

## Balancing Inflation Control and Economic Growth

### Why in news?

Recently The Monetary Policy Committee (MPC) has maintained the status quo on the policy rates to stabilize headline inflation.

### What is inflation and growth dynamics?

- **Moderate inflation and growth** - In the short term, moderate inflation is often considered a sign of a growing economy.
- In this scenario, inflation is a natural result *of expanding economic activity, often paired with increased employment and investment.*
- **High inflation and economic slowdown** - When inflation rises too high, it can hurt economic growth.
- High inflation erodes the purchasing power of consumers and it leads to low consumption, higher input costs that reduce investments and reduced demand for goods and services.
- **Hyperinflation and recession** - Rapidly rising prices can undermine confidence in the currency, discourage savings, and lead to capital flight, making it difficult for businesses to operate efficiently.
- This usually results in a severe economic contraction or recession.
- **Inflation and investment** - *High inflation can lead to higher interest rates*, as central banks raise rates to control inflation.
- This increases borrowing costs, which discourages business investment.
- As a result, gross capital formation may decline, further impacting growth.

*Gross Fixed Capital Formation refers to the growth in the size of fixed capital (investment in infrastructure, factories, machinery, equipment, etc..) in an economy.*

- **Inflation targeting** - Central banks often try to balance inflation and growth *through inflation targeting.*
- By controlling inflation, central banks aim to create a stable economic environment conducive to sustainable growth.
- However, this balancing act can be challenging, as attempts to curb inflation through tighter monetary policies can slow down economic growth
- **Current scenario** - In India, economic growth has slowed down significantly in the current fiscal year (2024-25), coupled with inflationary pressures.
- **GDP growth in Q2-FY25 dropped to 5.4%**, far below expectations, prompting the Reserve Bank of India (RBI) to lower its full-year growth projection from 7.2% to 6.6%.
- **Unchanged repo rate** - In response to the economic slowdown, the monetary policy

committed has ***maintained the repo rate at 6.5%*** but has lowered the Cash Reserve Ratio (CRR) to inject liquidity into the banking system.

To know more about RBI Monetary Policy, click [here](#)

*Inflation is the sustained increase in the general price level of goods and services.*

### **Why economic growth slowdowns despite higher inflation?**

- **Low government spending** - Fiscal consolidation efforts have limited the government's ability to inject capital into the economy.
- Reduced public spending, especially in rural areas, has slowed infrastructure development and demand generation, which are essential for driving growth
- **Decline in private consumption** - Private consumption, a key driver of GDP, has weakened due to inflation eroding purchasing power.
- Higher prices of essentials like food and fuel have forced households to cut back on discretionary spending, impacting sectors such as retail, automobiles and consumer goods.
- **Elevated food and fuel prices** - The inflation remains elevated due to high food prices, particularly from the unseasonal rise in vegetable prices.
- **Lower agriculture production** - Growth at 3.5% remains inconsistent due to erratic rainfall affecting yields
- This has not only reduced disposable incomes but also limited the effectiveness of fiscal and monetary interventions.
- Rising food prices affecting core inflation.
- **Reducing gross capital formation** - The gross fixed capital formation registered a growth of just 1.3%, the lowest seen in several quarters and this was mainly due to the slowdown in public sector capital formation.
- It is due to cautious investor sentiment and high borrowing costs.
- **Low industrial outputs** - Slowdown in key sectors like manufacturing, mining, and construction reflected in reduced industrial growth output.
- **Global economic pressures** - Factors like elevated crude oil prices, geopolitical uncertainties and tightening financial conditions globally impact India's trade performance.

### **What are the measures to revive economic growth?**

- **Increase in gross fixed capital formation** - Increase the investments in new projects and infrastructure
- **Supply-side interventions** - Addressing supply chain bottlenecks to reduce input costs.
- **Price liberalization** - Removing government price controls on goods and services to allow market forces to determine prices, which can help reduce supply bottlenecks and price distortions.
- **Increase capital expenditure** - Government needs to increase its capital expenditure

infrastructure to boost economic activity in manufacturing and mining.

- Increasing the investment rate to 40% of GDP.
- Tax incentives for industries to reduce production costs.
- **Inflation control** - Stabilizing food prices by increasing agricultural production and better irrigation and storage facilities.
- **Structural reforms** - Promote market competition, improving regulatory frameworks, enhancing financial market stability, implementing tax structures that incentivize investment and improve public sector efficiency.
- **Labor market reforms** - Fostering labor-intensive manufacturing to generate employment by reducing rigidities in hiring and firing practices, allowing for better wage adjustments based on economic conditions.

### What lies ahead?

- Inflation needs to be balanced with growth revival to bring economic stability and to achieve the vision of Viksit Bharat.
- Invest in infrastructure, education, and technology to boost productivity and long-term growth.
- Coordinate economic policies with other countries to stabilize the global economy.

### Quick facts

- **Monetary Policy Committee** - The Reserve Bank of India Act of 1934 (RBI Act) was replaced by the ***Finance Act of 2016*** to establish a formal framework for a Monetary Policy Committee (MPC).
- **Role** - The MPC is *responsible for determining the key policy rate*, known as the repo rate, to maintain inflation within the designated target range.
- The MPC replaced the former *Technical Advisory Committee*.
- **Structure** - The MPC consists of six members, that includes:
  - RBI Governor (who acts as Chairperson),
  - RBI Deputy Governor responsible for monetary policy,
  - One official appointed by the RBI Board and
  - Three additional members representing the Government of India.
- *The external members serve a term of four years.*
- A meeting requires a *quorum of four members*, including the Governor or, in their absence, the Deputy Governor who serves as a member of the MPC.
- Decisions are made based on a majority vote. In the event of a tie, the RBI Governor has the casting vote.
- The MPC's ***decisions are binding on the RBI.***

### Reference

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