Trade Credit and Access to Finance in Low Income Countries

Policy brief DFID/Tilburg University research: *'Enabling Innovation and Productivity Growth in Low Income Countries' (EIP-LIC)'*.
http://www.tilburguniversity.edu/dfid-innovation-and-growth/

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Many African countries have achieved promising economic growth rates in recent years. However, credit market imperfections are still persistent, resulting in limited access to formal bank credit for many firms, especially small and micro enterprises. Trade credit, as a method of direct 'in-kind' business financing, can be popular as an alternative to bank credit in locations with limited financial sector development. From this perspective, trade credit and bank credit can be considered substitutes.

In the framework of a DFID-funded research project entitled *'Enabling Innovation and Productivity Growth in Low Income Countries (EIP-LIC)*', a team of researchers from Cass Business School (University of London), the Institute for Management and Planning Studies (Iran), and Tilburg University investigated the relationship between bank credit and trade credit in the context of a developing county. Specifically, the research question addressed whether usage of trade credit decreases with access to bank credit, or whether the use of trade credit and bank credit are positively associated. The research further highlights the role of formality of firms. The team analysed firm-level data from 5,500 Ethiopian retailers. The original working paper is entitled 'Trade Credit and Access to Finance of Retailers in Ethiopia' (2017) by Thorsten Beck, Mohammad Hoseini and Burak Uras[1].

Research approach and findings

The findings suggest that bank finance and trade credit are substitutes in Ethiopia. In locations with lesser access to formal bank finance, the use of trade credit is higher. The extension of trade credit by suppliers generates a credible signal to banks with regard to the customers' creditworthiness, which can make trade credit and bank credit complementary on the individual firm-level. For informal retailers, bank credit acts as a counterpart to trade credit in the sense that higher bank loan exposure is associated with greater access to trade credit. For formal firms, however, the research reveals that having more bank loans is not a significant explanatory factor of the use of trade credit. These results could imply that receiving bank credit increases the creditworthiness of informal firms that have less transparent operations and motivates their suppliers to extend them trade credit. Formal firms, on the other hand, are more transparent and the level of obtaining trade credit is mainly restricted by the availability of such sources of external finance in the locality.

Having a relationship with a bank can also act as a signal of the creditworthiness of firms to their suppliers and reduce the agency problems associated with trade credit. An important issue for studying trade credit as a form of financing is its substitutability versus complementarity with respect to bank credit. The researchers

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[1] The paper is accessible at the project's website (http://www.tilburguniversity.edu/dfid-innovation-and-growth)

find that trade credit usage is more prevalent in locations with lower access to finance, consistent with the substitutability theory. The research, however, also finds that bank credit acts as a complement to trade credit for informal firms who lack transparency and suffer more from agency problems with their suppliers.

Policy implications

Although the link between trade credit and bank credit has been studied in the literature, investigating this relationship in the context of a developing country with low levels of access to finance provides several original insights for policy makers. Financial inclusion has been a key topic in development policy debates in many underdeveloped countries, but most policy initiatives address the direct effect of bank credit constraints.

This research stresses the importance of the role of informality in understanding the association between trade credit and bank credit. Informal firms feature non-transparent operations and rely on cash-based transactions, partly to hide from tax authorities and partly due to the unavailability of bank accounts. Operational transparency is a major element in accessing external finance, because without transparent (formal) accounting standards, creditors cannot determine the quality of borrowers. Informal sector promotion policies could focus on the notions and necessity of transparent operations though awareness, training and education policies.

Facilitating trade credit and bank credit could mutually strengthen each other, for instance, in combined policy and development programmes integrating the two.

Policies to expand financial inclusion by increasing operational transparency might alleviate the agency problems of informal enterprises vis-à-vis suppliers and enable them to obtain not only formal finance from banks but also informal finance in the form of trade credit.

For the formal sector, however, the research suggests less expected policy impact. Although obtaining a bank loan is positively associated with receiving trade credit for informal firms, the team does not find a similar significant link for the sample of formal firms.

This policy brief is the product of a research project funded by the British Department for International Development (DFID) entitled ‘Enabling Innovation and Productivity Growth in Low Income Countries’ (EIP-LIC). The project is implemented by Tilburg University (The Netherlands) and explores SME-level innovation in Low Income Countries (LICs) and factors that contribute to or limit its diffusion. Data collection and research collaborations took place in 10 African and Asian countries (Bangladesh, Ethiopia, Ghana, India, Indonesia, Kenya, Tanzania, South Africa, Uganda and Vietnam). The policy implications of this research are presented in a series of policy briefs, targeted at a broad audience of policy makers within governments, business and development agencies with a view to quantifying research outcomes and promoting evidence-based policy making.