Is there a Business Cycle in Guatemala?

Estefanía Luján Padilla

Abstract

The Austrian Business Cycle Theory states that business cycles follow excessive growth in bank credit loans, often as the result of attempting an economic stimulus package artificially, lowering interest rates. In order to capitalize production processes, it is necessary that some individuals have saved in the past so that other individuals can use this resources to facilitate the assembling of new structures. That is, individuals need to lower their time preference for consumption goods and increase their time preference on producer goods.

In Guatemala, the central bank controls monetary, exchange, and credit policy. It is also a lender of last resort for the financial system, and is not allowed to finance the central government through issuing new paper money. However, more than 50% of the bank credits are intended for direct consumption, leaving too little space for the investment of capital goods. Therefore, it is not possible for the central bank to stimulate the economy, and consequently create bubbles, even with their intervention.

Business cycles according to the Austrian theory

The Austrian Business Cycle Theory (ABCT) finds its roots in Eugen von Böhm-Bawerk as well as in Carl Menger's work on *The Positive Theory of Capital* and the *Principles of Economics*, respectively. Both figures contributed to the Austrians' believe that in order for the production to add value, consumption must be postponed. Those who do postpone their consumption are rewarded by a payment of interest, which is afforded with the additional output that the resources will yield over time. This means that in order for entrepreneurs to invest in capital and prolong the processes of production, there must be a large base of consumers who prefer to postpone consumption in favor of savings. As more consumers are willing to save, more funds are available for funding; thus, the supply of money increases –lowering the interest rate. Therefore, entrepreneurs will undergo more capital investment projects that will yield greater outputs to pay for their loans with interests. The interest rate, when responding solely to market forces, will coordinate intertemporal consumption and investment decisions.

As the market for loans evolved, more institutionalized intermediaries were needed – in this case, commercial banks. But it is not until the birth of central banks and the loss of gold standard that the credit becomes troubling, according to the Austrians. From then, banks are allowed to issue fiduciary media (bank notes without gold backing and excessive current accounts). Here is how the business cycle begins, according to Mises[1], with the creation of fiduciary media, credit is extended beyond a bank's assets and funds. When money supply has increased with the fiduciary media, interest rates lower and the economic activity increases because projects that weren't previously justifiable, may become marginally profitable. As more projects are undertaken, demand for means of production, including labor, will increase – with costs of production and wages rising proportionately. As means of production and labor become more expensive, the price of consumer goods rise; leaving authorities with the "need" of creating more fiduciary media to overcome it, encaging the economy in the everlasting business or trade cycle.

If economic activity increased because of a savings-induced growth it would be sustainable, but a *"credit-induced decrease in the rate of interest engenders a disconformity between intertemporal resource usage and intertemporal consumption preferences. (…) the artificially low rate of interest that triggered the boom eventually gives way to a high real interest rate (…)"*[2]. As intertemporal preferences of consumers have not actually changed, at the new rate of interest, they are now willing to save less money. This in return, leaves the loans market with a smaller base to sustain the *mal*investments[3] undertaken by the entrepreneurs. The solution to this, in short, is for the government to do nothing. This implies to cease inflating as soon as possible, not bail out business firms in trouble, not prop up wage rates and do nothing to encourage consumption. The longer it takes to stop the credit growth, the worse

[1] Mises 1996: 25

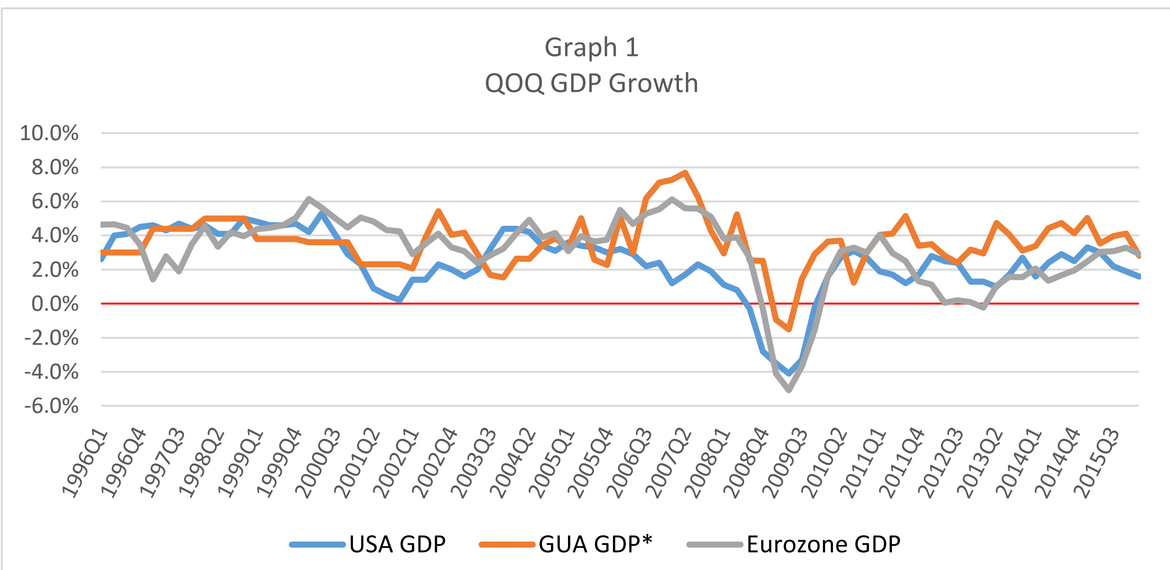
[2] Garrison 1996: 111

[3] Mises developed the concept which refers to a mistaken investment that inevitably leads to waste of capital and economic losses due to a systematically distorted price signals in the free market.

the consequences of the *mal*investments will become, lengthening the recession and making full recovery more uncertain.

Taking ABCT to the Guatemalan economy

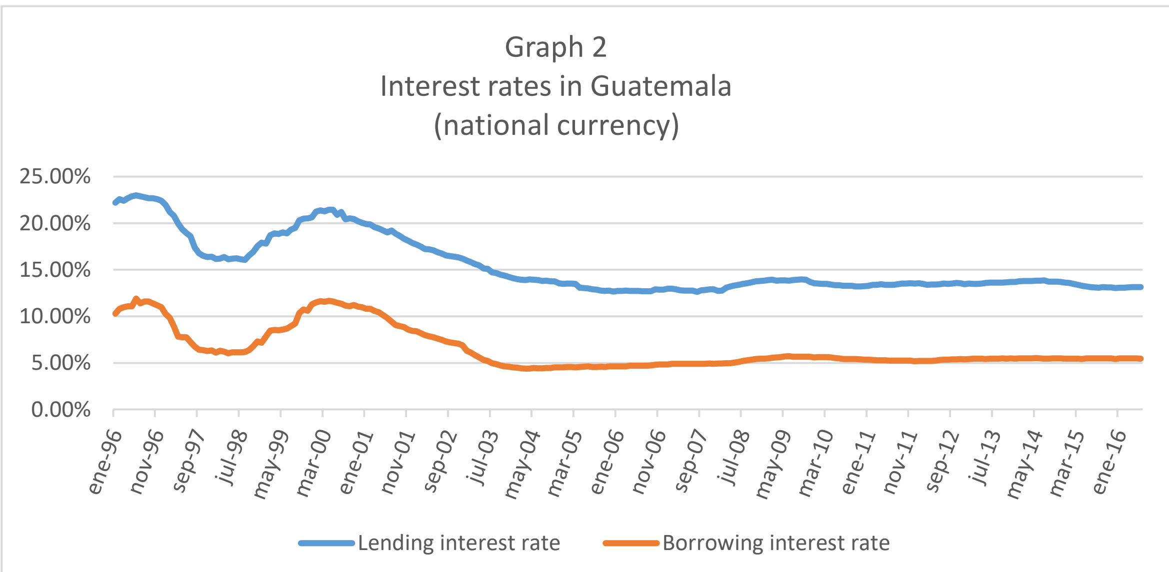
Even though Guatemalan GDP does present a marked cyclical behavior, it can hardly be considered volatile. As shown in Graph 1, Guatemalan economic activity does experience fluctuations, but it has remained within a range of growth that, compared to other economies, is very predictable. It shows slowdowns in the last two periods of recession (2000-01 and 2008-09) but not as severe as shown in the cases of the United States or even the Eurozone, in the last recession. In fact, in the last 20 years, economic activity in Guatemala has only presented odd percentages of growth during the period from 2006 to 2009 due to the last boom and bust in the American economy. Given that USA is the main trading partner of Guatemala, there is a correlation between both economic activities.



Sources: Federal Reserve Bank of St. Louis for USA GDP, Bank of Guatemala for GUA GDP and Eurostat for Eurozone GDP.

*From 1996Q1 to 2001Q4, it was assumed the same growth at the end of the year for every quarter since no trustworthy data was able to be found.

The banking industry in Guatemala is well known for being very conservative and stable. However, at the end of the 20th century, Guatemala began changing its monetary policy. The civil war had left high inflation to deal with. The monetary bomb had to get under control since the exchange rate was increasing rapidly, year by year. In the 90s, as the Central Bank could not lend any more money to directly finance the government, the open market operations started to keep the exchange rate under control without having to increase the interest rates[4]. From then, interest rates have not shown any sudden growth, as Graph 2 demonstrates.



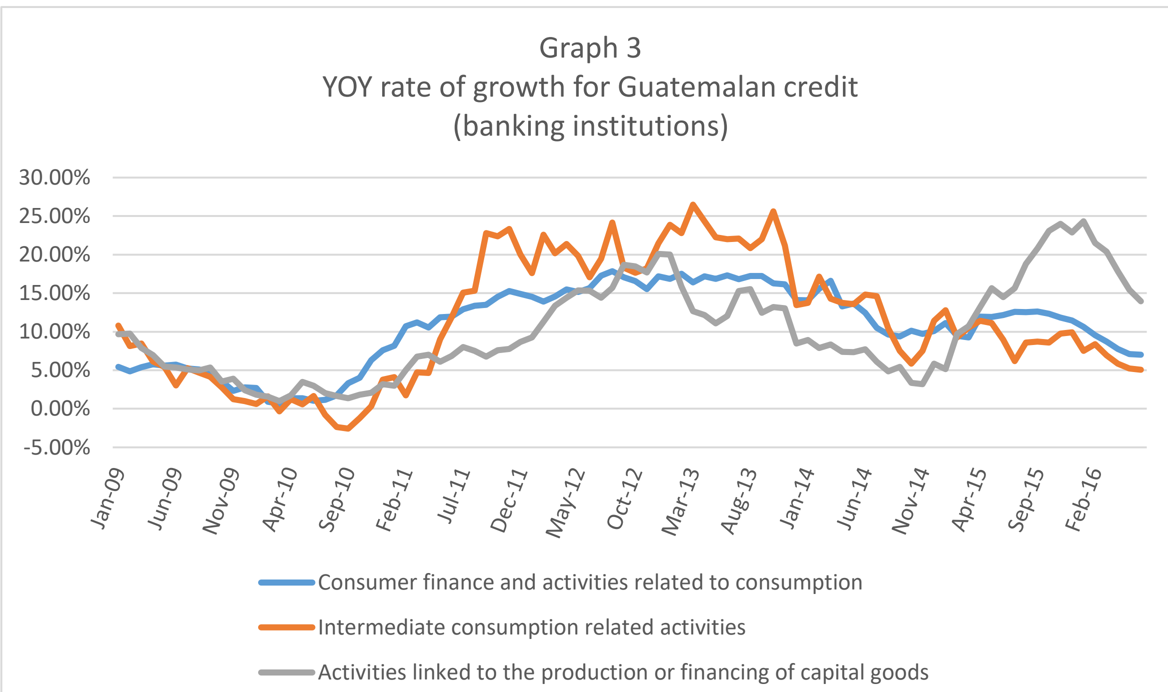
Source: Bank of Guatemala

Notwithstanding, Guatemalan economy does have fiduciary media and, as conservative as the banking system could be, the banks do extend credit beyond their assets and funds. The banking accounts are protected with a banking reserve of 14% and with a Fund for the Protection of Savings (FOPA, acronym in Spanish), managed by the central bank, that covers up to GTQ 20,000, or its equivalent in foreign currency, per individual. It may not seem much, but it could be enough to distort the market prices.

[4] Bank of Guatemala 2016. Monetary Policy.

On the other hand, Guatemalan economy is still based on primary and secondary sectors by almost 40%, while only 7% of the economic activity represents financial activities[5]. Levels of credit seem, at first glance, very cyclical; however, when analyzed closely, it becomes evident that the primary destination of credit is consumption. In fact, at UFM Market Trends a sorting of the Guatemalan bank loans, according to Hayek's triangle of the stages of production, has been made, showing that more than 50% is destined for activities directly related to consumption; approximately 20%, for intermediate consumption related activities; and less than 30%, for the production and financing of capital goods.[6] Over the last year, the latter sector showed an abnormal rate of growth given the oil prices, as shown in Graph 3. Nevertheless, as prices have increased, the growth of credit for the production or financing of capital goods has slowed down – but even when this use of credit peaked, consumption activities remained as the overwhelming destination of credit, with more than 70%.

Source: Elaborated from data published by the Banking Superintendence of Guatemala.



[5] Bank of Guatemala 2016.

[6] Market Trends found at http://trends.ufm.edu/newsletter/las-nocivas-consecuencias-de-la-reciente-legislacion-guatemalteca

In addition, informality levels reach 68%[7], and the percentage of adults with at least one bank loan is only 13.9%[8]. This means that even if the authorities wanted to increase the economic growth through a credit induction, it could only affect a minority of economic activities since the financial inclusion is so low – and the informality so high – in Guatemala. This demonstrates, the ABCT was built for a capitalized well-structured economy where informality was not an issue to take into account.

Conclusion

Even when there is fiduciary media and intervention from the central bank in the banking system, the economic activity in Guatemala is not yet too capitalized to further invest in capital goods. Its economy still depends on activities which cannot prolong their production processes much more. Conversely, Guatemalan consumers have very positive intertemporal preferences. They are more interested in consuming today than postponing their consumption, given that their destination of credit is mainly consumption. This could even be a problem if the financial inclusion in the banking system was significant, because it could mean that authorities could induce temporary growth through credit, and there would be almost no savings base, relatively speaking, to sustain the investments. However, levels of informality and financial inclusion are two blind spots in the ABCT. The informality in the Guatemalan economy is so disproportionately high that investment on capital goods have a very small share in a banking system where the financial inclusion is close to null. Business cycles can only develop in countries with a vast financial inclusion, since the credit-induced growth can only directly affect the interest rates in the formal sector of the economy. The Guatemalan economy lacks business cycles, not because of a free intervention market economy but, because it has a very significant percentage of informality.

[7] INE found at https://www.ine.gob.gt/index.php/estadisticas/tema-indicadores
[8] Bank Superintendence found at http://www.sib.gob.gt/web/sib/Boletin-Trimestral-de-Inclusion-Financiera

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