Crowding Out Effect Quiz

Directions: Remember that $AD = C + I + G + NX$. Draw a square around the initial spending change that shifts the AD curve. Circle the offsetting spending change(s) that reduce the effectiveness of fiscal policy by shifting the AD curve again. Then tell which of these are Keynesian explanations and which is the new Classical explanation and where they are found in these notes.

1. $G \rightarrow C$ \hspace{1cm} \text{keynesian}

2. $G \rightarrow \text{the government runs a deficit} \rightarrow \text{the government borrows} \rightarrow r \uparrow$ \hspace{1cm} $\rightarrow C$ \hspace{1cm} \text{and} \hspace{1cm} $\uparrow$ \hspace{1cm} \text{keynesian}

3. $G \rightarrow \text{the government runs a deficit} \rightarrow \text{the government borrows} \rightarrow r \uparrow$ \hspace{1cm} $\rightarrow$ \hspace{1cm} $\text{foreigners buy US dollars}$ \hspace{1cm} $\rightarrow$ \hspace{1cm} $\text{the value of the dollar rises}$ \hspace{1cm} $\rightarrow$ \hspace{1cm} $\text{two things happen:}$ \hspace{1cm} $r \uparrow$ \hspace{1cm} $\rightarrow$ \hspace{1cm} $\text{NX}$ \hspace{1cm} \text{keynesian}

4. $G \rightarrow \text{the government runs a deficit} \rightarrow \text{the government borrows} \rightarrow r \uparrow$ and taxpayers expect higher future taxes \hspace{1cm} two things happen: $S \uparrow \rightarrow r \downarrow$ \hspace{1cm} \text{classical}

Crowding In Effects

Crowding In Effects occur when the government runs a surplus in the process of trying to fix an inflationary gap. Crowding In Effects also diminish the effectiveness of fiscal policy.

Rewrite 1-4, above, for contractionary fiscal policy:

1. $G \downarrow \rightarrow C \uparrow$

2. $G \downarrow \rightarrow \text{the government runs a surplus} \rightarrow \text{the government}$ \hspace{1cm} \text{pays off} \hspace{1cm} $\text{bondholders}$ \hspace{1cm} $\rightarrow$ \hspace{1cm} $r \downarrow$ \hspace{1cm} $\rightarrow C \uparrow$ and $I \uparrow$ \hspace{1cm} \text{pays off}$

3. $G \downarrow \rightarrow \text{the government runs a surplus} \rightarrow \text{the government}$ \hspace{1cm} \text{pays off} \hspace{1cm} $\text{bondholders}$ \hspace{1cm} $\rightarrow r \downarrow$ \hspace{1cm} $\rightarrow$ \hspace{1cm} $\text{foreigners sell US dollars}$ \hspace{1cm} $\rightarrow$ \hspace{1cm} $\text{the value of the dollar}$ \hspace{1cm} \text{calls} \hspace{1cm} $\rightarrow$ \hspace{1cm} $\text{two things}$ \hspace{1cm} happen: $r \uparrow$ \hspace{1cm} $\rightarrow$ \hspace{1cm} $\text{NX}$ \hspace{1cm} \text{pays off}$

4. $G \downarrow \rightarrow \text{the government runs a surplus} \rightarrow \text{the government}$ \hspace{1cm} \text{pays off} \hspace{1cm} $\text{bondholders}$ \hspace{1cm} $\rightarrow r \downarrow$ \hspace{1cm} and taxpayers expect lower future taxes \hspace{1cm} $S \downarrow$ \hspace{1cm} $\rightarrow r \uparrow$ \hspace{1cm} $C \uparrow$