ABSTRACT
We bring to light a benefit of trade credit relationships in which large investment-grade firms borrow from their smaller suppliers despite the ability to secure less expensive financing elsewhere. The use of trade credit allows a firm, which is wary of a supply disruption, to indirectly acquire information regarding the stability of a supplier. This information allows the firm to improve its sourcing decisions and to better protect against supply chain disturbances. We also show that the demand for trade credit increases with the probability that a supplier is unstable and with the cost of supplier failure to the focal firm. These results provide theoretical justification for various empirical associations documented in the literature on trade credit. Paradoxically, we also show that a necessary condition for trade credit to arise in our setting is that a bank or other financial intermediary holds a comparative advantage in lending over the other firms in our model. This result stands in contrast to much of the theoretical literature on trade credit which justifies inter-firm lending by assuming the advantage in lending lies with a supplier.

(Copies of the paper are available in the AOIS Department offices)