AP MACROECONOMICS • EXERCISE SHEET

5.5 Crowding Out

Name: ____________ Class: ________ Date: __________ **Total: 9 marks**

KEY WORDS crowding out 挤出效应 • fiscal policy 财政政策

Objective

Build the skills to answer exam questions on **crowding out**.

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

1 Worked examples

Study these first. Each one shows the method for a question type used later.

> **■ 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**.
>
> **■ In the loanable funds market**
>
> Government borrowing shifts the **demand** for funds right → the real interest rate rises → private investment falls.
>
> **■ Effect on growth**
>
> Less private investment means a smaller capital stock over time, weakening the long-run growth benefit of the spending.

2 Practice

2.1 Define crowding out. [1]

2.2 State how heavy government borrowing affects the real interest rate. [1]

2.3 Explain how crowding out can weaken fiscal policy. [2]

3 Exam-style questions

3.1 Crowding out is a fall in [1]

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

3.2 Deficit spending raises the real interest rate in the [1]

- **A** money market
- **B** loanable funds market
- **C** foreign exchange market
- **D** goods market

3.3 A government borrows heavily to fund new spending.

(a) State the effect on the real interest rate. [1]

(b) State the effect on private investment. [1]

(c) Name this effect. [1]

Solutions

2.1 the fall in private investment caused by government borrowing.

2.2 it raises it.

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

3.1 B.

3.2 B.

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