



**INDIAN INSTITUTE OF TECHNOLOGY ROPAR**

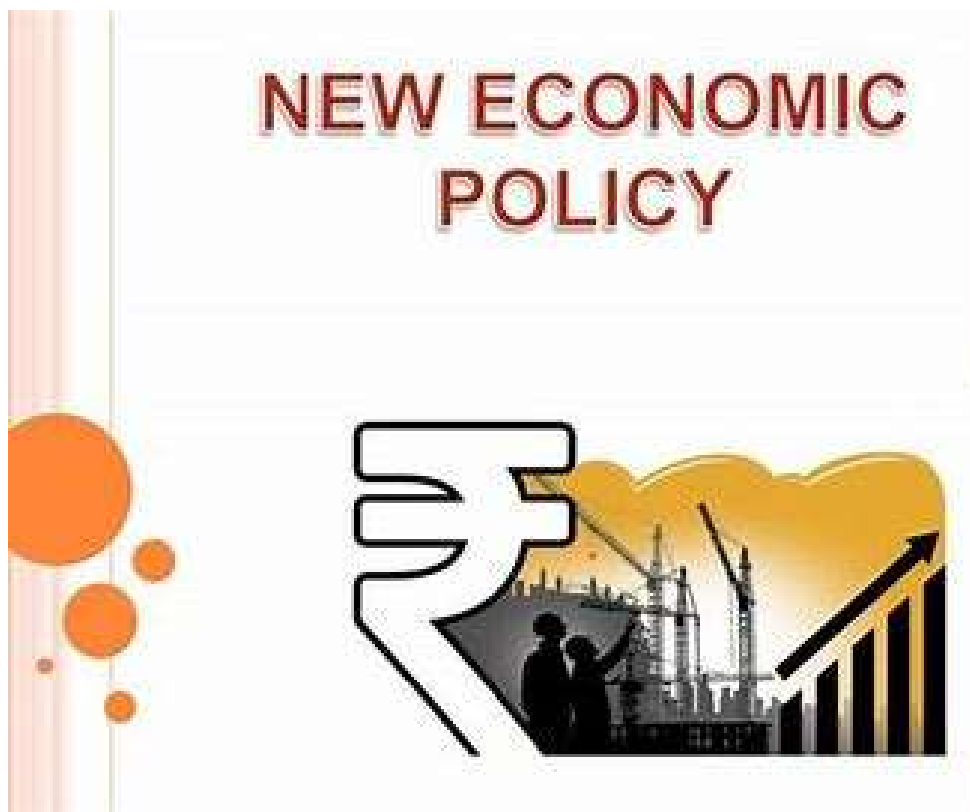
**HS 201: ECONOMICS**  
**~BHAVESH GARG**



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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 INR12 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'.*

*With fears of the Indian economy's growth slowing down amid muted consumption demand growth and rising global uncertainties, i.e., GDP growth estimates for FY26 revised downwards from 6.7% to 6.5%, fiscal and monetary policy steps have been undertaken in the last three months.*

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

## **Overview of the problem statement:**

*At the 54th Monetary Policy Committee meeting, the RBI lowered India's GDP growth forecast to 6.5% for FY26 due to rising global challenges and changing domestic economic conditions. The economy slowed in FY25 because of weak consumer spending and reduced government investment. To tackle this, both fiscal (tax cuts, infrastructure spending) and monetary (interest rate cuts) steps were taken. This analysis explains how these policies aim to revive growth and stabilize the economy.*

## **Introduction:**

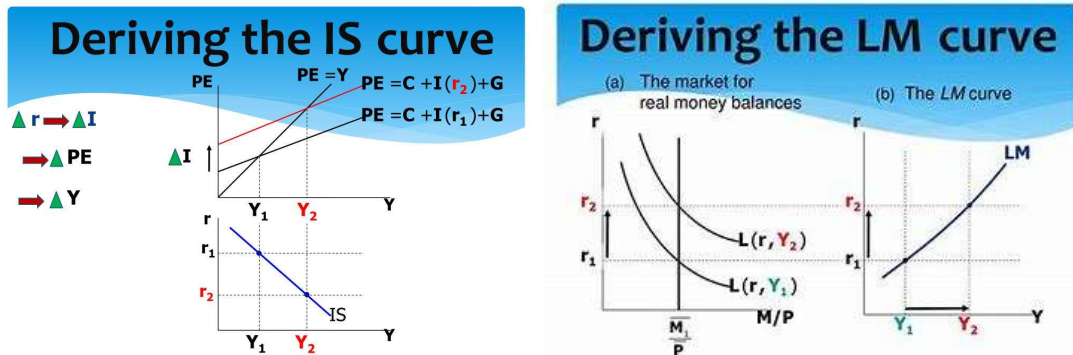
*The Indian economy, like many others, relies on coordinated fiscal and monetary policies to maintain stable growth. The Reserve Bank of India (RBI), through its Monetary Policy Committee (MPC), conducts four meetings annually to adjust policy tools such as interest rates and liquidity measures. These decisions aim to balance economic growth with inflation control, as unchecked GDP fluctuations can lead to inflationary pressures or deflationary risks. In FY2025, India faced a slowdown triggered by weak domestic consumption, reduced government spending, and global trade tensions. Consequently, the RBI revised its GDP growth projection for FY2026 downward from 6.7% to 6.5%. To counter this, the government introduced fiscal measures—including income tax relief for individuals earning up to ₹12 lakh annually and sustained infrastructure investments—while the RBI cut interest rates twice (from 6.5% to 6%) and adopted an accommodative monetary stance. This analysis evaluates the effectiveness of these policies from April 2025 to March 2026 (FY2026), focusing on their impact on reviving growth, stabilizing inflation, and mitigating external risks.*

## **Theoretical framework:**

*To assess the impact of the monetary and fiscal policy measures, the IS-LM framework is applied. This model helps analyse how changes in interest rates (monetary policy) and government spending/taxation (fiscal policy) influence economic output and equilibrium in the short run.*

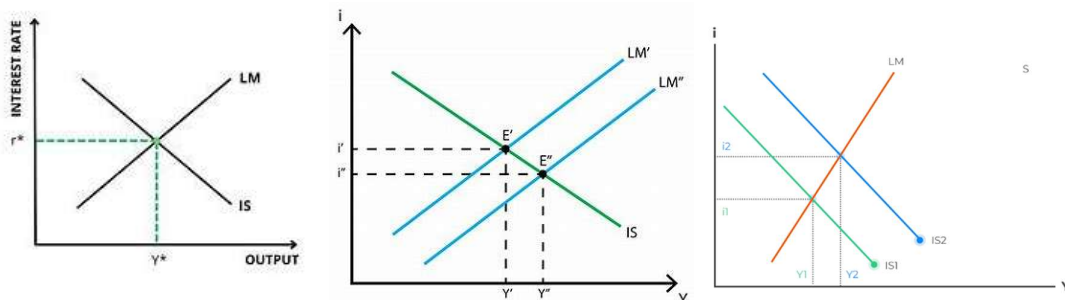
*The IS curve illustrates combinations of interest rates ( $r$ ) and output ( $Y$ ) where total spending (consumption + investment + government spending) equals total production in the goods market. It slopes downward: higher interest rates reduce borrowing and demand, lowering equilibrium output. It represents short-run equilibrium between spending and economic activity.*

The LM curve shows combinations of interest rates ( $r$ ) and output ( $Y$ ) where money demand equals money supply. It slopes upward: higher income ( $Y$ ) raises money demand, increasing interest rates for equilibrium. Central banks control money supply, influencing the curve's position. It represents short-run money market equilibrium.



The IS-LM framework combines the IS (goods market equilibrium) and LM (money market equilibrium) curves to determine the equilibrium interest rate ( $r$ ) and output ( $Y$ ). The IS curve slopes downward (higher  $r$  reduces  $Y$  via lower investment), while the LM curve slopes upward (higher  $Y$  raises  $r$  via money demand). Their intersection shows short-run macroeconomic balance or GDP.

The IS-LM framework illustrates how fiscal and monetary policies influence economic output ( $Y$ ) and interest rates ( $r$ ). Fiscal policies, such as tax cuts or increased government spending, shift the IS curve rightward by boosting aggregate demand, raising output but potentially increasing interest rates if the money supply remains unchanged. Conversely, monetary policies, like interest rate cuts or expanding the money supply, shift the LM curve rightward, lowering borrowing costs and stimulating investment, which increases output while reducing interest rates. When used together—such as India's recent tax relief (fiscal expansion) and RBI rate cuts (monetary easing)—both curves shift rightward, leading to higher economic growth with a neutral or modest impact on interest rates. This coordinated approach helps counteract slowdowns by targeting demand (via IS) and liquidity (via LM), balancing short-term growth and stability.



### **Brief Analysis:**

Some basic equations used in analysis are:

Consumption function:  $C = C_0 + c(Y - T)$

IS curve Function:  $Y(1 - c) = G + NX + c.T - b.i$

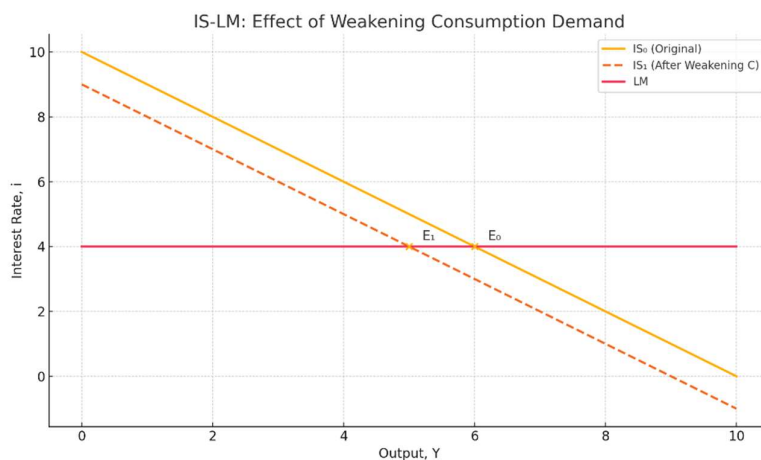
Money Demand function:  $L = k.y - h.r$

LM curve Function:  $M/P = k.y - h.r$

### **For FY2025**

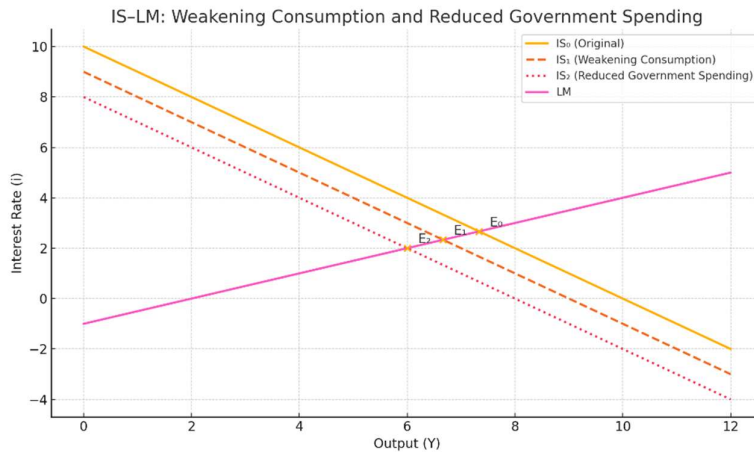
The Indian economy experienced a slowdown in the previous financial year (FY2025), driven by weakened consumption demand and reduced government spending, as outlined in the problem statement.

### **Effect of weakening consumption demand**



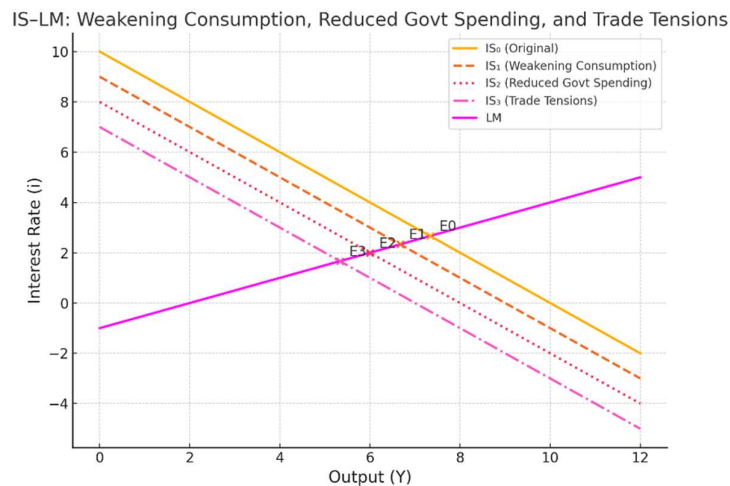
Weakening consumption demand reduces economic growth as household spending, a major GDP component, declines. Lower demand forces businesses to cut production, leading to layoffs and higher unemployment. This creates deflationary pressure, as firms' lower prices to clear excess inventory, while consumers delay purchases, worsening the slump. Reduced sales also deter business investment, further slowing growth. Weakening Consumption Demand reduces  $C_0$  or  $c$ , lowering  $C$ .

### **Effect of reduction in government spending**



A reduction in government spending ( $GG$ ) lowers aggregate demand, shifting the IS curve leftward. This decreases equilibrium output ( $Y$ ) as fewer goods/services are produced. Lower  $Y$  reduces money demand, causing interest rates ( $r$ ) to fall along the unchanged LM curve. The economy moves to a new equilibrium with lower GDP and lower interest rates, potentially worsening unemployment but easing borrowing costs.

### Effect of Trade tensions



Trade tensions, such as tariffs or export restrictions, reduce net exports ( $NX$ )—exports fall (due to foreign retaliation) and imports may decline (due to higher costs). Lower  $NX$  decreases aggregate demand, shifting the IS curve leftward. This reduces equilibrium output (GDP,  $Y$ ) and leads to lower interest rates ( $r$ ) as the economy moves along the unchanged LM curve (money market remains stable).

### Overall effect:

*In FY2025, India's economy slowed due to weakened household consumption, reduced government spending, and global trade tensions. Lower consumption (C) and fiscal cuts (G) reduced aggregate demand, shifting the IS curve leftward, lowering GDP growth (revised to 6.5%) and interest rates (r). Trade tensions further dampened exports (NX↓), worsening the demand slump. This led to production cuts, rising unemployment, and deflationary risks as prices fell amid weak spending. The RBI and government responded with tax relief, infrastructure investments, and rate cuts (6.5% → 6%) to revive growth, stabilize output, and address economic vulnerabilities in FY2026.*

### **For FY2026**

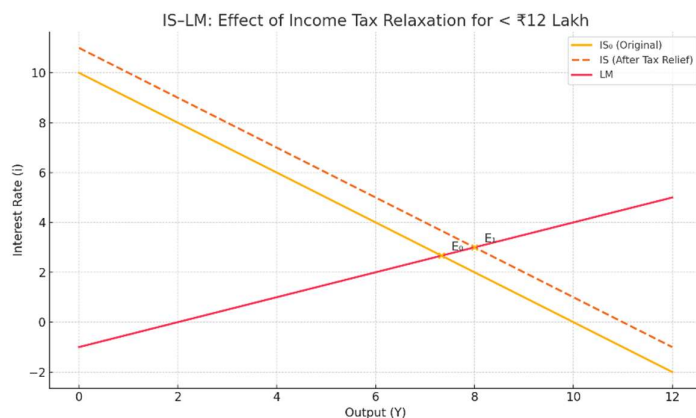
*The Reserve Bank of India (RBI) lowered its FY26 GDP growth forecast from 6.7% to 6.5%, citing weak domestic consumption and global risks. To address this, the government introduced fiscal measures—income tax cuts for individuals earning up to ₹12 lakh annually and sustained infrastructure investments—to boost demand. Simultaneously, the RBI reduced interest rates (6.5% to 6% between February-April 2025) and shifted to an accommodative monetary stance, easing credit access. These coordinated policies aim to revive economic activity, counter slowdown pressures, and stabilize growth amid external uncertainties.*

### **Effect of revising of GDP growth estimates downwards from 6.7% to 6.5%:**

*The downward revision of India's FY26 GDP growth forecast reflects heightened risks from muted domestic consumption, reduced government spending, and global trade tensions. This revision signals potential economic deceleration, prompting policymakers to act pre-emptively. Fiscal measures (tax relief, infrastructure spending) aim to stimulate demand, while monetary easing (rate cuts, accommodative stance) lowers borrowing costs to encourage investment. Together, these steps seek to counteract the slowdown, stabilize growth near 6.5%, and mitigate risks like unemployment or deflation. However, persistent global uncertainties and implementation challenges could temper outcomes, underscoring the need for vigilant policy calibration and structural reforms to sustain long-term resilience.*

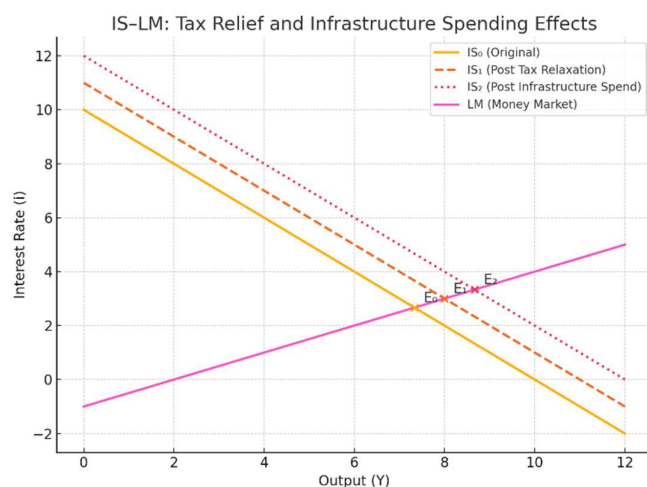
### **Fiscal Policy:**

**Effect of relaxation in income tax liability for individuals earning up to INR12 lakhs annually:**



*The reduction in income tax liability increases disposable income for middle-income households, boosting private consumption demand—a key driver of GDP growth. This fiscal measure shifts the IS curve rightward by raising aggregate demand (C), stimulating production and employment. Higher consumption also amplifies multiplier effects, benefiting sectors like retail, housing, and durables. However, the impact depends on the marginal propensity to consume (MPC) and timely implementation. Combined with monetary easing, this policy aims to counteract India’s slowdown and align growth closer to RBI’s revised FY26 target (6.5%).*

### **Effect of significant capital expenditure for building infrastructure:**



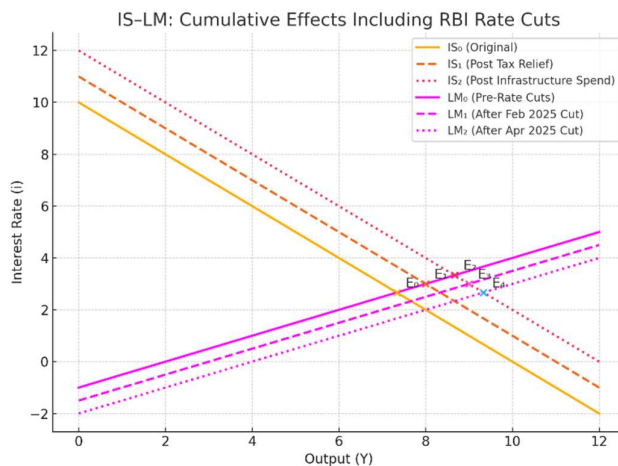
*Increased infrastructure spending stimulates economic growth by creating jobs, boosting demand for construction materials, and enhancing productivity through improved transport, energy, and digital networks. In the short run, it shifts the IS curve rightward by raising aggregate demand (G), lifting output (Y) and employment. Over time, better infrastructure attracts private investment, reduces logistical costs, and raises long-term growth potential. Coordinated with accommodative monetary policy*



(e.g., RBI's rate cuts), this fiscal measure helps counter slowdowns while minimizing inflationary or crowding-out risks.

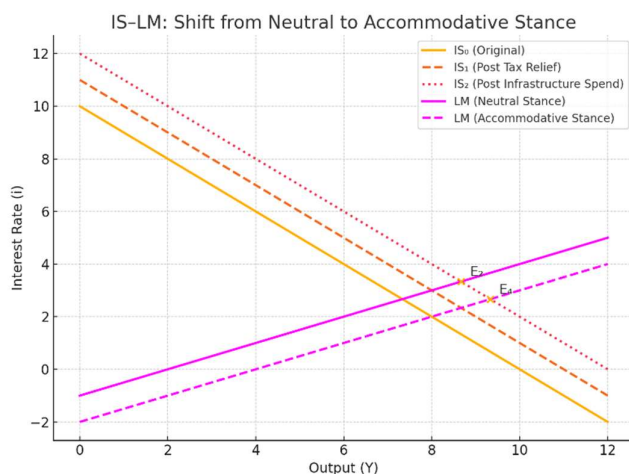
### **Monetary Policy:**

#### **Effect of slashed interest rates from 6.5% to 6.25% in February 2025 and then again to 6% in April 2025:**



The Reserve Bank of India's (RBI) consecutive interest rate reductions—from 6.5% to 6.25% in February 2025 and further to 6% in April 2025—aim to stimulate economic activity by lowering borrowing costs for businesses and households. Cheaper credit encourages investment in productive projects (e.g., factories, technology) and boosts consumer spending (e.g., loans for homes, vehicles), shifting the IS curve rightward (output). Concurrently, the shift to an accommodative monetary stance increases liquidity (money supply), shifting the LM curve rightward (interest rates). This dual easing supports higher GDP growth by raising aggregate demand while mitigating upward pressure on interest rates. However, prolonged low rates risk inflationary pressures if supply-side constraints (e.g., infrastructure bottlenecks) limit output expansion. The policy prioritizes short-term revival of consumption and investment amid global uncertainties.

#### **Effect of shift in the stance from 'neutral' to 'accommodative':**



A shift from a 'neutral' to an 'accommodative' monetary stance signals the central bank's focus on stimulating economic growth over inflation control. By lowering interest rates (e.g., RBI's cuts from 6.5% to 6%) and increasing liquidity, borrowing costs decline for businesses and households. This encourages investment and consumption, shifting the LM curve rightward (money supply, interest rates). Combined with fiscal measures (tax cuts, infrastructure spending), this supports aggregate demand, raises equilibrium output (GDP), and mitigates slowdown risks. However, prolonged accommodation may require monitoring inflation and financial stability.

### **Overall effect:**

In FY2026, India's coordinated fiscal-monetary policies aim to revive growth after FY2025's slowdown. Tax cuts for middle-income earners and infrastructure spending boost household consumption (C) and public investment (G), shifting the IS curve rightward to raise output. Simultaneously, RBI's rate cuts (6.5% - 6%) and accommodative stance increase liquidity, lowering borrowing costs and shifting the LM curve rightward (r). These measures target a GDP growth stabilization near 6.5%, countering weak consumption, global risks, and trade tensions. While short-term demand revival and job creation are expected, challenges like inflation risks, supply bottlenecks, and external uncertainties persist. Proactive policy calibration seeks to balance growth recovery with long-term stability, emphasizing structural reforms for sustained resilience.

### **Conclusion:**

In conclusion, the coordinated fiscal and monetary measures undertaken in FY2026—namely targeted income-tax relief for middle-income households, accelerated

*infrastructure spending and successive policy-rate cuts alongside an accommodative RBI stance—effectively bolster aggregate demand, revive private investment and consumption, and mitigate downside risks from both domestic weakness and global uncertainties. While complementary long-term structural reforms (such as labour-market liberalization, land-use rationalization, and enhanced digital-governance frameworks) could further strengthen India’s growth potential, these initiatives require extended implementation horizons. By contrast, the government’s focus on short-run measures delivers an immediate stimulus to economic activity and market confidence, thereby arresting the slowdown and laying a more resilient foundation for future reforms.*