Linkages between Real Sector and Financial Sector in Nepal: A Vector Error Correction Model

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Abstract

The financial development is considered as a pre-requisite condition for the overall economic development of the nation and rousing to economists. This paper investigates the short run and long run causality between monetary variables (M_1, CPI, NFA, DC) and real sector variables (GDP, TE, TI) of Nepal using some of the econometric techniques like Johansen's co-integration analysis and the Vector Error Correction Model (VECM). The study employs the data from 1975 to 2014. The results of the investigation aver that there exists short run and long run causality between monetary and real sector variables. The impulse responses of exports and domestic credits show that these variables have positive impacts on the economic growth which is consistent with the theoretical frameworks. The impulse responses of GDP to domestic credit seemed insignificant in the short run and started to be significant in the long run gradually. On the contrary to this, the impulse response of GDP and domestic credit to export seemed negatively responsive. So, giving proper focus on the macroeconomic policies and strategies which reduces the nebulous situations of economy and promote the allocation of resources, production activities, and competitiveness to increase the domestic credits and exports will probably promote economic development of the nation.

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