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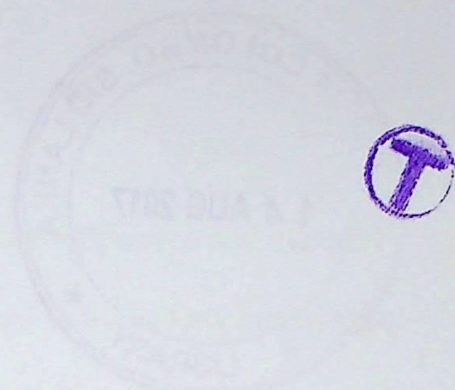
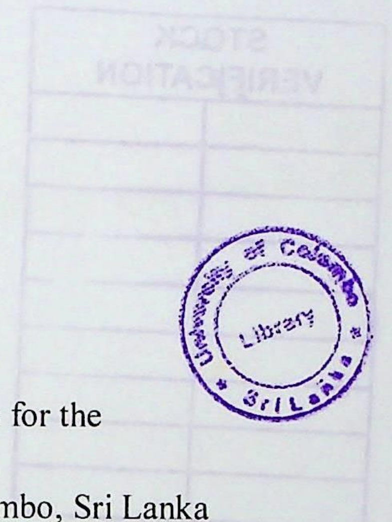


A Firm-Level Approach to the Explanation of Business Cycles – The Cases of the United States and Japan



By

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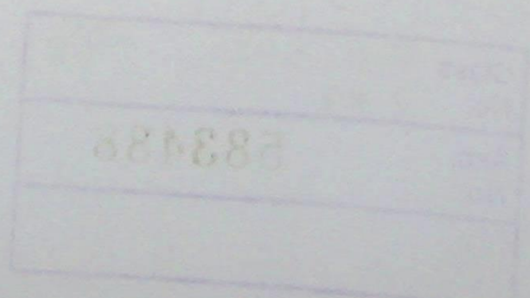

Abstract

Business cycles have fascinated writers of different disciplinary backgrounds, economists in particular, since the early eighteenth century. Today it has become a topic that has raised many questions regarding orthodox economic theory, particularly its lack of ability to identify and forecast cycles. The failure in indentifying cycles accurately stems from the lack of understanding on how firm level behavior can be used to explain causality of business cycles. The US recession of 2001-2002, 2007-2009 and Japan's three decade long recession from around 1990's are now well documented subjects lending support to a more robust analysis to understand business cycles. In this context, the thesis critically examines cycle theories of both endogenous and exogenous types as well as the empirical work on the subject. The thesis also examines the validity of various hypotheses on the basis of firm/sector level data based on the behavior of balances sheets and financial statements, in order to decipher cyclical outcomes. The study draws on the widely used technique of financial ratio analysis with a particular emphasis on the behavior of firm and sector profitability ratios.

In conclusion the thesis links microeconomics behavior of the firm/sector with aggregate macroeconomic outcomes, using key financial ratios as its main analytical tools. The financial ratios used in this thesis examine the empirical literature on the causes of cycles in the US and Japanese firms/sectors and particularly their financial sectors.

The notable outcomes of the combined micro and macro study, are twofold: a) the firm-level perspective suggests that mainstream approaches to the explanation of business cycles have essentially created a misguided view of the causes of business cycles; and b) the analysis of firm/sector financial statement ratios provides a useful method by which cycles can be identified.

More importantly variations in the firm/sector profitability ratios, namely, pre tax ROE, pre tax ROA and EBITDA, are found to be useful in explaining the causality of business cycles. Finally, the empirical research of the thesis indicates that the phenomenon of '*falling rate of profits*' is indeed a significant contributor to business cycle fluctuations.