Exercise walk-through

Crowding Out ▪ 5.5

eXercise

You must be able to

- define **crowding out 挤出效应** as reduced private investment caused by government borrowing
- use the **loanable funds market** to show how deficit spending raises the real interest rate
- explain how crowding out can weaken the long-run growth effect of fiscal policy

Method — Crowding out

When the government borrows heavily to fund a deficit, it competes for loanable funds and **raises the real interest rate**, which discourages **private investment**.

Method — In the loanable funds market

Government borrowing shifts the **demand** for funds right $\rightarrow$ the real interest rate rises $\rightarrow$ private investment falls.

Method — Effect on growth

Less private investment means a smaller capital stock over time, weakening the long-run growth benefit of the spending.

Practice 2.1 ▪ 1 mark

Define crowding out.

Solution 2.1

Worked steps

the fall in private investment caused by government borrowing **B1**.

Practice 2.2 ▪ 1 mark

State how heavy government borrowing affects the real interest rate.

Solution 2.2

Method: In the loanable funds market

Worked steps

it raises it **B1**.

Practice 2.3 ▪ 2 marks

Explain how crowding out can weaken fiscal policy.

Solution 2.3

Worked steps

the higher real interest rate reduces private investment **B1**, so the total effect on AD and future growth is smaller than intended **B1**.

Exam-style 3.1 ▪ 1 mark

Crowding out is a fall in

- **A** government spending
- **B** private investment
- **C** taxes
- **D** the money supply

Solution 3.1

A government spending

B private investment ✓

C taxes

D the money supply

Worked steps

B.

Exam-style 3.2 ▪ 1 mark

Deficit spending raises the real interest rate in the

A money market

B loanable funds market

C foreign exchange market

D goods market

Solution 3.2

Method: Crowding out

A money market

B loanable funds market ✓

C foreign exchange market

D goods market

Worked steps

B.

Exam-style 3.3 ▪ 1 mark

A government borrows heavily to fund new spending.
(a) State the effect on the real interest rate.
(b) State the effect on private investment.
(c) Name this effect.

Solution 3.3

Method: Crowding out

Worked steps

(a) it rises B1. (b) it falls B1. (c) crowding out B1.