Faculty Seminar, 28 May 2019

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Trade Credit and Markups (with Alvaro Garcia-Marin and Santiago Justel)

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Abstract:

Trade credit is the most important form of short-term finance for U.S. firms. In 2017, non-financial firms had about $3 trillion in trade credit outstanding equaling 20 percent of U.S. GDP. Why do sellers lend to their buyers in the presence of a well-developed financial sector? This paper proposes an explanation for the puzzling dominance of trade credit: When sellers charge markups over production costs and financial intermediation is costly, then buyer-seller pairs can save on their overall financing costs by utilizing trade credit. We derive a model of trade credit and markups that captures this mechanism. In the model, the larger is the markup and the larger is the difference between the borrowing and the deposit rate, the more attractive is trade credit. The model also implies that trade credit use increases with repeated interactions and that this effect is stronger for complex products. Using Chilean data at the firm-level to estimate markups and at the trade-transaction level to analyze payment choices, we find strong support for the model.