Comments on: Credit Rationing in Informal Markets: The case of small firms in India

by Sankar De and Manpreet Singh

Discussant: Johanna Francis (Fordham University and UCSC)
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Questions

- How important is relationship based informal credit (trade credit) for small firms in India?
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- What factors determine provision and cost of this credit?
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- What factors determine provision and cost of this credit?
- Does credit rationing occur in the provision of informal credit?
Paper contributions

- Rich data set on informal lending linkages combined with detailed financial information on borrowing firms
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- First to document facts regarding provision of informal credit in India
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- First to document diversity of types of relationship credit
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- First to document facts regarding provision of informal credit in India
- First to document diversity of types of relationship credit
- Provides evidence on credit rationing even in informal markets
Framework

Two types of relationship lending

- Business relationship
- Social relationship
Credit Rationing

Two behavioural phenomena generate rationing in the presence of informational asymmetries

- Adverse selection
Credit Rationing

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- Adverse selection
- Moral hazard and monitoring costs
Credit Rationing

- Increasing collateral requirement or reducing leverage ratios increases incentives to avoid risky projects but can generate adverse selection effects.

- **Two mechanisms:**
  - Causes firms to choose smaller (potentially riskier projects)
  - Firms with large amounts of collateral may have acquired it through choice of high-risk, high return projects (selection effect)

- Trade credit creates different moral hazard concerns than investment finance.

- Firms with insufficient funding for operations may produce at a level too low to meet financing obligations.
Data

- 67% of firms are in manufacturing
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- 92% of sample would be considered a mature firm (10 years +)
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- 92% of sample would be considered a mature firm (10 years+)
- 75% of firms have more than 50 employees
- Some percentage of firms have no sales
First stage regression assumptions to generate credit demand are very strong

- Assumption of inelastic supply of credit
Identification strategy

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- Assumption of interest rigidity
- Assumption that demand for trade credit is independent of demand for other types of credit
- Assumption that supplier or credit is not affected by credit shock within window of estimation
Identification strategy

Second stage regression assumptions

- Assume supply of credit does not influence demand
Identification strategy

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- Identify equilibrium quantity as credit supply
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Second stage regression assumptions

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- Identify equilibrium quantity as credit supply
- Credit supply is unrelated to provider’s balance sheet
Evidence of rationing of both types of relationship based credit.
Results

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2. Firms reduce credit provision when costs reach maximum of 50-58%
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4. Lending is sensitive to collateral even if relationship exists
Results

1. Evidence of rationing of both types of relationship based credit
2. Firms reduce credit provision when costs reach maximum of 50-58%
3. Social relationship based lending is subject to rationing at a higher interest rate than business-based lending
4. Lending is sensitive to collateral even if relationship exists
5. Smaller firms (in terms of assets) appear more likely to be rationed
Specific questions about results

- Is trade credit different?
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- Each firm has fixed cost of credit over quantity/time but aggregation over firms gives upward sloping supply curve?

Cross-sectional versus time series variation?

Only borrowers who repay trade-credit within discount window have interest free loan?

Lenders' credit limitations

Trade credit versus bank credit: should supply of credit be related to default rate not just to interest rate?
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- Changing signs of relationship between credit and collateral over different lags
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- Older firms and credit
A couple econometric points

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- Hypotheses 2 and 3 ignore potential non-linearities between amount of pledged collateral and loan contract
- Difficult to separately identify terms of contract that are determined simultaneously
Overall & Future

- Contributes to understanding lending relationships in countries with lower levels of financial development
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- Explore relationship to inefficient allocation
- Examine effect on credit supply of balance sheets of providers