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Leverage Dynamics over the Business Cycle *

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ABSTRACT

Surprisingly little is known about the business cycle dynamics of leverage. The existing evidence documents that target leverage evolves pro-cyclically either for all firms or financially constrained ones. In contrast, we show that, on average, target leverage ratios evolve counter-cyclically once cyclicality is measured comprehensively, accounting for variation in explanatory variables and model parameters. These counter-cyclical dynamics are robust to different subsamples of firms, data samples, empirical models of leverage, and definitions of leverage. There is a fraction of 10% to 25% of firms with pro-cyclical dynamics whose characteristics are consistent with counter-cyclical dynamics for loss-given-default and probability of default.

JEL Classifications: G32, G15.

Keywords: Empirical corporate finance, capital structure dynamics, business cycle variation.

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