

The Distribution of SME Expectations and Business Cycles: Evidence from Firm-Level Survey Data

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Abstract

This paper studies the informational content of the distribution of small and medium-sized enterprises' (SMEs') expectations for Japanese business cycle dynamics. Using firm-level survey data that classify firms' current and one-year-ahead business conditions into good, normal, and bad categories, we go beyond conventional diffusion indices and decompose SME sentiment into three orthogonal components: current sentiment direction, forward-looking sentiment direction, and expectation polarization. The current sentiment direction component mainly summarizes contemporaneous business cycle conditions. In contrast, the forward-looking sentiment direction component predicts subsequent improvements in composite business cycle indicators, while the expectation polarization component predicts weaker subsequent activity. We show that these results reflect distinct distributional shifts. Forward-looking direction reduces the share of firms with pessimistic expectations and increases the shares with normal or optimistic expectations. Expectation polarization instead shifts firms away from neutral expectations toward both optimistic and pessimistic responses. A simple model in which lenders cannot verify SME optimism, capping the upside of expectations while leaving the downside free, rationalizes why polarization is contractionary and why its predictive content concentrates on the pessimistic side. A simple decomposition indicates that the macroeconomic information in SME expectations is driven primarily by movements into and out of the pessimistic-expectation pool. The results suggest that SME-oriented survey data contain information about business cycle risks that is not captured by average sentiment alone, and that expectation polarization among SMEs is a useful indicator of unevenness and downside risks in future business conditions.