Access to Institutional Finance and the Use of Trade Credit

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I develop a conceptual framework for analyzing the effect of the availability of institutional loans on firms' demand for supplier (trade) finance. I test for the existence of credit constraints and their effect on corporate financing policies. My empirical results support the hypothesis that trade credit is taken up by firms as a substitute for institutional finance at the margin when they are credit constrained. Further, in line with studies on the credit channel of monetary policy transmission, I find an increased reliance on trade credit by financially constrained firms during periods of tight money.

For most firms, trade credit is an essential element of their operations. In developed countries, the majority of firms rely heavily on trade credit extension as a source of finance. In a Federal Reserve Board study, Eliehauzen and Wolken (1993) note that in 1987, accounts payable constituted 20% of all non-bank, non-farm, small businesses' liabilities and 15% of all large firms' liabilities. On the other hand, accounts receivable represents one of the main assets on most corporate balance sheets. Therefore, an important aspect of trade credit is the two-way nature of the transaction. Many companies, particularly those at intermediate points in the value chain, use trade credit as customers and provide it as suppliers. Thus, trade credit represents a substantial component of both corporate liabilities and assets.

Alongside this obvious economic importance, trade finance should be considered by policymakers because of its ability to affect the outcome of policy interventions. For example, Davis and Yeoman (1974) show evidence that large UK firms used trade credit to cushion themselves from tight monetary policy in the late 1960s.

In this paper, I study the interdependence between the two major sources of short- to medium-term corporate funds: 1) institutional loans (bank debt of short- to medium-term maturity, lines of credit, etc.) and 2) trade credit. Trade credit is a more expensive financing alternative to conventional loans because suppliers have a higher direct cost of funds. For example, for suppliers, these higher costs can take the form of inefficiencies in the collection of payments, but financial intermediaries enjoy cost advantages due to specialization.

Previous studies offer numerous examples of how, for some firms, financial market imperfections may create dependence on trade credit as a source of funds. Petersen and Rajan (1997) and Nilsen (2002) argue that firms that have no access to markets for traded long-term securities or commercial paper rely on trade credit for financing during economic downturns and monetary policy contractions. Deloof and Jegers (1999) provide empirical evidence that the amount of trade credit used is

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