

Is there a business cycle in Guatemala?

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Abstract

The Austrian Business Cycle Theory states that business cycles follow excessive growth in bank credit loans, often as the result of attempted an economic stimulus package artificially lowering interest rates. In order to capitalize production processes, in a free market economy, 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 policies. It has the legal authority and the tools to increase the money supply. However, given the very positive intertemporal preferences and the size of the informal sector of the economy, it is not possible for the central bank to stimulate the economy, and consequently create bubbles.

Keywords: Guatemalan economy, Austrian Business Cycle, informal sector, financial access.

1. Introduction

The Austrian Business Cycle Theory (ABCT) states that a business cycle occurs given an excessive growth in bank credit loans, due to an attempt of economic stimulus through 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. This process takes time, which means the individual needs to save in the present in order to consume more in the future.

In Guatemala, the central bank controls monetary, exchange, and credit policy. It is also a lender of last resort for the financial system, manipulates the supply of money through open market operations and term deposit certificates. However, more than 50% of the bank credits are intended for direct consumption, leaving too little space for the investment of capital goods. Additionally, the informal sector of the economy represents almost 70% and the financial inclusion is less than 15%, two factors not taken into account in the ABCT. Therefore, it is not possible for the central bank to stimulate the economy, and consequently create bubbles, even with their intervention capacity.

2. Business cycles according to the Austrian theory

The Austrian Business Cycle Theory finds its roots in Carl Menger as well as in Eugen von Böhm-Bawerk's work on *Principles of Economics* and the *The Positive Theory of Capital*, respectively. Both figures contributed to the Austrians' thought in 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 subjected over time yield. This means that, in order for entrepreneurs to invest in capital to elongate their processes of production, there must be a large base of individuals who prefer to resign their early consumption for a later consumption, that is save. As more consumers are willing to save, more loanable funds will be available; supply increases lowering the interest rate. Therefore, entrepreneurs will undergo more capital investment in projects that will yield greater outputs to pay for their loans with interests. The interest rate, left to the market forces, already coordinates intertemporal consumption and investment decisions.

As the market for loans evolved, more institutionalized intermediaries were needed: commercial banks. But it is not until the birth of central banks and the loss of gold standard that the credit begins to be something to worry about, 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 Mises¹, with the creation of fiduciary media, credit is extended beyond a bank's assets and funds. Because money supply has increased with the fiduciary media, interest rates lower and the economic activity pumps up because projects that weren't profitable before, will be undertaken now. As more projects are undertaken, the demand for means of production and labor will increase, increasing the price of means of production and wages as well. As means of production and labor have become more expensive, the price of consumption goods rise; leaving authorities with the "necessity" of creating more fiduciary media to overcome it, engaging the economy in the everlasting business or trade cycle.

¹ Mises 1996: 25

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 *malinvestments*³ undertaken by the entrepreneurs. The solution to this, in short, since is not part of this work to discuss about it, is for the government to do nothing. These 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.

3. Taking ABCT to the Guatemalan economy

The Guatemalan GDP does present a marked cyclical behavior, as shown in Graph 1. It shows slowdowns in the last two periods of recession (2000-01 and 2008-09) but not as severe as it shows to have been the case of the United States or even as Eurozone, in the last recession. Guatemalan economic activity does experience fluctuations, but it has remained within a range of growth that, compared to other economies, is very predictable. 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. Even when United States is a complete different economy of that of Guatemala, it becomes an important comparison since the former is the main trading

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.

partner of the latter. Exports to and imports from United States represent 34% and 40%⁴, respectively. Therefore, there is a direct relation between both economic activities.

3.1. The Central Bank

The central bank controls the monetary, exchange, and credit policy. It has the capacity to control the liquidity of the economy through fiduciary media and arbitrary control in the flow of foreign currencies. From the end of 2016, election year in United States⁵, the exchange rate of quetzal-dollar have been significantly decreasing from Q7.50 by September 2016 to Q7.36 by February 2017. Consequently, the president of the central bank announced two actions to be taken: 1) the emission of term deposit certificates in dollars and 2) the activation of the rule to participate in the Electronic System of the Negotiation of Foreign Currencies⁶. These actions aimed to control the claimed “excess” of \$1 billion dollars in the economy that pushed the exchange rate.

The leading interest rate is 2.75% and the inflation target rate is $4\% \pm 1$ pp. However, not only has the CPI measurement been discredited because of the dubious inconsistent reports in prices by the National Statistics Institute (INE), but also the Central Bank reported 5.68% as the closing inflation for 2017.

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 (around USD 2,700), or its equivalent in foreign currency, per individual. It may not seem much, but it could be enough to distort the market prices.

⁴ Banco de Guatemala, 2018.

⁵ It is relevant to mention that 2016 was an election year in United States because, given the uncertainty of many migrants due to the change in government, a large increase in the flow of remittances was observed. Being this the main cause of the alleged excess of dollars in the economy.

⁶ Gamarro, Urias, 2017.

In theory, the Guatemalan Central bank has all the authority and tools to increase the money supply through the financial system and cause an Austrian business cycle. In practice, it does not happen.

4. Then... why doesn't it apply to Guatemala?

The ABC does not apply to Guatemala, not because the theory is wrong or because it is a free market economy. It does not apply, first, because the financial access is very low. Only 14% of adults have at least 1 loan through the financial system. Additionally, according to the INE, the informal sector represents 70%⁷ of the total economy. The Institute further calculates that 82% of the economy in the rural areas is in the informal sector.

Second, Guatemalan economy is still based on primary sectors for almost 40%, while only 7% of the economic activity represents financial activities⁸. For the ABC to occur, there must be space to elongate the processes of production. This cannot happen since most of the economic activities are agricultural.

Third, not only there a very low financial access in the economy but, the destination of the credit is mainly for consumption. UFM Market Trends⁹ does a sorting of the Guatemalan bank loans, according to Hayek's triangle of the stages of production. It shows 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

⁷ INE 2018.

⁸ Bank of Guatemala 2016.

⁹ A project from the Universidad Francisco Marroquin that attempts to forecast the probability of the next recession (through indicators such as liquidity gap, yield curve, ratio Q and some others) of United States, Eurozone, China, Spain, Mexico and Guatemala.

and financing of capital goods.¹⁰ The latter sector showed an abnormal rate of growth given the significant decrease in oil prices through late 2015 to the beginning of 2016, as shown in Graph 2. Nevertheless, as prices increased, the growth of credit for the production or financing of capital goods have slowed down – but even when this use of credit peaked, consumption activities remained as the overwhelming destination of credit, with more than 70%.

5. Conclusion

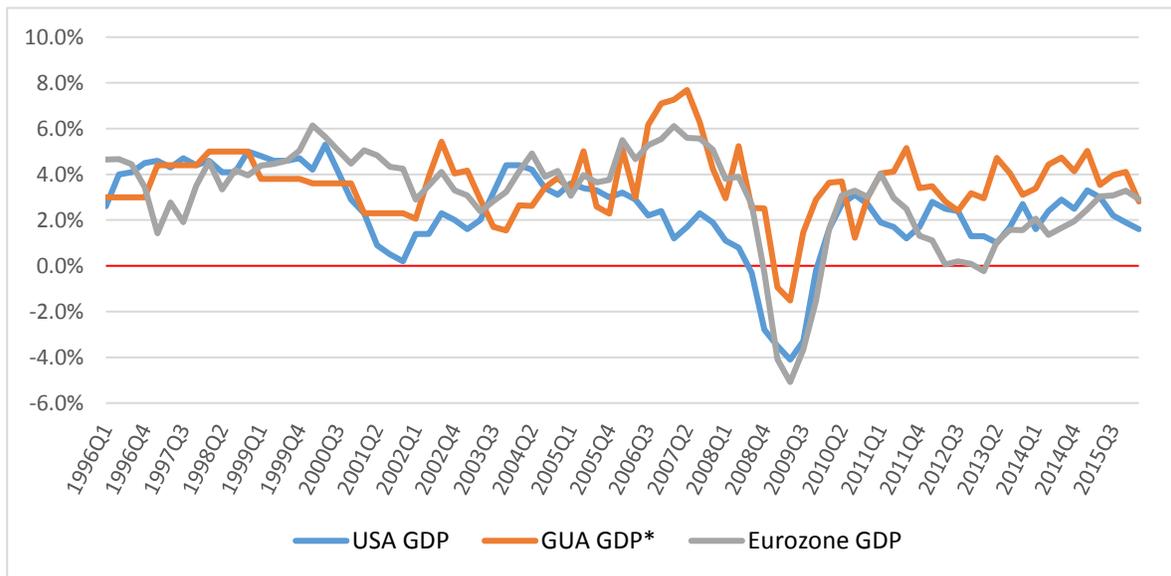
Even when there is fiduciary media and intervention from the central bank in the banking system, the economic activity in Guatemala is no yet too capitalized to further invest in capital goods. Its economy still depends on activities which cannot prolong much more their production processes. Conversely, Guatemalan consumers have a very positive intertemporal preferences. They are more interested in consuming today than postponing their consumption, given their destination of credit is mainly consumption. This could even be a problem if the financial access to 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.

Levels of informality and financial access to the banking system 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

¹⁰ Market Trends found at <http://trends.ufm.edu/newsletter/las-nocivas-consecuencias-de-la-reciente-legislacion-guatemalteca>

formal sector of the economy. The Guatemalan economy lacks business cycles, in the Austrian tradition, not because of a free intervention market economy but, because it has a very significant percentage of informality.

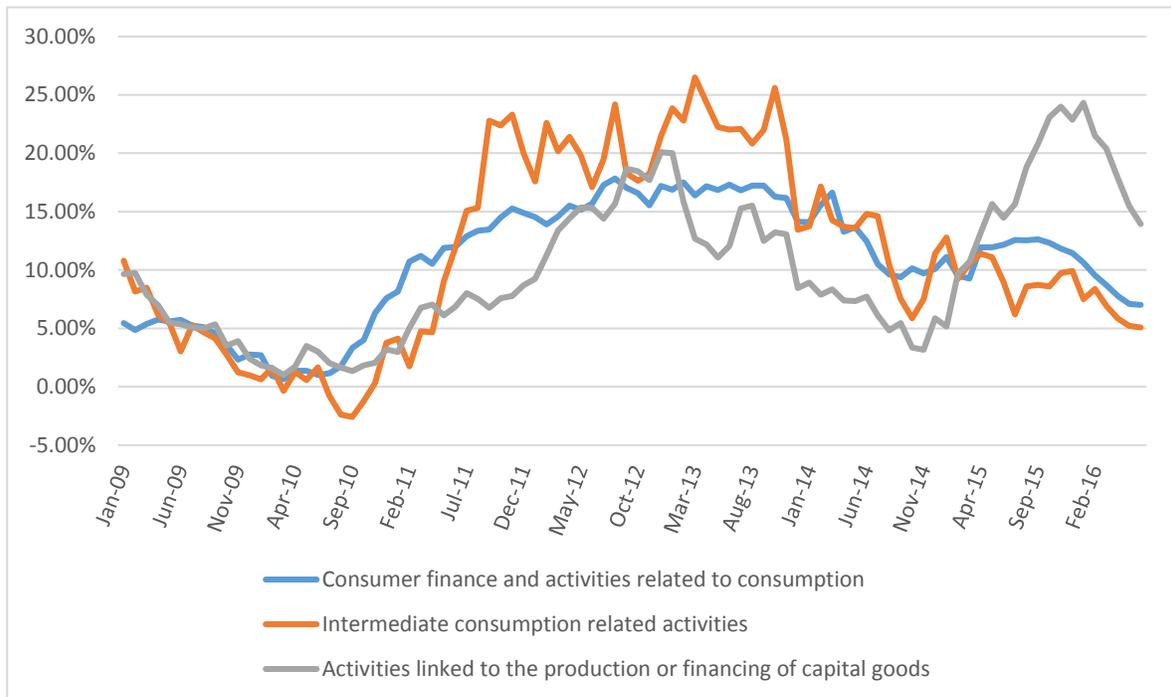
Graph 1 QoQ GDP Growth



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.

Graph 2 YoY rate of growth for Guatemalan credit (banking institutions)



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

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