VERTICAL RELATIONS UNDER CREDIT CONSTRAINTS

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Abstract
We model the impact credit constraints and market risk have on the vertical relationships between firms in the supply chain. Firms which might face credit constraints in future investments become endogenously risk averse when accumulating pledgable assets. In the short run, the optimal supply contract involves risk sharing, so inducing double marginalization. Credit constraints thus result in higher retail prices, and this is true whether the firm is debt or equity funded. Further, we offer a new theory of supplier finance arms as we show an intrinsic complementarity between supply and lending which reduces financing inefficiencies created by informational asymmetries. The model offers: a theory of countervailing power based on credit constraints; a transmission mechanism linking the cost of borrowing with retail prices; and a motive for outsourcing supply (or distribution) in the face of market risk. (JEL: L14, L16)