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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