to a 0.097 percent rise in CPI, supporting the demand-pull inflation hypothesis. Nepal's heavy reliance on remittances (nearly 25 percent of GDP) fuels consumption-driven demand without a proportional increase in domestic supply, particularly in non-tradable sectors like real estate and services. This phenomenon has been observed in other remittance-dependent economies, such as the Philippines and Bangladesh (Ratha, 2013), where excessive liquidity from remittances exacerbates price pressures. The temporary decline in remittances during the COVID-19 pandemic (2019-2020) provided a natural experiment, demonstrating how reduced inflows eased inflationary pressures before the subsequent rebound reignited demand-side inflation. To address this, policymakers should incentivize productive investments of remittances-such as small and medium enterprises (SMEs) and agriculture-rather than speculative real estate purchases. Additionally, targeted fiscal measures, such as subsidies on essential goods, could help cushion low-income households from inflationary shocks.

The study also identifies broad money supply (M2) as a significant contributor to inflation, with a 1 percent increase leading to a 0.142 percent rise in CPI. This finding reinforces the quantity theory of money, which posits that excessive monetary expansion fuels inflation. Nepal's rapid growth in money supply stems from remittance-induced liquidity, fiscal deficits financed by domestic borrowing, and credit expansion in the banking sector. However, the effectiveness of monetary policy in Nepal is constrained by structural factors, including an underdeveloped financial sector and high currency leakage due to import dependency. Unlike advanced economies where central banks adjust interest rates to control inflation, Nepal Rastra Bank (NRB) faces limitations due to the fixed exchange rate regime and excess liquidity in the banking system. Therefore, policymakers should focus on strengthening liquidity management tools, such as open market operations (OMO) and reserve requirements, to curb excessive money supply growth. Additionally, improving credit allocation toward productive sectors-rather than speculative investments-could enhance monetary policy transmission.

Interestingly, government expenditure (GE) and imports (IMP) were found to be statistically insignificant in the short run, contrary to theoretical expectations. This could be attributed to delayed fiscal multipliers, where government spending on infrastructure and social programs takes time to influence prices. Additionally, Nepal's imports consist

largely of essential goods (e.g., fuel and food), making demand relatively inelastic to price changes. However, the Johansen cointegration test confirms a long-run relationship, suggesting that persistent fiscal deficits and import dependency do contribute to inflation over time. This underscores the need for sustainable fiscal policies that balance public expenditure with revenue generation while reducing reliance on volatile import prices.

These findings align with prior studies on Nepal's inflation but provide a more comprehensive analysis by incorporating remittances and fiscal variables. Earlier research (Adhikari & Poudel, 2018; NRB Reports) primarily focused on monetary factors and Indian inflation, often overlooking the demand-side effects of remittances. International studies on remittance-dependent economies (e.g., Ratha, 2013) support the notion that excessive liquidity from remittances can fuel inflation, particularly in countries with weak productive capacities. However, Nepal's case is unique due to its dual dependency on India for trade and remittance inflows from the Middle East and Southeast Asia, creating a complex inflationary dynamic that requires tailored policy responses.

Conclusions

This study reveals that Nepal's inflation is primarily driven by a mix of external and domestic factors, with Indian inflation, remittances, and broad money supply being the key contributors. Nepal's CPI is highly influenced by Indian prices due to the open border, pegged exchange rate, and heavy import dependence on India. This strong link makes controlling inflation challenging, as price changes in India directly affect Nepal's inflation. While government expenditure and imports have weaker short-term effects, they still influence long-run inflation. Broad money supply and remittance inflows also positively impact inflation by raising household incomes and consumption levels. Therefore, inflation in Nepal reflects both external price pressures and internal economic dynamics. To manage inflation, policymakers should monitor price trends in India closely to anticipate and respond to changes. Controlling excessive money supply through monetary tightening is essential for maintaining price stability. Additionally, encouraging remittances via formal channels and promoting their use in productive investments rather than luxury imports can help reduce inflationary pressures.

This research provides some policy recommendations as strengthening liquidity management, implementing regulations to limit speculative lending, and increasing investments in agriculture to reduce food import dependence. Exploring limited exchange rate flexibility and diversifying import sources would also help absorb external shocks. Incentives for productive use of remittances and developing capital markets to absorb these funds more effectively are important for sustainable inflation control.

Despite its rigor, the present study is limited by its focus on aggregate data and a timeframe ending in 2021, missing recent inflation shocks. Future research should analyze sector-specific inflation, extend the study period, and use advanced models to better understand inflation dynamics in Nepal's open and remittance-dependent economy.

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