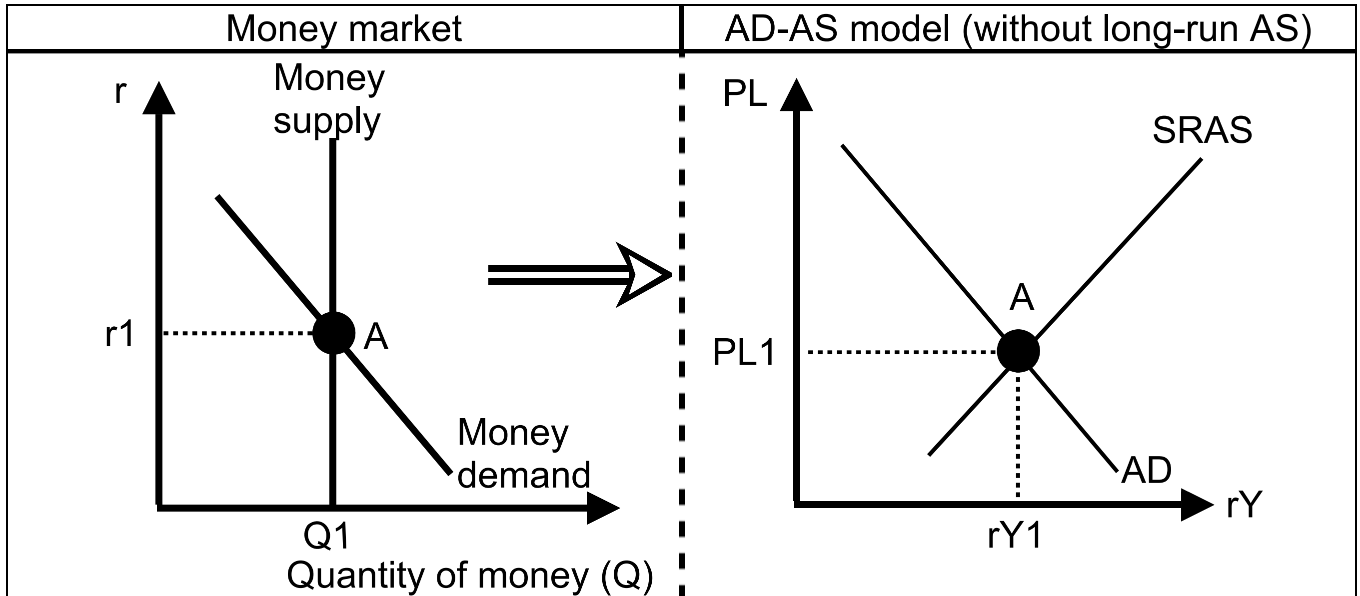
Crowding-out effect 2

AS = Aggregate supply
PL = Price level
SRAS = Short-run AS

AD = Aggregate demand = C + I + G + (X-M)
rY = real gross domestic product
r = Interest rate

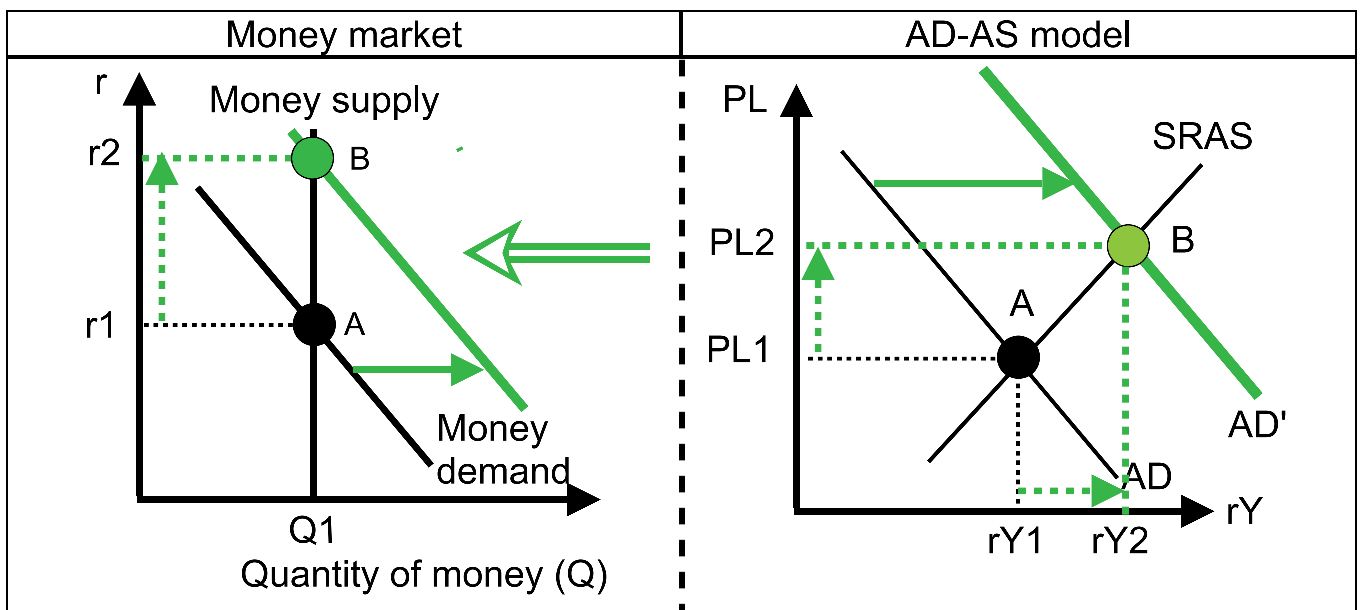
The crowding-out effect limits the impact of the fiscal policy (government spending, taxes).

Step 1: Starting point



Step 2: Increase in government spending (G) and AD

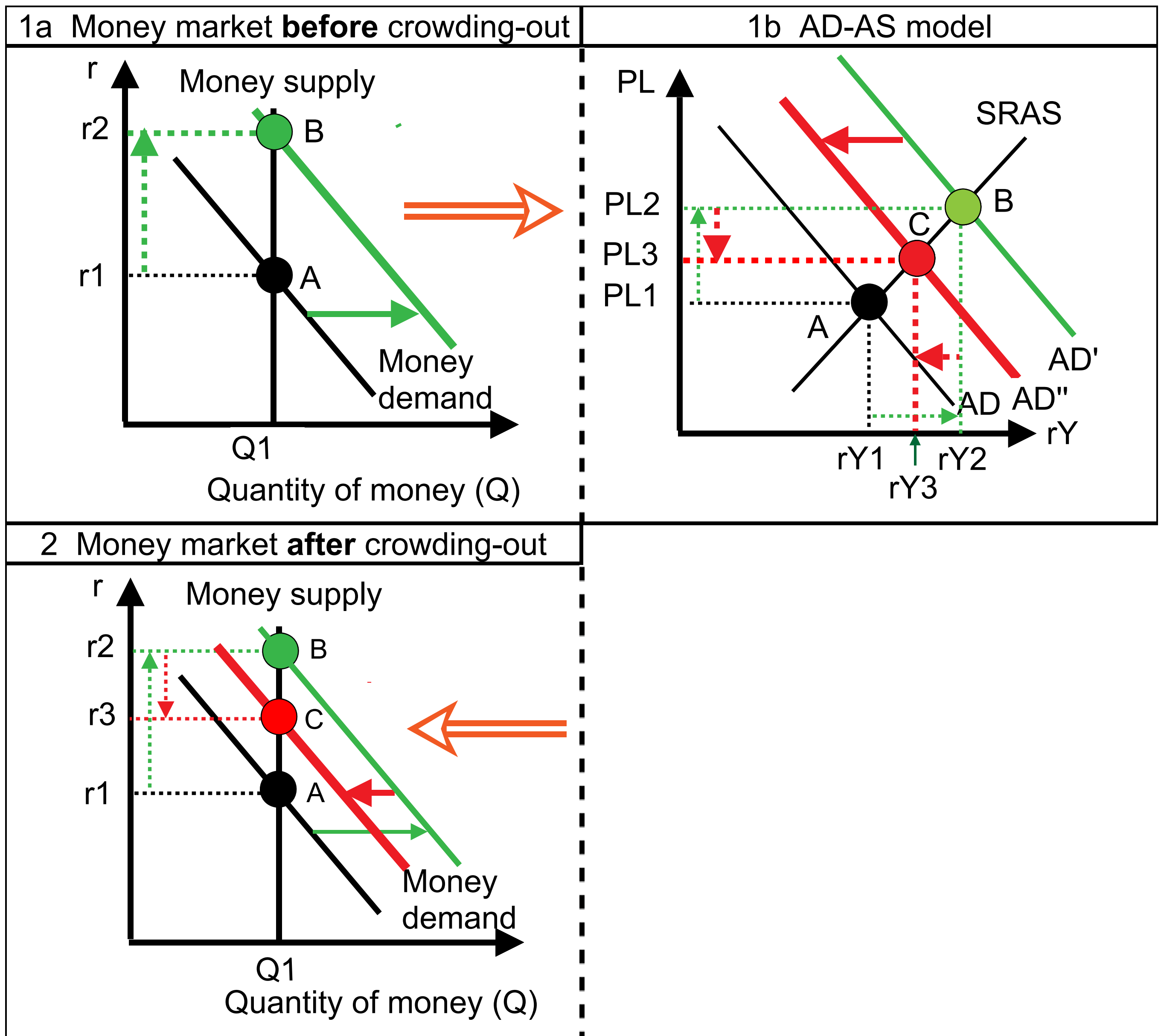
(in the case of a recession)



The demand for money shifts to the right and the interest rate rises. This happens for two reasons: Increased income and increased PL.

Step 3: Crowding-out effect in action

The higher interest rate results in less investment and consumption. AD falls and thus part of the additional AD.



Only the 1st round of the crowding-out effect is shown above. In the 2nd round, the lower interest rate r3 will impact on a rise in investment and in consumption, causing the AD curve to shift a little to the right. A repeated adjustment process could be set in motion, similar to the multiplier effect, but limiting the latter effect.