

# Determinants of inflation and impact of selected Macro variable on Inflation in Nepal

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## Abstract

*This paper aimed to identify the impact of selected macro variable on inflation and examining the relationship between inflation rate and selected macro variables. Generally, both fiscal and monetary policies seek at achieving relative macroeconomic stability through stable prices or low and stable inflation. In the light of this, this study empirically investigates the impact of some macro variable on inflation in Nepal with the use of econometric technique multiple regression, correlation and trend analysis using time series data from 2001 to 2018. The annual data is collected from Nepal Rastra Bank and web site of World Bank. The result revealed that money supply is positively correlated with inflation, but the result is however insignificant in the case of GDP growth rate and to determine the inflation rate in context of Nepal. The regression analysis indicates that 85.9% of inflation rate is determined by exchange rate, money supply, GDP, per capita income and inflation rate of India, rest in 14.1% inflation rate is determined by other factors. The study found that there is positive correlation between exchange rate and inflation rate, money supply and inflation, per capita income and inflation rate and Indian inflation and inflation rate of Nepal. But study also revealed that insignificant negative correlation between GDP and inflation rate of Nepal. The exchange rate, money supply and Indian inflation are significant with inflation but GDP and per capita income are insignificant with inflation over the time period under study. There is only the monetary policy is not capable to control inflation, the fiscal measure are highly effective to controlling government expenditure, personal expenditure and private & public investment. The study therefore recommends that the central bank of Nepal need to deal with monetary and fiscal policy in more transparent manner so as to address the issue of inflation in Nepal.*

*Keywords: money supply, inflation, exchange rate, GDP, per capital income.*

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## Introduction

Inflation refers to a persistent and appreciable rise in price level over a period. Inflation can be defined as the persistent rise in the general price level across the economy over time. Inflation is an increase in the volume of money and credit relative to available goods resulting in a substantial and continuing rise in the general price level. High inflation is more likely to raise unemployment than to lower it (Friedman, 1977). More specifically, it hurts the poorest of the poor having fixed level of income, as inflation erodes their real wealth. In other words, it further widens the income inequality in society. According to Keynes, "inflation" can be applied to an underdeveloped country where unemployment of means and resources exist side by side with inflationary rise in prices. This is due to the existence of bottlenecks, such as limited amount of capital, machinery, transport facilities and absence of technical know-how. As a result of these bottlenecks and shortages, a rise in the price level may not lead to increase output beyond a certain stage, even though the country may not have reached the stage of full employment. Shapiro (2010) defines inflation as a rising price level. If such rise in price level persist for a long time, then it is known as inflation. Consumer price index, gross domestic product deflator and other several indices measure the changes in price level.

Jalali (2011) defines inflation as a progressive rise in price level, usually over a period of time. Inflation is caused by continuous increase in the supply of money, a progressive decrease for money or both.

The quantity theory of money explained that increasing quantity of money supply would lead to almost equal percentage of the increase in price of commodities. The theory asserts that general changes in price are primarily caused by changes in the money in circulation (Ricardo, 1817). The Keynesian theory on the other hand states savings have no positive effect on investment as long as the economy suffers under employment. Keynes explained that an increase in the general price level or inflation is created caused by an increase in aggregate demand which is above the aggregate supply. Monetary theory advocates for the idea that market to regulate itself through market efficiency and reject most of government intervention. Monetarist argues that an increase in money supply will only lead to increase in output or production and employment levels in the short run and not in the long run.

Consequently, the effectiveness of monetary policy in timing inflationary trends in under developing economics such as Nepalese economy has been in doubt although appreciable progress has been made in this regard since the introduction of various financial sector reform program in 1986. The main objective of monetary policy in Nepal is price stability and control inflation. The fixed exchange rate of India and budget deficit is the main problem of inflation in Nepal. Inflation is price increase of product or services in market in abnormal way. It creates great depression in the economy. Paudyal (2011) stated that the main determinants of inflation were budget deficit, board money supply,

Indian prices, exchange rate and real GDP (gross domestic product). This result suggests that these factors were the main determinant of inflation in Nepal.

Inflation depreciates domestic currency value and imports become more expensive which further push up the domestic prices. In short, inflation is a burning issue in the macroeconomics. The main objective and function of central bank is to control inflation. In case of Nepal inflation has increased persistently over the years. It has increased by little over twenty-six times (from 6.8 to 178.8) during 1975 to 2018. This means the purchasing power of the Nepalese rupee has decreased in the same speed. The impact of rising prices on the real sector is stylized fact. It constrains the rise of per capita real GDP and thereby reduces the standard of livings of the common people in the country. The stationary price level has been one of success parameters of the government. However, it has been a Herculean task to achieve in developing countries. In case of Nepal, however, there appear some positive signals in slowing down the speed of price rise in the later years. Chaudhary (2018) was considered broad money supply, real GDP, Indian prices. The study indicates board money supply and exchange rate is significant and positive with inflation rate.

Measurement of prices in Nepal was began from 1973 using the expenditure weightage of the goods and services of the people obtained from first household budget survey (HBS). Consumer price index (CPI) in 1975 is 6.8 and 178.8 in 2018. It means price of goods and services are

increase in same way. Due to the fixed exchange rate between India and Nepal it affects the inflation or CPI in Nepal. Devaluation of Indian currency and increase price of product in Indian market directly affect the Nepalese consumer price index. The study therefore deals with the following issues:

What is the trend of selected determinants of inflation in Nepal?

What is the relationship between selected macro variables and inflation in Nepal?

What is the impact of selected macro variables on inflation rate in Nepal?

The general purpose of this study is to analyze the impact of selected macro variables on inflation in Nepal. The specific objectives are as follows:

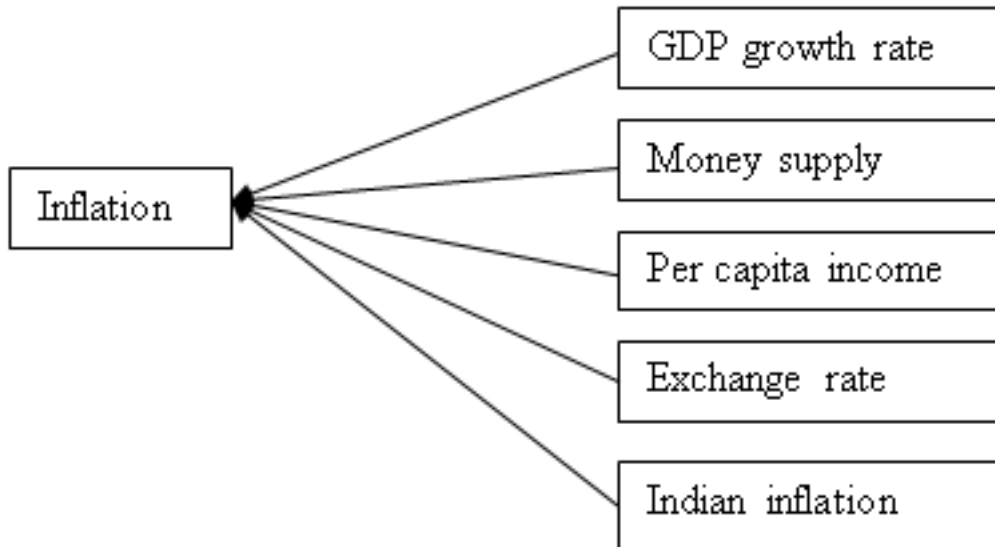
To analyze the trend of selected determinants of inflation in Nepal.

To examine the relationship between selected macro variable and inflation in Nepal.

To analyze the impact of selected macro variables on inflation in Nepal.

### Conceptual Framework

This study has used Inflation as dependent variable and GDP growth rate, money supply (M2) per capital income, exchange rate, and Indian Inflation rate as independent variables to examine the determinant of inflation of GDP growth rate, Money supply, per capita income, Exchange rate and Indian inflation.



#### Empirical Review

Gatawal (2017) examined the impact of money supply, inflation, and interest rate on economic growth in Nigeria using time series data from 1973-2013. VAR Model and Granger Causality test within error correction framework were used. The VAR model shows that there was a positive impact of broad money supply while inflation and interest rate exhibits a negative impact on growth most especially in the long run. The short run parsimonious results revealed that with the exception of inflation, broad money supply and interest rate were negatively related to economic growth. Chaudhary (2018) examined the relationship between inflation, money supply, real GDP and imported price (CPI) by reviewing relevant studies using Nepal as the reference country. The study used regression model to analysis the time series data. The study founded that the growth of money supply, the growth rate of real GDP and import price are the main determinants of inflation in Nepal. The study concluded the prices in Nepal are highly

dependent on Indian prices because of a weaker supply of domestic production and increased imported goods and services from India from India. Paudyal (2014) investigated short term and long term effects of the macroeconomic variables on the inflation in Nepal during 1975-2011. The variables considered in study were budget deficits, Indian prices, broad money supply, exchange rate and real GDP with used regression model and Wickens-Breusch Single Equation Error Correction model to analysis the data. The study found fixed exchange rate with India and Indian inflation are the main determinant of inflation in Nepal. The exchange rate and inflation rate of India were significant in long run and only budget deficit, money supply and Indian prices cause inflation in the short run. This study concluded that fixed exchange rate with India and Indian inflation is the main determinants of inflation in Nepal. Mohamed (2016) investigated the impact of monetary policy on inflation rate in Sudan during the

period of 1970 to 2014 and used both descriptive and analytical method in this study. The result found that there is strong correlation between money supply, GDP, budget deficit and inflation but the exchange rate and government expenditure are not influence in inflation in Sudan. The study recommended that the government should depend on real sources in financing budget deficit rather than monetizing deficit by and borrowing from the central Bank, which has significant impact on increasing money supply, it has to ensure effective role in financing budget deficit and controlling inflation. Sec (2015) examined the determinant of inflation in high inflation countries and low inflation countries by using Error correction model with time serious data 1970 to 2011. The study founded that money supply and national expenditure have significant effect on inflation in high inflation countries. In low inflation countries GDP growth have a negative impact and import of goods and services have positive impact on inflation. The study concluded all exogenous variables impact on inflation except national expenditure in low inflation countries. Ghani (2017) studied the determinant of inflation in Malaysia by using econometric model and mathematical model to analysis the data. The study founded that 60% of inflation in Malaysia was explained by these variables and 40% in others. The money supply, exchange rate, unemployment rate was positively correlated with inflation rate in Malaysia. He concluded high inflation may cause negative impact to a particular country. The study suggested to reduce the inflation government should try to reduce unlimited expenditure on non-development activities, reduce unlimited consumption and increase rate of tax. Sabaey (2012) studied the sources of inflation in developing and developed countries by using

supply, oil prices, interest rate, and exchange rate population are independent variable and inflation is the dependent variable. The result shows determinant of inflation in developed countries include government spending, money supply, oil prices, interest rate, exchange rate and population in developing countries. He concluded that the inflation in developed countries determined by monetary variable, demand side and supply side. Mameed (2011) studied the impact of monetary policy on gross domestic product (GDP) by using Regression analysis technique. The analysis found only 81.1 % explained by the independent variable and rest in other factor. The study concluded that to achieve main objective of monetary policy government control money supply, reduce inflation and increase reserve money in the economy. Yolanda (2017) analyzed factor affecting inflation and its impact on human development index and poverty in Indonesia by using multiple regression models. The result shows money supply, exchange rate, oil prices, gold prices and BI rate are positive and significant in Indonesian economy. Nigina (2013) studied the factor affecting inflation in Tajikistan by using VAR model. The study found two types of factor on is cost pull factor of inflation and another is demand pull inflation. The study concluded supply of labor play important role in price level of economy and the under production inside the economy create unemployment problem. Wulan (2015) analyzed the factor affecting inflation in Indonesia by using multiple linear regression models. The study found interest rate, money supply and exchange rate partially significant on inflation. The study concluded that interest rate, money supply and exchange rate have positive impact on inflation. Taiwo (2011) analyzed the impact of inflation and monetary

policy stabilization on economic growth performance in Nigeria. The result showed that money supply is positive related to economic growth and significant in inflation but inflation is insignificant with GDP. The study concluded that monetary policy along is incapable of controlling inflation. It should be supplemented by fiscal measure, non monetary and non fiscal measures. Abdullah (2012) analyzed the impacts of monetary policy on inflation in Bangladesh by using multiple regression models. There is positive correlation between GDP growth and inflation but negative correlation between inflation and money supply. Honore (2018) examined the relationship between monetary policy and inflation in Cameroon by using VAR models. The result shows that there is a long run equilibrium relationship between the money supply and inflation, money supply has a positive and significant effect on inflation in Cameroon. The study concluded monetary policy should be planned to maintain price stability by controlling the growth of the money supply in the Cameroonian economy. Denbel (2016) examined the relationship between inflation, money supply and economic growth in Ethiopia. The result indicated that there was bi-directional causal relationship between inflation and money supply and uni-directional causality from money supply and inflation. Hossain (2013) examined the determinant of inflation in Bangladesh by ordinary least square (OLS) method. The researcher found money supply and interest rate significant with inflation in long run and in short run money supply and fiscal deficit are significantly and negatively influence over inflation rate. The study suggested increase production of goods and services, control wages and import from abroad for reduction of inflation. Cioran (2014) examined the

relationship between monetary policy and inflation. The researcher found there was significant direct relation between monetary policy interest rate and inflation. He also found there were inverse statistically significant relation between inflation rate and unemployment rate. The study concluded that interest rate an efficient instrument for central bank to prevent inflation and the inflation rate was an effective instrument in preventing the increase of the unemployment. Rehman (2010) examined the relationship between macroeconomic variable and exchange rate. The result shows that positive significant relationship between inflation and exchange rate while a negative significant relationship between interest rate and exchange rate. Yugange (2017) examined the relationship between money supply and macroeconomic variables in China. The finding of analysis revealed that in China increase in GDP can result increase money supply, and increase rate of inflation also increase money supply; oppositely increase interest rate can cause decrease in the money supply

## Material and methods

The data for this study is taken from NepalRastra Bank and annual publication of world Bank during 2001 to 2018. To describe and examine the impact of the monetary policy tools in countering inflation in Nepal for that period ,the study has used descriptive statistics,multiple regression analysis, correlation, T – test, and F – test. The main purpose of this study is to analyze the impact of monetary policy tools in inflation and examining the relationship between the variables.

## Variables

The dependent variable was inflation(Y) .This

refers to the change witnessed in the level of prices paid by the average consumer during a given period in the course of his purchase of goods and services. To measure inflation, the consumer price index is used. The independent variables are Monetary policy (X2): This is the channel by which the monetary authority, generally the central bank, acts on the supply of money in order to stabilize prices. The exchange rate (X1): shows the relationship of a currency with others. It determines the competitiveness of a country's exports. A favorable exchange rate enables better negotiations worldwide. In this study, the rate of exchange of the local currency (NC) with respect to the Indian currency (IC) is used. The exchange rate plays an important role in the determination of inflation in developing countries. Gross Domestic Product (X3): Gross domestic product is a total market value of the goods and services produced by a country's economy during a specified period of time. It includes all final goods and services that are produced by the economic agents located in that country regardless of their ownership and that are not resold in any form. Per capita Income (X4): Per capita is a measure of the amount of money earned per person in a certain area. Per capita income is calculated national income divided by population size. Per capita income is often used to measure a sector's average income and compare the wealth of different populations.

The data for this study are obtained from central bank of Nepal (NRB) annually statistical bulletin and annual report of World Bank from 2001 to 2018. The multiple Regression Models should employ to obtaining the numerical estimates of the coefficient in different equation.

#### Multiple Regression Model

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + e$$

Where  $y$  = Inflation,  $X_1$  = Exchange rate,  $X_2$  = Money supply growth rate,  $X_3$  = gross domestic product growth rate,  $X_4$  = Per capita income,  $X_5$  = Indian inflation,  $\beta_0$  = Constant,  $\beta_1, \beta_2, \beta_3, \beta_4$  &  $\beta_5$  = Parameters, and  $e$  = error term.

#### Descriptive Statistics

The Descriptive statistics of the independent variables like inflation rate, Exchange rate, M2 growth rate has shown in the table below.

**Table 5.1**  
*Descriptive Statistics*

	N	Minimum	Maximum	Mean	Std. Deviation
Inflation rate	18	2.4	12.6	6.883	2.9004
Exchange rate	18	56.02	106.35	82.2617	14.64841
M2 growth rate	18	4.4	28.0	17.056	6.3308
GDP growth rate	18	.1200	8.2200	4.288333	1.9548951
Per capita income	18	245	1026	554.28	248.154
Indian inflation rate	18	2.4910	11.9890	6.493333	2.8679998

Source: SPSS

Correlation Analysis : Correlation is the measurement of relationship between two or more variables. and takes the values 0 and 1 inclusively. The following tables has shown the correlation between inflation and macroeconomic variables inflation rate of Nepal, exchange rate, Money supply growth rate, GDP growth rate, per capita income and Indian inflation which is denoted by INF, X1, X2, X3, X4, and X5 respectively.

**Table 5.2**  
*Correlations*

		Inflation rate	Exchange rate	M2 growth rate	GDP growth rate	Per capita income	Indian inflation rate
Inflation rate	Pearson Correlation	1					
	Sig. (2-tailed)						
	N	18					
Exchange rate	Pearson Correlation	.075	1				
	Sig. (2-tailed)	.769					
	N	18	18				
M2 growth rate	Pearson Correlation	.654**	.053	1			
	Sig. (2-tailed)	.003	.835				
	N	18	18	18			
GDP growth rate	Pearson Correlation	-.119	.123	.297	1		
	Sig. (2-tailed)	.637	.627	.231			
	N	18	18	18	18		
Per capita income	Pearson Correlation	.355	.764**	.510*	.354	1	
	Sig. (2-tailed)	.148	.000	.030	.150		
	N	18	18	18	18	18	
Indian inflation rate	Pearson Correlation	.791**	-.278	.533*	.004	.186	1
	Sig. (2-tailed)	.000	.265	.023	.987	.459	
	N	18	18	18	18	18	18

Source: SPSS output



Table 5.2 shows the bivariate Pearson correlation coefficient between inflation and other macroeconomic variable exchange rate, money supply growth rate, GDP growth rate, per capita income, and Indian inflation. The correlation coefficient of exchange rate and inflation rate is 0.075; there is insignificant and positive correlation between exchange rate and inflation rate in Nepal. The correlation coefficient of Money supply growth rate and inflation rate is 0.654; there is significant and positive correlation between money supply growth rate and inflation rate of Nepal. The correlation coefficient of GDP growth rate and inflation rate is -0.119; there is

insignificant and negative correlation between GDP growth rate inflation rates. The correlation coefficient of per capita income and inflation rate is 0.355; there is insignificant and positive correlation between per capita income and inflation rate of Nepal. The correlation coefficient of inflation rate of Nepal and India is 0.791 there is significant and positive correlation between inflation rate of Nepal and India.

### Multicollinearity Test

Multicollinearity is the existence of perfect or exact linear relationship among some or all explanatory variables included in a regression model.

**Table 5.3**  
*Coefficients*

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	-9.240	4.047		-2.283	.041		
	Exchange rate	.138	.052	.696	2.658	.021	.171	5.850
	M2 growth rate	.229	.074	.500	3.090	.009	.447	2.238
	GDP growth rate	-.255	.187	-.172	-1.361	.198	.737	1.356
	Per capita income	-.006	.003	-.524	-1.788	.099	.137	7.324
	Indian inflation	.825	.160	.816	5.151	.000	.467	2.142

Source: SPSS

### Regression Analysis

The process of developing the mathematical equation between dependent variable and independent variables is known as regression. The analysis applied the statistical package for social sciences (SPSS) version 22 to compute the measurements of multiple regressions for the study.

**Table 5.4***Model Summary*

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.927 <sup>a</sup>	.859	.801	1.2949

Source: SPSS

The table 5.4 shows the output From the findings the 85.9%.of the inflation in Nepal was attributed to combination of the five independent factors (Money supply growth rate, exchange rate, GDP growth rate, per capita income and Indian inflation) and rest 14.1 present inflation of Nepal is determined by other factor which are not consider in this study. The adjusted

R square is 80.1, which is less than the unadjusted F square by around 5.8 points. This decline adjusted r square is due to the addition of independent variables, without much explanatory power, to the regression plane.

**Table 5.5***ANOVAs*

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	122.885	5	24.577	14.658	.000 <sup>a</sup>
	Residual	20.120	12	1.677		
	Total	143.005	17			

Source : SPSS

The regression analysis of ANOVA table shows the P value is 0.00 which means model is significant at 5 percent significance level. At 0.05 level of significance ( $\alpha$ ), the test statistics required to carry out the test F-statistics which is  $F=14.658$  from the ANOVA table. The critical value of F at 0.05 level of significance, based on  $v_1=5$  and  $v_2=12$  degree of freedom is 3.11. Since the calculated value of F exceeds the critical value of F, we reject  $H_0$ .

**Table 5.6***Coefficients*

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-9.240	4.047		-2.283	.041
	Exchange rate	.138	.052	.696	2.658	.021
	M2 growth rate	.229	.074	.500	3.090	.009
	GDP growth rate	-.255	.187	-.172	-1.361	.198
	Per capita income	-.006	.003	-.524	-1.788	.099
	Indian inflation rate	.825	.160	.816	5.151	.000

Source: SPSS

Table 4.4 shows the regression analysis,  $\beta$  coefficient, F- Test T- Test and P-value.. The table shows the exchange rate, money supply growth rate and Indian inflation is the significant with inflation and GDP growth rate and per capita income is insignificant with inflation. The equation after including the coefficient of the variables observed from the analysis becomes:  $Y = -9.240 + 0.138X_1 + 0.229X_2 - 0.255X_3 - 0.006X_4 + 0.825X_5 + E$

### 6) Conclusion and Recommendation

The empirical results of this study emphasize a significant and positive correlation between the money supply, inflation rate and exchange rate and inflation rate. But there is negatively insignificant correlation between inflation rate and GDP growth rate and positive insignificant correlation between per capita income and inflation rate of Nepal. Higher GDP growth rate increase the supply in domestic market as well as foreign market. Large volume of production reduces per unit production cost of product in market and reduces price level.

The high per capita income increases the consumption and demand of product, which leads to raise price of product in market. Indian inflation rate is the main factors to determining inflation rate of Nepal. The analysis indicates the other variable remain constant only 1 unit change price in Indian market affect the 0.82 unit of inflation of Nepal. The Indian inflation highly influenced the determining inflation in Nepal. The study concluded that the money supply, exchange rate, GDP growth rate, per capita income and Indian inflation rate are the main determinants of inflation of Nepal. These variables explained the 85.9% of inflation rate of Nepal and 14.1% are explained by other. The study concludes that exchange rates and Indian inflation are critical element of general price levels in Nepal. This is because Nepal has a negative balance of trade, therefore being a net importer which means that in purchases more in foreign currency than it exports. The prices of imported goods heavily correlate with the prevailing rates of foreign exchange. The study also indicates that negative insignificant correlation between inflation rate

and GDP growth rate. But there is insignificant positive correlation between inflation rate and per capita income. The higher GDP purchase less from foreign market and export more in international level. These macro variables play measure role to reduce inflation and to achieve price stability in the economy. The study recommends that the policy makers mainly the Central Bank should make a critical analysis of the intended inflation targets when making the economic policy (monetary policy and fiscal policy). The Policy makers should align the money supply targets with the medium and long-term economical goals. The study recommends that the policy makers involved in setting economic goals to ensure that that there are geared towards maintaining a stable foreign exchange rate. Because of importer and exporter fluctuating exchange rate significantly affect the price level of Nepal. The Nepal government must consider the consumer price index of India when formulating economic policy, because it's impact on inflation of Nepal is significant and positive correlation. It is a common knowledge that there could be black markets and other factors that might affect inflation hence more studies need to be carried to ensure all factors that affect inflation are studied. The most of the foreign transaction done through shadow banking in Nepal, it affects the price level of in economy.

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