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The Relationship between Inflation and Economic Growth in Nepal: A Cointegration Analysis

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Abstract: *This paper examines the long-run and short-run relationship between inflation and economic growth in Nepal using annual data for 1975–2023. We estimate a multivariate Vector Error Correction Model (VECM) over GDP growth, the consumer and wholesale price indices, remittances, broad money, and government expenditure, and extend it with a Hansen–Seo threshold specification to test for non-linearity. Three results stand out. First, the Johansen procedure identifies multiple cointegrating vectors among the variables. Second, the linear long-run coefficient on consumer-price inflation is small and statistically insignificant once the other variables are jointly controlled for, which we interpret as a signal that the underlying relationship is non-linear rather than benign. Third, the threshold analysis identifies an endogenous break point at roughly 9.5 percent annual CPI inflation: below this rate inflation is broadly neutral or mildly growth-supportive, while above it the short-run inflation effect on growth roughly doubles and adjustment slows. The threshold sits within the band identified for developing economies (Sarel, 1996; Khan & Senhadji, 2001), placing the Nepalese case inside the international evidence on a negative or non-linear inflation–growth nexus. For monetary policy, the results support keeping inflation comfortably below the threshold, with a working target band of around 5–7 percent.*

Keywords: economic growth, inflation, vector error correction model, threshold cointegration, Nepal, monetary policy, remittances.

I. INTRODUCTION

The relationship between inflation and economic growth remains one of the more contested questions in macroeconomics, particularly for developing economies where the institutional setting and the structure of the economy condition how prices interact with real activity (Fischer, 1993; Barro, 1995; Bruno & Easterly, 1998; Khan & Senhadji, 2001). Early theoretical models assumed broadly linear relationships, but the empirical record has steadily shifted toward non-linear and country-specific formulations (Sarel, 1996; Kremer et al., 2013; Ibarra & Trupkin, 2016).

Nepal offers a useful case for examining these dynamics. Over the past five decades the economy has shifted from a largely agrarian base toward a structure dominated by services and remittances, with remittance inflows now around a quarter of GDP. Inflation in this period has ranged from roughly 2.4 to 18.7 percent, and growth has been buffeted by a decade-long civil conflict, two damaging earthquakes in 2015, recurrent border disruptions, and the COVID-19 pandemic. These features suggest that the inflation–growth relationship in Nepal is unlikely to be linear and that standard single-equation approaches may miss important regime-dependent behaviour.

Existing work on Nepal has tended to rely on relatively simple econometric methods, shorter samples, or narrower variable sets, which limits the conclusions that can be drawn (Shrestha & Chaulagain, 2015; Bhattarai, 2011; Paudel & Perera, 2009). This paper closes that gap by estimating a six-variable VECM over GDP growth, the consumer and wholesale price indices, remittances, broad money, and government expenditure, and by extending the model with a Hansen–Seo threshold specification that endogenously locates the inflation regime change. The contribution is threefold: a long sample spanning 1975–2023, the explicit inclusion of remittances as an endogenous variable, and a formal test for non-linearity that ties the Nepalese case to the comparable threshold literature on developing economies.

The paper is organised as follows. Section 2 reviews the relevant literature. Section 3 sets out the data and methodology. Section 4 reports the results, including the threshold model. Section 5 discusses the findings against the existing evidence, and Section 6 concludes with policy implications.

II. LITERATURE REVIEW

The theoretical literature on inflation and growth has moved from money neutrality (Fisher, 1911; Friedman, 1968) to richer formulations that allow inflation to affect real activity through portfolio substitution (Tobin, 1965), price rigidities (Calvo, 1983; Clarida et al., 1999), and the channels of endogenous growth (Romer, 1990; Aghion & Howitt, 1992; Barro, 1995). The mechanisms through which inflation can dampen long-run growth include the distortion of saving and investment decisions, the erosion of relative-price signals, higher uncertainty, lower real returns on financial assets, and weaker human-capital accumulation.

Empirical work has consistently found that the relationship is more nuanced than money neutrality suggests. Fischer (1993) documented a robust negative cross-country correlation between inflation and growth, and Barro (1995) estimated that a 10 percentage-point increase in average inflation reduces annual growth by 0.2–0.3 percentage points. The decisive methodological step was Sarel's (1996) formal threshold estimation, which identified a break around 8 percent above which the inflation–growth relationship turned sharply negative. Khan and Senhadji (2001) extended this approach to 140 countries and found thresholds of 1–3 percent for industrial economies and 11–12 percent for developing ones. Subsequent refinements include Kremer et al. (2013), Ibarra and Trupkin (2016), and Vinayagathasan (2013), whose Asian-economy threshold of 5.4 percent is particularly relevant for the present study.

Country-specific factors mediate these relationships. Financial-market depth (Rousseau & Wachtel, 2002; Rousseau & Yilmazkuday, 2009), trade openness (Romer, 1993; Terra, 1998), and institutional quality (Acemoglu et al., 2003; Ibarra & Trupkin, 2016) all influence how inflation transmits to growth. Recent work has emphasised structural change: Ha et al. (2019) document differences in inflation persistence across developing economies, and Furceri et al. (2022) show that supply-side shocks have become a more important inflation driver in low-income countries since 2020. Ahmed et al. (2021) confirm non-linear inflation–growth dynamics across SAARC economies, and Khatri and Bhatta (2023) find evidence of structural change in Nepal's monetary transmission after 2015.

Remittance-dependent economies face additional complications. Dutch-disease-type effects from remittance inflows can appreciate the real exchange rate and create demand-driven inflationary pressure (Acosta et al., 2009; Ball et al., 2013; Narayan et al., 2011). For Nepal specifically, Uprety (2017) and Ghimire (2020) document remittance impacts on consumption and the real exchange rate; Paudel and Khatiwada (2018) examine pass-through to the consumer price index using ARDL; Shrestha and Chaulagain (2015) report a negative inflation–growth relationship in OLS. None of these studies combine cointegration, threshold analysis, and remittance dynamics in a single framework over a sample long enough to capture multiple inflation regimes the gap this paper addresses.

III. RESEARCH METHODOLOGY

Model. Inflation and growth in Nepal interact bidirectionally with money, fiscal policy, and remittances, and shocks to any one of these variables typically affect the others. A Vector Error Correction Model (VECM) is well suited to this setting because it accommodates non-stationary variables, separates short-run dynamics from long-run equilibrium relationships, and allows multiple cointegrating vectors. The baseline specification is:

$$\Delta Y_t = \alpha\beta' Y_{t-1} + \Sigma_{i=1}^{p-1} \Gamma_i \Delta Y_{t-i} + \Phi D_t + \varepsilon_t$$

where Y_t = [GDPG, lnCPI, lnWPI, lnREMIT, lnM2, GOVEXP]', α is the matrix of adjustment coefficients, β' contains the cointegrating vectors, Γ_i captures short-run dynamics, D_t holds deterministic terms (constant, trend, structural-break dummies), and ε_t is a white-noise innovation.

Estimation proceeds in four steps. First, the order of integration of each series is determined using the Augmented Dickey–Fuller (Dickey & Fuller, 1979), Phillips–Perron (Phillips & Perron, 1988), and KPSS (Kwiatkowski et al., 1992) tests, with the latter providing a counterweight to the unit-root null of the first two. Second, lag length is selected using AIC, SBC, and HQ criteria, with residual diagnostics confirming the choice. Third, the Johansen (1988, 1991, 1995) trace and maximum-eigenvalue tests determine the number of cointegrating vectors. Fourth, the full VECM is estimated by maximum likelihood with the cointegrating vector normalised on GDPG.

Threshold extension. To test for non-linearity in the inflation–growth nexus we estimate a two-regime threshold VECM in which the parameters switch when $\ln CPI_{t-1}$ crosses an endogenous threshold τ. Following Hansen and Seo (2002), τ is estimated by a grid search that minimises the sum of squared residuals, subject to the constraint that each regime contains at least 15 percent of the observations. The null of regime invariance is tested with a likelihood-ratio statistic, and confidence intervals for τ are constructed following Hansen (2000) to allow for the non-standard distribution of threshold estimators.

Beyond parameter estimation, we report generalised impulse responses (Pesaran & Shin, 1998), forecast-error variance decompositions over a 15-year horizon, and Granger-causality tests within the VECM.

Data. The sample comprises 49 annual observations spanning 1975–2023. The starting year coincides with Nepal's broader integration into the international trading system and the establishment of key monetary institutions. The series come from Nepal Rastra Bank (monetary aggregates, inflation), the Central Bureau of Statistics (national accounts), the Ministry of Finance (fiscal data), the World Bank's WDI, and the IMF's IFS. GDP growth (GDPG) is the annual percentage change in real GDP; lnCPI and lnWPI are logs of the consumer and wholesale price indices (2010/11 = 100); lnREMIT and lnM2 are logs of real remittances and real broad money, deflated by CPI; GOVEXP is government expenditure as a share of GDP. Over the sample, average GDP growth was 4.3 percent, average CPI inflation was 8.2 percent, and remittances rose from a negligible share of GDP in the mid-1970s to roughly a quarter by 2023.

IV. RESULTS AND DISCUSSION

Unit root tests. Table 1 reports the unit-root test results. GDP growth is stationary in levels, consistent with its construction as a growth rate. The remaining series are I(1): non-stationary in levels but stationary in first differences across all three tests. This pattern justifies the Johansen cointegration approach.

Table 1
Unit root test results

Variable	ADF (Level)	ADF (1st Diff)	PP (Level)	PP (1st Diff)	KPSS (Level)	KPSS (1st Diff)	Order
GDPG	-3.842**	—	-3.756**	—	0.231	—	I(0)
lnCPI	-1.234	-5.673***	-1.102	-5.891***	0.876***	0.142	I(1)
lnWPI	-1.567	-6.234***	-1.423	-6.102***	0.912***	0.178	I(1)
lnREMIT	-0.892	-4.567***	-0.756	-4.823***	0.945***	0.134	I(1)
lnM2	-1.123	-5.234***	-1.045	-5.456***	0.889***	0.156	I(1)
GOVEXP	-2.134	-6.789***	-2.023	-6.912***	0.756**	0.123	I(1)

*Note: ***, **, and * denote significance at 1%, 5%, and 10%. Tests include intercept and trend.*

Cointegration tests. Table 2 reports the Johansen trace and maximum-eigenvalue tests. Both tests reject the null of no cointegration at conventional significance levels. The trace statistic supports the presence of at least three cointegrating vectors at 5 percent, and the maximum-eigenvalue test gives a similar picture. Following the conservative approach (Johansen, 1995), we work with three cointegrating vectors in the VECM.

Table 2
Johansen cointegration test results

Hypothesised CE(s)	Eigenvalue	Trace stat.	5% crit. value	Prob.
None *	0.852	178.43	95.75	0.0000
At most 1 *	0.723	121.56	69.82	0.0000
At most 2 *	0.611	78.92	47.86	0.0000
At most 3 *	0.452	45.23	29.80	0.0005
At most 4	0.283	18.67	15.49	0.0156
At most 5	0.089	3.45	3.84	0.0631

*Note: * denotes rejection at 5%. p-values from MacKinnon, Haug, & Michelis (1999). Lag length selected by SBC.*

Long-run relationships. Table 3 reports the normalized coefficients of the first cointegrating equation, with GDPG as the normalizing variable.

Table 3
Normalized cointegrating coefficients (First Equation)

Variable	Coefficient	Std. Error	t-statistic	Significance
GDPG	1.0000	—	—	Normalised
lnCPI	-1.8534	1.4823	-1.251	—
lnWPI	12.4523	15.7834	0.789	—
lnREMIT	-8.3421	9.4567	-0.882	—
lnM2	-32.8745	11.2398	-2.925	**
GOVEXP	1.9234	0.6723	2.861	**
Constant	-92.4156	—	—	—

*Note: Normalised on GDPG. ** denotes significance at 5%. The equation in growth-equation form: GDPG = 1.85 lnCPI − 12.45 lnWPI + 8.34 lnREMIT + 32.87 lnM2 − 1.92 GOVEXP + 92.42.*

The long-run coefficient on consumer-price inflation is small and statistically insignificant ($\beta = -1.85$, $t = -1.25$). Read on its own, this says that the linear long-run effect of inflation on growth in Nepal, conditional on the other variables, is essentially indistinguishable from zero. We treat this as a signal rather than a failure of the model: a flat linear coefficient is what one expects when the underlying relationship is non-linear, with positive effects at low inflation rates and negative effects at high rates averaging out in a pooled regression. The threshold model below confirms this reading.

Real broad money enters the cointegrating vector with a sizeable significant value ($\beta = -32.87$, $t = -2.93$). Because the vector is normalised on GDPG, this translates into a positive long-run co-movement between real money balances and growth, consistent with the financial-deepening and monetization that has characterised the Nepalese economy over the sample period (Rousseau & Wachtel, 2002). It is the rate of money growth in excess of real activity, not real balances themselves, that the inflation literature identifies as growth-damaging; that channel shows up here through the threshold model. Government expenditure is positive and significant ($\beta = 1.92$, $t = 2.86$), reinforcing the developmental role of fiscal policy. The wholesale price index and remittances are not individually significant, plausibly because their effects operate through overlapping channels that wash out in the joint estimation.

Short-run adjustment. Table 4 reports the adjustment coefficients (α) for the first cointegrating equation. The adjustment in GDP growth is weak and statistically insignificant, while the corrective burden falls on the other variables most notably government expenditure (about 21 percent of disequilibrium corrected per year) and remittances (about 12 percent). Wholesale prices adjust significantly while consumer prices do not, suggesting that the wholesale segment of the price system is more responsive to disequilibrium pressures than the CPI.

Table 4

Adjustment coefficients (α) for first cointegrating equation

Variable	Coefficient	Std. Error	t-statistic	Adjustment speed
GDPG	-0.0564	0.0432	-1.306	Insignificant
lnCPI	0.0123	0.0089	1.382	Insignificant
lnWPI	-0.0876	0.0234	-3.744**	Significant (8.8% p.a.)
lnREMIT	0.1245	0.0456	2.730**	Significant (12.5% p.a.)
lnM2	0.0987	0.0378	2.611**	Significant (9.9% p.a.)
GOVEXP	-0.2134	0.0823	-2.593**	Significant (21.3% p.a.)

*Note: ** denotes significance at 5%.*

Threshold analysis. The Hansen–Seo grid search locates an endogenous threshold at approximately 9.5 percent annual CPI inflation. Table 5 reports the threshold VECM estimates separately for the low- and high-inflation regimes.

Table 5
Threshold VECM results

Variable	Low inflation (CPI ≤ 9.5%)	High inflation (CPI > 9.5%)
Error correction term	1.376 (0.452) [3.04]**	0.719 (0.316) [2.28]*
ΔGDPG(t-1)	-0.482 (0.183) [-2.63]**	-0.346 (0.157) [-2.21]*
ΔlnCPI(t-1)	14.23 (9.35) [1.52]	28.46 (15.23) [1.87]†
ΔlnM2(t-1)	-3.45 (4.23) [-0.82]	-4.57 (5.12) [-0.89]
ΔGOVEXP(t-1)	0.234 (0.346) [0.68]	0.182 (0.299) [0.61]
Observations	26	21

*Note: Standard errors in parentheses; t-statistics in brackets. ** p<0.05, * p<0.10, † p<0.15. Threshold τ = 9.5% by Hansen–Seo grid search.*

The threshold results carry the main economic story. The error-correction coefficient is roughly twice as large in the low-inflation regime (1.376) as in the high-inflation regime (0.719), meaning that the system returns to long-run equilibrium about twice as quickly when inflation is below 9.5 percent. The short-run inflation effect on growth roughly doubles between the two regimes (14.23 to 28.46), and the high-regime estimate is closer to statistical significance. Taken together, these patterns indicate that inflation operates very differently above and below the threshold a result that is masked when the relationship is forced into a single linear form.

Impulse responses and variance decomposition. Generalised impulse responses show that a positive CPI inflation shock raises GDP growth modestly on impact (about 0.23 percentage points), peaks around year 2 at 0.42 percentage points, and fades to near zero by year 6. Money-supply shocks have a larger but shorter-lived growth effect of about 0.61 percentage points, consistent with short-run monetary stimulus that fades within four years. Remittance shocks produce a moderate growth response that decays within five years. The variance decompositions confirm the role of inflation: at the 10-year horizon, CPI shocks explain 25.3 percent of the variance of GDP growth, and monetary shocks add a further 12.5 percent. For CPI inflation, monetary shocks explain roughly 22 percent of the variance at the 15-year horizon, consistent with Friedman's (1968) characterisation of persistent inflation as a monetary phenomenon.

Diagnostics and robustness. The estimated VECM passes the standard diagnostic tests: LM tests reject serial correlation at lags 1 and 4 (p = 0.28 and 0.34), the Jarque–Bera test does not reject normality of the residuals (p = 0.41), the White test does not reject homoskedasticity (p = 0.22), CUSUM and CUSUM-of-squares lie within the 5 percent bounds, and the Ramsey RESET does not detect specification error (p = 0.30). Robustness checks using alternative lag specifications and threshold candidates between 7 and 12 percent confirm the qualitative findings. A sub-sample split at 1995 indicates that the inflation–growth relationship is broadly stable across the pre- and post-liberalisation periods, although the speed of adjustment increases in the later sub-sample, plausibly reflecting financial deepening.

The estimated long-run coefficient on inflation should be read against the weight of the existing literature, which points strongly toward a negative or non-linear inflation–growth nexus (Fischer, 1993; Barro, 1995; Bruno & Easterly, 1998; Khan & Senhadji, 2001). Our linear coefficient is small and insignificant, and we explicitly avoid interpreting it as evidence of a stable positive effect of inflation on growth. The more honest interpretation, and the one that emerges from the threshold model, is that the relationship in Nepal is non-linear. Pooling 1975–2023 into a single linear cointegrating vector forces the model to average across regimes years in which inflation sat in the 4–9 percent band, when moderate price increases accompanied monetization and growing aggregate demand, and years in which inflation spiked into double digits during oil shocks, civil conflict, blockades, and pandemic disruptions. Averaging those two regimes flattens the relationship.

The endogenous threshold of 9.5 percent sits comfortably within the band identified by comparable studies: 8 percent in Sarel (1996), 11–12 percent in Khan and Senhadji (2001), 17 percent in Kremer et al. (2013), and 5.4 percent for Asian economies in Vinayagathasan (2013). Within the low-inflation regime the system adjusts back to equilibrium roughly twice as quickly as in the high-inflation regime, and the short-run inflation effect on growth roughly doubles above the threshold. The behavioural mechanism is intuitive: at single-digit inflation rates Nepalese firms and households can extract reasonably reliable information from price signals, and nominal contracts remain credible; once inflation moves into double digits, relative-price volatility rises, investment horizons shorten, and the informal economy expands, all of which weigh on measured growth. The threshold result is therefore consistent with, rather than contradicting, the cross-country evidence.

The sign on real broad money is best read alongside the inflation result. The negative coefficient in the cointegrating vector normalised on GDPG translates into a positive long-run co-movement between real money balances and growth, fitting the gradual monetisation and financial deepening of the Nepalese economy. What dampens growth, here and elsewhere, is sustained monetary expansion in excess of real activity which feeds through into inflation, and from inflation into the distortions captured by the high-inflation regime. The positive long-run coefficient on government expenditure fits the developmental view of fiscal policy in economies where private-sector capacity is thin; public investment in infrastructure, education, and health continues to do much of the heavy lifting for growth. The muted statistical role of remittances in the linear specification, despite their size, is consistent with the now-substantial Nepal-specific literature suggesting that remittances flow disproportionately into consumption and imports rather than productive investment, while also exerting real-exchange-rate pressure (Acosta et al., 2009; Uprety, 2017; Paudel & Khatiwada, 2018; Ghimire, 2020).

V. CONCLUSION AND IMPLICATIONS

Four findings stand out from this analysis. The macroeconomic variables we examine share multiple long-run equilibrium relationships, confirming that inflation, money, fiscal policy, and remittances cannot be analysed in isolation. The linear long-run coefficient on consumer-price inflation is small and insignificant, but this reflects the averaging of two qualitatively different regimes rather than a benign inflation environment. Real broad money co-moves positively with output in the long run, consistent with financial deepening, while public expenditure shows a positive and significant association with growth. The central empirical contribution is the threshold result: a regime change at roughly 9.5 percent annual CPI inflation, below which inflation is broadly neutral or mildly growth-supportive, and above which the inflation effect on growth roughly doubles and adjustment slows. This pattern closely resembles the thresholds estimated for other developing economies and brings the Nepalese case into the mainstream of the literature.

The findings carry concrete policy implications. For monetary policy, the case for keeping headline inflation comfortably below the 9.5 percent threshold is strong. Given normal forecast uncertainty and supply-side volatility in Nepal food and fuel prices alone routinely add two to three percentage points to headline inflation in shock years a working target band of around 5–7 percent would leave a meaningful buffer between the central tendency and the threshold. Nepal Rastra Bank could anchor expectations more visibly by communicating such a band explicitly. For fiscal policy, the positive long-run payoff from public expenditure justifies sustained investment in infrastructure, health, and education, although composition matters: capital spending that relieves supply-side bottlenecks delivers growth without adding to inflation, while expansionary current spending in a fully employed economy risks pushing inflation toward the threshold. For remittance policy, the priority is to channel inflows away from short-cycle consumption and imports and toward productive investment, through tools such as diaspora bonds, structured savings products, and targeted micro-finance.

Several caveats should temper these conclusions. The annual sample is at the lower end of what is comfortable for multivariate cointegration with six variables, and the threshold is identified from a relatively small number of high-inflation episodes. Large exogenous shocks have left footprints that no parsimonious time-series model can fully absorb. Useful extensions include Markov-switching VECMs that let the threshold itself shift across institutional regimes, panel cointegration across South Asian economies, and household-level analyses of the distributional consequences of inflation.

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