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HS-202 PROJECT

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PROBLEM STATEMENT:

The Indian economy has experienced a slowdown in FY25 due to muted consumption demand growth and government spending. With global uncertainties and trade tensions looming in the world economy, India is also not insulated from them. Consequently, the RBI revised its GDP growth estimates downwards from 6.7% to 6.5% for FY26. In response, fiscal and monetary policy steps have been undertaken in the last three months.

- On the fiscal side, the Indian government relaxes income tax liability for individuals earning up to INR 12 lakhs annually and continues significant capital expenditure for building infrastructure.
- On the monetary side, the RBI slashed interest rates from 6.5% to 6.25% in February 2025 and then again to 6% in April 2025, along with a shift in the stance from 'neutral' to 'accommodative'.

In light of this we have to analyse how these policies would affect the Indian economy using an IS-LM framework.

INTRODUCTION:

During a slowdown, there is a dip in economic activity, which leads to fewer investments and halt in the economic and overall growth of a nation. As we can see in the case of India, muted consumption growth and government spending has led to decrease in the GDP growth rate speculation of India by 0.2% (6.7% to 6.5%). During these times, policymakers have to devise measures to restore economic activity. For this, India introduces two policies namely

- Expansionary Fiscal Policy and
- Expansionary Monetary Policy.

Analysis of these policies is an integral part of the **IS-LM Model.**

IS-LM FRAMEWORK ANALYSIS:

The IS-LM model demonstrates the equilibrium in the goods market (IS curve) and the money market (LM curve).

IS Curve: Goods Market Effects

The IS curve, derived from the Keynesian national income identity, reflects equilibrium in the goods market and is given by:

$$Y = C + I(Y,i) + G$$

where output 'Y' equals the sum of consumption 'C', investment 'I'—which is inversely related to the interest rate 'i' and positively related to income—and government expenditure 'G'. Initially in the derivation of the above relation the fiscal policy is kept constant but recent policy changes render this assumption invalid. The government's tax relief enhances disposable income, thereby stimulating household consumption, while elevated public capital expenditure directly increases G. Both effects raise autonomous demand, causing a rightward shift of the IS curve. This shift signifies a higher level of equilibrium output for any given interest rate.

LM Curve: Money Market Effects

Within the IS–LM framework, the **LM curve** represents equilibrium in the **money market**, where the demand for real money balances equals the supply. This equilibrium condition is expressed as:

$$M/P=L(Y,i)$$

Here, M/P denotes the **real money balances**, with 'M' being the nominal money supply and 'P' the general price level. The function L(Y,i) represents **liquidity preference**—the demand for money—which is positively related to real income 'Y' and negatively related to the nominal interest rate 'i'. A commonly used linear form of this function is:

$$L(Y,i)=kY-hi$$

where:

- $k>0$: the income sensitivity of money demand (transactions motive),
- $h>0$: the interest sensitivity of money demand (speculative motive).

Solving for the interest rate, we obtain the LM curve as:

$$i=(kY-M/P)/h$$

This implies that for a given real money supply, higher income Y raises the demand for money, leading to a higher equilibrium interest rate i. Thus, the LM curve is **upward-sloping** in the (Y, i) space.

EXPANSIONARY FISCAL POLICY:

To counter India's economic deceleration in FY25, the government has implemented expansionary fiscal measures. Key initiatives include:

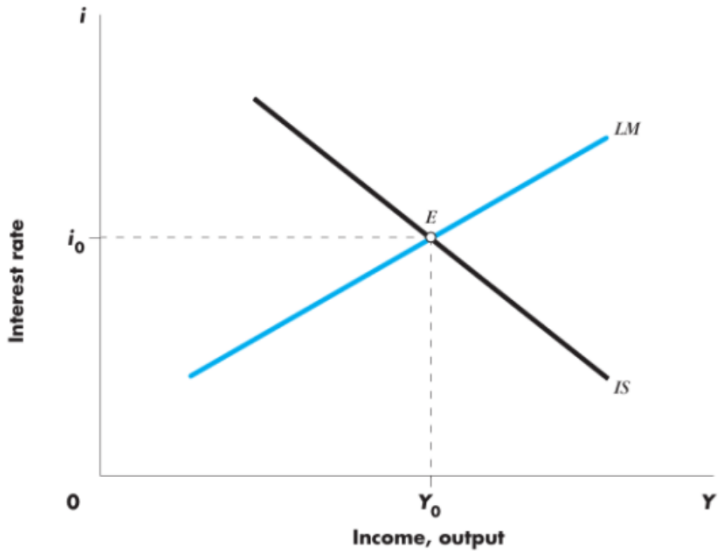
- Income tax relief for individuals earning up to ₹12 lakh annually to boost disposable income and consumption demand.
- Sustained high capital expenditure on infrastructure aims to stimulate investment, create jobs, and increase overall aggregate consumption expenditure.

These targeted fiscal interventions complement monetary easing, forming a dual-pronged approach to reinvigorate growth amid weakening private demand and global uncertainties that prompted the RBI's FY26 GDP forecast revision downward to 6.5%.

Equilibrium In Money and goods market:

The IS and LM schedules summarize the conditions that have to be satisfied in order for the goods and money markets, respectively, to be in equilibrium. For simultaneous equilibrium, interest rates and income levels have to be such that both the goods market and the money market are in equilibrium.

Fig.1 : Equilibrium levels of Interest rate and output



Impact on IS Curve:

- The increase in Government spending directly affects the IS curve by increasing aggregate demand. This increase is shown as a **rightward shift of the IS curve**.

- The reduction in taxes has a positive impact on disposable income and which leads to aggregate consumption This leads to the **rightward shifting of the IS curve**.

Impact on LM Curve:

- In general, expansionary fiscal policy has **no direct impact on the LM curve**. On the other hand, more government expenditure can raise the demand for money.
- **Interest rates may increase** in order to keep the money market in balance, which would affect investment and consumption.

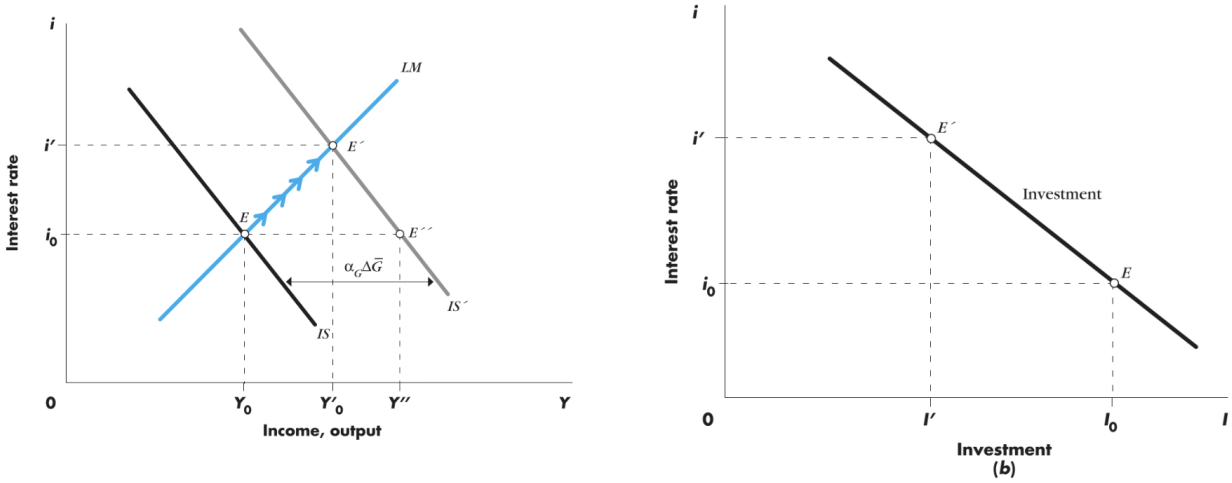


Fig.2: Rightward Shift of the IS Curve

EXPANSIONARY MONETARY POLICY:

To stimulate India's slowing economy, the RBI has implemented aggressive monetary easing, cutting interest rates by 0.5% (from 6.5% to 6%) between February and April 2025 while shifting to an accommodative stance. These deliberate rate reductions aim to:

- Lower borrowing costs for businesses to invest
- Encourage consumer spending on relatively expensive items
- Support entrepreneurs in launching new ventures

Simultaneously, the increased money supply increases the cash flow in the banks, ensuring easier credit availability. This dual-pronged monetary approach seeks to cover weak consumption demand and revive economic growth amid global uncertainties.

Impact on LM Curve:

- An expansionary monetary policy is indicated by the **LM curve shifting to the right**. Reduced interest rates lead to lower borrowing costs as well as higher investment and consumption.

- The expansion of the money supply boosts economic activity and **raises GDP**.

Impact on IS Curve:

- Monetary policy largely influences the LM curve, although interest rate movements have an **indirect but no direct effect** on the IS curve. The IS curve may shift to the right as a result of higher investment and consumption brought on by lower interest rates.

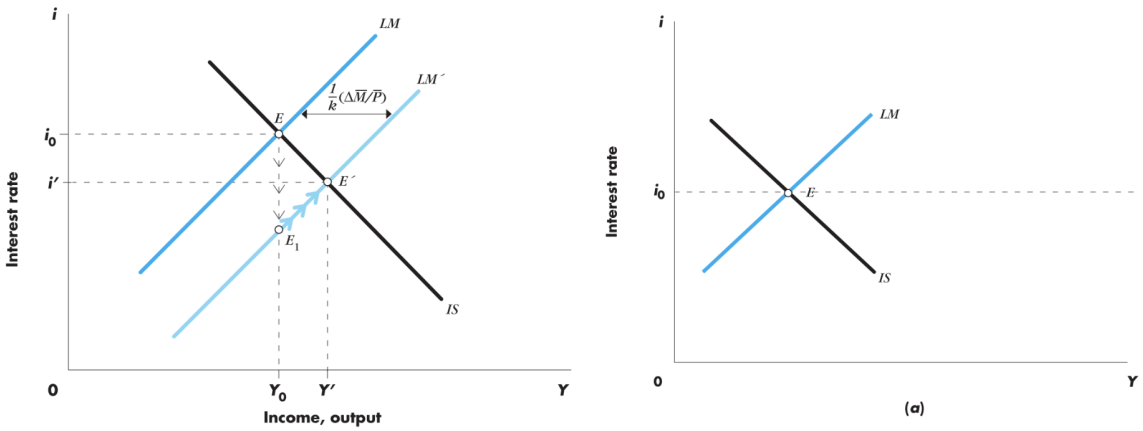


Fig.3: Rightward Shift of the LM Curve

SIMULTANEOUS EFFECT OF BOTH POLICIES:

Aggregate Demand:

The government's spending and RBI's rate cuts are working together to boost overall spending in the economy. When the government spends directly on projects, it creates demand. At the same time, lower interest rates make people and businesses more willing to borrow and spend money. This double push causes rapid increase in AD.

Money Supply and Demand:

The RBI is putting more money into banks (increasing money supply), while government spending creates more need for money (increasing money demand). These two effects balance each other somewhat, but the overall result is that interest rates are coming down (from 6.5% to 6%), which helps both investors and regular borrowers.

Interest Rates:

The lower interest rates make all kinds of loans cheaper - for businesses wanting to expand, for people buying homes or cars, and for new entrepreneurs starting businesses. This should lead to more economic activity, though it depends on banks actually passing these lower rates to customers.

Gross Domestic Product (GDP)

The main goal of these policies is to get GDP growth back up. The combination should help recover the 0.2% growth we lost in the forecasts (from 6.7% to 6.5%). Government projects create immediate jobs and activity, while the cheaper loans help sustain growth over time.

CONCLUSION:

Facing India's economic slowdown, policymakers are using both government spending (fiscal policy) and RBI rate cuts (monetary policy) to get growth back on track. The IS-LM framework helps us understand how these policies affect interest rates, money supply, and overall economic output. While these measures should help recover growth to target, their success depends on proper implementation - projects need to start on time, banks need to pass on rate cuts, and global conditions need to stabilize. If everything works as planned, this combined approach can lead to sustainable recovery across all sectors of the economy.

RESOURCES AND BIBLIOGRAPHY:

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- Reserve Bank of India. "Annual Reports and Monetary Policy Reviews”.