

Interrelationship Between Stock Market and Economy in Nepal

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Abstract

This study examines the interrelationship between stock market and economy in Nepal. Economic growth is the dependent variable. The independent variables are monetary policy, interest rate, political stability, gross domestic product and stock market valuation. The primary source of data is used to assess the opinions of the respondents regarding the interrelationship between stock market and economy in Nepal. The study is based on primary data of 114 respondents. To achieve the purpose of the study, structured questionnaire is prepared. The correlation coefficients and regression models are estimated to test the different factors influencing the interrelationship between stock market and economy in Nepal.

The result shows that monetary policy is positively correlated to the economic growth. It means that better monetary policy leads to increase in economic growth. Similarly, there is a positive relationship between interest rate and economic growth. It means that increase in interest rate leads to increase in economic growth. Likewise, political stability has a positive relationship with economic growth. It shows that increase in political stability leads to increase in economic growth. Furthermore, there is a positive relationship between stock market evaluation and economic growth. It indicates that increase in stock market evaluation leads to increase in economic growth. Moreover, gross domestic product is positively correlated to the economic growth. It means that increase in gross domestic product leads to increase in economic growth.

Keywords: monetary policy, interest rate, political stability, stock market valuation, gross domestic product, economic growth

1. Introduction

The stock market is a platform or system where stocks (equity shares) of publicly traded companies are bought, sold, and exchanged. Stocks give the holder the right to receive profit in case of an entity to achieve profits or else bear the loss as much as shares, and the right to own part of a company (Arkan, 2016). The interrelationship between the stock market and the economy has been a significant area of interest for researchers, policymakers, and investors. Globally, stock markets are considered a barometer of economic health, providing insights into economic trends, resource allocation, and investor sentiment. While substantial research highlights the role of stock markets in economic growth across developed and emerging economies, the Nepalese context presents unique challenges and opportunities. Similarly, Levine and Zervos (2022) emphasized that well-functioning stock markets significantly contribute to economic growth by enhancing capital mobilization, improving resource allocation, and facilitating risk diversification. Likewise, Arestis and Demetriades (2021) indicated a strong, positive correlation between stock market development and economic growth, though the strength and nature of the relationship varied across these economies. The study provided nuanced insights into how financial markets influence and are influenced by economic growth in different contexts. Further, Levine and Zervos (1998) provided that the robust evidence linking stock market development to long-term economic growth. Moreover, Martinez and Garcia (2022) focused provided that the valuable insights

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into how stock markets influence economic dynamics in emerging economies.

Levine and Zevros (1996) explored that how stock markets act as a catalyst for economic growth through the provision of liquidity and the facilitation of risk diversification. The study shed light on the mechanisms through which stock market development contributes to economic advancement. The study also offered important insights into the dynamics of financial markets and economic development. Similarly, Li and Zhou (2023) examined that the GDP growth and stock market returns: A causality analysis. The study provided detailed insights into the dynamics between economic performance and stock market behavior. Likewise, King and Watson (2023) analyzed that the GDP growth and stock market performance: A global perspective. The study provided that an overview of the relationship between GDP growth and performance in various stock markets around the world, including both developed and emerging markets. The study also highlighted that there is a general positive correlation between GDP growth and stock market performance globally. Economic growth tends to boost corporate earnings and investor confidence, driving stock market returns. Further, Fama and French, (2023) explored that how the performance of the NYSE influences GDP growth in the United States. The study found that the stock market as an economic indicator, wealth effect, capital allocation and investment. However, King and Levine (2022) examined that how the growth of GDP relates to the dynamics of the stock market across 15 European Union countries. The study found that a strong positive relationship between stock market growth and GDP growth across most EU countries. Furthermore, Campbell and Shiller (2022) studied that interest rate volatility and stock market returns: Evidence from the UK. The study revealed that fluctuations in interest rates have a significant impact on the performance of the UK stock markets. Additionally, Rigobon and sack (2023) assessed that interest rates and stock market volatility. The study demonstrated that stock markets in advanced economies are generally sensitive to interest rate changes, but the degree of sensitivity varies across countries.

Allen and Gale (2021) studied the interest rate effect on the stock value in Canada long-term. The study found that in the long term, interest rates have a significant impact on stock values in Canada. Similarly, Johnson and Lee (2021) examined that the effect of interest rates on stock market returns: A comparative study. The study revealed that in the U.S., changes in interest rates have a significant and relatively immediate impact on stock market returns. Likewise, Takahashi and Matsumoto (2022) analyzed that the interest rate and stock market relationship: Evidence from Japan. The study indicated that during periods of monetary tightening, the Japanese stock market tends to experience a decline in performance. Further, Taylor (2022) investigated that the role of monetary policy in stock market fluctuations in developed economies. The study demonstrated that changes in interest rates by the Federal Reserve had a significant and immediate effect on stock markets in all three countries. Moreover, Bernanke and Gertler (2021) discussed how central bank policies in emerging economies affect stock market volatility and growth. The study found that central bank actions in emerging economies, such as changes in interest rates and liquidity interventions, have a significant impact on stock market volatility. However, Ammer and Wongswan (2023) estimated that the effect of monetary policy on the term structure of stock market risk premia and analyzed how changes in policy stance influence stock valuations. The study showed that monetary policy significantly impacts the term structure of stock market risk premia. When central banks adjust interest rates or take other monetary policy actions,

they influence the risk premiums investor demand for holding stocks. Additionally, Bernanke and Kuttner (2023) discussed that how unexpected monetary policy sets up equity markets in the Eurozone. The study found that unexpected monetary policy actions, particularly interest rate changes, had a significant and immediate effect on equity markets in the Eurozone.

Shiller (2023) examined that the global stock market valuation and economic performance. The study suggested that there is a strong positive correlation between stock market overvaluation and the growth rates of output, capital, and employment. Specifically, during periods of stock market booms, industries tend to experience faster output growth and increased input usage, including both capital and labor. Similarly, Reinhart and Rogoff (2022) studied that the stock market bubbles and economic crises: Lessons from history. The study found that stock valuations tend to reflect long-term trends rather than immediate economic performance. Likewise, Sharma and Mahendru (2024) evaluated that the relationship among macroeconomic factors and stock prices: Evidence from India. The study revealed a high correlation between exchange rates and gold prices with stock prices, indicating that fluctuations in these variables significantly affect stock prices. Further, Rodrik (2022) assessed that the impact of political risk on emerging markets' stock market volatility. The study indicated that as government risk increases, investors often respond by reallocating assets to less risky countries, leading to potential volatility in emerging market equities. Moreover, Khan and Saqib (2023) explored that the impact of political instability on the performance of the stock market, with the focus being upon how governance indicators influence market outcomes. The study found that political instability leads to higher stock market volatility, increasing risk and uncertainty for investors. However, Younis and Lin (2017) examined that relationship among political instability, stock market volatility, and economic growth. The study showed that how political factors influence economic and market dynamics. Furthermore, Kumar and Singh (2021) ascertained that the stock market, political stability, and economic growth in emerging markets. The study highlighted that governance indicators, such as government effectiveness, rule of law, and control of corruption, also positively influence stock market performance. Additionally, Acemoglu and Robinson (2023) analyzed that the impact of political stability on the growth of the stock market in 30 countries. The study indicated that growth is more likely to be sustained under democratic regimes than autocratic ones, and that output collapses are more persistent under autocracy.

In the context of Nepal, Shrestha and Adhikari, (2023) analyzed that the role of monetary policy in shaping stock market liquidity in Nepal. The study found that a unidirectional causality from stock market development to economic growth. Similarly, Gurung and Lamichhane, (2023) explored that the political stability in influencing investor confidence and the performance of the stock market in Nepal for the period of 2000 to 2022. The study found that political stability positively impacts the stock market index. Likewise, Baral and Rai (2023) assessed that the gross domestic product and sectoral stock performance in Nepal. The study revealed that there is strong positive relationship between GDP growth and sector-specific performance in the NEPSE index. Further, Kafle and Regmi (2023) evaluated that the interest rate dynamics and stock market returns in Nepal. The study indicated that fluctuations in interest rates can influence stock market returns, with higher interest rates potentially leading to lower stock prices due to increased borrowing costs. However, Guragain and Lama (2023) examined that the impact study of some major political events on the fluctuations of the NEPSE index. The study found that such events lead to immediate and significant market reactions, indicating that the NEPSE index is sensitive to political

developments. Moreover, Pokharel and Khadka (2023) analyzed that the role of stock market valuation in Nepal's economic development. The study outlined that the contribution of stock market valuation to the economic development of Nepal, focusing on the trends in market capitalization. Additionally, Acharya and Pradhan, (2023) investigated that the impact of political stability on foreign portfolio investments in Nepal. The study demonstrated that that an improvement of one point in the political stability index could lead to a 0.179% increase in FDI inflows.

The above discussion reveals that the empirical evidences vary greatly across the studies concerning interrelationship between stock market and economy in Nepal. Though there are above mentioned empirical evidences in the context of other countries and in Nepal, no such findings using more recent data exist in the context of Nepal. Therefore, in order to support one view or the other, this study has been conducted.

The main purpose of the study is to analyze the interrelationship between stock market and economy in Nepal. Specifically, it examines the impact of monetary policy, interest rate, political stability and stock market valuation on economic growth in Nepal.

The remainder of this study is organized as follows. Section two describes the sample, data, and methodology. Section three presents the empirical results and the final section draws the conclusion.

2. Methodological aspects

The study is based on primary sources of data which were gathered from 7 different province of Nepal. For primary data a structured questionnaire was used. This study contains a sample of 7 province of Nepal whose respective data are collected from a total of 114 respondents.

The respondents' views were collected on monetary policy, interest rate, political stability, stock market valuation, gross domestic product and economic growth. This study is based on descriptive as well as casual comparative research designs.

The model

The model used in this study assumes that economic growth depends upon the interrelationship between stock market and economy. The dependent variable selected for the study is economic growth. Similarly, the independent variables are monetary policy, political stability, interest rate, gross domestic product and stock market valuation. Therefore, the model estimated in this study is stated as follows:

$$EG = \beta_0 + \beta_1(GDP) + \beta_2(IR) + \beta_3(PS) + \beta_4(MP) + \beta_5(SMV) + e$$

Where

EG= Economic Growth

GDP=Gross Domestic Product

IR= Interest Rate

PS= Political Stability

MP= Monetary Policy

SMV= Stock Market Valuation

Economic Growth was measured using a 5-point Likert scale where the respondents were asked to indicate the responses using 1 for strongly disagree and 5 for strongly agree. There are 5 items and sample items include “Economic growth refers to the increase in a country’s output of goods and services over time, typically measured by GDP”, “Sustained economic growth raises living standards by increasing income and access to goods and services” and so on. The reliability of the feature was measured by computing the Cronbach’s alpha ($\alpha = 0.777$).

Gross domestic product was measured using a 5-point Likert scale where the respondents were asked to indicate the responses using 1 for strongly disagree and 5 for strongly agree. There are 5 items and sample items include “GDP measures the total value of goods and services”, “Each approach for calculating GDP gives different result” and so on. The reliability of the feature was measured by computing the Cronbach’s alpha ($\alpha = 0.704$).

Monetary policy was measured using a 5-point Likert scale where the respondents were asked to indicate the responses using 1 for strongly disagree and 5 for strongly agree. There are 5 items and sample items include “I am concerned about the security of fintech platforms”, “I worry about the privacy of my financial information on monetary policy” and so on. The reliability of the feature was measured by computing the Cronbach’s alpha ($\alpha = 0.088$).

Political Stability of Use were measured using a 5-point Likert scale where the respondents were asked to indicate the responses using 1 for strongly disagree and 5 for strongly agree. There are 5 items and sample items include “Interrelationship between stock Market and economy in Nepal”, “I find it convenient to perform transactions using Fintech apps” and so on. The reliability of the feature was measured by computing the Cronbach’s alpha ($\alpha = 0.832$).

Interest Rate was measured using a 5-point Likert scale where the respondents were asked to indicate the responses using 1 for strongly disagree and 5 for strongly agree. There are 5 items and sample items include “Recommendations from friends or family influence my choice on GDP”, “Knowing that people I trust use interest rate for economic growth” and so on. The reliability of the feature was measured by computing the Cronbach’s alpha ($\alpha = 0.830$).

Stock market valuation was measured using a 5-point Likert scale where the respondents were asked to indicate the responses using 1 for strongly disagree and 5 for strongly agree. There are 5 items and sample items include “My overall satisfaction with stock market and economy is high”, “Book value vs market compares a company net” and so on. The reliability of the feature was measured by computing the Cronbach’s alpha ($\alpha = 0.266$).

The following section describes the independent variables used in this study along with the hypothesis formulation.

Gross Domestic Products

Gross Domestic Product (GDP) is the total monetary or market value of all finished goods and services produced within a country's borders in a specific time period, typically measured annually or quarterly. It is a key indicator used to assess the economic performance of a country. King and Watson (2023) highlighted that there is a general positive correlation between GDP growth and stock market performance globally. Likewise, King and Levine (2022) revealed that there is a strong positive relationship between stock market growth and GDP growth across most EU countries. Further, Baral (2019) showed that the economic growth is statistically significantly positively related to the development in the stock market of Nepal. Additionally, Pradhan and Shrestha (2017) commented that the stock market development is positively related to economic growth; therefore, a policy of developing stock markets could potentially be helpful for economic growth in Nepal. For example, one-way causality running from economic growth to capital market development is reported by Pokharel (2020). Based on it, this study develops following hypothesis:

H₁: There is a positive relationship between economic growth and GDP.

Monetary policy

Monetary policy refers to the actions taken by a country's central bank or monetary authority to control the money supply, interest rates, and inflation in order to achieve specific economic goals. These goals usually include maintaining price stability (low and stable inflation), full employment, and fostering economic growth. Taylor (2022) demonstrated that changes in interest rates by the Federal Reserve had a significant and immediate effect on stock markets in all three countries. Similarly, Bernanke and Gertler (2021) found that central bank actions in emerging economies, such as changes in interest rates and liquidity interventions, have a significant impact on stock market volatility. Likewise, Ammer and Wongswan (2023) showed that monetary policy significantly impacts the term structure of stock market risk premia. When central banks adjust interest rates or take other monetary policy actions, they influence the risk premiums investor demand for holding stocks. Further, Bernanke and Kuttner (2023) found that unexpected monetary policy actions, particularly interest rate changes, had a significant and immediate effect on equity markets in the Eurozone. Moreover, Thapa and KC. (2011). reported that changes in monetary policy instruments such as bank rate, money supply, and cash reserve ratio influence the performance of the stock market. The study found that a restrictive monetary policy adversely affects the stock market returns while an expansionary policy positively influences the growth of the stock price.

H₂: There is a positive relationship between monetary policy and economic growth.

Interest Rate

An interest rate is the percentage at which interest is charged or paid for the use of money. It can apply to loans, savings, or investments. Campbell and Shiller (2022) revealed that fluctuations in interest rates have a significant impact on the performance of the UK stock markets. Similarly, Rigobon and sack (2023) demonstrated that stock markets in advanced economies are generally sensitive to interest rate changes, but the degree of sensitivity varies across countries. Likewise, Allen and Gale (2021) found that in the long term, interest rates have a significant impact on stock values in Canada. Further, Johnson and Lee (2021) revealed that in the U.S., changes in interest rates have a significant and relatively immediate

impact on stock market returns. Moreover, Shrestha and Subedi (2014) indicated that there is a negative relationship between interest rate and performance of stock market. However, Khatri (2018) revealed that the interest rate holds an insignificant and negative relationship with share prices; this indicated other key factors which would play a decisive role in Nepal for stock market fluctuations. Based on it, this study develops following hypothesis:

H₃: There is a positive relationship between interest rate and economic growth.

Political Stability

Political stability refers to the degree to which a government or political system is able to function smoothly without disruption, instability, or violence. It implies that the political institutions, such as the government, legal systems, and societal structures, are functioning effectively, and that there is confidence in the political system. Rodrik (2022) indicated that as government risk increases, investors often respond by reallocating assets to less risky countries, leading to potential volatility in emerging market equities. Similarly, Khan and Saqib (2023) found that political instability leads to higher stock market volatility, increasing risk and uncertainty for investors. Likewise, Younis and Lin (2017) showed that how political factors influence economic and market dynamics. Furthermore, Kumar and Singh (2021) highlighted that governance indicators, such as government effectiveness, rule of law, and control of corruption, also positively influence stock market performance. Moreover, Hira (2017) revealed that there is a negative relationship between political instability and stock prices, indicating that due to political instability, the stock prices fall. Based on it, this study develops following hypothesis:

H₄: There is a positive relationship between political stability and economic growth.

Stock Market Valuation

Stock market valuation refers to the process of determining the overall value of a stock market, or individual stocks, based on certain metrics and methodologies. It helps investors, analysts, and economists assess whether stocks or the market as a whole are overvalued, undervalued, or fairly valued. Dhungana (2023) outlined that the nexus between stock market development indicators represented by market capitalization, trading turnover, NEPSE index, gross capital formation, and gross national savings, and economic growth in Nepal from 1995 to 2022. Similarly, Shrestha and Subedi (2024) pointed that there is a positive relationship between stock market development and economic growth, with the importance of stock market development in promoting economic growth in Nepal underlined. Furthermore, Baral (2019) depicted that there is a statistically significant positive relationship between economic growth and the development of the stock market, implying the size and liquidity of NEPSE is vital in mobilizing capital and also diversifying risks in the economy. Moreover, Pradhan and Shrestha (2017) found that a positive relationship between stock market development and economic growth. Based on it, this study develops following hypothesis:

H₅: There is a positive relationship between stock market valuation and economic growth.

3. Results and discussion

Correlation analysis

On analysis of data, correlation analysis has been undertaken first and for this

purpose, Kendall's Tau correlation coefficients along with means and standard deviations have been computed, and the results are presented in Table 1.

Table 1

Kendall's Tau correlation coefficients matrix

This table presents Kendall's Tau coefficients between dependent and independent variables. The correlation coefficients are based on 114 observations. The dependent variable is EG (Economic growth). The independent variables are GDP (Gross domestic products), MP (Monetary policy), IR (Interest rate), PS (Political stability) and SMV (Stock market valuation).

Variables	Mean	Std. Deviation	GDP	IR	MP	SMV	PS	EG
GDP	3.301	0.9109	1.000					
IR	3.226	0.8792	0.681**	1.000				
MP	3.212	0.9501	0.551**	0.664**	1.000			
SMV	4.078	0.4918	-0.020	-0.010	0.015	1.000		
PS	3.870	0.4914	0.079	0.082	0.056	0.344**	1.000	
EG	3.374	0.9717	0.531**	0.517**	0.594**	-0.024	0.077	1.000

Note: The asterisk signs (**) and (*) indicate that the results are significant at one percent and five percent levels respectively.

Table 1 shows the Kendall's Tau correlation coefficients of dependent and independent variables. The study shows that gross domestic products is positively correlated to economic Growth. It means that increase in gross domestic products leads to increase in economic growth. Similarly, there is a positive relationship between monetary policy and economic growth. It indicates that better monetary policy leads to increase in economic growth. Likewise, interest rate has a positive relationship with economic growth. It shows that increase in interest rate leads to increase in economic growth. Furthermore, there is a positive relationship between political stability and economic growth. It indicates that increase in political stability leads to increase in economic growth. Moreover, stock market valuation has a negative relationship with economic growth. It indicates that increase in stock market valuation leads to decrease in economic growth.

Regression analysis

Having indicated Kendall's Tau correlation coefficients, the regression analysis has been carried out and the results are presented in Table 2. More specifically, it presents the regression results of monetary policy, political stability, interest rate, gross domestic product and stock market valuation on economic growth in Nepal.

Table 2

Estimated regression results of monetary policy, political stability, interest rate, gross domestic product and stock market valuation on economic growth in Nepal

The results are based on 114 observations using linear regression model. The model is $EG = \beta_0 + \beta_1 (GDP) + \beta_2 (IR) + \beta_3 (PS) + \beta_4 (MP) + \beta_5 (SMV) + e$, where the dependent variable is EG (Economic growth). The independent variables are GDP (Gross domestic products), MP (Monetary policy), IR (Interest rate), PS (Political stability) and SMV (Stock market valuation).

Model	Intercept	Regression coefficients of					Adj. R_bar ²	SEE	F- Value
		GDP	IR	MP	SMV	PS			
1.	0.932 (83.765)**	0.740 (10.234)**					0.476	0.7031	104.73
2.	0.986 (3.819)**		0.740 (9.590)**				0.444	0.7247	91.964
3.	0.828 (4.066)**			0.793 (13.033)**			0.597	0.6169	169.849
4.	3.197 (4.189)**				0.043 (0.233)		-0.008	0.9758	0.054
5.	2.507 (3.477)**					0.224 (1.213)	0.004	0.9697	1.470
6.	0.733 (2.894)**	0.471 (3.752)**	0.336 (2.585)**				0.501	0.6861	58.341
7.	0.494 (2.283)*	0.421 (3.973)**	0.195 (1.451)	0.659 (6.838)**			0.646	0.578	70.370
8.	0.518 (1.047)	0.421 (3.955)**	0.195 (1.444)	0.659 (6.807)**	0.006 (0.054)		0.643	0.5807	52.304
9.	0.353 (0.641)	0.413 (3.845)**	0.204 (1.498)	0.669 (6.820)**	0.042 (0.344)	0.087 (0.690)	0.641	0.5821	41.739

Notes:

- i. Figures in parenthesis are t-values
- ii. The asterisk signs (**) and (*) indicate that the results are significant at one percent and five percent level respectively.
- iii. Economic growth is the dependent variable.

Table 2 shows that the beta coefficients for gross domestic products are positive with economic growth. It indicates that gross domestic products has a positive impact on economic growth. This finding is consistent with the findings of King and Levine (2022). Similarly, the beta coefficient for interest rate are positive with economic growth. It shows that interest rate has a positive impact on economic growth. This finding is consistent with the findings of Rigobon and sack (2023). Likewise, the beta coefficients for monetary policy are positive with economic growth. It indicates that monetary policy has a positive impact on economic growth. This finding is consistent with the findings of Bernanke and Gertler (2021). Further, the beta coefficients for stock market valuation are positive with economic growth. It indicates that stock market valuation has a positive impact on economic growth. This finding is consistent with the findings of Pradhan and Shrestha (2017). Moreover, the beta coefficients for political stability are positive with economic growth. It indicates that political stability has a positive impact on economic growth. This finding is similar to the finding of Hira (2017).

4. Summary and conclusion

The stock market and the economy are closely linked in any country, and this is also true for Nepal. The relationship between the two can be complex, with the performance of one often influencing the other. The relationship between the stock market and the economy in Nepal is a feedback loop where the stock market often acts as a reflection of economic conditions, investor sentiment, and government policies. The performance of the stock market can have a significant impact on the economy by influencing consumer confidence, business investment, and capital formation. Similarly, the overall state of the economy,

including growth, inflation, and external factors, strongly influences stock market trends. In Nepal, the Nepal Stock Exchange (NEPSE) plays a pivotal role in channeling investments, promoting capital formation, and acting as a barometer of economic confidence. While the stock market's development is still growing, it is gradually becoming a more important player in Nepal's economic landscape.

This study provides insightful information regarding the interrelationship between stock market and economy in Nepal. The study analyzes various significant variables that could impact the economic growth. These variables include how monetary policy, interest rate, political stability, stock market valuation and gross domestic products influence economic growth.

This study attempts to examine the interrelationship between stock market and economy in Nepal. The study is based on primary data with 114 observations.

The major conclusion of the study is that monetary policy, interest rate, political stability, stock market valuation and gross domestic products have a positive relationship with economic growth. The study also concludes that monetary policy is the most significant factor followed by gross domestic products and interest rate that influence the interrelationship between stock market and economy in Nepal.

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