CROWDING OUT

SimplySimple.in

vEcoSys

CROWDING OUT

There have been several articles in the Indian media that the huge Government borrowing program on account of the large fiscal deficit is likely to ‘crowd out’ private investment.

But what does ‘crowding out’ mean? Is it a good thing or bad thing? Let me try & explain…

Understanding

the concept of Crowding Out

– By Prof. *Simply* Simple

CROWDING OUT

- **In economics, crowding out is the process of a reduction in private consumption or investment that occurs because of an increase in government spending.**

- **In other words, usually when economists use the term 'crowding out' they are referring to government's spending using up financial and other resources that would otherwise be used by private enterprises.**

CROWDING OUT

Now…

- **Governments often borrow money (by issuing bonds) to fund additional spending and expenses that they incur.**

- **The problem occurs when government debt 'crowds out' private companies and individuals from the lending market.**

CROWDING OUT

But why does pvt. investment get “crowded out”?

- **Increased government borrowing tends towards an increase in market interest rates.**
- **The problem is that the government can always pay the market interest rate, but there comes a point when corporations and individuals can no longer afford to borrow at these rates.**
- **Also lenders always prefer lending to the government before lending to private borrowers because of the ‘safety’ factor of the government borrowing.**
- **Thus private borrowers are left in the lurch while the government merrily borrows money.**
- **This fall in fixed investment by businesses can hurt long-term economic growth of the supply side, i.e., the growth of potential output.**

CROWDING OUT

Now…

- **Crowding out can, in principle, be avoided if the deficit is financed by simply printing money, but this would fuel 'inflation'.**
- **The negative effects on long-term economic growth that occur when private investments are crowded out can be moderated if the government uses its deficit to finance productive investment in education, basic research etc.**
- **The situation is made worse, of course, if the government wastes borrowed money.**

CROWDING OUT

However…

- **If the impact of crowding out was small, then fiscal policy would still work pretty well.**

- **Otherwise it could have a detrimental effect on GDP growth.**

CROWDING OUT

To Sum Up

- **What: Government spends using up financial and other resources that would otherwise be used by private enterprises.**
- **Why: Governments often borrow money (by issuing bonds) to fund additional spending and expenses and to meet its fiscal deficit**
- **How: The government is able to crowd out private borrowers because its credit rating is so high and because it is willing to pay the interest rate demanded by the market.**

CROWDING OUT

Hope you have now understood the concept of Crowding Out

Simply Simple.in

Thinking of Investment

Contact

vEcoSys

Simply Simple.in

DISCLAIMER

The views expressed in this lesson are for information purposes only and do not construe to be any investment, legal or taxation advice. The lesson is a conceptual representation and may not include several nuances that are associated and vital. The purpose of this lesson is to clarify the basics of the concept so that readers at large can relate and thereby take more interest in the product / concept. In a nutshell, Professor Simply Simple lessons should be seen from the perspective of it being a primer on financial concepts. The contents are topical in nature and held true at the time of creation of the lesson. This is not indicative of future market trends, nor is vEcoSys IMF Pvt. Ltd. attempting to predict the same. Reprinting any part of this material will be at your own risk. vEcoSys IMF Pvt. Ltd. will not be liable for the consequences of such action.

Mutual Fund investments are subject to market risks,

read all scheme related documents carefully.

Simply Simple.in