Edexcel (B) Economics A-level

Theme 1: Markets, Consumers and Firms

1.4 Role of Credit in the Economy

1.4.3 Types and sources of credit and the impact of credit within the economy

Notes

Types of credit

○ Loans

A loan involves borrowing money from elsewhere for a short period of time. It is then repaid over time with interest.

Some loans are secured against an asset, such as a house. This is to protect the bank's funds if the loan is not repaid.

Loans could be in the form of cash credit, on demand or only for the short term. Cash credit loans are based on bonds and approved securities. Banks enter agreements with customers so money can be withdrawn several times a year. Banks deposit money periodically into the accounts of the customer. Loans on demand are when the entire loan is paid into the account of the borrower. Therefore, the loan is charged with interest immediately. Short-term loans tend to be personal or for working capital and are usually against a security.

An advantage of a loan for firms which can gain them is that they are guaranteed money for a certain period of time. Some interest rates are fixed, so it is easier to know how much interest the firm has to pay.

However, loans may require security in the form of business assets, so if the loan is not repaid, the bank can gain control of the assets. Also, loans can be inflexible. If less is needed than is borrowed, the firm has to pay interest on the full amount borrowed and not just what they needed.

○ Overdrafts

An overdraft can be agreed and it allows a consumer or firm to temporarily borrow from the bank by spending more than is saved in the account.

When a current account has no deposits, consumers can still borrow money from the bank in the form of an overdraft. These are at a high interest rate and the amount that can be borrowed is limited.

The advantages of an overdraft include that interest is only paid on the amount of money borrowed, and the amount borrowed is flexible. However, they cannot be used for large loans and the interest rate is much higher than on a loan.

○ Trade credit

Trade credit is the credit which is extended to a firm by suppliers, so a good can be bought immediately and paid later. It is especially useful for small firms to finance their growth.

Trade credits allow sellers to generate more sales, since buyers can purchase a good or service without having immediate access to cash. However, if it takes the buyer a long time to repay the debt, it could lead to lower profits for the supplier if the debt is written off, or it means they have to wait to receive their revenue.

Trade credit loans are an easy and fast source of finance. However, it can become expensive if the due date is not met.

Sources of credit

○ Banks

The main source of income for commercial banks is interest, which banks earn through providing loans. Banks **create credit** by using deposited funds as loans.

Some loans are secured against an asset, such as a house. This is to protect the bank's funds if the loan is not repaid.

For firms, the main source of credit is from commercial and high street banks.

Other types of finance

○ Venture capital

This is funding from specialist firms in return for a share in a company. It is for the short to medium term to help new firms establish themselves. The investor receives a return on their investment in the form of dividends.

○ Share capital

This can be raised by selling shares to investors. This is applicable to both private and public limited companies. Shareholders get a say in how the firm is run. The reward for investing in a firm is a dividend, which is a share of the firm's profits.

○ Leasing

A lease is a long term agreement for rent that allows firms to use an asset without paying the full amount up front. The firm can own and control the asset during an agreed period of time. The firm pays rent to cover the depreciation of the asset and they pay interest to cover the cost of the capital. For example, a firm could take out a lease on a property or a piece of capital equipment.

Other sources of finance

○ Owner's capital: personal savings

This is the amount of money that an owner has available to put into the firm. It saves the firm from borrowing potentially expensive credit from a bank.

Since owners already own the capital, there are no costs involved in obtaining the capital. Interest does not need to be paid on a loan and dividends do not need to be shared with shareholders.

The major disadvantage of this is that if the capital is lost, the owner loses it. For example, if a retirement fund is invested and the owner loses it, they will have little or no money left for retirement.

○ Retained profit

This is the money left after deductions, taken from total sales revenue. The deductions include taxes, interest and dividends given to shareholders. Retained profit can then be reinvested into the firm. Retained profits are a cheap source of finance, which saves paying high interest rates on loans. This could be used for investment during periods where the interest rate is high.

One of the advantages of using retained profits is that firms are not borrowing more money, so they are not increasing their debt burden. This gives owners more control over their firm since they are not involving third parties in their firm. It could be cheaper since firms are not paying high interest rates on loans.

However, this requires careful saving of business funds, which could be both slow and result in firms missing out on other opportunities. Third parties might also be able to provide valuable experience to the firm, enhancing its potential to grow.

○ Sale of assets

A firm could sell its assets, such as buildings, vehicles and land, to raise money. The firm could then lease the assets.

If the assets are unwanted or unused, the sale of assets could provide an immediate source of finance for the firm. This is especially useful in the short run if money is needed immediately. It also reduces the costs involved with maintaining and keeping the capital.

However, the firm might have to accept a lower price for their assets. Moreover, not all firms have access to unused capital, and those that do only have a limited amount of capital.

○ Individual investors

Friends and family can make up the individual investors which help finance the business. This method of raising finance for a firm could lead to conflicts between stakeholders. However, it spreads the risk between many shareholders rather than just one owner.

The investors might be passive or have an active role in the firm. A problem with external investors is that the original owner might have to give up some control of the firm. This can lead to conflicts between stakeholders. By sharing the risk between investors, profits also have to be shared.

○ Online collaborative funding

One way of raising finance is crowd funding. This is useful for new firms which often find it difficult to gain access to credit from a bank, although established firms looking to expand their business can also benefit from this. This involves raising funds from several people, or a crowd, and it is usually conducted through the internet.

One of the advantages of this is that firms can raise finance quickly and at a low cost. Moreover, by raising funds through the internet, the firm is also advertising their business, which can help raise awareness and widen their consumer base. Additionally, it is especially useful for firms which cannot access credit otherwise.

However, firms have to raise funds to a certain target. Otherwise, they do not get to receive anything. Moreover, if the investment is unsuccessful, the firm risks building a bad reputation, which could make it hard to raise funding through crowdfunding in the future. By advertising an idea on the internet with the intention of raising funds, the firm risks having their ideas stolen, if they are not protected with a copyright.

Challenges in obtaining credit

○ Role and impact of credit on the economy

New and small firms are often limited when it comes to gaining access to credit from banks, because they do not have the strong credit rating that larger or more established firms have. It is difficult and takes a long time to build up a strong credit rating. Around 60% of small firms have a poor credit rating, which could mean they cannot access and borrow funds. It also means that if funds can be borrowed, the conditions will be difficult, such as being offered loans with higher interest rates. Larger firms, which might have better credit ratings, are more likely to be able to access cheaper credit.