European Journal of Economic and Financial Research
ISSN: 2501-9430
ISSN-L: 2501-9430
Available on-line at: http://www.oapub.org/soc

doi: 10.5281/zenodo.3934267 Volume 2 │ Issue 1 │ 2017

TRADE CREDIT AND FIRM PERFORMANCE: A REVIEW OF CLASSICAL LITERATURE

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Abstract:
Firms with access to financial institutions credits have been found to extend more trade credits to customers. This is based on the fact that the firm is believed to have more information about the customers compared to external financiers. This conjecture points to the fact that the information advantage which the firm has over the conventional lenders like banks may have been due to regular and repeated interactions with the customers, sometimes on a personal level. Suppliers are more likely to offer more trade credit to customers with whom they have had long business relationship. From the standpoint of extant literature, this paper reviews the nexus between trade credit and firm performance. Based on the reviews, there seem to be a consensus that trade credit is positively related to firm performance. However, monetary policy stance is found to be a key determinant of trade credit supplies. This is because contractionary monetary policies are expected to have effects on trade credit relative to sales and ultimately have implications on firm profitability.

JEL: F10, L20, L22

Keywords: trade credit; firm performance

1. Introduction

Evidently, the link between trade credit and the performance of firms have been largely ignored in recent years. It appears that, globally, this very subject has been generally overlooked, hence the dearth of literature on the discourse. Lamentations concerning such disregard did not manifest at this time, as the few studies that attempted to fill the

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yawning knowledge gap, albeit theoretically, were as far as 1960s. Brasch (1972) explained that thorough search of libraries pitiably produces little result in terms of published research on the role of trade credit in economic development of developing countries. If the contribution of trade credit to economic growth is not insignificant, then such unfortunate remiss in literature can be described as an oversight by researchers and economic analysts. However, considering the substantial amount of credits extended by the banking industry for the purpose of trade, the influence cannot be reckoned as insignificant. Arguably, trade credit is necessary for the stimulation of the growth process. Besides the mammoth of currencies that exchange hands across the globe everyday, trade also creates value through a chain - from production to consumption. Domestic and international trade can be adversely hindered if no credit is extended to tap into short-term opportunities and even out deficiencies of occasional economic slacks.

Atanasova (2007) succinctly highlighted that even in the developed countries, majority of firms are dependent of trade credit as their main source of finance. This leads us to say that every economic system is made up of large enterprises or corporation, and weak or small business units. The activities of the later are often marred by limited capital, which consequently hinder their growth and drive for expansion. To enable them take advantage of economies of scale and grow rapidly, they need trade credit to augment their limited financial resources. Business in developing countries like Nigeria is typified by small and medium scale enterprises. This fact is therefore reason why efficient trade credit system can be considered very advantageous to the economic growth of the country. This is because, with the capital gap narrowed, they stand a chance of operating optimally thereby creating outputs and adding value to the economic system.

Deposit money banks in Nigeria and in other developing countries may be said to have conservative proclivity of rejecting loan requests by small and financially constrained firms. Therefore, trade credit appears to be an alternative to loans especially regarding the funding of domestic and transnational trades. It can be rightly inferred that when such motive is the essence, small and large businesses alike benefits from the short-term facilities. It is noteworthy that empirical studies on this very subject are very sketchy. While bank credit in general have received ample attention from researchers, from a macroeconomic point of view, the effect of trade credit, as a source of finance, on the performance of firms have been understudied. It is against this backdrop that this paper evaluates the linkages between trade credit and firm performance from the perspective of *extant* classical literature.

2. Theory and Empirics

A neoclassical model, a theoretical framework, which takes into consideration the costs associated with trade credit provision was credited to Nadiri (1969). This theory assumes that firms incur costs in the curse of supplying trade credit, hence the opportunity costs of providing trade credit to customer. This model contends that trade credit supply has positive relationship with sales growth as well as profitability of firms. In other words, firms use trade credit to increase both sales and profitability level. This entails that firms

that spend more on trade credit provision tend to record a higher level of sales and profit margins (Nguyen, 2011). One major element of trade credit is associated with the length of time for which trade credit may be extended. Within a single economy, different implicit or explicit credit maturity terms translate into different credit costs. In turn, however, these relative costs are mainly reflected in price differences (Hekman, 1981).

Existing body of literature on trade credit has perceived trade credit as a reliable source of finance for customers who have constraints in borrowing from financial institutions. Ferris (1981) analysed a transactions theory of trade credit use from the perspectives of trading partners to economise on the joint exchange costs. The study suggests that uncertain delivery time is applied to generate a demand by companies to hold inventories both in the form of goods and money. Trade credit is regarded as a mechanism that isolates the exchange of money from perceived uncertainty inherent in the exchange of goods (see Ashton, 1987; Tamari, 1970; Petersen & Rajan, 1997; Burkart & Ellingsen, 2004; Biais & Gollier, 1997; Tamari, 1973).

Junk (1964) contends that the level of supply of trade credit may be dependent on the prevailing monetary policy stance. He argues that tight monetary policies are expected to have effects on trade credit relative to sales. This is based on the fact that tight money would push interest rates upward (higher cost of borrowing) and, all things being equal, will cause the supply of trade credit to decrease (see also Fisman & Love, 2003; Laumas, 1975; Zahn & Hosek, 1973; Bhole, 1984; Ferris, 1981; Hekman, 1981; Schwartz, 1974).

Li et al. (2015) used a survey of firms in China conducted by the World Bank in early 2003 to determine whether trade credit actually boosts firm performance. The ordinary least squares results indicated that trade credit has significantly and positively correlation with firm performance. In a related study, Kim (2016) contends that young firms, as well as firms with larger size and greater leverage appear to demand more for trade credit.

Babalola and Chig (n.d.) assessed the effect of granting trade credit on firm profitability of quoted firms in Nigeria. Panel data for the study was obtained from 80 quoted firms for the period 2000-2009. The result showed that trade credit has positive influence on the profitability of firms in Nigeria.

Nguyen (2011) examined the effect of trade credit provision on sales growth of firms using the fixed-effects and the one step system GMM models for determinants of sales. The estimated coefficient revealed that firms that offer more trade credit record higher sales growth rates. Consequently, the empirical evidence of positive linkages between trade credit provision and firm sale growth supports the argument that trade credit is indeed a marketing instrument.

In a related study, Xia (2017) model indicated that trade credit amplified the impact of the financial crisis on firm's sales performance. The study used Chinese firm-level data, and the quantitative analysis suggested that if a firm increases trade credit by 1%, sales growth grew by 0.21% prior to the financial crisis. However, after the 2007-2008 financial crisis, the baseline specification suggested that if a firm increases trade credit by

1%, sales growth would decline by 0.27%. He therefore argued that in order to mitigate such impact, firms need to improve their sales position and initial finances.

Kapkiyai and Mugo (2015) analysed the relationship between trade credit and financial performance for a sampled 50 audited Kenyan Small and Medium Enterprise firms using Pearson correlation coefficient and the multiple regression model. Findings revealed that trade credit impacted positively on liquidity, profit margin and return on assets. Tang (n.d.) examined how trade credit supply and demand influence the profitability of SMEs. The study sampled 71 SMEs in Netherlands for the period 2009 to 2013. The findings indicated that accounts payable is positively related to the profitability. However, evidence of a link between accounts receivable and profitability was not clear (see also Barrot, 2014; Ozlu and Yalcin, 2010).

Ferrando and Mulier (2012) using over 2.5 million observations for 600.000 firms in 8 euro area countries for the period 1993 to 2009 in examine the link between trade credit and firm growth. The result revealed that firms use the trade credit channel to manage growth. The marginal impact is lower in countries where trade credit channel has more presence, but the overall impact remains bigger. The study also concludes that overall market condition is essential in the relation between trade credit channel and growth.

3. Conclusion

Firms with access to financial institutions credits have been found to extend more trade credits to customers. This is based on the fact that the firm is believed to have more information about the customers compared to external financiers. This conjecture points to the fact that the information advantage which the firm has over the conventional lenders like banks may have been due to regular and repeated interactions with the customers, sometimes on a personal level. Suppliers are more likely to offer more trade credit to customers with whom they have had long business relationship. It is therefore easier for the firms to identify customers who are creditworthy or solvent. Businesses with low creditworthiness are more likely to be financed by suppliers than the banks. The duration of trading relationship is understood to be associated with the size of trade credit provision (Barrot, 2014). However, this theory equally underscores the notion that, even when price discrimination is not allowed, cash-rich buyers enjoy more trade credits from suppliers compared to constrained cash-poor buyers. From the perspective extant literature, there seem to be a consensus that trade credit is positively related to firm performance. However, monetary policy stance is found to be a key determinant of trade credit supplies. This is because contractionary monetary policies are expected to have effects on trade credit relative to sales and ultimately have implications on firm profitability. This is based on the fact that tight money would push interest rates upward and, *ceteris paribus*, will cause the supply of trade credit to decline, hence adversely affecting turnover and by extension, profitability.

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