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]