Business Cycles and Entrepreneurial Activities

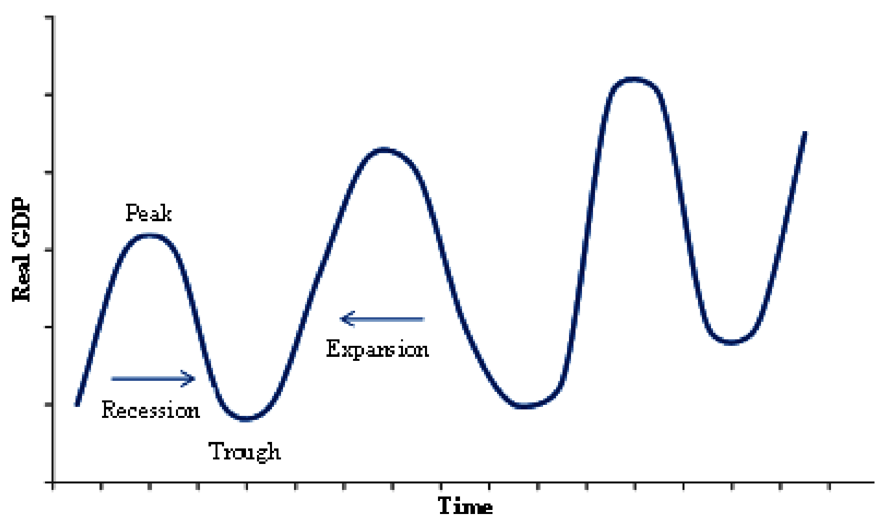
TresVista
FINANCIAL SERVICES

This article analyzes the theory of entrepreneurship and business cycle and helps understand the link between the two. Business cycle analysis is the purview of macroeconomics and entrepreneurship studies are largely the domain of applied management theory

Business Cycle

The four stages of a business cycle are growth (expansion), peak, recession (contraction), and trough.

In other words, business cycles are recurrent periods during which the nation's economy moves in and out of recession and recovery phases. There are short-term (2 to 3 years) to long-term (50 to 60 years) business cycles. These fluctuations are generally irregular, varying in frequency, magnitude, and duration and are often measured using the real GDP.



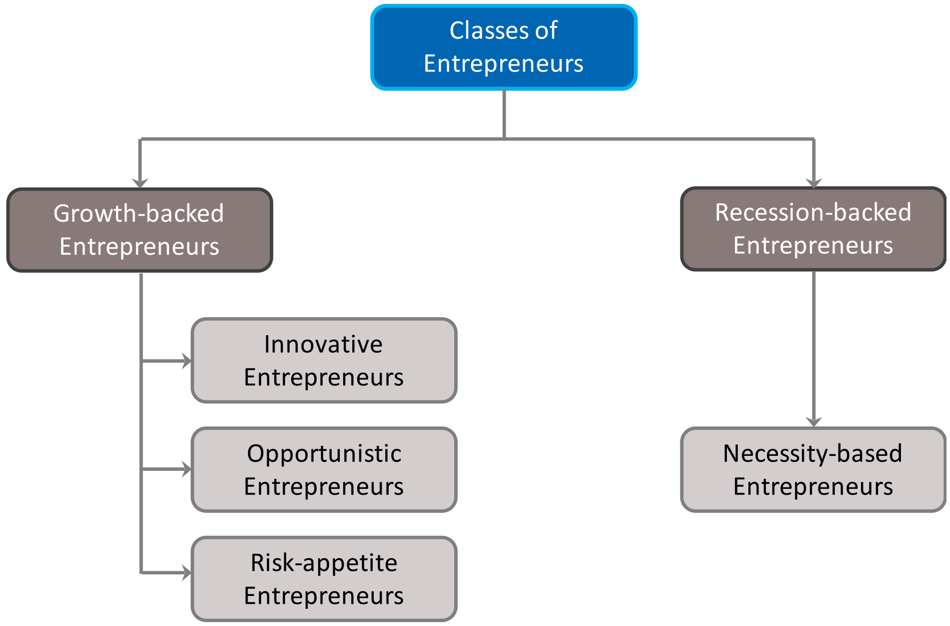
"Business Cycle is the recurring and fluctuating levels of economic activity that an economy experiences over a long period of time"

Entrepreneurship

Entrepreneurship is more than simply starting a business. We understand entrepreneurship as *"a process through which individuals identify opportunities, allocate resources, and create value."*

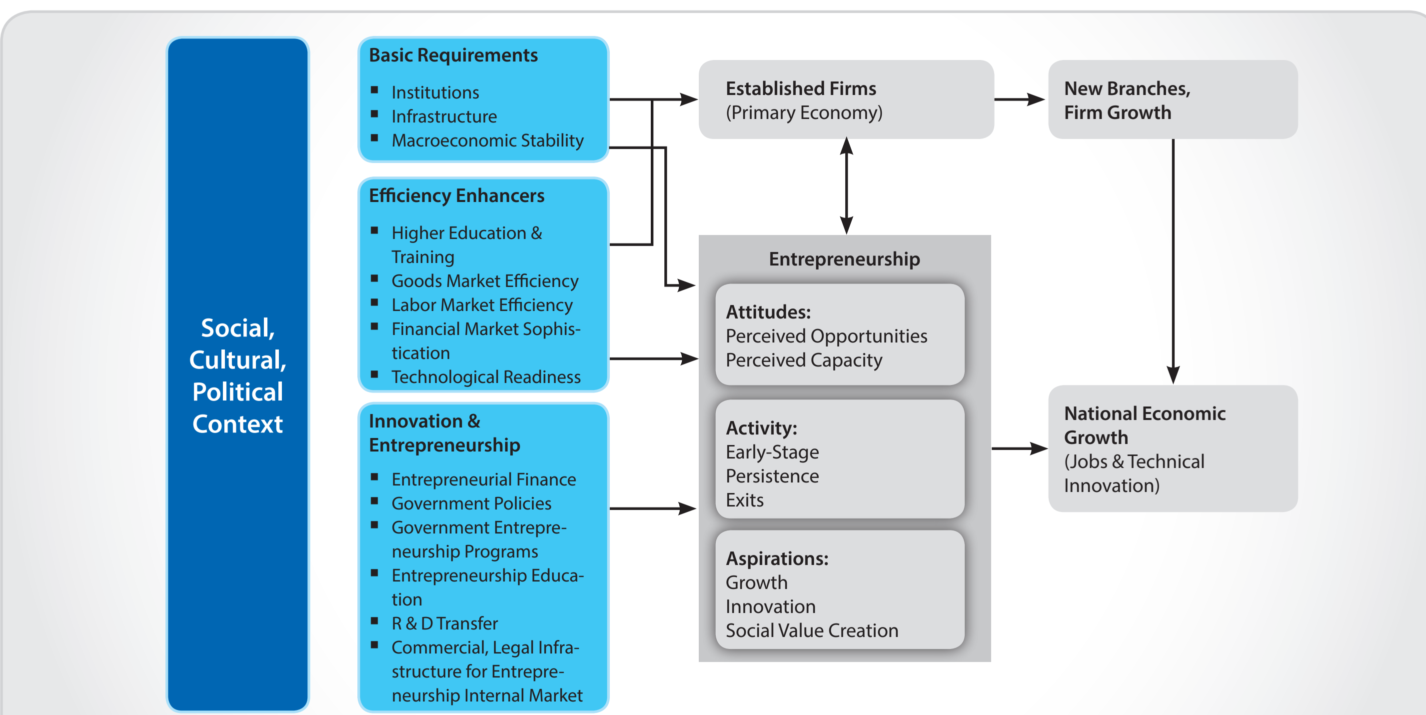
Entrepreneurial success is a function of the ability of an entrepreneur to see opportunities in the market place, initiate change, and create value through solutions.

There are two main classes of entrepreneurs:



The GEM Conceptual Framework for Entrepreneurship

A number of researchers and experts have conducted studies on the relation between macroeconomics, business cycles, and entrepreneurial activity. We refer to the entrepreneurship framework developed by Global Entrepreneurship Monitor (GEM) to establish the inherent interdependence between entrepreneurship and business cycles.



Source: Global Entrepreneurship Monitor 2009 Global Report.

GEM model illustrates that macroeconomics is correlated to entrepreneurial activity at every phase: boom or recession

The top portion of the framework focuses on established and developed firms. In time, these firms explore newer markets, innovate newer products, and increase their risk appetite. These expansion activities provide additional employment in the economy. People find more reasons to explore their entrepreneurial spirit – new market/product/service to be exploited, outsourcing of functions by established firms, boost in consumer spending, etc.

The lower half of the model details the pre-conditions and ambience necessary to promote entrepreneurship. The entrepreneurial process occurs in the context of a set of framework conditions (Efficiency Enhancers and Innovation & Entrepreneurship). GEM considers three major components of entrepreneurship: attitudes, activity and aspirations. The new entrepreneurs, with the right attitude and aspirations help improve the market conditions by developing their firms and providing opportunities to others.

We believe that the GEM model illustrates that macroeconomics is correlated to entrepreneurial activity at every phase: boom or recession. Entrepreneurs have an essential role in explaining business cycle dynamics. We explain the degree and magnitude of this relationship in our analysis.

Correlation between Business Cycles and Entrepreneurial Activity in an Economy

1. **Growth:** Under this phase an economy witnesses a boom and increased activity. There is macro-level stability in the economy. Opportunities are plenty and people are willing to take more risks. The labor market is strong and banks are willing to lend money at competitive rates. The growth phase is marked by increase in innovations, opening up of new market opportunities, and a generally high risk-appetite.

   Research has shown that as the growth phase evolves, entrepreneurial activity picks up such that it becomes the driving force behind growth. The study conducted by Iowa State University concluded that individuals are more likely to start a venture during the growth phase because of favoring market conditions.

   The growth phase is the most favorable for entrepreneurial activity. We have formulated the following incentives that an aspiring entrepreneur needs to actualize his ideas:

   - Increasing access to finance: Since a growth phase starts at the end of an economic recession, cost of funds are usually low. This, coupled with government-backed funding options and increasing presence of venture capital, make it easier for aspiring entrepreneurs to obtain seed capital. Increased consumer spending also helps entrepreneurs generate more funds internally through increased scale of operations.

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- Regulatory assistance: Entrepreneurial framework conditions are probably shaped as much by regulatory and administrative environments as by markets. Governments usually prefer streamlining the administrative set-up monitoring business ventures to induce a growth phase in the economy. This includes relaxing registration regulations, tax-breaks, bankruptcy protection, subsidies on inputs, etc. This is highly evident in closed developing economies emerging out of a recession.

- Shadow support by established firms: An important aspect of the growth phase is the expansionary measures engaged into by established firms. As these firms explore untapped markets and discover new products and services, the opportunity to grow as an ancillary unit to these firms increase. Opportunities to manage the outsourced functions of these firms, or to act in the capacity of a supplier are aplenty.

2. **Recession:** A recession is marked by a fall in the real GDP of an economy. It is usually initiated by a macroeconomic shock – collapse of an industry (banking, real estate), mounting fiscal debt, collapse of the government, etc. There are fewer opportunities in the markets leading to stagnation in the growth of the economy. People tend to be more risk averse in economic downturns. The business world sees job cuts leading to a decline in the disposable income of consumers. People spend less and thus demand declines. As spending drops, returns for enterprises drop further, leading to further unemployment.

   Data shows that as GDP and inflation decline, innovation, opportunity, and high risk based entrepreneurship decline with increasing fervor. According to the demographics of USA presented by Global Entrepreneurship Monitor (GEM), all growth-backed entrepreneurial activity decreased in the recent debt ridden economic crisis.

   Recessions are unlikely to be ideal for starting a business due to the following constraints that entrepreneurs face during this phase:

   - Increased risk aversion: The economy and all its participants harbor a cynical outlook in a recessionary phase. The established firms, on their part, reduce investments in new products/services or untapped markets. The support systems (usually SMEs) collapse as the intensifying competition for the limited business offered by large firms eliminate weaker and, generally, nascent ventures. Government on its part, tries absorbing the excess liquidity in the market to control inflation. The subsequent increase in interest rates makes funding more difficult. In a survey conducted by GEM, it was found that in 2009 (recession), 63.1% of nascent entrepreneurs in UK were refused funding as compared to 37.5% in 2007 (boom).

People tend to be more risk averse in economic downturns

   - Perceived lower returns: Individuals choose between self-employment and salaried-employment with an eye on perceived expected future returns. In recession, with a bleak business outlook, it is more probable that the perceived returns for a start-up venture would seem lower than salaried returns. The increased risk inherent to start-ups will only magnify this problem. The study conducted by Iowa State University concluded that ventures started in recession are more likely to fail due to weak economic conditions. The study also proved that probability of prospective individuals starting a business in growth was larger than those starting in recession.

3. **Trough:** The lowest point of the economy in the business cycle is called the trough. National income declines substantially, expenditure declines and economic activity slows down. In this phase, more bankruptcy is observed leading to a further increase in the unemployment. Resources (labor, land, raw materials) become readily available due to lower demand and relatively higher supply. All prices, interest rates, and wages are at the lowest. National inflation borders around zero and often results in deflation.

   While conventional types of entrepreneurs take a hit by either closing their ventures or delaying its start for a much favorable time, there is a certain class of individuals who bring in a slight growth in the economy. Due to job cuts, limited opportunity in employment and to sustain their respective life styles, these individuals start their own businesses as a measure of last resort. These individuals are called necessity-based entrepreneurs. Entrepreneurs at this stage are largely replicators of products and services.

   These entrepreneurs take advantage of the following factors prevailing in the depressed market:

   - Less competition: An economic downturn clears the competitive landscape for start-ups. Most of the nascent and weak companies with inferior products and weak business models go bust. The government, in order to increase trade and activity, relaxes regulations and licensing. This encourages self-reliant individuals to start-up new ventures.

   - Cheap labor: As unemployment increase significantly, cost of labor falls considerably. This provides plenty of recruitment options for start-ups.

- Lower costs: The costs for land, office space, equipments, machines, etc. drop due to a lag in the economy. Suppliers and ancillary service providers are willing to sell factors of production at lower costs due to the fall in demand caused by trough.
- Less pressure to innovate and seek new markets: As competition is low in a recessionary stage, entrepreneurs can reduce their budget allocation for R&D and market expansion. As most of the necessity entrepreneurs are replicators of goods/services, this is a good opportunity for them to consolidate their business structure and optimize resource allocation.

Necessity entrepreneurship tends to be proportionately higher in low and medium income countries than in high income countries. These types of entrepreneurs increase activity in markets by creating jobs, increasing disposable income and thereby, affecting demand in the economy. This, along with concentrated efforts by the government and established firms, kick-starts the economy leading to a shift from trough to growth. In a way, necessity-based entrepreneurs help the economy attain the trough-stage and start the recovery/growth-stage.

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Conclusion

We find that, entrepreneurship and economic growth complement each other at every phase of a business cycle. At growth stage, the motive is to take advantage of the market opportunities while at trough, the motive is to survive.

From being backed by the economy in the growth phase, entrepreneurship ends up as a catalyst of the economy at trough. We summarize the relationship between the business cycle and entrepreneurship below:

1. **Growth:** Growth-backed entrepreneurial activity increases under encouraging economic environment until they start driving the growth themselves
2. **Recession:** Prospective entrepreneurs hesitate to start business as market conditions do not support them
3. **Trough:** Necessity-based entrepreneurs start their ventures taking advantage of low cost resources and low competition, which then kick-starts the economy and puts it back on the track of recovery

As a leading indicator of business cycle, entrepreneurial activity governs, limits and stimulates the growth and recessionary phases of an economy

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