Indian Economy · GS - III

Analyse the challenges faced by central banks in responding to supply-side inflation, particularly when rising energy prices coexist with stable core inflation.

EXAM YEAR	PAPER	SUBJECT
DAILY PRACTICE 19/11/2026	GS - III	Indian Economy

MARKS	WORD LIMIT
15	~250 words

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Answer Hint

Supply-side shocks, energy price volatility, headline and core inflation, monetary policy transmission, stagflation risk, inflation expectations, second-round effects, interest rate trade-off, growth slowdown, policy credibility.

Model Answer

Introduction

Supply-side inflation arises when disruptions in production or supply increase the cost of goods and services. Rising global fuel prices can create inflationary pressure even when domestic demand remains relatively stable.

Key Challenges for Central Banks

- **Limited policy effectiveness:** Interest rate increases cannot directly resolve geopolitical disruptions or restore energy supplies.
- **Growth-inflation trade-off:** Monetary tightening may control inflationary expectations but also raise borrowing costs and weaken investment and consumption.
- **Headline-core divergence:** A temporary rise in fuel prices may increase headline inflation while core inflation remains stable, complicating policy decisions.

- **Second-round effects:** Higher energy and transportation costs may spread to food prices, wages and other sectors, making inflation persistent.
- **Inflation expectations:** Delayed action may weaken policy credibility if households and businesses begin expecting sustained price increases.

Policy Considerations

Central banks should assess the duration of supply shocks, inflation expectations and their transmission into core prices. Monetary policy must remain data-dependent rather than reacting mechanically to every temporary price increase.

Fiscal measures such as targeted support for vulnerable households, energy diversification and improved supply-chain resilience can complement monetary action.

Conclusion

Managing supply-side inflation requires a careful balance between price stability and economic growth. Coordination between monetary and fiscal policies is essential to prevent temporary external shocks from becoming persistent domestic inflation.

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