STUDY SUMMARY

The Impact of Credit Constraints on Exporting Firms

Improving access to credit is thought to help small- and medium- sized businesses participate in international trade, but existing evidence on the link between financing and exportation is mixed. This study evaluated the impact of credit constraints on exporting firms by examining two policy changes in India—one in 1998 that extended subsidized credit to businesses, and another in 2000 that revoked the subsidized credit for a portion of these businesses. Results showed that the 1998 credit expansion increased borrowing and improved export earnings for newly eligible businesses, and that businesses continued to borrow and earn more from exporting even after the subsidized credit was revoked.

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PARTNER

PROGRAM AREA
Small and Medium Enterprises

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TIMELINE
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Policy Issue

Exportation is widely considered to be an important way for small and medium enterprises (SMEs) in developing countries to expand their markets, scale up production, acquire new technology, and mitigate risk. In many developing countries, the banking sector tends to under-lend to SMEs, meaning that businesses would be able to make additional profit if they could access more credit. This financing constraint is thought to be a possible barrier to increased exportation, as well as a constraint to SME growth in general. For this reason, governments in some developing countries work to promote SME financing through various reforms and interventions. However, there is mixed evidence on the link between access to finance and the propensity to export.[1] This study aims to shed light on the causal relationship between financing and exportation by looking at the impact of changes in the availability of subsidized loans to SMEs in India.

Evaluation Context

The banking sector in India is largely dominated by public sector banks, which are corporate banks in which the government is the majority shareholder. Seventy eight percent of total deposits are collected by public banks, and 77 percent of total loans and advances are made by these banks. Until 1997, the Reserve Bank of India intensely regulated the amount of financing offered by banks, and they continue to be involved in determining bank lending policies. These rigid banking policies are thought to be one of the reasons that banks in India lend less than the amount that businesses would use to maximize profit.

In addition to the rigid policies discussed above, two other characteristics of the Indian banking sector are thought to cause under-lending. First, banks in India are slow to respond to changes in lending patterns, so banks will not necessarily start lending to certain types of firms even if recent data suggests that it would be profitable. Second, because the public sector is the majority shareholder of most banks in India, bank employees are considered public servants, and are therefore held to strict anti-corruption laws. Research shows that the fear of being prosecuted significantly reduces lending.[2]

To promote lending to the agriculture sector and small scale industries, sectors that the Indian government considers priorities, all banks in India are required to lend 40 percent of their credit at a subsidized rate to these sectors. Prior to 1998, small-scale industries were considered firms with investments below 6.5 million rupees. In January 1998, the cut off was raised, making larger firms suddenly eligible for subsidized credit. In January 2000, the 1998 reform was partially undone when the cut off was lowered again.

Details of the Intervention

To measure the impact of increasing the amount of available credit on SMEs, researchers used the policy changes in 1998 and 2000 as the basis for a natural experiment. Data from the Center for Monitoring Indian Economy on 1000 firms in the manufacturing sector in India was used to assess changes in the international trade habits of exporting businesses when they were made eligible for credit subsidies and when those subsidies were revoked.

For the years 1999 and 2000, all new firms that became eligible for the subsidy formed the treatment group, while from 2001 to 2006 all firms that lost their eligibility formed the treatment group. Firms that were not affected by these policy changes were considered the comparison group in this evaluation.

Results and Policy Lessons

Results show that the firms affected by the 1998 policy change were credit constrained. The rate of short-term bank credit for newly eligible firms increased by 18 percent and total bank borrowing increased by about 20 percent. Borrowing from other sources also increased, meaning that firms were taking advantage of more credit rather than substituting other sources of credit with subsidized credit.

The availability of credit for newly eligible firms led to a 22 percent increase in export earnings for these businesses. This supports the view that increased access to credit can cause higher levels of exportation. The study further shows that there is a positive relationship between exportation and firm growth and financial health.

The policy reversal in 2000 had little to no effect on bank borrowing and export earnings for the firms whose eligibility was revoked. This supports the view that the Indian banking sector tends to under-lend, since the increased credit access granted to the newly eligible firms in 1998 allowed these firms to grow rapidly. Given the positive performance of these firms, the banks had no reason to reduce their credit limit when the policy was reversed in 2000 and firms continued to borrow at the market interest rate.

It is important to note that while the 1998 policy change increased borrowing for newly eligible firms, it decreased borrowing for small firms that were already eligible for subsidized credit and larger firms that never qualified. Hence, the policy change resulted in a reallocation of credit from these firms to the newly eligible firms.

Sources

[1] Paravisini, Daniel, Veronica Rappoport, Philipp Schnabl, and Daniel Wolfenzon.*Dissecting the effect of credit supply on trade: Evidence from matched credit-export data*. No. w16975. National Bureau of Economic Research, 2011.

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[2] Banerjee, Abhijit V., Shawn Cole, and Esther Duflo. "Bank financing in India." (2003).