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The role of social trust in times of crisis

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Research shows social trust improves the resilience of firms to banking crises

Financial crises are ubiquitous. The United States, for example, has experienced several financial crises and economic recessions including the 2007-2008 subprime mortgage crisis. European countries, such as the United Kingdom, Belgium and Spain have gone through financial crises. Asia was also devastated by the Asian financial crisis in 1997. During a financial crisis, however, not all companies respond in the same way; some are more resilient than the others. A recent research study by The Chinese University of Hong Kong (CUHK) Business School reveals how corporations in different countries respond differently to financial crises.

The study entitled Corporate Resilience to Banking Crises: The Role of Trust and Trade Credit examines the relationship between social trust and the ability of corporations to obtain financing through informal channels in crises as well as the resilience of profits and employment to the crises.

The study was conducted by Prof. **Xie Wensi**, Assistant Professor in the Department of Finance at the Chinese University of Hong Kong (CUHK) Business School in collaboration with researchers at the University of California, Berkeley and the University of Hong Kong.

“Our study complements a large number of studies of how social trust, and social capital more generally, influences economic activities. It reveals that trust influences corporate resilience to banking crises,” says Prof. Xie.

THE ROLE OF SOCIAL TRUST IN FINANCIAL CRISES

Social trust refers to the expectations within a community that people will behave in honest and cooperative ways and their interactions are governed by the social norms of reciprocity and trustworthiness. Trust changes very slowly in the long run and exhibit high persistence across generations. In line with this view, prior research shows that African descendent of those heavily exposed to the almost 100-year-old slave trades display low trusting of others today, which continues to influence modern economic outcomes.

“Existing research suggests how social trust could enhance corporate resilience to systemic banking crises,” says Prof. Xie.

“First, when a systemic banking crisis impedes the bank-lending channel, access to trade credit could partially offset the contraction in bank loans and ameliorate the impact of the crisis on corporate profits and employment,” she says.

A trade credit is a business-to-business agreement in which one party could purchase goods without paying cash immediately and instead, could arrange for a scheduled payment later. Firms often receive trade credit that does not involve collateral or promissory notes subject to formal judicial enforcement mechanisms. Trade credit accounts for 25% of the average firm’s total debt liabilities, representing a large proportion of debt financing in the sample firms.

“Second, social trust could facilitate access to trade credit during a banking crisis. People who view their communities as more trustworthy are more likely to lend money and payback loans even when there are no formal enforcement mechanisms in place,” she explains.

THE STUDY

Prof. Xie and her collaborators started with an initial sample of 65 countries that have data on social trust in the World Values Survey (WVS) as well as experienced at least one systemic banking crisis from 1990 to 2011. The firm-level data, including profitability and employment, was obtained from Worldscope by Thomson Reuters. After filtering the sample through various selection criteria, the final sample consisted of over 3,500 firms across 34 countries.

To measure social trust, the team computed the percentage of survey respondents who answered “most people can be trusted” in response to the question “Generally speaking, would you say that most people can be trusted, or that you can’t be too careful in dealing with people?” in WVS.

The level of trust was measured three years before the start of a country’s banking crisis. Then, they looked into the relation between social trust and firm trade credit, profits, and employment differs across industries. In addition to examining whether the firms are more resilient to banking crises in higher-trust countries, they also looked into the differences in the cross-industry resilience to such crises.

REAL IMPACT OF SOCIAL TRUST

The results were revealing. “We discover that firms in higher-trust countries receive more trade credit financing and suffer smaller reductions in profits and employment than firms in lower-trust countries during systemic banking crises,” says Prof. Xie.

“Moreover, the relation between social trust and trade credit, profitability, and employment is more pronounced among industries that depend heavily on external liquidity provision,” she says.

The empirical evidence is consistent with the view that social trust facilitates access to trade credit during banking crises, ameliorates the detrimental effect of the crises on profit and employment, and such effect of social trust is strongest among firms that rely most heavily on external liquidity. In particular, firms in industries that depend more heavily on liquid funds in high-trust countries experience a 43% smaller contraction in trade credit than those in the average trust countries during a banking crisis. That is, social trust improves the resilience of corporations to banking crises, especially those liquidity-dependent firms.

“Our study suggests that cross-country differences in social trust shape cross-country differences in the degree to which firms substitute trade credit for bank credit during banking crises,” says Prof. Xie.

Prof. Xie adds that the findings of their study cannot be explained by other characteristics such as the severity of a banking crisis, the development of financial institution and markets, the legal protections to creditors and shareholders, or the overall economic conditions.

“Adding to a growing literature on finance and employment, our research shows that social trust helps to mitigate the adverse impact of banking crises on unemployment by facilitating firms’ access to alternative, informal sources of financing,” Prof. Xie says.

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