International Research Journal of MMC (IRJMMC)

Vol- 5, No. 5, December 2024 ISSN 2717-4999 (Online) 2717-4980 (Print)

Remittance and Inflation Dynamics in Nepal: An Econometric Analysis

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KEYWORDS

Remittance income

Inflation

Unit root

Co-integration

ARDL model

JEL Classification

E50, E51, E52, E60

ABSTRACT

This empirical study investigates the remittance and inflation dynamics in the present context of Nepal. Major objective of the study is to find out the impact of remittance on inflation in Nepal. It also aims to find out the relationship between CPI and the independent variables-remittance, exchange rate, money supply and population. Data were obtained from the published source of world bank from 1993 to 2022. Augmented Dickey-Fuller unit root test was implied to test the stationary situation of the variables to remove the problem of spurious regression. After confirming some variables were integrated in I (0) and some are in I (1) order, ARDL model was applied to find out co-integration of the variables for long run relationship. Error corrections model was used after ARDL model that helps to show the speed of adjustment towards long-run equilibrium. Results show remittance and inflation are co-integrated and the coefficient of error correction term was negative and significant which indicates the long-run relationship. So remittance from foreign sectors should be used not only in consumption sectors that promotes inflation but it should be used in productive sectors too. This study will be helpful to policymakers whether remittance is causing inflation in the country.

1. INTRODUCTION

Remittance flows are important, growing and large for many economies. Except the increase in absolute terms, remittances have importance in relative to other flows (Ball et al., 2013). Remittance became major source of GDP in Nepalese economy and importance of it cannot be ignored in the present context. Major source of foreign income is covered by remittance and it is increasing every year in Nepal. Most of the citizen's family income is dependent on remittance from foreign countries. Due to lack of sufficient domestic job opportunities in Nepal, overseas migration has become an important part of employment (Sapkota, 2013). Remittance helps to reduce adverse balance of payments. As a major source of foreign currency to the developing country, remittance is a substantial factor of making current account surplus in the foreign trade (Gaudel, 2006).

On the other hand, Inflation is an emerging issue in every developed or

developing countries and it is consistent increase in price level and decrease in value of money. The effect of remittance on inflation is found different in short-run and long-run. Narayan et al. (2011) find evidence that in developing countries remittances generate inflation. In the long run, the impact of remittances on inflation is more pronounced.

Dichotomous views between remittance and inflation found in literatures where scholarly literature established the view that remittances are inflationary from a macroeconomic perspective because they support higher consumer spending from increased income. However, remittances will taper consumption variations and reduces inflationary pressures from the view of household decision-making (Rivera &Tullao, 2020). Remittances play a major role in the economic development of the economy through different microeconomic and macroeconomic channels. The adverse effect of remittances in the form of inflation and Dutch disease cannot be overlooked (Joshi, 2022).

The major objective of this study is to examine the impact of remittance on inflation in Nepal. This study helps policy makers to find out whether the remittance is causing inflation in the country because inflation is harmful if it is out of its limit. This study explains the relationship between remittance and inflation in the present context of Nepal and It has limited variables to explain the relation that is the delimitation of the study. The study uses secondary time-series data from 1993 to 2022 which is the next delimitation of this study.

The remittance incoming in the country is increasing every year and the rate of inflation is also rising so a question is relevant in this context- Is there any relationship between remittance and inflation in Nepal? What is the effect of remittance on inflation in Nepal? The major objective of this study is to establish the relationship between remittance and inflation in the present context of Nepal and it also aims to show the relationship of consumer price index with remittance, exchange rate, population and money supply.

1.1 LITERATURE REVIEW

Remittance, which is the major source of GDP of Nepal, is the income flow from foreign countries to the domestic country. It shows the dual behavior patterns that some literatures indicate it is inflationary and the others explain not inflationary. Different literatures are reviewed in this context and shown in the following section. The literature review is mentioned in two sections – theoretical review and empirical review.

1.2 THEORETICAL REVIEW

The quantity theory of money by Fisher is the base for the theory of inflation where inverse relationship exists between money supply and value of money. According to the theory higher the quantity of money in the economy leads to lower the value of money and higher the price level and vice versa. Fisher explained the law in which the following equation is mentioned.

$MV = PT$

Where M = Money Supply, V = Velocity of Circulation of Money, P = Price Level and T = Total Volume of Transaction of Money.

1.3 EMPIRICAL REVIEW RELATING REMITTANCE AND INFLATION

Different international literatures relating remittance and inflation are reviewed and presented in the following ways. Some literatures are in the favor of the positive relationship between remittance and inflation but other literatures show the opposite states of relation.

Studying the relationship between remittance and inflation, Rivera et al. (2020) evaluate the impact of inflation in the Philippines and found that increases in inflation can support in sending of more remittances from migrant countries in the short run. More than the anticipated remittances during inflationary periods, it seemed that remittances should not be necessarily inflationary. More other

dominant internal factors are there that can promote inflationary pressures. Supporting the mentioned view, Ball et al. (2013) find the theoretical model predicts that the remittances should increase inflation, the domestic money supply, GDP and appreciate the RER under a fixed regime temporarily, but under a flexible regime temporarily fall inflation, appreciate the RER, increase GDP, and generate no change in the money supply.

Criticizing the above view, Balderas and Nath (2008) conducted a research that find out the positive association between inflation and relative-price variability (RPV); remittances have positive significant effects on both inflation and RPV. These results are explained as providing evidence in support of intuition that remittances could be responsible for creating a positive relationship between inflation and RPV. Supporting the view, Dilanchiev et al. (2021) revealed that all the variables have an effect on the long-run inflation; long-run inflation is positively related with the leading variable remittance, but no short-run relation is found between them. The paper found that adjustment of inflation level to its equilibrium is 12% annually. In the same way, Basnet et al. (2022) state the results suggest that in South Asia the inflationary effect of remittances depends on the time length. The inflow shows to lower inflation in the short run, but it increases in the long run. The findings support the regional peculiarity in the effect of remittances on the price level. The results are significant statistically and confirmed by the Mean Group estimation. Supporting the relation, Jain and Mathur (2022) explain that the findings provide important insights into the nature of relation between remittances and inflation supporting causality between inflation, remittances, real effective exchange rates, real GDP and money supply due to increased remittances.

1.4 EMPIRICAL REVIEW OF NATIONAL LITERATURES

Literatures regarding remittance and inflation in Nepalese context are reviewed and they are explained in the following. Literatures at different time periods support the positive relationship between remittance and inflation in Nepal.

Examining the role of remittance, Srivastava and Chaudhary (2007) have explained and also shown the positive effect on the PCI but this is comparatively low. Using a Vector autoregression (VAR) model and a quarterly data set from Nepal Maskay et al. (2015) find the impact of remittance on inflation to be positive, even after controlling of inflation from India. The findings of Dahal et al. (2019) indicate that the inflow of remittances has a worsening effect on the inflation rate. It suggests that remittances have a pivotal role in increasing import of relatively more affordable goods, notwithstanding their effect on the overall expenditure of the economy. Remittance shows the positive impact on inflation while conducting a study by Ghimire (2020) examines the remittance and showed a strong positive relation with the national gross domestic product and a positive but low relation with inflation. In the short run, growing remittance inflows boost the economy by increasing consumption and decreasing poverty, but they may support to economic decline in the long run. Using Zivot unit root test and NARDL method, Pokhrel and Adhikari (2023) found that the findings of the study show a long-term asymmetric cointegrating between remittance inflow and inflation and found the positive shocks of inflation increasing remittance inflow subsequently in Nepal

2. METHODS AND MATERIALS

2.1 RESEARCH DESIGN AND SOURCES OF DATA

This study examined the relationship between remittance and inflation in Nepal and data are extracted from the published source of World Bank from 1993 to 2022 for inferential analysis. Augmented Dickey-Fuller unit root tests was performed to test the stationary situation of the variables. For co-integration test, ARDL Bounds test was applied then error correction model was conducted for long run speed of adjustment. Other OLS violation tests were

also used to obtain the situation of the model.

2.2 MODEL SPECIFICATION

CPI was taken as dependent variable and remittance, exchange rate, money supply and population were taken as explanatory variables to show the relationship in this study. The model of the study specifying the relationship between the variables can be stated as follows:

$CPIt = f(REMt, EXRt, M2t, POPt)$ ---------- (i)

2.3 ECONOMETRIC MODEL

The model explained above can be expressed in econometric form in the following ways:

$CPIt = \beta_0 + \beta_1 REMt + \beta_2 EXRt + \beta_3 M2t + \beta_4 ln POPt + \varepsilon t$ ---------- (ii)

Where, CPI = Consumer Price Index, REM = Remittance, EXR = Exchange Rate, M2 = Broad Money, lnPOP = Log of population and εt =Error term.

2.4 UNIT ROOT TEST

The unit root test is applied after supposing the error terms are correlated to each other. It is calculated to find the stationary situation of the variables to remove the problem of spurious regression in the model. Augmented Dickey-Fuller unit root tests is used for this purpose. After unit root test, the test of co-integration can be applied to find the long-run relationship. The regressions of this test can be specified as follows:

$\Delta CPIt = \beta_1 + \beta_2 t + \delta CPIt\text{-}1 + \sum_{i=1}^{p} \alpha i \Delta CPT\, t\text{-}1$ ---------- (iii)

Where, ΔCPIt = CPIt-1 – CPIt-2 and t is a trend.

2.5 COINTEGRATION TEST (ARDL MODEL)

In this study, some variables are found in I (0) whereas others are in I (1) order. Engel and Granger (1987), Johansen (1988) and Johansen et al. (1990) co-integration tests are applied in the case of stationary at first difference and all variables in same order. ARDL Bounds test by Pesaran et al. (2001) solves this type of case to find co-integration between the variables under the series I (0) and I(1) order. The regression model of the test can be mentioned in the following equation as:

$$\Delta CPIt = \alpha_0 + \sum_{i=1}^{p} \alpha 1 i \Delta CPI\, t-1 + \sum_{i=1}^{q} \alpha 2 i \Delta REMt-1 + \sum_{i=1}^{r} \alpha 3 i \Delta EXRt-1 + \sum_{i=1}^{s} \alpha 4 i \Delta M2\, t-1 \sum_{i=1}^{t} \alpha 5 i \Delta lnPOP\, t-1 + b_1 CPIt\text{-}1 + b_2 REMt\text{-}1 + b_3 EXRt\text{-}1 + b_4 M2t\text{-}1 + b_5 lnPOPt\text{-}1 + \mathcal{E}$$ ---------- (iv)

Where Δ is first difference operator. α1i, α2i, α3i, α4i and α5i represent short-run parameters and b, b2, b3, b4 and b5 are long-run parameters. Similarly, ε indicates for the error term. To test ARDL model the long-run relationship can be obtained in the following conditions.

Null hypothesis (H0): b1 = b2 = b3 = b4 = b5 = 0 does not exist co-integration

Alternative hypothesis (H1): b1 ≠ b2 ≠ b3 ≠ b4 ≠ b5 ≠ 0 exists co-integration

2.6 ERROR CORRECTION MODEL

Error correction model expresses the situation of speed of adjustment in which the model is adjusting from short-run towards long-run equilibrium condition. ECM is calculated after ARDL test when co-integration is found between the variables.

$$\Delta CPIt = \alpha_{01} + \sum_{i=1}^{p} \alpha 1 i \Delta CPI\, t-1 + \sum_{i=1}^{q} \alpha 2 i \Delta REMt-1 + \sum_{i=1}^{r} \alpha 3 i \Delta EXR\, t-1 + + \sum_{i=1}^{s} \alpha 4 i \Delta M2\, t-1 + \sum_{i=1}^{t} \alpha 5 i \Delta lnPOP\, t-1 + \lambda ECTt\text{-}1 + \mathcal{E}_t$$ -------- (vi)

In the ECM model λECTt-1 represents error correction term, α1i, α2i, α3i, α4i and α5i are short-run dynamic coefficients.

3. RESULTS

3.1 OPTIMUM LAG LENGTH CRITERIA

ARDL co-integration test indicating long-run relationship and error correction model showing the speed of adjustment towards long-run equilibrium are obtained after conforming optimum lag length selection criteria. All the criteria LR, FPE, AIC, SC and HQ are supporting to select the lag length 1 for further analysis that is followed in this study.

Table 1: *Optimum Lag Length Criteria*

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-307.5024	NA	3402.842	22.32160	22.55949	22.39433
1	-120.2356	294.2765*	0.032564*	10.73111*	12.15847*	11.16747*
2	-99.46854	25.21710	0.053250	11.03347	13.65030	11.83346

3.2 UNIT ROOT TEST RESULT

Unit root tests confirm the stationary situation of the given variables that helps to remove the problem of spurious regression in the model. Augmented Dickey-Fuller unit root test is used for this purpose. After these tests ARDL Bounds test for co-integration was applied and the results of the tests of the variables CPI, REM, EXR, M2 and lnPOP are presents in the Table 2.

Table 2: *Unit Root Test*

	Level		First Difference	
Variables	t-Stat	Prob.	t-Stat	Prob.
CPI	-3.654140**	0.0106	----------	----------
REM	-1.139630	0.6861	-4.763370*	0.0007
EXR	0.409459	0.9799	-4.613559*	0.0010
M2	0.077987	0.9583	-4.526380*	0.0013
lnPOP	-3.234652**	0.0314	----------	----------

Note. *, ** and *** indicate significant at 1%, 5% and 10%

Table 1 shows the result of Augmented Dickey-Fuller unit root test where ADF test shows CPI and lnPOP were stationary at level and other variables – REM, EXR and M2 were significant at first difference. CPI and lnPOP are significant at 5% level and other variables were significant at 1 percent level.

3.3 THE COINTEGRATION TEST (ARDL MODEL)

ARDL test is selected to find out the co-integration after the tests of unit root that indicate some variables are found in I(0) and some are in I(1) order. The test is applied after conforming lag length structure such as LR, FPE, AIC, SC and HQ that is supposed to take lag 1 for computation. ARDL model is applied to test long-run co-integration between the variables under study that shows the long-run relationship in the model.

Table 3: *ARDL F-bound statistics*

F-Bounds Test		Null Hypothesis: No levels relationship		
Test Statistic	Value	Signif.	I(0)	I(1)
		Asymptotic: n=1000		
F-statistic	9.633983	10%	2.2	3.09
k	4	5%	2.56	3.49
		2.5%	2.88	3.87
		1%	3.29	4.37
Actual Sample Size	29	Finite Sample: n=35		
		10%	2.46	3.46
		5%	2.947	4.088
		1%	4.093	5.532
		Finite Sample: n=30		
		10%	2.525	3.56
		5%	3.058	4.223
		1%	4.28	5.84

The value of F-statistics is 9.633983 is greater than Pesaran and Shin (1999) critical value bound that indicates the model was significant at 5 percent level of significance. It implies the rejection of null hypothesis and acceptance of alternative hypothesis that there was long run relationship between independent and dependent variables. It means that the variables remittance had long-run relationship with consumer price index of the country.

Table 4: *ARDL bounds Test*

Levels Equation
Case 2: Restricted Constant and No Trend

Variable	Coefficient	Std. Error	t-Statistic	Prob.
REM	0.279130	0.083738	3.333377	0.0032
EXR	-0.170795	0.053397	-3.198598	0.0043
LNPOP	-26.50815	14.94539	-1.773668	0.0906
M2	0.125841	0.050829	2.475769	0.0219
C	459.9210	251.9440	1.825489	0.0822

Variable	Coefficient	Std. Error	t-Statistic	Prob.*
CPI(-1)	0.003695	0.142826	0.025868	0.9796
REM	0.278098	0.092140	3.018215	0.0065
EXR	0.292242	0.090798	3.218595	0.0041
EXR(-1)	-0.462406	0.097069	-4.763706	0.0001
LNPOP	-26.41021	15.84610	-1.666669	0.1104
M2	-0.046581	0.067574	-0.689329	0.4982
M2(-1)	0.171957	0.070113	2.452575	0.0230
C	458.2218	267.7446	1.711414	0.1017

R-squared	0.688132	Mean dependent var	6.684106
Adjusted R-squared	0.584176	S.D. dependent var	2.764718
S.E. of regression	1.782813	Akaike info criterion	4.223212
Sum squared resid	66.74685	Schwarz criterion	4.600397
Log likelihood	-53.23658	Hannan-Quinn criter.	4.341342
F-statistic	6.619452	Durbin-Watson stat	2.115444
Prob(F-statistic)	0.000332		

Table 4 shows the result of ARDL bounds test which indicates long-run relationship between independent and dependent variables in the model. It signifies that the null hypothesis of there is no co-integration was rejected that shows long-run co-integration between CPI with REM, EXR, lnPOP and M2. It means all independent variables except lnPOP were significant at one percent level showing the coefficient of REM is 0.279130, EXR is -0.170795 and M2 was 0.125841. But lnPOP is significant at 10% level showing the coefficient -26.50815. Remittance shows the positive long-run relationship with consumer price index that expresses one-unit increase in remittance can increase the consumer price index by 0.27 units. In the same way money supply had positive relation with CPI showing one unit change in money supply can cause 0.12 unit change in consumer price index.

3.4 ERROR CORRECTION MODEL

Error correction model is obtained after the co-integration test. When the model shows there is co-integration between independent and dependent variables, error correction model is applied. Error correction model explains the speed of adjustment of short-run towards long-run equilibrium. Co-integration model has short-run errors that should be adjusted over the periods and ARDL error correction model is adopted for this purpose.

Table 5: *Error Correction Term*

ECM Regression
Case 2: Restricted Constant and No Trend

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(EXR)	0.292242	0.070769	4.129536	0.0005
D(M2)	-0.046581	0.052539	-0.886601	0.3853
CointEq(-1)*	-0.996305	0.117771	-8.459712	0.0000

R-squared	0.764572	Mean dependent var	0.006459
Adjusted R-squared	0.746462	S.D. dependent var	3.182054
S.E. of regression	1.602244	Akaike info criterion	3.878385
Sum squared resid	66.74685	Schwarz criterion	4.019829
Log likelihood	-53.23658	Hannan-Quinn criter.	3.922683
Durbin-Watson stat	2.115444		

R-squared: 0.764572; Adjusted R-squared: 0.746462; Durbin Watson stat: 2.115444

The error correction term highlights the short-run error of the variables that have long-run relationship properties. It shows the speed of adjustment of the errors towards long-run equilibrium and the ECM should be negative and significant. The condition is satisfied showing the coefficient of ECM is -0.996305 and p-value 0.0000. It shows the short term errors are adjusting by 99.63% towards long-run equilibrium having higher speed of adjustment.

3.5 STABILITY TEST

The stability test is used to test the model is economically sound and stable. Stability of parameter is presented through cumulative sum (CUSUM) and cumulative sum of square (CUSUMSQ) tests. CUSUM test measures the systematic parameter and CUSUMSQ test measures the sudden changes. Sequence outside the range indicates structural change in the model over time. The tests show the model was stable and sound at 5% level of significance.

Figure 1: *CUSUM Test*

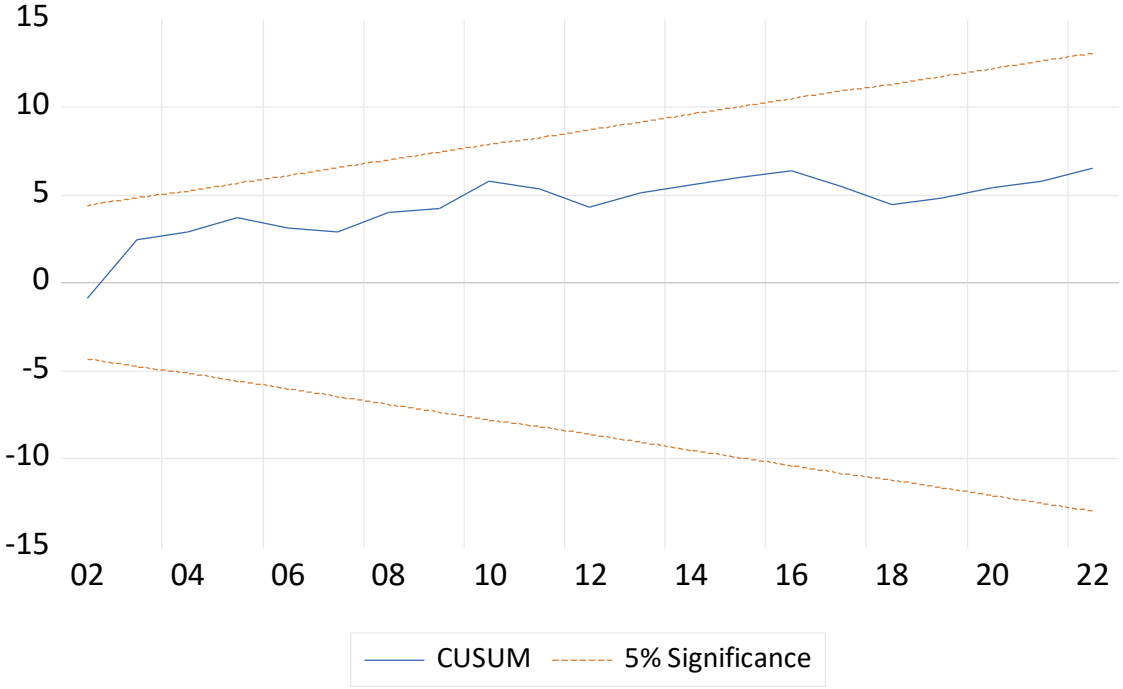
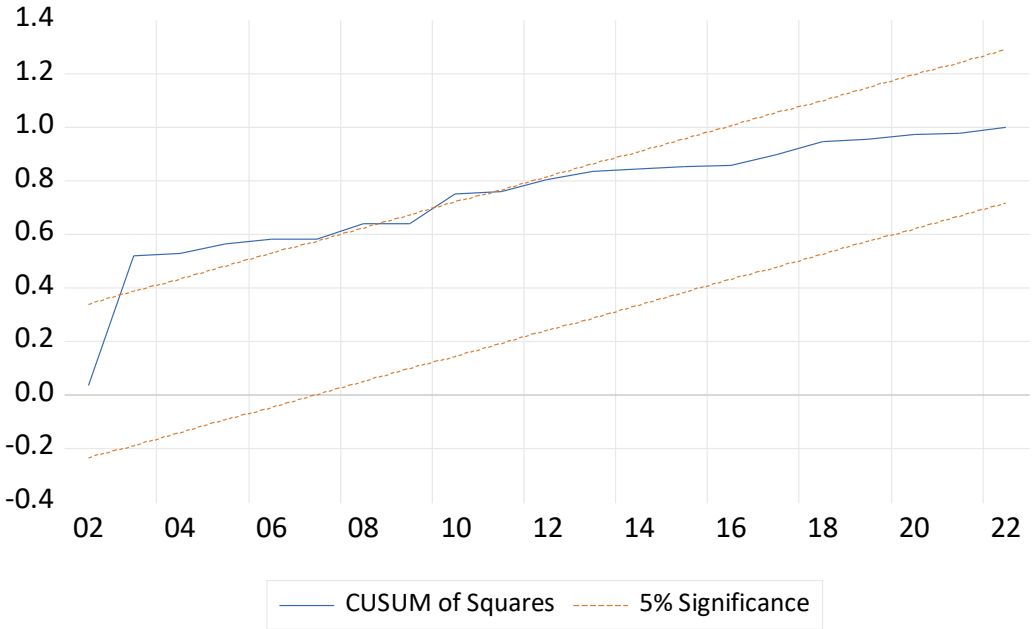


Figure 2: *CUSUMSQ Test*



3.6 OTHER TEST

3.6.1 SERIAL CORRELATION TEST

This test is used to find autocorrelation in the study variables. Null hypothesis shows serial correlation does not exist and alternative hypothesis indicates there was the problem of serial correlation in the model. The result of Breusch-Godfrey serial correlation LM test is given in the following Table 6.

Table 6: *Serial Correlation Test*

Breusch-Godfrey Serial Correlation LM Test:
Null hypothesis: No serial correlation at up to 1 lag

F-statistic	0.193058	Prob. F(1,20)	0.6651
Obs*R-squared	0.277258	Prob. Chi-Square(1)	0.5985

The result of Breusch-Godfrey test shows the probability of F-statistic and Obs*R-squared are more than 5 percent level of significance that shows the null hypothesis was not rejected indicating there is no serial correlation in the variables.

3.6.2 HETEROSKEDASTCITY TEST

For the test of Heteroskedasticity, Breusch-Pagan-Gosfrey test is used. The variability of error terms are measured from this test and the result is presented in the following Table 7.

Table 7: *Heteroskedasticity Test*

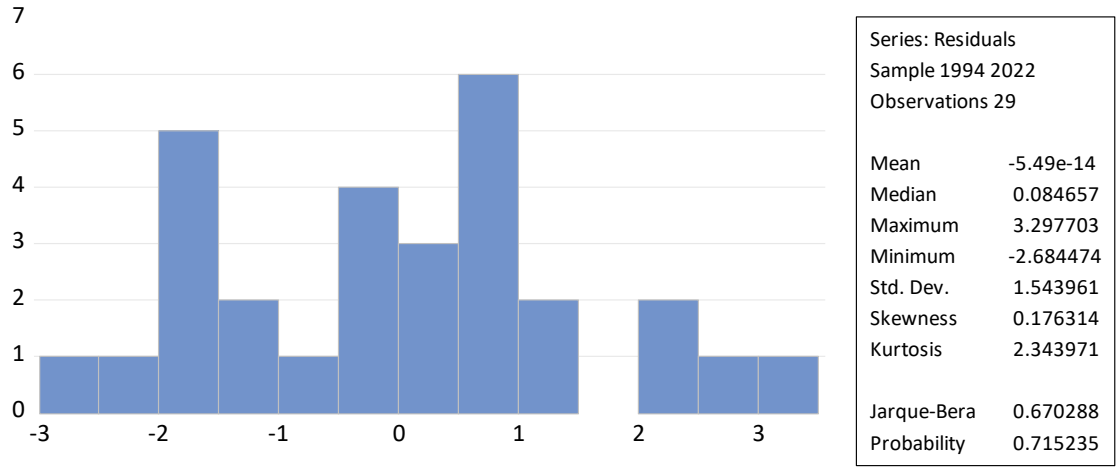
Heteroskedasticity Test: Breusch-Pagan-Godfrey
Null hypothesis: Homoskedasticity

F-statistic	1.713591	Prob. F(7,21)	0.1600
Obs*R-squared	10.54273	Prob. Chi-Square(7)	0.1598
Scaled explained SS	3.714973	Prob. Chi-Square(7)	0.8120

The result of Breusch- Pagan-Godfrey test shows probabilities of F-statistic, ObsR-squared are not significant at 5 percent level which means the null hypothesis of no heteroskedasticity is not rejected and the model was free from this problem.

3.6.3 NORMALITY TEST

Normality test conforms the variables are normally distributed so Jarque-Bera test is applied for this test where null hypothesis indicates data are normally distributed. The result of normality test is given in the Figure 3 below. Result of Jarque-Bera normality test shows the the coefficient was 0.715235 which indicates insignificant at 5 percent level that means null hypothesis of normally distributed data is not rejected.



4. CONCLUSION

The study, remittance and inflation dynamics in Nepal, tries to find out the short run and long run dynamics between remittance and inflation in the present context of Nepal where dependent variable is CPI as well as remittance, exchange rate, money supply and population are taken as independent variables. Augmented Dickey-Fuller unit root test is performed to test the stationary situation of the variables that help to remove the problem of spurious regression. The tests confirm some variables are integrated in I(0) and some are in I(1) order which means ARDL model is appropriate for the test of co-integration that finds the long run relationship then error correction model is applied for speed of adjustment towards long run equilibrium.

Results show remittance has long run relationship from ARDL Bounds Test and the error correction term is negative (-0.996305) and significant (p = 0.0000) which shows the speed of adjustment. The coefficient shows the model is adjusting from short-run toward long-run equilibrium by 99.63%. The model can be taken as best fit and robust model from the tests of serial correlation, heteroscedasticity and normality tests. It means remittance has the long-run relationship with inflation in Nepal indicating the remittance should not be used only for house-hold consumption expenditure which promotes inflation but it should be used in investment purposes too.

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TO CITE THIS ARTICLE
Joshi, U. L. (2024). Remittance and inflation dynamics in Nepal: An econometric analysis. *International Research Journal of MMC, 5* (5), 133–144.
https://doi.org/10.3126/irjmmc.v5i5.73703

Submitted: 11 November 2024 **Accepted:** 29 December 2024 **Published:** 31 December 2024

International Research Journal of MMC (IRJMMC) is a peer-reviewed open access journal published by Research Management Cell, Makawanpur Multiple Campus, Hetauda