

Dynamic Interactions Between Monetary Indicators and Stock Market Behavior in Nepal

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Abstract

Background: The relationship between monetary indicators and equity market performance is a critical area of study, particularly in emerging economies like Nepal, where financial markets are still developing. Understanding how monetary variables influence the Nepal Stock Exchange Index (NEPSE) can provide key insights for investors, policymakers, and financial institutions.

Objectives: This study aims to examine the dynamic short-run and long-run effects of monetary indicators—reserve money, deposits, liquidity, and lending interest rates—on NEPSE performance. It seeks to uncover the complex transmission mechanisms between monetary policy and stock market behavior in Nepal.

Methods: A quantitative research design is employed, utilizing the Autoregressive Distributed Lag (ARDL) model on monthly data from 2005 to 2024. Stationarity tests confirm mixed-order integration of variables, validating the ARDL approach. The model assesses both immediate and lagged effects while ensuring robustness through diagnostic checks for serial correlation and heteroskedasticity.

Findings: The results reveal time-dependent effects—reserve money and deposits exhibit varying positive and negative impacts across different lags, reflecting delayed transmission mechanisms. Liquidity positively influences NEPSE at a three-month lag, while the lending interest rate has a consistent and significant negative effect. The model demonstrates strong diagnostic validity, supporting the reliability of the findings.

Conclusion: The study underscores the importance of macroeconomic stability and well-timed policy interventions in fostering stock market growth. It provides empirical evidence on the nuanced relationship between monetary policy and equity markets in Nepal, offering actionable insights for stakeholders.

Novelty: This research contributes to the limited literature on Nepal’s stock market by applying the ARDL framework to capture both short-run and long-run dynamics. Future studies could extend this work by incorporating nonlinear models or additional macroeconomic variables.

Keywords: Nepal Stock Exchange (NEPSE), Autoregressive Distributed Lagged (ARDL), Stock Market Performance, Reserve Money, Lending Interest Rates

JEL Classification Codes: G11, G12, G14, G41

Introduction

The equity market plays a vital role in a national economic development by providing a platform for capital mobilization and investment activities. In Nepal, the Nepal Stock Exchange Index (NEPSE) acts as a key indicator of economic performance and investor sentiment. Understanding the interplay between stock market movements and macroeconomic variables—such as reserve money, liquidity, deposits, and lending interest rates—is essential for policymakers, investors, and financial institutions. These relationships hold significant implications for financial stability, economic planning, and policy formulation.

Despite growing recognition of macroeconomic variables as determinants of stock market behavior, there remains a significant gap in the literature concerning their interrelationships in the Nepalese context. Foundational studies, such as (Fama, 2081), laid the groundwork for linking macroeconomic factors to financial markets. Subsequent research by (Maysami & Koh, 2000) showed the influence of interest and exchange rates on Singapore’s stock market. Similarly, (P. Naik & Reddy, 2024) analyzed macroeconomic determinants of stock market liquidity in emerging markets, (Muthike & Sakwa, 2012) highlighted the predictive power of macroeconomic indicators in Nairobi, (Haq & Larsson, 2016) used the ARDL approach to assess market returns, and (Mohnot, et al., 2024) explored asymmetric macroeconomic effects in Malaysia. However, comprehensive empirical studies on NEPSE remain limited.

NEPSE’s volatility and sensitivity to macroeconomic shifts raise questions about its stability and predictability. A major challenge lies in selecting suitable models to accurately capture these dynamic relationships. The models may fall short in accounting for the complexity of financial markets, such as Vector Autoregression Model (VARM), Vector Error Correction Model (VECM), and Autoregressive Distributed Lagged Model (ARDLM), making it necessary to apply advanced econometric techniques. This study is adopted the ARDL model

for removing the spurious in the connection of among the variables. This study aims to observe the association between NEPSE and key macro-economic variables to deepen the understanding of Nepalese financial market dynamics. Specifically, it seeks to impact of long-run equilibrium relationships; to analyze short-term dynamics in response to macroeconomic shocks through ARDL model. The core premise of this study is that stock market performance is shaped by macroeconomic variables—particularly reserve money, liquidity, deposits, and lending interest rates—which may exert both short- and long-term effects through multiple transmission channels.

Literature Review

The relationship between equity market and macro-economic variables has been usually examined, particularly in developed economies. Key indicators such as deposits, reserve money, lending interest rates, and liquidity have been found to significantly influence stock market behavior. These macroeconomic variables play a pivotal role in shaping market dynamics and investor sentiment.

Fama (2081) investigated the link between stock returns, money supply, real economic activity, and CPI. The article hypothesized that stock returns are positively associated with real economic activity and negatively associated with inflation. The study concluded that the adverse correlation between equity returns and CPI arises due to inflation's inverse connection with real activity. In the Nepalese context, (Shrestha & Bhatta, 2018) studied the impact of CPI, broad money, and Treasury bills on NEPSE fluctuations, concluding that price rises have a notable effect on equity market performance. Deposits, as a key financial resource, contribute to investment flows, support lending, and foster financial sector growth. K. P. Naik and Padhi (2012) demonstrated “a long-run equilibrium relationship between macroeconomic variables and the stock market index, with findings indicating that stock prices are positively influenced by money supply and industrial production, and negatively by inflation. However, exchange rates and short-term interest rates were not found to be significant. The study also revealed that macroeconomic variables Granger-cause stock prices in the long run, but not in the short term”. AL- Shubiri (2010) analyzed stock price determinants in the Amman Stock Exchange, focusing on 14 commercial banks from 2005 to 2008. The regression analysis revealed a strong positive relationship between stock prices and factors such as net-asset-value per-share and GDP, whereas inflation and lending interest rates had a negative but inconsistent impact.

Rjoub (2017) highlighted those variables such as “asset quality, management quality, earnings, size, money supply, and interest rates significantly affect stock prices, with bidirectional causality observed in certain cases”. The findings emphasized the vulnerability of bank stock prices during economic crises, underscoring the importance of firm-specific information. Eita (2019) “Investigated the macroeconomic determinants of stock prices in Namibia using the VECM methodology. The study concluded that economic activity and money supply have a positive influence on stock prices, while inflation and interest rates exert negative effects, suggesting that equities are not effective hedges against inflation in Namibia”. Bhatta and Mishra (2021) examined the relationship between stock returns and GDP in Nepal from 1994

to 2017 using the ARDL model. Their findings indicated a weak but statistically significant impact of stock returns on GDP growth, limited by structural and institutional constraints that reduce the stock market's predictive capacity.

Thapa and Chamlagain (2025) examined the relationship between macro-economic and equity-market-performance. An article revealed that reserve money, deposit, and liquidity have positive long-run association, however, lending interest rate has the long-run negative association on the stock market performance. Naka et al. (1991) employed a “Vector Error Correction Model (VECM) to explore the long- and short-run relationships between stock markets and macroeconomic factors in Japan, finding significant long-term associations”. Their study emphasized the importance of determining optimal lag lengths and understanding variable interactions for effective economic policy and planning. Several other studies have utilized econometric approaches to analyze stock-macro-economy linkages. Thapa, (2023a) used a VAR model to explore the causal relationship between NEPSE and macroeconomic variables, finding that lending interest rates and deposits significantly impact stock market movements. Hayes (2012) discussed the “Efficient Market Hypothesis (EMH)”, suggesting that stock prices reflect all publicly available information, thereby limiting the predictability of price movements. Dahal et al. (2024) focused on the effect of liquidity and reserve money on stock prices, commercial banks of Nepal. Similarly, Thapa (2019) found that liquidity access significantly influences equity market performance in Nepal. Pesaran et al. (2001) developed the bounds testing approach, useful for analyzing long-run financial relationships. Poudel (2019) applied an ARDL model to examine the relationship between stock returns and trading volume in Nepal, identifying a significantly positive correlation in both the short and long run. This relationship is particularly valuable from an investment standpoint. Thapa (2025) results indicated a negative long-run impact of reserve money on equity market performance. Short-run dynamics were more evident in some lagged variables, inducing stock market behavior. Granger causality tests acknowledged one-way causality from money supply, deposit, reserve money, and liquidity to stock market performance.

Despite growing academic interest in the stock market–macroeconomy nexus, several research gaps persist. First, most empirical studies focus on developed or large emerging economies, with limited attention to Nepal’s stock market. Second, while some studies examine macroeconomic impacts on stock markets, few have systematically determined the optimal lag structure for NEPSE using rigorous techniques like VAR. This study aims to address these gaps by applying advanced econometric techniques to examine the dynamic relationships between NEPSE and macroeconomic indicators. The findings will contribute empirical evidence necessary for developing effective monetary and fiscal policies in Nepal. The hypotheses, developed based on the literature and conceptual framework, “posit that: there exists a long-run equilibrium relationship between NEPSE and key macroeconomic variables”. Short-term fluctuations in NEPSE are significantly influenced by macroeconomic changes.

Research Materials and Methods

This study adopted a quantitative research design, employing inferential statistical techniques with time-series data. A quantitative approach is considered appropriate as it facilitated the application of advanced econometric models to analyze the dynamic interplay amid macroeconomic variables and equity-market-performance. By focusing on time-series data, the study could effectively assess both short-term and long-term impacts, providing insights into how macroeconomic factors influence stock prices over time. Data were sourced from reputable institutions, including the “World Bank, Nepal Stock Exchange (NEPSE), Nepal Rastra Bank (NRB), the Securities Board of Nepal (SEBON)”, and relevant listed companies. Monthly data spanning from January 2005 to December 2024 were collected, yielding a total of 203 observations. A judgmental sampling method was employed to ensure the inclusion of relevant and reliable data.

The econometric analysis was conducted using EViews 12 software, which enabled the application of time-series regression techniques. To determine the appropriate lag length for the model, various model selection criteria were utilized, including the “Akaike Information Criterion (AIC), Schwarz Criterion (SC), and Hannan-Quinn Criterion (HQ)”. The study implemented an econometric model to assess the impact and interdependence of selected macroeconomic indicators on stock prices. An article employs the “Autoregressive Distributed Lag (ARDL) model” to examine the relationship between the NEPSE index and particular macro-economic variables: “reserve money (RESE), deposits (DEPO), liquidity (LIQ), and lending interest rate (LIR)”. Results showed that NEPSE, LIQ, RESE, and DEPO are integrated of order one $I(1)$, while LIR is marginally stationary at level, suggesting it maybe $I(0)$. Given this mixed order of integration, neither “the Vector Autoregression (VAR) model nor the Vector Error Correction Model (VECM)” is appropriate. The ARDL model is selected as it accommodates a combination of $I(0)$ and $I(1)$ variables and is suitable for small sample sizes. For the reliability test, this study is used to conform heteroskedasticity, serial correlation the robustness of the ARDL model. Then after the ARDL model (3, 4, 4, 3, 0) is estimated, allowing for the analysis of both short- long-run dynamics.

Results and Findings

Table 1 shows the most appropriate econometric model for analyzing the relationship between the NEPSE index and selected macroeconomic variables—reserve money (RESE), deposits (DEPO), liquidity (LIQ), and lending interest rate (LIR). “Augmented Dickey-Fuller (ADF)” test is conducted to examine the stationarity properties of the variables. The results reveal that NEPSE, LIQ, RESE, and DEPO are non-stationary at $I(0)$ but become stationary after first-differencing, indicating they are integrated of order one, $I(1)$.

Table 1: Stationarity / ADF Test

Variables	Level [Prob. Value]	First-Diff. [Prob. Value]	Order of Inte-gration
NEPSE	0.91	0.00	I (1)
LIQ	0.94	0.00	I (1)
LIR	0.051	0.00	I (0)* / I(1)
RESE	0.93	0.00	I (1)
DEPO	1	0.85	I (1)

However, LIR was found to be marginally stationary at level ($p = 0.052$), suggesting it may be integrated of order zero, $I(0)$. Given this mixture of integration orders, the Vector Autoregression (VAR) model becomes unsuitable, as it requires all variables to be stationary at level. Similarly, the “Vector Error Correction Model (VECM)”, which requires all indicators to be $I(1)$ and cointegrated, is not appropriate due to the inclusion of an $I(0)$ variable. In contrast, the Autoregressive Distributed Lag (ARDL) model is well-suited for this scenario, as it allows for a combination of $I(0)$ and $I(1)$ variables, provided none are $I(2)$. ARDL also offers advantages such as better performance in small samples and the ability to model both short long-run dynamics through bounds testing and error correction mechanisms. Therefore, based on the integration properties of the variables, the ARDL model is the most reliable and methodologically appropriate approach for this study.

Table 2: Hetero-skedasticity Test ARCH

Statistic of F	0.416292	Prob. F (1,175)	0.5196
Observed*R-sq.	0.420050	Prob. Chi-Square (1)	0.5169

Table 2 demonstrates an F-st. of 0.4163 with a p-value of 0.5196, and an Obs*R-sq.-value of 0.4201 with a p-value of 0.5169. Both p-values are greater than 0.05, which indicates that the null hypothesis of no ARCH effects cannot be rejected. Therefore, there is no significant evidence of heteroskedasticity in the residuals.

Table 3: Serial-Correlation LM-Test

H0: No serial-correlation at up to two lags

Statistic of F	1.447369	Prob. F (2,157)	0.2383
Observed*R-sq.	3.222516	Prob. Chi-S (2)	0.1996

Table 3 shows “the Breusch-Godfrey Serial Correlation LM Test” that an F-stcs of 1.4474 with a p-value of 0.2383 and an Obs*R-squared value of 3.2225 with a p-value of 0.1996. Both p-values are above the 0.05 significance level, suggesting that the H0 of no serial correlation up to 2 lags cannot be rejected. Thus, there is no evidence of serial-correlation in the model residuals.

Table 4 reveals the autoregressive distributed lag model which presents the relationship of reserve money, deposit, liquidity, and lending interest rate on stock market performance. The impact of reserve money on NEPSE is mixed and depends on the lag structure. Specifically, the first lag of reserve money (RESERVEM(-1)) stands a positive and statistically substantial effect on NEPSE (coefficient = 0.0011, $p = 0.0402$), indicating, increase in reserve money, leads to an increase in stock market performance in the following month. In contrast, the fourth

lag (RESERVEM(-4)) shows a negative and significant relationship (coefficient = -0.0013 , $p = 0.0080$), suggesting that expansionary monetary effects may reverse or contribute to market corrections after a few months. Deposits also exhibit lagged and contrasting effects. DEPO(-1) stands a negative and substantial impact on NEPSE (coefficient = -0.0010 , $p = 0.0010$), implying that a rise in deposits initially diverts funds away from the stock market, possibly toward safer bank instruments. However, DEPO(-4) has a positive and highly significant effect (coefficient = 0.0010 , $p = 0.0001$), indicating that increased deposit mobilization eventually supports stock market growth, potentially through increased lending and investment activity.

Table 4: Autoregressive Distributed Lag (ARDL Model) (3, 4, 4, 3, 0)

Variables	Co-efficient	Std. E	t-Stcs	Prob.*
NEPSE(-1)	0.9407	0.0748	12.5791	0
NEPSE(-2)	0.1046	0.0959	1.0906	0.2771
NEPSE(-3)	-0.1726	0.0734	-2.3511	0.0199
RESERVEM	-0.0004	0.0002	-1.8933	0.0601
RESERVEM(-1)	0.0011	0.0005	2.0685	0.0402
RESERVEM(-2)	-0.0001	0.0006	-0.2396	0.811
RESERVEM(-3)	0.001	0.0006	1.6209	0.107
RESERVEM(-4)	-0.0013	0.0005	-2.6873	0.008
DEPO	0.0002	0.0003	0.8981	0.3705
DEPO(-1)	-0.001	0.0003	-3.3597	0.001
DEPO(-2)	0.0002	0.0003	0.6125	0.5411
DEPO(-3)	-0.0003	0.0003	-1.2416	0.2162
DEPO(-4)	0.001	0.0002	4.0048	0.0001
LIQ	-0.0004	0.0006	-0.6544	0.5138
LIQ(-1)	-0.0006	0.0007	-0.8195	0.4137
LIQ(-2)	0.0001	0.0007	0.1629	0.8708
LIQ(-3)	0.0014	0.0006	2.5805	0.0108
LIR	-17.0438	5.2816	-3.227	0.0015
C	98.959	57.7418	1.7138	0.0885
R-squ.	0.985	F-stcs		573.658
Adj. R-squ.	0.983	Prob(F-stcs)		0
D-W stcs	1.884			

The effect of liquidity is found to be positive and statistically significant only at the third lag (LIQ(-3); coefficient = 0.0014 , $p = 0.0108$), suggesting that improved market liquidity conditions take approximately three months to positively influence the NEPSE index. No other lagged values of liquidity were significant, indicating the effect is delayed rather than immediate. The lending interest rate has a direct, strong, and statistically significant negative effect on NEPSE (coefficient = -17.0438 , $p = 0.0015$). This indicates that higher lending rates suppress stock market performance by increasing borrowing costs, discouraging both corporate

investments and retail investor participation. Among the macroeconomic variables, reserve money exhibited a mixed effect. While RESERVEM(-1) had a positive and significant influence on NEPSE, RESERVEM(-4) showed a significant negative effect, highlighting the complexity of monetary expansion impacts over time. Deposit levels also had a notable influence, where DEPO(-1) negatively affected the NEPSE index, but DEPO(-4) showed a strong positive effect, implying distinct short=long-run effects of banking sector deposits on stock market performance. Liquidity was found to impact NEPSE only through its third lag, suggesting a delayed positive influence of liquidity conditions on market activity. Most notably, the lending interest rate had a significant negative effect on NEPSE, indicating that higher interest rates reduce market performance by increasing borrowing costs and weakening investor sentiment. In instant, reserve money and deposits influence NEPSE in both positive + negative directions depending on the lag, liquidity positively affects the equity market with a delay, and the lending interest rate consistently exerts a negative influence on NEPSE. These results emphasize the importance of considering time-lagged effects and the dynamic nature of macroeconomic influences on stock market behavior in Nepal.

Discussions

The current findings present both consistencies and contrasts with previous literature on the influence of macro-economic variables on equity-market-performance, particularly within the Nepalese context and broader international studies. The positive short-run impact of reserve money (RESERVEM(-1)) on NEPSE aligns with studies like those of Eita (2019), which found that money supply has a positive influence on stock prices, suggesting that monetary expansion supports market growth through increased liquidity and investment. However, the negative effect at a longer lag (RESERVEM(-4)) introduces a nuanced perspective, implying potential market corrections or inflationary pressures from prolonged monetary expansion, which aligns with Fama's (1981) hypothesis that inflation, often a byproduct of excess money supply, negatively affects stock returns due to its inverse relationship with real activity. Regarding deposits, the study finds a negative short-run effect (DEPO(-1)) but a positive long-run effect (DEPO(-4)) on NEPSE. Thapa and Chamlagain (2025) revealed that reserve money, deposit, and liquidity have positive long-run association, however, lending interest rate has the long-run negative association on the stock market performance. This dual nature is consistent with Shrestha and Bhatta (2018), who noted that while deposit mobilization can initially divert funds from the stock market to savings instruments, over time it contributes to credit availability and financial market development, ultimately boosting stock performance. Thapa (2023) also observed that deposits significantly influence stock market movements, affirming the long-run relevance of this variable. The positive impact of liquidity at a lag (LIQ(-3)) is in line with the conclusions of Dahal et al. (2024) and Thapa (2019), who emphasized the role of liquidity in enhancing market performance by enabling smoother transaction flows and investor confidence. This result supports the argument that adequate liquidity in the financial system facilitates investment and trading activities, which subsequently reflect in stock market indices like NEPSE. The negative relationship between lending interest rate and NEPSE, as revealed

in the current study, is consistent with a wide range of literature, including [AL-Shubiri \(2010\)](#), [Eita \(2019\)](#), and [Thapa \(2023\)](#). These studies collectively suggest that higher lending interest rates raise the cost of capital, discourage borrowing for investment, and reduce both corporate earnings and investor enthusiasm, thereby negatively impacting stock prices. The current finding reinforces this established relationship and underscores the sensitivity of Nepal's capital market to monetary policy shifts. In instant, the present research largely corroborates earlier findings in both local and international contexts. However, its additional insight into lagged dynamics, particularly the mixed and delayed effects of reserve money and deposits, adds a new dimension to understanding the transmission mechanisms of macroeconomic variables in shaping Nepalese stock market behavior.

Conclusion

This article highlights the dynamic association between macro-economic indicators and the performance of the Nepal Stock Exchange Index (NEPSE), using the ARDL model to address the mixed integration order of the variables. The findings reveal that reserve money and deposits exert both positive and negative effects on NEPSE depending on time lags, while liquidity impacts the market positively with a delay. Lending interest rate consistently shows a significant negative influence, confirming its dampening effect on investor activity and market performance. These results underscore the importance of time-lagged macroeconomic effects and suggest that NEPSE is sensitive to shifts in monetary and banking conditions. Importantly, the adoption of the ARDL model proves effective in capturing both short-run adjustments and long-run equilibrium dynamics. The absence of serial correlation and heteroskedasticity validates the model's reliability. This research fills a critical gap in Nepalese capital market literature and offers actionable insights for policymakers, investors, and financial institutions. Future studies could incorporate additional variables such as inflation and exchange rates, and apply nonlinear or machine learning models to better capture complex market behaviors. The emerging stock market in Nepal, understanding these macro-financial linkages will be vital for informed investment decisions and sound economic policymaking.

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