Indian Economy · GS - III

Evaluate the challenges faced by central banks in controlling inflation when demand-side pressures and supply-side shocks operate simultaneously.

EXAM YEAR	PAPER	SUBJECT
DAILY PRACTICE 25/11/2026	GS - III	Indian Economy

MARKS	WORD LIMIT
15	~250 words

Answer Hint

Demand-pull inflation, cost-push inflation, monetary transmission, interest rates, inflation expectations, output growth, policy trade-offs

Model Answer

Inflation control becomes particularly difficult when strong aggregate demand coincides with supply disruptions. Central banks must contain persistent price pressures without unnecessarily weakening economic growth.

The policy dilemma

1. **Demand-side pressures:** Strong consumption, credit expansion and investment can raise aggregate demand beyond productive capacity. Monetary tightening can moderate borrowing and spending.
2. **Supply-side shocks:** Higher energy prices, input shortages and logistical disruptions increase production costs. Interest-rate increases cannot directly expand supply or eliminate these constraints.
3. **Investment uncertainty:** Higher interest rates may discourage productive investment, including infrastructure and emerging technologies, potentially affecting future productive capacity.
4. **Inflation expectations:** If households and firms anticipate persistent inflation, wage demands and price-setting behaviour may reinforce it.

Limitations of monetary policy

Aggressive tightening can reduce inflation but also slow output growth, increase borrowing costs and weaken employment. Conversely, delayed action may allow inflation expectations to become entrenched. Central banks

therefore face a trade-off between price stability and economic activity.

Towards a balanced response

Central banks should distinguish persistent demand pressures from temporary supply shocks, monitor core inflation and expectations, and calibrate interest-rate decisions accordingly. Governments must complement monetary policy through logistics improvements, diversified energy supplies, competitive markets and targeted support for vulnerable households.

India's flexible inflation-targeting framework, centred on price stability while keeping growth in mind, illustrates the importance of a calibrated approach.

Thus, effective inflation management requires coordinated monetary and supply-side measures rather than relying exclusively on interest-rate adjustments.

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