3. The *wisdom* of continuing to make a prime loss will depend upon the costliness of the most attractive alternative. It may be cheaper, for example, to shut down temporarily, putting the plant on a care and maintenance basis. But this is a course which firms are reluctant to take, since it may mean the loss of business connections, disorganization of staff, and the dispersion of a reliable and carefully selected body of workers, trained in the ways of the firm. Frequently, therefore, firms prefer to work on a skeleton output in order to maintain contact with markets, staff and workpeople. Where shut-down and reopening costs, broadly defined, are high, firms will prefer to go on producing at correspondingly high prime losses.

Marginal firms in the short period

In the short period, as in the long, there will be some firms that are marginal and others that are intra-marginal. Marginal firms will be on the verge of closing down or opening up, and a small change in price will be sufficient to turn the scale. The average short-period cost of such a firm can be calculated by deducting from its total costs the alternative cost of closing down and producing nothing and averaging the residue over the firm's output. Below this average cost, price will not fall. Monopolistic influences may, however, succeed in maintaining prices above the average short-period cost of even the least favourably situated firm.

Summary

A change in price will have immediate and delayed reactions on supply. These reactions will be governed at each stage by the alternatives open to producers, and the range of alternatives will widen with the passage of time. Supply is more elastic the longer the period which we have in view.

This is particularly true of a *reduction* in supply. What is saved by contracting output in the short period is often small in comparison with what can ultimately be saved (e.g., by refraining from plant renewals). Especially when overheads are high, the adjustment of an industry to a *fall* in price is difficult and protracted. On the other hand, an industry generally attempts to expand its capacity quickly to meet a *rise* in price because short-period expedients for increasing output tend to be much more costly than the long-period expedient of installing more plant.

1. positive influences: the level of government spending, producers' expectations of future output prices; the availability of credit and supply of liquid assets; consumers' wealth and *expectations of future income*;
2. negative influences: tax rates; rates of interest; the current price levels of all goods.

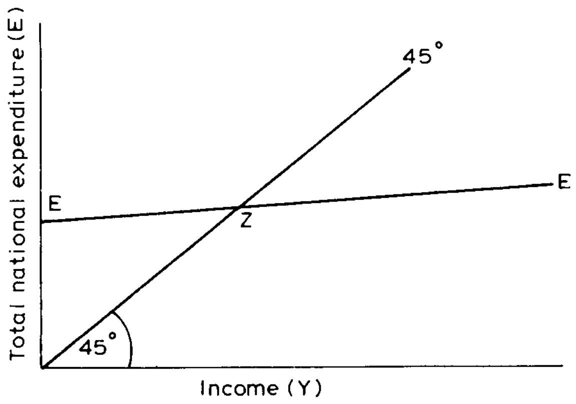

Figure 21.2 The total expenditure function

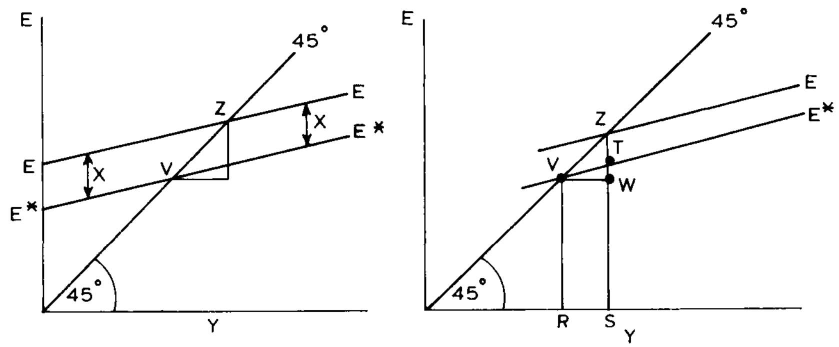

Figure 21.3 The effects of a fall in the total expenditure function, and the multiplier

Now two lines are drawn in *Figure 21.3*: the EE line, and a 45° line from the origin. The latter represents the equality between Y and E which we saw earlier to follow by definition, if one of two assumptions were made. In *Figure 21.3*, therefore, there are two relationships at work: a necessary equality between E and Y (the 45° line) and a dependence of E upon Y (the EE line). If both must be true, the levels of E (and Y) must be determined where the two lines cut, at Z. Y could not be higher than this, because production would then outstrip expenditure (this is known as a 'deflationary gap'); nor lower, because the opposite would then be true (an 'inflationary gap').

Suppose, now, that the line EE dropped by the vertical distance x. There could be many reasons for this: a rise in the value of any of the negative money on the stock exchange and invest it in securities. The distinguishing feature of a bank, or at least of a deposit bank accepting money on deposit from the public, lies in the character of the liabilities it creates. These liabilities, unlike deposits with a building society, shares in an investment trust, insurance policies, etc., are themselves money: not just something capable of being turned into money, or forming security for a loan of money, but money-at-the-bank.

It follows from this that banks are not alone in their power to create credit if by credit we mean liquid assets. The liabilities of most financial institutions are relatively liquid in the sense that they can be readily disposed of at little cost and without much sacrifice of their face value. They differ from money, but the difference is a matter of degree. If the liabilities of financial institutions other than deposit banks are increased, the money supply remains unaffected but something happens that is very much akin to an increase in the money supply: the economy becomes more liquid and less in need of bank money. If people have more on deposit with the building societies, or hold more savings certificates or bigger insurance policies, they have less motive for holding a large balance at the bank; their need for liquidity is satisfied in other ways. Now all financial institutions are in competition with one another for money and the banks are not immune from this competition; they may lose ground to savings banks, building societies, and other competitors. If this happens, the place of the banks in the whole financial structure will alter and so will the place of bank money in relation to other kinds of liquid asset. The changes taking place in the supply of money will then be a very misleading guide to the changes taking place in general liquidity and it is the latter that are significant in the management of the economy. Changes in the supply of money are no more than a means of acting on liquidity; and deposit banks are only one group of financial institutions capable of generating additional liquidity.

Moreover if we look at the process of credit creation through the eyes of an individual bank, its behaviour does not seem very different from that of other financial institutions. It balances it books just as they do, entertaining fresh applications for loans or buying additional securities only if there is a surplus above normal reserve requirements. If it decides to hold a rather larger or rather smaller reserve against its liabilities, it is again making a decision that other financial institutions may take when they think it prudent to increase their liquid reserves or are content with a narrower margin in hand. A bank can no more afford to increase its liabilities without regard to its reputation than can any other financial institution.

We must not push these arguments too far. While it is true that other institutions create credit, and that a great deal of credit is given by one business to another or by one person to another without the intervention of any institution, the banks occupy a central position in the creation of credit and liquidity. They do so for three reasons. First of all, banks as a group usually have command over larger resources than other financial institutions. In the United Kingdom, pension funds and building societies equal only the insurance companies and the clearing banks in the size of their assets, but insurance policies lie far apart from bank money in point of

Alternative systems of economic planning

In framing its plans the government may follow one or other of two courses. It may allow consumer spending to influence what is to be produced without itself planning production; or it may leave the consumer free to spend his money as he chooses, but only on such products as it allows to reach the market. The first alternative is the one adopted under a system of private enterprise, which confers on a great many individual producers the power to decide how the factors of production shall be employed, but submits these producers simultaneously to the compulsions of the market and the need to find willing buyers at prices to cover their costs. The second alternative involves comprehensive economic planning by the state and the setting of production targets that may bear little or no relation to current market shortages or surpluses.

There is a sharp antithesis between the two systems because the one is organized round market forces and prices and works through incentives of profit and loss, while the other sets out to organize production and supply by administrative decision. In a sense, the one system is the individual consumer writ large while the other is the individual firm writ large. In the one, planning is geared to demand, to the price mechanism, to discovering what consumers want most and letting them have it provided they can pay the price; there is a corresponding emphasis on selling and marketing – an emphasis which offends those critics of market forces who distrust the consumer's power to make sensible decisions under sales pressure. Under the other system, planning is looked at with the eye of a producer – one might almost say an engineer – aiming at an ever-expanding output and not much concerned about the demand for it; the task that is set each unit of production is not how to find a market for the goods that it can produce but how it can carry out its part of the plan, almost irrespective of the level of costs or profits; and the detachment of the plan from any necessary link with the spending of consumers gives to it a dictatorial character, quite apart from any drastic sanctions by which its fulfilment may be secured.

This sharp antithesis is often less acute in practice than it seems in theory. Under a system of private enterprise, there is already a large public sector in which the state is directly responsible for the planning of production and investment. Through taxation, moreover, it can abstract purchasing power from private consumers and apply it to purposes of which they, or rather the electorate, may only vaguely approve when they come to vote at the next election. It may also 'rig' market forces by taxes, subsidies, tariffs, and so on, in order to check some outputs and encourage others, until the result is almost indistinguishable from that obtained by central planning of production. In the last resort, it is because the consumer is also an elector rather than because of any difference in the role of the price mechanism that the two systems remain quite distinct.

Similarly, if one looks carefully at a centrally planned economy one finds that market forces are by no means disregarded and that individual producing units are not simply given a plan and told to carry it out; consumers' wants do influence production and producers still have to sell, if not their output, their view of what the plan for their factory should be. Just because an economic system is centrally planned, we need not assume