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# IMPACT OF INFLATION ON STOCK MARKET PERFORMANCE: A VECTOR AUTOREGRESSION APPROACH

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## ABSTRACT

This study investigates the relationship between the inflation, as measured by Consumer Price Index (CPI), and the Nepalese stock market index, exploring both short-term and long-term dynamics. Using econometric tools such as the Vector Autoregressive (VAR) model and Johansen co-integration tests, including time series data, the study examines whether inflation has a significant impact on stock market performance in Nepal. The results reveal that there is no long-term relationship between CPI and the stock market index. It suggests that inflation does not lead to a sustained equilibrium or long-run connection with stock market performance. However, a significant short-term relationship is found, where higher inflation has a weak negative impact on the stock market index, indicating that rising inflation can pressure stock prices in the immediate term. Additionally, Granger causality tests show no clear causal direction between CPI and stock market movements, suggesting that while the two variables may move together in the short run, their relationship does not follow a direct cause-and-effect pattern. The study provides valuable insights for policymakers and investors, suggesting that a comprehensive approach addressing multiple economic factors is essential for stabilizing the stock market. Further research is recommended to explore additional variables and extend the analysis over a longer period to gain a deeper understanding of these dynamics.

**Key words:** Stock Market Performance, Vector Autoregression, Johanson Cointegration, Granger Causality Test, and Consumer Price Index
JEL Classification Codes: G11, G12, G14, G41

## 1. INTRODUCTION

The stock market is a vital component of any economy, serving as a barometer for economic health and providing a platform for investment and wealth generation. Bodie et al. (2013) proposed the reasons for the study of macroeconomics and the stock market, understand economic trends, market sentiment and behaviour, risk and portfolio management, policy implication, and investment decision-making. Stock market driven by numerous factors, including investor sentiment, economic data, corporate earnings, and macroeconomic variables like inflation. The interaction between inflation and stock market performance is complex and has been the subject of extensive research across different economies. While the study (Thapa, 2025) suggests that inflation negatively affects stock prices due to the increased cost of capital and

reduced purchasing power, others argue that moderate inflation can be beneficial to the stock market as it may indicate healthy economic growth.

Inflation, often measured by the Consumer Price Index (CPI), is one of the most significant macroeconomic indicators, influencing numerous aspects of an economy. High inflation generally signifies an increase in the prices of goods and services, which can reduce the purchasing power of consumers and threaten the economy (Dahal et al., 2024). As a result, controlling inflation has been a key objective of economic policy across countries, including Nepal. Inflation directly impacts several economic variables, including interest rates, investments, and wages. Understanding the relationship between inflation and other key economic indicators, such as stock market performance, is critical for both policymakers and investors.

In the case of Nepal, the relationship between inflation and stock market performance has not been sufficiently explored. Nepal's stock market is relatively less compared to developed economies, and its dynamics are influenced by both domestic and external factors, including political instability, regulatory frameworks, and global economic conditions (Thapa, 2023a). Given the importance of inflation as a determinant of macroeconomic stability, understanding how changes in CPI affect stock prices in Nepal is crucial for both investors and policymakers.

The primary objective of this study is to explore the relationship between the Consumer Price Index (CPI) and the Nepalese Stock Market Performance. The specific objectives are to examine the long- and- short-run relationship, to assess the impact using VAR model, and to investigate the causal relationship between the Inflation and the Nepalese Stock Market Performance using Granger causality tests.

To achieve this, the study employs an econometric framework that includes the Vector Autoregressive (VAR) model and Johansen co-integration test. These tools allow for a comprehensive analysis of both the short-run dynamics and long-run equilibrium relationships between CPI and the stock market performance. The VAR model is particularly useful for analyzing the interdependence of multiple time-series variables, such as CPI and stock market prices, while the Johansen co-integration test helps determine whether a long-term equilibrium relationship exists between these variables. The study of (Agrawal & Srivastava, 2011) analyzed macroeconomic variables with the Indian stock exchange. This study employed co-integration and vector error correction model. The article concluded that there is a strong co-integration between wholesale price

index, and interest rate with the stock returns in the long run. The study also examines the Granger causality between CPI and stock prices, which helps in understanding the direction of influence between the two variables. Granger causality tests are essential in determining whether past values of one variable have predictive power over the other. This type of analysis is particularly useful for understanding the short-run dynamics of the relationship between inflation and stock prices, as well as the potential implications for investors and policymakers.

## 2. REVIEW OF LITERATURE

The study (Akaike, 1974; Schwarz, 1978; Phillips & Perron, 1988)) propose the Akaike Information Criterion (AIC), the Bayesian Information Criterion (BIC), and the Phillips-Perron (PP)) as a model selection tool, balancing goodness of fit and model complexity through a numerical criterion respectively. The papers outline the theoretical foundations and demonstrates its practical application in model comparison. Dickey & Fuller (1979) develop a method for testing the stationarity of time series data, focusing on a model where the series is generated with a parameter p. Their work provides tools for testing the null hypothesis that p equals 1, offering insights into the behavior of time series data. Sims (1980) propose empirical approaches like the Vector Autoregressive (VAR) model which links macroeconomic variables, including inflation, to macroeconomic activity. The study reveals that inflationary shocks have significant effects on stock market performance in both the short and long term. The research approach emphasizes the importance of using observed data to better understand complex economic systems and interdependencies. Engle & Granger (1987) introduce co-integration and error correction models, which allow for examining long-term relationships between non-stationary variables. Their work established these models as essential tools in time series econometrics, influencing both theoretical and empirical research. Johansen (1995) develops a maximum likelihood estimation method for identifying co-integration vectors in Gaussian VAR models, alongside hypothesis testing procedures. The research work provided a framework for analyzing multiple co-integrating relationships and has become a standard in applied econometrics.

Fama (1981) investigates the relationship between stock returns, real economic activity, inflation, and money supply. The result reveals that inflation has a negative impact on stock returns, emphasizing the importance of economic policy in managing inflation. Anjum & Habib (2025)

use a nonstationary approach to examine the relationship between stock returns, inflation, and money. The authors find that inflation and stock returns are often negatively correlated, particularly during periods of high inflation. The study of (Asaolu et al., 2011) suggests that inflation and economic variables such as interest rates and industrial production can explain stock market movements. They find that inflation has a significant impact on stock returns, depending on the stage of the business cycle.

Mohnot et al. (2024) examines the effect of inflation on stock market performance, arguing that inflation affects stock returns by altering investor expectations and the cost of capital. The study highlights the need for policymakers to manage inflation effectively to stabilize markets. Pradhan and Patna (2019) explores the relationship between inflation and stock market returns in developed and emerging markets. The study finds that inflation negatively affects stock returns in emerging markets, particularly in countries with high inflation. The article (Shanken & Weinstein, 2006) explores how inflation influences stock returns in different economic environments. It finds a negative correlation between inflation and stock returns, suggesting that high inflation periods are typically followed by low stock market performance. (Bodie et al., 2013) discusses the relationship between macroeconomic variables, including inflation, and asset returns. The authors provide a comprehensive analysis of how inflation affects investment portfolios, including stocks. Poudel (2019) examines the impact of external shocks, such as oil price changes, on inflation and stock market performance. The findings suggest that rising oil prices, which often lead to inflationary pressures, negatively affect stock market returns. Eldomiaty et al. (2020) focuses on the inflation-unemployment trade-off and its broader economic implications. The study discusses how inflation impacts overall economic stability, including stock market performance, by reducing investor confidence. The research (Suharsono et al., 2017) investigate the relationship between stock prices, exchange rates, and inflation in China. The authors find that inflation plays a crucial role in determining stock market performance, especially in emerging markets like China. The paper (Thapa, 2023b) examines how inflation influences stock market performance, taking into account the role of macroeconomic activity. The study finds that inflation negatively impacts stock market performance, particularly when it is unanticipated. The article (Mohnot et al., 2024) investigate the threshold effects of inflation on economic growth, arguing that inflation above a certain level can harm economic stability, which in

turn negatively affects stock market performance. The investigation (Dahal et al., 2024) explores the relationship between inflation and economic growth, suggesting that high inflation leads to instability and negatively impacts long-term economic and stock market performance.

Thapa and Chamlagain (2025) examined the Johansen co-integration test and revealing no evidence of a long-term equilibrium relationship between the inflation rate (CPI) and the stock market index. Shahbaz et al. (2016) examine the impact of macroeconomic factors on the growth of Pakistan's stock market from 1974 to 2010, employing the Zivot-Andrews unit root test, ARDL bounds testing, and the VEC model Granger causality approach. Their findings revealed that economic expansion, inflation, financial development, and investment foster stock market growth, while inflation influence stock market growth, financial development, and investment. Sengupta et al. (2019)assess the influence of macroeconomic factors on the Indian Stock Market's performance from 2006 to 2016, analyzing variables such as interest rates, inflation, and GDP. Through regression and factor analysis, the study explored how these macroeconomic determinants shape the performance of the CNX Nifty index, reflecting the broader economic trends.

The research on the Nepalese stock market needs for which has not received much attention in comparison to the stock markets of developed and developing countries. It explores the magnitude (Variance Decomposition Model) of the stock market and macroeconomic relationship. The study analyzes the impact of multiple lags effects by using Wald tests. This incorporates the up-to-date data and information for a contemporary analysis. This study limits the analysis of impact between inflation and stock market performance among the macroeconomic variables with time series data.

## 3. METHODS

This study employed a quantitative research design, utilizing time series data analysis methods to explore the relationship between various economic variables and investor behavior in Nepal. The research aimed to analyze data spanning from June 2005 to July 2024. It provided insights into market trends and behaviors over time. The research used the secondary data. The data were obtained from various sources, including the Nepal Stock Exchange (NEPSE), Nepal Rastra Bank (NRB), Securities Board of Nepal (SEBON), World Bank, and financial statements of listed companies. The secondary data encompassed monthly observations over the study period. The data were collected from

organizational websites, reports, and direct visits to financial institutions. The data collection procedures are websites and physically visit in the concerned offices. Econometric tools including stationarity tests, lag selection, co-integration analysis, VAR, Granger causality tests, and variance decomposition analysis were employed. The study applied the Johansen co-integration test for variables that were stationary at first difference (I(1)), and based on co-integration results, either the VEC or VAR models were used for further analysis. If variables were stationary at levels (I(0)) or I(2), the ARDL model was applied.

## 4. RESULTS AND DISCUSSIONS

### a. RESULTS

The unit root test findings presented that the inflation rate and stock market index have same one order of integration. So, Johansen co-integration used for exploring the long-term relationship between inflation rate and stock market index. the study applies the regression method using ordinary least square technique. Before doing Johansen co-integration test, it is essential to govern the optimal lag-length for the VAR model.

**Table 1. VAR Lag Order Selection Criteria for CPI to Index**

| Lag | LogL | LR | FPE | AIC | SC | HQ |
|---|---|---|---|---|---|---|
| 0 | -1141.7 | NA | 481.5025 | 11.85267 | 11.88648 | 11.86636 |
| 1 | -522.11 | 1220.082* | 0.8161* | 5.4726* | 5.5740* | 5.5137* |
| 2 | -519.31 | 5.451970 | 0.826425 | 5.485084 | 5.654136 | 5.553545 |
| 3 | -518.43 | 1.696984 | 0.853612 | 5.517412 | 5.754083 | 5.613256 |
| 4 | -516.31 | 4.045232 | 0.870453 | 5.536877 | 5.841170 | 5.660106 |

Notes: * Indicates Lag order selected by the criterion
Source: Author Calculation by using Eviews-10

Table 1 the study determines the appropriate lag length for the auto-regressive model before conducting the Johansen's co-integration test. Five widely used criteria, including AIC, SIC, LR, FPE, and HQC, are used to determine the optimum lag length. The results showed that one lag is suggested by all selection criteria for Index and CPI. The study uses one lag as optimum for running the VAR model between CPI and Index.

Johansen's maximum likelihood approach is used to determine the number of co-integrating vectors among variables based on trace and max-eigen statistics. To reject the null hypothesis, the trace value and maximum eigenvalue should exceed their critical values,

and the p-value should be less than five percent, according to Johansen's co-integration guideline. The MacKinnon-Haug-Michelis method is commonly used to calculate p-values for co-integration tests. The hypothesis for Johansen's co-integration test is H0: no co-integration or long-run relationship.

**Table 2. Trace and Max-Eigen Value Tests of Inflation to Index**

| Lags interval (in first differences): 1 to 1 | | | | |
|---|---|---|---|---|
| Unrestricted Co-integration Rank Test (Trace) | | | | |
| Hypothesized No. of CE(s) | Trace Values | | Max-Eigen Values | |
| | None | At most 1 | None | At most 1 |
| Eigen value | 0.03 | 0.00 | 0.03 | 0.00 |
| Trace Statistic | 5.61 | 0.18 | 5.43 | 0.18 |
| 0.05 Critical Value | 15.49 | 3.84 | 14.26 | 3.84 |
| Prob.** | 0.74 | 0.67 | 0.69 | 0.67 |

*Trace and Max test indicated no co-integration at the 0.05 level*

*Note: * denoted rejection of the hypothesis at the 0.05 level*

*Source: Author Calculation by using Eviews-10*

Table 2 shows the trace and max-eigenvalues, along with their corresponding test statistics for two hypotheses. The eigenvalues are 0.03 and 0.00. The test statistics are 5.61 and 0.18 for the trace value and 5.43 and 0.18 for the max-eigen value. Critical values for both tests at a 5% significance level are also provided. P-values calculated using the MacKinnon-Haug-Michelis method is presented as well. The results indicate no co-integration at the 0.05 significance level, rejecting the alternative hypothesis. The suggestion is no long-term relationship between consumer prices (inflation) and the Nepalese stock index. Therefore, the VAR model should be employed to analyze the short-term relationship. The short run VAR model is outlined below.

Table 3 presents the results of the vector auto-regression estimation for CPI and Index. The t- values related with the coefficient of the lag-value of the factors. Whether the vector auto-regression estimation shows the CPI affect the movement of the Index in the short run or not. Index and CPI are both dependent variables. The lag of the index and CPI are the independent variables. In the case of Index dependent variable, the hypothesis is as given H0: CPI does not cause or influence changes in

the Index. Table shows that the coefficient for the variable "LINDEX (-1)" in the LINDEX equation is 0.988711, indicating a strong positive relationship between the current LINDEX and the lagged LINDEX value. The coefficient for the variable "LCPI(-1)" in the LINDEX equation is -0.012997, indicating a weak negative relationship between the current LINDEX to the lagged LCPI value. The coefficient for the variable "LINDEX(-1)" in the LCPI equation is -0.028634, indicating a weak negative relationship between the current LCPI and the lagged LINDEX value. The coefficient for the variable "LCPI(-1)" in the LCPI equation is 0.952154, indicating a strong positive relationship between the current LCPI and the lagged LCPI value. The coefficient for the variable "C" in both the LINDEX and LCPI equations values are 0.232513 and 0.327148 are positive respectively.

**Table 3. Results of VAR estimation of Index and CPI**

| Variables | LINDEX | LCPI |
|---|---|---|
| LINDEX(-1) | 0.988711 | -0.012997 |
| | (0.01126) | (0.00952) |
| | [ 87.7983] | [-1.36496] |
| LCPI(-1) | -0.028634 | 0.952154 |
| | (0.02552) | (0.02158) |
| | [-1.12194] | [ 44.1206] |
| C | 0.232513 | 0.327148 |
| | (0.18145) | (0.15343) |
| | [ 1.28140] | [ 2.13221] |

*Source: Author Calculation by using Eviews-10*

Specifically, a one-unit rise in the lagged LCPI is associated with a reduction of approximately 0.028634 units in the current LINDEX. The negative coefficient suggests that there is an inverse relationship between the lagged LINDEX and the current LCPI, implying that changes in LINDEX may have an impact on subsequent changes in LCPI. However, the coefficient of INDEX to INDEX(-1) is positive and significant and the coefficient of LCPI to LCPI(-1) is also positive and significant indicating both are regressed by own lag values. In conclusion, the impact of the dependent variable LINDEX on the independent variable LCPI can be assessed by examining the coefficient of the lagged

LINDEX variable (LINDEX(-1)) in the equation for LCPI. From the table, the coefficient for LINDEX(-1) in the LCPI equation is -0.028634. This negative coefficient indicates a negative association between the lagged LINDEX and the current LCPI.

Table 4 exhibits the Pairwise Granger-Causality Test to determine whether there is a causal relationship between variables in a dependent variable. The hypotheses for the test can be stated as follows: H0: CPI does not have a causal relationship with Index. The p-value for the CPI to Index relationship is 0.2633, which is bigger than the five percent level of significance for the F-Statistic. Therefore, it fails to reject the null hypothesis, indicating that CPI does not have a causal relationship with Index. In other words, CPI does not affect the Index in a significant way.

**Table 4. Pairwise Granger Causality Tests of CPI**

| Null Hypothesis: | Obs | F-Statistic | Prob. |
|---|---|---|---|
| LCPI does not Granger Cause LINDEX | 196 | 1.25874 | 0.2633 |
| LINDEX does not Granger Cause LCPI | | 1.86311 | 0.1739 |

*Source: Author Calculation by using Eviews-10*

Additionally, **Error! Reference source not found.** shows that the p-value for the Index to CPI relationship is 0.1739, which is also larger than the five percent-level of significance for the F-Statistic. Therefore, it fails to reject the null hypothesis for this relationship as well. It cannot accept the alternative hypothesis, which means that Index does not have a causal relationship or impact on CPI. Based on the information provided, researcher can conclude that CPI and Index do not have a causal relationship each other.

In an Unrestricted VAR model, it is necessary for all variables to exhibit stationarity at first difference. Prior to conducting the analysis, it has been confirmed that all variables meet this requirement. The lag selection criteria recommend choosing an optimal lag length for the VAR model. The theoretical framework suggests examining two aspects: the short-term and the long-term, through variance decomposition in the unrestricted VAR model. Essentially, variance decomposition allows for an assessment of the association between variables in both the short run and the long run.

**Table 5. Variance Decomposition of INDEX and CPI**

| Variance Decomposition of INDEX | | | | Variance Decomposition of CPI | | |
|---|---|---|---|---|---|---|
| Period | S.E. | LINDEX | LCPI | S.E. | LINDEX | LCPI |
| 1 | 0.07823 | 100 | 0 | 0.066149 | 2.416836 | 97.58316 |
| 2 | 0.10982 | 99.97097 | 0.029028 | 0.091235 | 2.195523 | 97.80448 |
| 3 | 0.13356 | 99.90645 | 0.093552 | 0.109043 | 1.991752 | 98.00825 |
| 4 | 0.1532 | 99.80978 | 0.190217 | 0.122948 | 1.806034 | 98.19397 |
| 5 | 0.17021 | 99.68417 | 0.31583 | 0.134306 | 1.638789 | 98.36121 |
| 6 | 0.18534 | 99.53263 | 0.46737 | 0.143834 | 1.490347 | 98.50965 |
| 7 | 0.19905 | 99.35801 | 0.641991 | 0.151974 | 1.360946 | 98.63905 |
| 8 | 0.21165 | 99.16297 | 0.837028 | 0.159019 | 1.250733 | 98.74927 |
| 9 | 0.22333 | 98.95001 | 1.049995 | 0.165181 | 1.159768 | 98.84023 |
| 10 | 0.23425 | 98.72142 | 1.278583 | 0.170614 | 1.088022 | 98.91198 |

*Source: Author Calculation by using Eviews-10*

Table 5 presents the results of the variance decomposition analysis, showing the contribution of different time periods to the short-run and long-run fluctuations in the index. In the short run, specifically during the first to third month, the impulse or shock to the index accounts for 99.90% of the variation in the index (own shock), while CPI only contributes to a 0.20% fluctuation. Therefore, the total fluctuation is 100%. The indexes own lag value is highly significant as the cause of its fluctuations in the short run, whereas the impact of CPI is negligible and not significant.

In the long run, particularly during the eighth to tenth month, the impulse or shock to the index accounts for 98.72% of the variation in the index (own shock), while CPI contributes to a 1.28% fluctuation. Hence, in the long run, the index's own lag value remains highly significant as the primary driver of its fluctuations. The influence of CPI on the index in the long run is minimal and not statistically significant. The variance decomposition analysis indicates that the movement of the index is primarily guided by its own lag values, both in the long run and the short run.

The major findings from each table summarized as: all five lag selection criteria (AIC, SC, LR, FPE, HQ) unanimously indicate that the optimal lag length for the VAR model between CPI and Index is one. The Johansen co-integration test finds no evidence of a long-term equilibrium relationship between the inflation rate (CPI) and the stock market index.

The VAR estimation reveals that both the stock index and CPI are significantly influenced by their own past values, but the cross-variable influences between CPI and the index are weak and statistically insignificant. The Granger causality test shows no significant causal relationship in either direction between CPI and the stock market index. The variance decomposition analysis demonstrates that fluctuations in the stock market index are almost entirely driven by its own past values, with CPI having an insignificant impact in both the short and long run.

**b. Discussions**

The Johansen co-integration test results indicate that there is no long-run relationship between the CPI and the Nepalese stock market index. This finding suggests that despite fluctuations in inflation over time, CPI does not lead to a sustained equilibrium or long-term relationship with stock market performance. However, previous studies have documented a significant negative relationship between inflation and stock market performance, this study presents a contrasting view in the context of Nepal. For instance, Fama (1981), Anjum & Habib (2025), and Mohnot et al. (2024) found that inflation adversely affects stock returns by impacting investor expectations and economic activity. Similarly, Pradhan and Patna (2019) and Suharsono et al. (2017) emphasized inflation's inverse effects, particularly in emerging markets. However, the current study's findings diverge from this consensus. Using Johansen co-integration, Granger causality, and VAR analysis, it finds no long-term or causal relationship between the consumer price index (CPI) and the Nepalese stock market index. Both variables are significantly influenced by their own lag values, with negligible cross-effects, and variance decomposition confirms that stock index fluctuations are largely driven by its own past behavior rather than inflation.

This study's findings are consistent with (Thapa and Chamlagain, 2025), who also reported no long-term co-integrating relationship between CPI and the stock index in Nepal. This suggests that inflation may not be a critical determinant of stock market movements in Nepal, possibly due to structural characteristics, market inefficiencies, or limited investor sensitivity to inflationary changes, setting it apart from broader emerging market trends. In developing economies like Nepal, the absence of a long-run relationship could be attributed to several factors. One significant factor is the volatility and relatively shallow nature of the stock market in Nepal. The Nepalese stock market is still evolving, and investor behavior may be driven more by external shocks, political

instability, and other non-economic factors rather than solely by inflation.

## 5. CONCLUSIONS

This study examines the relationship and impact between inflation, measured by the Consumer Price Index (CPI), and the stock market performance in Nepal. The findings suggest that there is no long-term equilibrium relationship between inflation and the stock market performance, as indicated by the Johansen co-integration test. This lack of long-run co-integration aligns with the findings of other studies in emerging economies, where stock markets may be influenced by external shocks, political instability, and non-economic factors rather than solely inflation. However, the Vector Autoregressive (VAR) model reveals a significant short-term negative relationship between CPI and stock market performance, supporting the theory that rising inflation may adversely affect stock prices in the immediate term by raising the cost of capital and reducing purchasing power. Furthermore, the Granger causality tests suggest that there is no clear causal relationship between CPI and stock market index in Nepal. The study indicates that changes in inflation do not lead to significant changes in stock prices and vice versa. It highlights the possibility that the relationship between these variables may be more coincidental or driven by other factors such as investor sentiment, government policies, and global economic conditions. These findings are consistent with the broader literature, which suggests that macroeconomic factors influencing stock market performance may be multifaceted and context-dependent. This study contributes to a better understanding of the inflation-stock market relationship in emerging markets like Nepal. Policymakers should consider a comprehensive approach that addresses inflation alongside other economic factors to stabilize the stock market, while investors should adopt a holistic view of the market, although it has certain limitations. Future research could explore additional macroeconomic variables and extend the time frame to capture long-term effects, providing a deeper understanding of how inflation interacts with investor behavior and stock market movements in Nepal.

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