Theory of Crowding Out

Crowding out is an economic theory of what could happen when a country’s debt becomes too large. What is too large? While no one truly knows, theoretically, the more bonds the government sells to finance its growing deficits, the less investors should be willing to pay for them, all else being equal. That, in turn, should push up long term interest rates, punishing the government by increasing its cost of borrowing. The higher interest rates would also hurt economic growth by making corporate borrowing less attractive -- an effect that economists call "crowding out." That is many private investors are “crowded out” of the market when long term interest rates increase. Since fewer companies borrow money, GDP slows down and the entire economy suffers.

The bottom line is that, when long term interest rise there are 3 negative consequences:

- **Governments** have to pay higher interest payments on bonds
- **Companies** borrow less money to expand their business
- **Consumers** borrow less to buy houses/cars.

Of course economics is a social science and some real-world experience directly challenges the crowding out theory. For example, Japan saw long-term interest rates fall amid persistent large budget deficits in the 1990s (although the Japanese people more than made up for the growing government spending by saving a lot themselves).

In the U.S. the government budget has swung from a surplus of more than $200 billion in 2000 to a deficit of $800 billion in 2013, yet the interest rate on the 10-year U.S. Treasury Bond has fallen from more than 6.0% then to approximately 2.7% in 2014!

"We've learned during the Bush administration that you can run big deficits and there isn't any short-run pain," says Kevin Hassett, a former Federal Reserve economist who now directs economic policy studies at the right-leaning American Enterprise Institute. "So politicians can be irresponsible...and get away with it." (at least in the short run!) Recently, President Obama has learned the same lesson: large short run deficits do not cause immediate pain. President Obama cut social security taxes and increased Government spending—both of which increased the deficit during the Great Recession.

Economists and analysts offer various explanations for why crowding out has not occurred yet in either the U.S. or Japan. Most notably, deficits don't happen in a vacuum. In both the U.S. and Japan, downward pressure on inflation (and in Japan's case outright deflation) played a critical role in driving down interest rates even as deficits mounted.

In addition, some say a "global savings glut" has helped to keep U.S. long term interest rates low, as foreigners (China) put extra savings into U.S. Government bonds, pushing prices up and long term interest rates down. Other factors are at play. For instance, some argue that total U.S. government debt actually hasn't reached the danger zone yet: The national debt of the USA is 17.4 Trillion with a GDP of 17.1 Trillion, or 108% of GDP! The current deficit is $700 Billion or 4.3% of GDP.

Is the USA about to enter a long period where the dangers of the debt actually severely hurt the U.S. economy? Since economics is a social science, we cannot really say for certain. However the recent problems in Europe in countries such as Greece, Spain and Ireland may serve as a warning sign that the risk of excessive debt is indeed real.

1) What is the size of the U.S. current deficit and debt?
   a. Both absolute number and as a percent of GDP

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<th>Dollar Amount</th>
<th>Deficit</th>
<th>National Debt</th>
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2) Briefly explain the economic theory of crowding out.
3) Which is the best definition of the theory of crowding out?
   a. Government falls into large debt, government buys more bonds, short term interest rates rise
   b. Government falls into large debt, government sells more bonds, short term interest rates rise
   c. Government falls into large debt, government sells more bonds, long term interest rates rise
   d. Government falls into large debt, government sells more bonds, short term interest rates fall

4) Which is true when crowding out occurs:
   a. Governments have to pay higher interest payments on the debt
   b. Private investors borrow more money to expand their business
   c. The U.S. government has less need to cut spending
   d. Both A & B are true
   e. None listed are true

5) Long term interest rates in the USA today can be described as:
   a. Very high
   b. Somewhat high
   c. Somewhat low
   d. Historically at record low levels

6) How would crowding out hurt the U.S. economy (GDP) if it were to occur?
   a. Think which components of GDP would fall       \[ GDP = C + I + G + (X-M) \]

7) Why will entitlement spending eventually put the theory of “crowding out” to the test?

8) List several reforms which would help improve the Entitlement Spending problem in the USA?
   Social Security
   Medicare

9) What are some theories on why the USA has not suffered from crowding out yet?