CENTRE FOR MACROECONOMICS

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Firm Cyclicality and Financial Frictions

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Using administrative micro data we document how firms' sensitivities to business cycles differ by size and age. Among the youngest firms, small firms are more cyclical than large, but the reverse is true among older firms. The differences in cyclicality are large: "young and small firms" are nearly twice as cyclical as large firms, who respond one-and-half to one to the aggregate business cycle. In contrast, "old and small" firms are almost acyclical on average. High leverage firms are more cyclical than low leverage firms which—when combined with the age-profiles and cyclicalities of financial variables—suggests that financial frictions are likely to explain the excess cyclicality of "young and small" firms, but not of large firms. Augmenting a dynamic heterogeneous-firm model with heterogeneous returns-to-scale and entrant wealth allows it to replicate these findings, and implies that financial policies targeted at young firms become less effective in stimulating aggregate output while the opposite is true for direct labor subsidies.