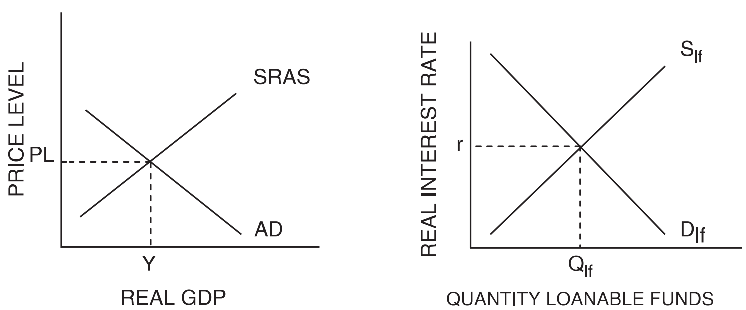
Crowding Out

Expansionary fiscal policy increases aggregate demand and moves the budget toward deficit. If deficit spending is financed through borrowing, the government will demand loanable funds. The government's demand for loanable funds (D_{lf}) added to the demand for loanable funds by private borrowers. Thus expansionary fiscal policy increases D_{lf} and may cause interest rates to rise. Because the government is borrowing money to finance its expansionary fiscal policy, consumers and businesses will be "crowded out" of financial markets. If consumers and businesses are not able to borrow to finance spending, it will lead to a decrease in aggregate demand (AD).

Crowding out occurs when the government borrows to pursue expansionary fiscal policy and such government borrowing replaces private borrowing and spending. Because some private borrowing and spending is "crowded out" of the economy, part of the increase in aggregate demand from increased government spending (and/or decreased taxes) is offset by a decrease in aggregate demand from decreased consumption and investment as interest rates rise.

Figure 5-7.1
Crowding Out



1. Assume fiscal policy is expansionary and the government funds the resulting deficit through borrowing. In Figure 5-7.1, shift one curve in each graph to illustrate the effect of the fiscal policy, and label the new equilibrium values.

2. How will the change in the equilibrium interest rate in the loanable funds market affect the short-run aggregate supply (SRAS) curve in the long run? Show on the AS/AD graph above, and explain.