Syllabus Weight:	Syllabus Item(s):	Webnote
5	119	243

SYLLABUS REFERENCE 2.4: Crowding Out -bized (HL)

- key issue here is the role of government in stimulating economy
- consequences of government demand management: Keynes vs monetarists

'Crowding out' – monetarist criticism of Keynesian demand management

According to monetarists fiscal policy has no role to play in demand management as it simply increases the demand for money. 'Crowding' our refers to a situation whereby public spending crowds out private spending resulting in higher interest rates raising investment costs for the private sector. See also examples **A)** and **B)** below

AD = C+I+G+X-M

Could an increase in I, G or X cause a fall in one of the other components of spending e.g. G crowding out I in that sufficient resources (including funds) may not be available for I ?

Investment is dependant on 4 factors:

1. rate of interest
2. past changes in N.I.
3. business expectations
4. rate of profitability

Crowding IN = Keynesian response

- Keynesians argued that government intervention could lead to a positive outcome in terms of N.I. growth
- This is the term used to describe a situation where I or G or X result in an increase in aggregate expenditure. In other words the multiplier > 1. (for multiplier see webnote 323.

Crowding Out (monetarist)

- Excessive growth in public spending 'crowds out' private sector spending
- This is the opposite effect where the multiplier effect results in the injection (I, G or X) have an effect of < 1
- Note that the Keynesian model does not allow for a 'crowding out' effect for 2 reasons:
  1. I, X and G are exogenous (value not determined by variables inside of the model) and cannot affect each other and take place independent of Y
  2. MPC is < 1 therefore the Keynesian multiplier is always greater than 1.

A) Crowding out: HOW?

If G increases on infrastructure e.g. an airport. This may in turn cause a shortage of skilled engineers and architects diverting them from investment projects that could be carried out by the Firm or at least causing delays in such investment

B) Crowding out: HOW?

If on the other hand G causes inflation this may increase the need for tight monetary policy in the form of higher rates of interest thus reducing the environment for Investment by the firm

Note: total crowding out exists if spending in I falls by 100 % of the injection, G. Partial is < 100 %