THE BUSINESS CYCLE: A DEFINITION

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There can be no facts in a world without values.
— Frank van Dun

“Oh! What a tangled web we weave, when first we practice to deceive!”
— Sir Walter Scott
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1. INTRODUCTION

The business cycle is a phenomenon with legendary allure. It does its venomous work in disguise, unnoticeably contaminating entire societies, whole continents even. And once its crisis and depression strike, they sweep mercilessly through strata rich and poor, shattering dreams and demolishing businesses, leaving in their wake hardship, disillusionment and despair. The business cycle is the basilisk of our day, a mystical creature where everybody speaks of but which few know how to handle. As with any serpent, we can only rid us of it for once and for all, if we uncover how and where it is hatched and on what it feeds to survive and reproduce. What follows is an attempt to do exactly that.

A contribution we like to think to have made in this text, is that by breaking up the characteristics of the business cycle into three categories (cyclicality, pervasiveness, recurrence), and by identifying a different social phenomenon at the root of each of these three, we've laid the groundwork for a better general understanding of this phenomenon.

Another thing that, as far as we know, makes this text different from others, is that it traces the business cycle back to an unjust and immoral act—fraud—, and that it shows how some of the most essential characteristics of the business cycle are a direct consequence of this act. This suggests that a change of perspective is possible and necessary when debating the business cycle, a change from the domain of calculation, efficiency, and policy, towards the domain of morality, justice, and virtue.

2. METHOD

In this section, we discuss the nature of social phenomena, and three ways of talking about them: the description, the general explanation, and the definition. Throughout the article, we will work with these three ways to speak about the social phenomenon of the business cycle.

Social phenomena

One of the few characteristics of the business cycle where there is a quasi consensus about, is that it is not a phenomenon that should be investigated by the natural sciences, but rather one that the social sciences should be able to explain. Also, it is generally accepted that any occurrence of this phenomenon is the result of multitude of human actions. This is why we will call it, and investigate it as, a complex social phenomenon.

Now what are social phenomena? Here is our definition:

Social phenomena are acting man's choices and the necessary effects of these choices, in so far as they can be mutually understood.

This means first, that all social phenomena are born in human intentionality; social phenomena are intrinsically teleological. Indeed, money is for trading, buses are for transportation, courts are for justice, etc. And so we agree with Gabriel Zanotti that it is precisely their intentional meaning (purpose) that gives “sense and reality to social phenomena”. It is the intention, and the intention only, which initially motivates human choices and everything that follows from these choices.

Second, our definition means that social phenomena are intersubjective realities, they have have a meaning which is in principle equally accessible to all human beings. In this way, for example, we can understand and talk about saving as an act, money as a means, prosperity as an effect.

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Having said this, we are faced with an important question: given that the prime mover of an act is always something subjective, highly personal, and not publicly accessible; given that nobody can peer into my head and see what it is exactly that I desire in the big picture, how can we say anything meaningful at all about social phenomena?

Here is how. Even though the “prime mover” of social phenomena, that which gives sense to them, is indeed the ultimate intention, nonetheless, the aspect of my actions that imparts sense (or direction) onto the world boils in fact down to the *actual choice I make*. And so in order to understand a social phenomenon, it is sufficient to understand what actual choices lie at the root of it.\(^2\) For example, a person who wants to achieve his own particular interpretation of happiness may choose “honest work for a decent pay” as a means thereto. Even though the ultimate goal of this man cannot be observed and evaluated by an outside observer, his choices can: we can see him at work, and we can assess whether he is honest or dishonest in this endeavor.

The choices a man makes are ideally in harmony with his intentions: they help him move closer towards the goals of his desire. However, people often make mistakes or delude themselves. Choices may be unproductive with regards to the ultimate ends, or even be in blatant contradiction with these ends, and so a person with good intentions may nonetheless commit evil and unjust deeds. In this way for example, Robin Hood may have had nothing but charitable intentions by robbing the rich,\(^3\) but nonetheless we have to say he was engaged in robbery, not in charity (since charity consists in handing out what is one’s own, not what is from others). For what follows it is important to note that those things about which we can intersubjectively communicate and hold each other responsible, are not our intentions, but rather the actual choices that we make.

Social phenomena can be very complex, as for example the business cycle is. Any historical boom-bust cycle has been the result of innumerable actual choices, made by thousands or even millions of individuals. However, this shouldn’t scare us away from trying to explain it. A brief look at our colleagues from the hard sciences teaches us that they explain very complex phenomena such as hurricanes or volcano eruptions by referring to the combined appearance of a few simple physical principles. So why couldn’t we be able to come up with an explanation for the business cycle that is both simple and valid? As Ludwig von Mises says:

> “If we scrutinize the meaning of the various actions performed by individuals, we must necessarily learn everything about the actions of collective wholes.”\(^4\)

The challenge for explaining complex social phenomena, in our mind, is to find those simple choices that have the eventual social phenomenon as a necessary outcome, and without which the phenomenon could not come into existence in the first place. In this way, simple human choices can be shown to offer a necessary and sufficient condition for the occurrence of complex social phenomena.

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\(^1\) In this respect, see Gabriel Zanotti’s interesting discussion on the Neothomist distinction between the *finis operis* and the *finis operantis*:

> “First, the contemporary school of Saint Thomas Aquinas makes a distinction between the *finis operis* and the *finis operantis* of an action; the former meaning “the purpose of the work” (i.e., the purpose of an architect consists in designing a house), and the latter meaning the ultimate intention of the person (i.e., I am designing the house to become rich, or to do good, or to find a distraction). (...) it should be said that the *finis operis* is the kind of purpose that identifies the nature of the intersubjective relation (i.e., money is used for …), which therefore may be intersubjectively transmitted and shared, whereas the ultimate intention of the acting subject, may, in addition to the nature of the intersubjective relation, end up undisclosed within an intimate world, like some kind of solipsistic epoche, with natural intersubjective consequences. However, such intentions would not be identifying the nature of the intersubjective relationship at hand.” “Intersubjectivity, Subjectivism, Social Sciences, and the Austrian School of Economics”, *Journal of Markets & Morality*, Vol. 10, No 1 (Spring 2007), p. 125.

For more, see footnote 21.

\(^2\) We assume here, for the sake of argument, that the rich people that were robbed by Robin Hood were the rightful owners of the wealth taken from them. There seems to be historical evidence that contradicts this, but this does not detract from the point.

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So how do we go about that? There are three practical routes we suggest here below, but in general the method is this: a complex social phenomenon can be explained by reasoning from its effects, which are much more obvious and accessible to our senses, down to its essential causes, being very simple, straightforward human choices. Thomas Aquinas condensed it brilliantly when he said that “we must receive knowledge of the simple from the composite and arrive at what is prior from what is posterior”.

Three ways of saying things about social phenomena

There seem to be three different ways of saying things about phenomena, in this case social phenomena. Let's take a look at them:

1. **The description**

   The first things we notice about any given phenomenon are not its natural causes, which usually remain hidden if we don't specifically look for them, but rather its most obvious effects. In this way for example, we could speak about thunder as “a noise in the clouds”. Also, in the sphere of human action, we could describe the phenomenon of buying and selling as “money and material goods exchanging hands simultaneously”—because this is the first thing we notice when witnessing buying and selling going on.

   Now, some descriptions are better than others. For example, when a person hears the thunder, and another asks what it is, the first can answer “it is the sound I sometimes hear in the evenings”. Or he could say “it is the sound that comes from the sky”. The second description is obviously the better one. The reason why is that this description refers to an actual, intrinsic, property of thunder, whereas the first description refers to an accidental feature, to something that could change at any given time. And so we can say that the better descriptions are the ones that refer to the necessary effects, or properties, of a phenomenon, and that the worse descriptions are the ones that refer to the unnecessary effects, or accidents, of a phenomenon.

   Despite the distinction between worse and better ones, descriptions, here understood as statements that solely describe the effects of phenomena, don’t take an observer very far in understanding a phenomenon. For one, descriptions are vague and superficial. This makes them often misleading. For example, the description of thunder as a “noise in the clouds” is confusing because there are many more noises in the clouds than the noise produced by lightning. And looking at our description of buying and selling as “money and material goods exchanging hands simultaneously”, it is obvious that there are many other things that could be understood by it: it could just as well refer to a bribe, or to a child’s game involving some coins. And so we have to be wary of the description, since it is superficial and quite often deceiving. Nonetheless, a good description can be instructive, as a way to succinctly sum up the most obvious ways a certain phenomenon makes itself seen for the observer. This is also how we will use it in the text below.

2. **The general explanation**

   Many things can be said about social phenomena. Of a particular coin for example, we can say that it exists out of iron, that it has been produced by a minter, that it serves as a medium of exchange, among many other things. These things we can say about phenomena are called *predicates*. Now suppose that we, starting from a simple observation, want to come to an understanding of the nature, or the essence, of a certain social phenomenon. Which predicates should we consider then?

   Nature derives from Latin *nasci*, which means 'to be born'. And indeed, if we want to understand the nature of something, we have to know what caused it to be what it is; to understand “from what” it has come into being. It was Aristotle who proposed to use the term *genus* (γένος) in order to indicate that what brings about (or generates) a specific kind of phenomenon. In the case of social phenomena, as we have seen above, the primary mover of this generation-process is always one or more simple decisions made by individuals.

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We can illustrate this by applying it to our example of Robin Hood. Let's say that we have there, in medieval, legendary Nottinghamshire, an investigative contemporary who witnesses “rich people becoming poorer” on the one hand, and, on the other hand, “poor people becoming richer”. After asking around and after some reflection, he identifies both these effects as stemming from the complex social phenomenon “a gang of outlaws living in the forest, robbing rich people's chariots and handing out the loot to poor people”. Our fellow, determined to get to the heart of the matter, could then go on to decompose this phenomenon in the general phenomena of “robbing” and “handing out stuff”. Having done so, it becomes possible for him to identify the phenomenon of “robbing people” (to take property unlawfully by force or threat of force) as explaining the effect of wealthy people becoming poorer, and the phenomenon of “handing out stuff” (to give a share of something to each of a number of people) as explaining the effect whereby poor people become richer. And so if someone were to beam us back to that time and place, and we were to ask Robin Hood's contemporary “what is really going on here?”, then the answer would be “there is robbing going on, and handing out of the loot”. This then, is the general explanation.

In conclusion we can say that the general explanation of social phenomena ultimately always comes down to a description of the interaction of a few simple choices made by individuals.

3. The definition

Despite the great value it obviously possesses, the general explanation often fails at explaining why a specific phenomenon manifests itself exactly the way it does. In other words, it does not provide the clues that help one understand the effects of a phenomenon as being the inevitable or accidental consequences of what came before. This is where the definition comes into play. Aristotle taught that a definition takes this form (in our own words):

a phenomenon's essence or nature = its genus + its specific differences

In this way we can define a phenomenon by dividing it into, on the one hand, its genus, which is the “from what”, or the “kind” it belongs to; and, on the other hand, in its specific differences, which refer to “how” the phenomenon exists, to what makes it different from other phenomena belonging to the same genus. And so it is that a definition consists of a specific cause, referring to “how” the phenomenon exists, and a general cause, referring to that “out of which” the phenomenon exists.

Thus we can for example define the phenomenon “coin” as being constituted of the specific differences “flat, round piece of metal, carrying an official stamp” (specific cause) and the genus “money” (general cause). This genus can in turn be considered as a species of an even more general genus. We can then for example define the phenomenon “money” as being constituted by the specific difference “generally accepted” and the genus “medium of exchange”, which takes us to the essence of what a coin really is.

But why stop here? Why not try to divide this genus up to find an even more general genus? And then further decompose that genus? And so on indefinitely? The reason why we stop at this point is that in the social sciences, we do not study the reasons why people make choices (that would be psychology), but the consequences of the fact that they make choices. And so we can stop looking for causes of a complex social phenomenon once we have identified the simple choices that lie at its root. In the example above, “medium of exchange” represents the actual choice that is implicitly or explicitly assumed when considering money in general, or money in its more specific forms: the choice of certain goods as a medium of exchange. This choice is precisely what causes money to be money; and the fact that coins are chosen as media of exchange is why we call them coins.

Graphical representation
Here is a graphical representation of the three ways we can talk about a phenomenon. The general explanation describes the general cause of the phenomenon, that which explains the “sort” or “family” to which it belongs. Now, a phenomenon does not only have general causes, it also has specific causes. The definition of a phenomenon is composed of the general cause and the specific cause, or genus and specific difference. Finally, a phenomenon also produces effects; necessary effects, which we call properties, and unnecessary effects, which we call accidents. A description of a phenomenon sums up few or more of these effects.

What does this mean for our investigation of the business cycle?

With the above, we now have a theoretical framework that is sturdy enough for an investigation into the roots of the business cycle. This is how we shall go about it: first, we use a description to outline the general properties of the business cycle; next, as we uncover the essential choices that lie at the root of the business cycle, we formulate a theory that explains the consequences of these choices as properties of the business cycle; and finally, after explaining the additional properties of the business cycle, we combine the simple social phenomena that have been identified as causes of the business cycle into our definition.

3. Description of the Business Cycle

The business cycle seems to possess three main properties, characteristics that are inherent to it and that cannot be reduced to each other. First, the business cycle is a cyclical phenomenon, second, it is a recurrent phenomenon, and third, it is a pervasive phenomenon.

With “cyclical”, we mean that the phenomenon consists of different phases that necessary follow each other throughout time; with “recurrent”, we mean that it is a phenomenon that occurs not irregularly, but with consistent repetition; and with “pervasive”, we refer to the fact that when the phenomenon strikes in a certain region, virtually no one is left untouched by it.

With these general properties as a given, we can now formulate a description of the business cycle. We suggest the following: “the business cycle is a cycle which is pervasive and recurrent”.

Let us now look into each of the main properties separately, tracing them back to the simple social phenomenon that causes them. Given its importance and complexity, the characteristic of...
cyclicality will take the bulk of this article. After having dealt with that, we will give a briefer analysis of the characteristics of recurrence and pervasiveness.

4. **Why is the Business Cycle a Cyclical Phenomenon?**

**What is a Cycle?**

We here define a cycle as a causal chain of phenomena whereby the first phenomenon in the chain is essentially identical to the last one. A specific cycle is then in itself a complex phenomenon that can be decomposed into separate phases. Cycle derives from Greek *kyklos*, circle, and indeed, a cycle is a circular succession of events. One property inherent to cycles is that they are reproducible, a second is that they are *temporal*, i.e., stretched out in time.

**The cyclicality of the business cycle**

Here, we address the *cyclicality* of the business cycle and attempt to trace it back to the simple social phenomenon that caused it. In his *Man, Economy, and State*, Murray Rothbard provides a short description of the cyclical characteristics of the business cycle:

The business cycle has had certain definite features which reveal themselves again and again. First, there is a boom period, when prices and productive capacity expand. There is a greater boom in the heavy capital-goods and higher-order industries—such as industrial raw materials, machine goods, and construction, and in the markets for titles to these goods, such as the stock market and real estate. Then, suddenly, without warning, there is a “crash.” A financial panic with runs on banks ensues, prices fall very sharply, and there is a sudden piling up of unsold inventory; and particularly a revelation of great excess capacity in the higher-order capital goods follows. A painful period of liquidation and bankruptcy follows, accompanied by heavy unemployment, until recovery to normal conditions gradually takes place.

This description is in Austrian circles by now a traditional account of the business cycle qua cycle: the boom-phase is followed by a bust-phase, which allows for the recovery back to normal. And so the business cycle consists of three phases: a phase of misplaced optimism and wrong investments, a phase where these errors become apparent, and a phase where these errors are corrected. Explaining the cycle thus amounts to explaining the origins of clusters of errors. Rothbard formulates the question as to what causes these errors:

“No Businessman in the real world is equipped with perfect knowledge; all make errors. But the free-market process precisely rewards those businessmen who are equipped to make a minimum number of errors. Why should there suddenly be a cluster of errors?”

Jesús Huerta de Soto formulates the problem in more precise terms:

“Crisis and economic recession have hit, essentially due to a lack of real saved resources with which to complete investment projects which, as has become apparent, were too ambitious. The crisis is brought to a head by excessive investment (“overinvestment”) in the stages furthest from consumption, i.e., in capital goods industries (computer software and hardware, high-tech communications devices, blast furnaces, shipyards, construction, etc.), and in all other stages with a widened capital goods structure. It also erupts due to a parallel relative shortage in investment in the industries closest to consumption. The combined effect of the two errors is generalized malinvestment of productive resources; that is, investment of a style, quality, quantity, and geographic and entrepreneurial distribution typical of a situation in which much more voluntary saving has taken place.”

So how do we explain the occurrence of these malinvestments? Huerta De Soto, as most Austrian economists from Mises onwards, points at the practice of credit expansion:

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“the increased supply of loans which results from credit expansion will initially exert an effect very similar to that produced by the flow of new loans from saving (...): it will tend to cause a widening and lengthening of the stages in the productive structure. (...) The relative reduction credit expansion causes in the interest rate boosts the present value of capital goods, since the flow of rents they are expected to produce increases in value when discounted using a lower market rate of interest. In addition, the lowering of the interest rate gives the appearance of profitability to investment projects which until that point where not profitable, giving rise to new stages further from consumption, i.e., stages which are more capital-intensive. (...) In short, entrepreneurs decide to launch new investment projects, widening and lengthening the capital goods stages in the productive structure; that is, they act as if society’s saving had increased, when in fact such an event has not occurred. [This] triggers a process of maladjustment or discoordination in the behavior of the different economic agents. (...) In a nutshell, this is (...) an inducement of mass entrepreneurial error in economic calculation (...).”

He summarizes:

“In short, entrepreneurs have invested an inappropriate amount in an inadequate manner in the wrong places in the productive structure because they were under the impression, deceived as they were by bank credit expansion, that social saving would be much greater.”

And so we have traced back the boom-bust character of the business cycle back to deception of entrepreneurs by means of bank credit expansion. Ludwig von Mises describes the role of fiduciary media (the money substitutes bank credit expansion produces) as follows in his work Human Action:

“The issuance of additional fiduciary media, no matter what its quantity may be, always sets in motion those changes in the price structure the description of which is the task of the theory of the trade cycle.”

Let us remind ourselves what is meant by the term “fiduciary media”:

“If the money reserve kept by the debtor against the money-substitutes issued is less than the total amount of such substitutes, we call that amount of substitutes which exceeds the reserve fiduciary media.”

So we see that it is the issuance of this fiduciary media that somehow deceives the deposit holders into believing that they actually have access to more tangible goods than they really do, and the entrepreneurs into believing that there is more capital available than there really is. As a consequence, errors are committed on a large scale, which is the boom-phase of the business cycle, followed by the inevitable bust. In this way the issuance of fiduciary media somehow lies at the root of business cycles.

Question is whether any kind of issuing fiduciary media will equally lead to the cycle we are currently investigating. Put differently: what is it about the fiduciary media that brings about these cyclical effects?

Well, if there should be any specific kind of fiduciary media that somehow causes entrepreneurial errors, it seems only logical to assume that it must be deceptive fiduciary media that does so. But let’s not take that at face value. Let us put this theory to the test by assuming the reverse: can fiduciary media which is issued in an honest, non-deceptive, manner lead to business cycles?

Let us for example consider the case where the banker agrees—ideally, from the outset—with all the owners

12 Ibid., p. 375-76.
13 This idea saw light for the first time in Ludwig von Mises’s 1912 book Theorie des Geldes und der Umlaufsmittel. The so called Austrian Business Cycle Theory, as later refined and expanded by its author, states that the business cycle is caused by fractional reserve banking, and more specifically by the ex nihilo creation of fiduciary media (bank credit expansion).
15 Ibid., pp. 432-33.
16 As Selgin and White write: “Fractional-reserve arrangements cannot then be inherently or inescapably fraudulent. Whether a particular bank is committing fraud by holding fractional reserves must depend on the terms of the title-transfer agreement between the bank and its customers.”

George A. Selgin and Lawrence H. White, in their article “In Defense of Fiduciary Media—or, We are Not Devo(lutionists), We are Misesians!”, Review of Austrian Economics 9, no2:83-107, p. 86-87
of the money substitutes he has ever issued, to emit new money substitutes representing a quantity higher than the sum of money entrusted to him. For sure, this would render the presently and previously issued money substitutes to be (more) imperfect. But could such a practice, which essentially amounts to organizing a gambling game, produce the deception that leads to business cycles? The answer is, or so we hold, negative: the clients of a banker who practices honest fractional reserve banking must be aware that they are gambling, in the same way that the participants to any other gambling game know that they are. And so these participants will not consider the assets they use to gamble as an investment, let alone think that their capital is now kept under the good care of another person. Hence, honest fractional reserve banking, by its very nature, cannot produce malinvestments. From this it follows that fiduciary media that does not deceive does also not cause the effects ascribed to the business cycle: without fiduciary media causing deception, no misallocation; without misallocation, no crisis, and without crisis, no recession or depression.

Having come to the conclusion that it is really the deception inherent in certain forms of fiduciary media that causes the cyclical effects of the business cycle, we can finally ask ourselves whether fiduciary media themselves are at all a necessary cause of this cycle of deception, or “error cycle”. Could perhaps the step of issuing fiduciary media be altogether abandoned? The answer is yes. If an actor could find a way to deceive people on a large scale in such a manner that leads them to misallocate their resources, the cyclical effects resulting from this would be identical to those of the business cycle. We wouldn’t necessarily be able to explain the pervasiveness and the recurrence of the cycle anymore, as will become clear later in the text, but all the cyclical effects would be explained indeed, and that is our present pursuit. And so it seems that the general means that we are looking for, the simple social phenomenon that causes the cycle, must be deception. However, the deception we are after is deception of a special kind: it is a kind that inherently and inevitably leads to conflict, crisis, and social chaos. Do we know of such a phenomenon? Yes, we do: deception leading to crisis, conflict, and social chaos, in brief, leading to injustice, is what is called fraud. So then, logically, our claim now is that the inflationary boom, crisis, and deflationary correction are caused by fraud. In summary, the cyclical properties of the business cycle find their general origin in the simple social phenomenon of fraud. And so if we ask ourselves who is responsible for a given business cycle, the answer is that it must have been people who resorted to fraud as a means to achieve their goals.

On the cyclical features of fraud

In what follows we explain how the properties of fraud relate to the cyclical properties of the business cycle. More specifically, we show how the properties of the simple social phenomenon of fraud are the general causes from which the specific cyclical properties of the business cycle naturally flow:

This is how we will conduct our investigation: first, we discuss some preliminary issues concerning fraud, the most important of which are the concept “cycle”, the concept of “injustice”, and that of “imaginary goods”. Second, building upon these observations, we attempt to lay bear further properties of fraud in a suggested theory of the fraud cycle, which we will then illustrate with a diagram. Thirdly and finally, we reformulate this theory of the fraud cycle in specific terms, whereby we’ll explain how the specific properties of the business cycle—inflationary boom, malinvestments, crisis, deflationary correction and depression—relate back to fraud and the fraud cycle.

1. On whether fraud generates cycles

Above, we defined a cycle as a causal chain of phenomena of which the first phenomenon in the chain is essentially identical to the last one. Two important properties were that cycles are reproducible and temporal. In order to see whether fraud is a cyclical phenomenon, let us start from these properties. Is fraud reproducible? Yes it is, anyone who can engender even just a little bit of trust in another person can commit fraud, whenever he or she so chooses. And is fraud also temporal, i.e., stretched out in time? This also is the case. The reason why is that the time element is inherent to

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17 See Appendix 1: “On whether honest banking can cause business cycles”.
18 This is also why natural phenomena never serve as necessary causes for the business cycle: there are no natural phenomena that inherently and inevitably lead to conflict, crisis, and social chaos. The deceptiveness of natural phenomena is always an accidental quality, never a property inherent to them.
19 In the present paper, we define fraud in brief as being “deceit causing injustice”. In a more precise definition, we may call it an inherently deceptive act, or series of acts, with which someone brings into being a situation of injustice.
fraud, since, by definition, there exists a (short or long) time lag between the moment someone becomes the victim of fraud, and the moment in which the fraud is uncovered—there is no deception if one is not deceived at least for a while. Now, for the definition: does fraud indeed produce “a causal chain of phenomena of which the first phenomenon in the chain is essentially identical to the last one”? The answer, again, is yes. We will elaborate on this in the next section, but any instance of fraud indeed has distinct and necessarily succeeding phases to it: starting from genuine trust, the initiation of fraud has three phases: the phase of deceit, that of the crisis, and that of the restoration of trust.

To conclude, since any instance of fraud produces cyclical effects, we can say that cyclicality is a property of fraud.

2. On the condition that comes before and follows fraud: justice

Fraud is deceit causing injustice. The cycle of fraud is thus initiated by a breach of justice, and terminated by a restoration of justice. And so in order to study the appearance of the fraud cycle, we have to study the state of affairs prior to the initiation of fraud. In other words, we have to consider what is present when fraud is not, and given that the nature of fraud is injustice (because fraud is aimed at injustice20) it follows that we depart from a situation where injustice is absent: justice.21

Now what is justice, really? Justice is the domain in which man acts responsibly, only claims what is his to claim, and where he lives peacefully within his means. It is an orderly state of affairs, which we can call the convivial order22 or natural order. The sphere of justice is one in which people live next to one another and respect each other as natural, i.e., reasonable, persons; a situation where each person lives within his own means and where a basic level of trust is cultivated; bona fides, good faith, or goodwill. In this natural order, people in their daily dealings choose not to trap, trick or deceive one another, as a hunter would do to an animal, but rather try and resolve disagreements through reason and argumentation, as reasonable people do. Structural lack of this basic truthfulness would render all social cooperation impossible, causing the fabric of the convivial order to disintegrate.23

This is how professor Frank van Dun describes this natural, or convivial, order:

“[T]he convivial order is ius-based. The word ‘ius’ refers to the Latin verb ‘iurare’, which means to swear; to speak solemnly; to commit oneself toward others. The ius-relation implies no positions of authority or command, but direct personal contacts resulting in agreements, covenants and contracts, in mutual commitments, obligations or iura. Strictly speaking, the ius-relation can exist only between natural persons, as they are the only persons that are naturally capable of independent speech and action.” 24

In the convivial order, people maintain friendly relationships and generally trust each other. In this atmosphere of genuine trust,25 people engage in mutually beneficial cooperation, which results in peaceful commerce, division of labour, and sustainable economic growth. The attitude of genuine

20 Human action is essentially purposeful. The essence of an act is the end or purpose towards which it is intended. Without a purpose, behavior is “pointless” or “random”; it loses its meaning and ceases to be action. Now fraud is an act, which applies deception as a means, or intermediary end, towards injustice. It follows that the essential nature of fraud is injustice. See also Thomas Aquinas, II Sent., d. 2 a. 2, a. 1.: “the finis operis is the goal to which the deed is ordered by the doer, and this is called the nature of the deed”. On human action and the role of the finis operis, see Gabriel Zanotti, "El Metodo de la Economia Politica", Revista Libertas 40 (May 2004), p. 37. For more on this, see the earlier section “social phenomena”, especially footnote 2.

21 As the Latin dictum goes: “Fraus et jus nunquam cohabitant”; where there is justice, there is no fraud, and vice versa.

22 On the concept of the convivial order, see the work of Frank van Dun. In his “Concepts of Order” (2006, p. 23). There he writes, for example: “A convivial order is not a society. It is a catallaxy, an order of friendly exchange among independent persons. We can find examples of convivial order . . . wherever people meet and mingle and do business in their own name, whether or not they belong to the same or any social organisation. . . . [T]he paradigm of conviviality is a relation between natural persons.”

23 “The law of the first society is—‘let us act in good faith’ (bona fide agito) . . . . Thus, in the Roman system of right, at times, the expression ‘good faith’ is taken to signify natural right itself.” (Giambattista Vico, Universal Right (Amsterdam: Rodopi, 2000), p. 42.) When people act in bad faith, are double-minded and deceitful, the convivial order ceases to exist: “it would be impossible for men to live together, unless they believed one another, as declaring the truth one to another” (Thomas Aquinas, Summa Theologian, II-II, 109, art. 3). Toon van Houdt's comment where he describes the views of the scholastic theorists is also very relevant in this respect. See Toon van Houdt, On the Edge of Truth and Honesty, (Koninklijke Brill NV: Leiden, 2002) p. 9.

trust that exists in the convivial society is expressed in trusting relationships between individuals, or “trusts”. In a trust, a trustor assumes the truthfulness of another person and has good reasons to expect that the other will perform one or more actions. These good reasons may be implicit, embedded in the social and cultural context, or, they can be made explicit, for example by a specific promise of the other person. The person wherein the trust to perform a certain action is placed, is whom we can call the trustee.

3. On the nature of fraud: injustice and imaginary goods

Injustice, then, involves a transgression of this natural order: the lawbreaker refuses to live within his means and unjustifiably interferes with the means of others. We can define an unjust action or violation (i.e., an action violating justice) as an action that is brought to bear on a person or his property by an external agent, contrary to reason.

3. On how fraud produces imaginary goods

We now have a better understanding of how fraud is a breach with what was before. Given that fraud is based on deception, i.e., a distortion of sound judgment, it follows that the person who is subjected to fraud misconceives certain non-existing resources as existing, or misconceives certain unsuitable resources as being suitable. This illusionary reality is constituted of what we may call imaginary goods. Let us now investigate what is understood by this.

In the act of fraud, the deception of the swindler imprints in the minds of his victims an understanding of the world that is not conform to the way things really are: he makes them believe in the existence of goods that do not actually exist, or he secretly changes the state of affairs, thus instilling in them the mistaken belief that actually removed goods are still available to them. In either case, supposed goods are created that appear to be “fitted to satisfy human wants”, but do not actually:

Menger saw two possible ways in which imaginary goods can come into being:

“(1) when attributes, and therefore capacities, are erroneously ascribed to things that do not really possess them, or (2) when non-existent human needs are mistakenly assumed to exist. In both cases we have to deal with things that do not, in reality, stand in the relationship already

27 In all but the most extreme cases, reasonability implies the consent of the person who endures the effect of the action. “For an act to be violent it is not enough that its principle be extrinsic, but we must add 'without the concurrence of him that suffers violence.'” Thomas Aquinas, Summa Theologica, II-I, 9, art. 4.

For what follows, it is important to note that, since willing implies knowing, ignorance causes involuntariness. As Thomas Aquinas says,

“. . . a man may be ignorant of some circumstance of his act, which he was not bound to know; the result being that he does that which he would not do, if he knew of that circumstance . . . . Such ignorance causes involuntariness simply”. Thomas Aquinas, Summa Theologica, II-I, 6, art. 8 (“Whether ignorance causes involuntariness?”).

The reason why this is important is that it means that in the case of fraud, the ignorant victim has indeed been manipulated, or his means violated, against his will.

28 One could remark here that the word for deception in Germanic languages ('bedrog' in Dutch, 'Betrug' in German), is related to the on. drungr ('ghost'), the os. gidrag ('appearance', 'chimera'), wt. bitriaga ('administering damage in a cunning way') and the oi. drogha ('damage'). Indeed, mala fide deception, and thus also fraud, deliberately brings about a harmful illusion or 'mental high' to work to the advantage of the deceiver/swindler, and to the detriment of the victim.
29 Mises, Human Action, p. 93.
described as determining the goods-character of things, but do so only in the opinions of people.”

Menger errs, as has been pointed out by Mises\(^{31}\), when he claims in an elaboration of (2) that imaginary goods can derive from “imaginary value” or “imaginary wants”. The reason why Menger is mistaken is that imagination (phantasy, illusion) ultimately springs from the senses,\(^{32}\) but value and wants ultimately do not. Hence, wants nor value can possibly be illusory. However this does not in the least refute the possibility of the reality of imaginary goods, since the first cause of this phenomenon as suggested by Menger, the false ascription of capacities to things that do not really possess them, is perfectly valid. Capacities of substances are indeed detected by the senses, and can therefore be perceived where they are not present, or overlooked where they are. It follows that the distinction between imaginary and true goods is a valid one.

It is interesting to note that while Menger’s criteria of the good clearly exclude imaginary goods as actual goods (Menger stipulates the requirement of an objectively possible causal connection between the desired end and the potency of the resources), Mises’s suggested correction of Menger in fact lumps together imaginary goods with actual goods. Writes Mises:

“...the third prerequisite for a thing to become a good would have to read: the opinion of the economizing individuals that the thing is capable of satisfying their wants”\(^{33}\)

Mises goes on to recognize that “[t]his makes it possible to speak of a category of “imaginary” goods”, only to dismiss the distinction as “pointless”; reason being that imaginary goods are also sold for real prices in the marketplace.

Later authors in the Austrian tradition also seem to have rejected or at least brushed aside the category of imaginary goods. Joseph T. Salerno, for example, in Epistemological Problems of Economic Science (p. 185), calls the distinction “superfluous”. Further, George Reisman, though he acknowledges imaginary goods as a valid concept, states:

“it is not necessary, however, for economics to devote any special consideration to such goods beyond acknowledging the fact of their existence. This is both because they constitute unimportant exceptions and because the economic principles that apply to such goods, such as the laws of price determination, are the same as that apply to genuine goods”. George Reisman, Capitalism, (1996), p. 41.

We hold, however, that the distinction between true and imaginary goods is not pointless, but rather a vital one. First and foremost we suggest that the distinction between true and imaginary goods aligns exactly with the difference between fraudulent transactions on the one hand, and bona fide transactions on the other side; only actions in the category of fraud are intrinsically aimed at the creation of imaginary goods\(^{34}\).

Second, we hold that recognizing the existence of imaginary goods are crucial to understanding the workings of the business cycle (and with that, of understanding the Austrian Business Cycle Theory). Here is why: the fundamental explanation of why crises and recessions inevitably must take place following any fraudulent expansion of the money supply, lies exactly in the fact that credit expansion in the form of ex nihilo creation of fiduciary media essentially amounts to the generation of imaginary goods. Recognition of this fact leads

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\(^{30}\) Carl Menger, Principles of Economics, (Auburn, Ala.: Ludwig von Mises Institute, 2007), p. 53


\(^{32}\) “... an imaginary vision originates from sense; for the imagination is moved by sense to act.”

Thomas Aquinas, Summa Theologica, I, 12, art. 3.


\(^{34}\) Imaginary goods are an inevitable by-product of fraud. The intimate intertwining of both phenomena is illustrated by the origins of the word for deception in Germanic languages (‘bedrog’ in Dutch, ‘Betrug’ in German). These words are etymologically related to the on. drange (‘ghost’, cf. en. ‘dragon’, nl. ‘draak’), the os. gahun (‘apparition, illusion’), and the os. droga (‘damage’). Indeed, mala fide deception, and thus also fraud, deliberately brings about false impressions, ‘mental highs’, or, as we have called them above, imaginary goods, to work in the advantage of the deceiver/swindler, and at the cost of the victim.
to the insight that the bust phase of the crisis is simply the pop of an illusionary bubble and a return to reality.

And so we can conclude here, with the assertion that imaginary goods are a necessary effect, or a property, of fraud.

5. A Description of the Fraud Cycle

Now that we have established that fraud necessarily generates cycles, that fraud leads to injustice, and that fraud produces imaginary goods, let us now proceed to a more detailed description of the fraud cycle. As we will see in what follows, this cycle can be divided in three general phases: the first is the phase of deception, the second is the phase of revealing the deception, and the third is the phase of recovery. 35 Prior to the first phase, fraud, we find ourselves in an environment where good faith allows for trade and friendly relations: the convivial order.

Phase I: Fraud

The Swindler and the Ungenuine Trust

The violation of the convivial order by means of fraud begins when a person (we will further call him “the swindler”) decides to act in bad faith, thereby causing in the mind of another a distorted judgment of the potency of his means, in order to profit at the cost of this other person. And so the swindler abuses the goodwill of the other by representing something as true, knowing that it is not. He succeeds in getting the other man to enter in a trust with him, whereby he as trustee (or “fiduciary”) 36 commits himself to an act (or series of acts) that is regarded as beneficial in the eyes of the trustor, in return for one or more favors from the part of this trustor. The supposed benefits, falsely promised to the trustor, are what we can call imaginary goods. 37 The swindler is, namely, a trustee in bad faith: he does not intend (or will never be able) to fulfill his fiduciary duty and to meet the lawful claims of the trustor.

The swindler and his victim can now, as is common practice between trustor and trustee, decide to make up a trust agreement. This agreement serves as a fiduciary token, which makes explicit the existence of the trustee's fiduciary duty, and with that the relationship of trust between trustor and trustee. Such a fiduciary token can take many forms: it can be a written contract, a property title, a receipt of payment, or even a verbal agreement. Its essential characteristic is that it mediates between a trustor and a trustee. And so in the case of fraud, the fiduciary token confirms the swindler's promise and the claim of the victim; it confirms the title to a good that, given the malafide intentions of the swindler, is doomed to remain imaginary.

Inflationary boom, malinvestment and overconsumption

The fraud has now been committed, and the first phase of the fraud cycle is initiated. The supply of true goods (means) of the victim has been inflated by an additional supply of imaginary goods. 38

35 We use the same division as Hülsmann's: “Fundamentally, two stages can be distinguished. At the beginning of the first stage the error is committed. … The “crisis” marks the point in time where the error is discovered. Then begins the second stage, a phase of reestablished sobriety.” Guido Hülsmann, “Toward a General Theory of Error Cycles”, p. 8-9.

36 This would be a broad interpretation of fiduciary as it was used in Roman law. The Roman institution of the fiducia found its origins in the use of the pater familias (head of the family) to hand over the management of his family, domain, and possessions to a friend. See R.H. Maatman, Dutch Pension Funds (Nijmegen: Kluwer, 2004), p. 63.

37 These imaginary goods can take the shape of alleged future goods, promised but never actually given to the victim, or it can be actually received resources with properties different in quality or quantity than the goods the victim believes to have received.
goods. “Inflation” derives from the Latin verb *inflare*, from *in*—“into” + *flare*—“to blow”. The creation of imaginary goods indeed makes the total supply of goods seemingly swell, in the same way as that, when seen from a distance, a water balloon seems to contain ever more water, while in fact it is inflated with ever more air. Likewise, the “hot air” of the imaginary goods leads to a *seeming* but nonexistent expansion of the supply of true goods. This is why we consider the word “inflation” apt in this context, and call this phase the *inflationary boom.*

As long as the deceit lasts, the fraud victim finds himself in a “euphorical” state of mind, in that he imagines to possess more means than really is the case. Consequently, he will invest his means in different ways than otherwise would have been the case. These investment choices will later prove to be based on a mistaken estimation of available resources, which is why some, or many, will eventually have to be liquidated because there simply is not enough capital available for them. In short, fraud leads to *malinvestments*. A second implication of the misconceived supply of means is that, since the victim imagines to have command over means that are more potent than actually is the case, he will also ultimately consume more (and save less) than would have been the case in absence of the deceit. Another consequence of fraud is thus *overconsumption.*

**Phase II: Crisis**

The second phase of the fraud cycle, the *crisis*, is initiated at the point in time where the illusion has reached its maximum size (simply because it cannot get bigger after this): the moment where the fraud is revealed. Ludwig von Mises, in his description of the business cycle, used the term *Katastrophenhausse* to indicate this moment, and it illustrates the essence of this point in the cycle well: the sudden turn (catastrophe) following the rise (hausse). At some point in time the genie leaves the bottle, the “high” wears off and gives rise to the inevitable downturn. What provokes this downturn is the bursting of the illusion created by the swindler. The victim now realizes he has been fooled: the fiduciary tokens he received from the swindler no longer cover the flag or duty they embodied. Guido Hülsmann puts it this way:

> “The victim of fraudulent behavior is not aware of his situation and thus behaves as if everything was still in order. … he does not know that the quantity of his means has been diminished. Therefore, he will not adjust the structure of his property to the new circumstances. … People do not apprehend that the capital stock has been diminished by the embezzler and needs to be refilled through savings. Sooner or later they will discover this error. This is when the crisis sets in.”

The confrontation with the deceit makes the untenability of the situation obvious: the sum of the victim's means now turns out to be smaller than he thought it was (at any rate it can serve his intentions less well), and, consequently, this prohibits him from continuing on the same “investment path”. The swindler as well notices the change of climate and will have to change his strategy. This is what we can call the *crisis* (Gri. *krisis*: “conflict”, but also “decision”): the deciding moment, the “hour of truth”, has come, and the hidden conflict breaks loose. It is now clear that the trust that the victim had placed in the swindler was painfully misguided.

**Phase II: Correction, Depression, Recovery**

The inevitable loss in confidence seriously affects the value of the victim's fiduciary tokens; these have now appeared to consist largely, or completely, out of “hot air”. This causes the illusory bubble to deflate, and the inflationary boom reverses in a *deflationary correction.*

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38 In his *Human Action*, Mises warned against the use of popular terms such as “inflation” in academic (praxeological) discourse:

> The notions of inflation and deflation are not praxeological concepts. They were not created by economists, but by the mundane speech of the public and of politicians. … inflation and deflation are terms lacking the categorial precision required for praxeological, economic, and catallactic concepts. Their application is appropriate for history and politics. (*Human Action*, p. 419-420)

Nonetheless we think the terms of inflation and deflation, if properly defined, can prove useful in clarifying the the dynamics of both the “catallactic” business cycle as well as the more generic fraud cycle.


40 In the context of the fraud cycle, and understanding “law” as “order”, we agree with Philipp Bagus when he states that “deflation, in contrast to inflation, is not a “breach” of the law”, but rather, it is the restoration of
Hülsmann: “[t]he “crisis” marks the point in time when the error is discovered. Then begins the second stage, a phase of reestablished sobriety.” During this process, the fraud victim attempts to exchange the fiduciary tokens he possesses into true goods (‘flight into real goods’). However, since these are not covered by true goods, he will inevitably lose all or a large part of his original investments with the swindler.

The “ euphoria” of the inflationary boom has thus been replaced by a process of “ sobering up”; the victim of the fraud now assesses the means that are to his disposal in a more realistic way. This painful process, whereby misconceptions become manifest and the victim is confronted with the truth of the matter, is what we can call the depression. The restoration of his own sound judgment in the state of affairs is at the same time the beginning of the recovery process. This is the process whereby the victim readjusts his consumption and investment pattern in alignment with the actual means that are under his command. In this way, he frees himself from the disorder brought about by the lies of the swindler. When this process is finished, order is restored and the fraud cycle is brought to a close.

**Graphical Illustration of the Fraud Cycle**

Given all the problems involved with the visual and/or quantitative representation of theory in the field of axiological science, we suggest the graphical illustration below merely for educational purposes, in an attempt to give some oversight of how the simultaneous and successive phenomena involved in the fraud cycle coexist.

Fraudulent deception causes the generation and degeneration of imaginary goods over time. Hence the two axes of our graphical illustration of the fraud cycle: time (X) versus goods-character (Y). The X-axis is divided into three periods of time:

1. First comes the period of order, during which people are truthful and deal with each other in good faith. There is no deception, which means that each actor lives within his means, not claiming command over means that are not his. This absence of deception further implies that nobody is deceived into imagining certain goods to be present and available that in fact are not. During the phase of order, the actors in question still commit entrepreneurial errors, with the consequent appearance of imaginary goods, and the malinvestment and overconsumption following this. However we don’t consider these here, since we are dealing with the effects of fraud and not those of error in general.

2. Next is the first phase of the fraud cycle; the phase during which the actual fraud (in one or multiple acts) takes place. In the illustration there are three acts of fraud, marked by T1, T2, and T3. Every act of fraud causes a decrease in the availability of proper means (the illustration

the law”. Philippe Bagus, “Deflation: When Austrians Become Interventionists”, *The Quarterly Journal of Austrian Economics* vol. 6, no. 4 (Winter 2003), p. 25. Just as a restoration of order can only occur after a preceding phase of disorder, deflation, in the above sense of the word, can only occur after a foregoing phase of deflation.

does not consider accidental increases or decreases unrelated to the fraud), and an increase in the amount of deprived means. The actual losses suffered because of the fraud are covered up by a simultaneous creation of imaginary goods.\textsuperscript{42}

3. The second and third phase of the cycle are those of crisis and recovery. It starts when the fraud comes to light (crisis), and, as a consequence, the imaginary goods shrink rapidly in volume during a deflationary correction. This is also when the process of deprivation transforms into a readjustment or recovery process, consisting of a reallocation of the malinvested goods and an increase in savings (decrease in consumption). The fraud cycle ends when the damage or deprivation caused by the fraud has been undone.

Reformulating the general theory of the fraud cycle in specific terms.

In this section, we explain how the properties of the business cycle—the inflationary boom, overconsumption and malinvestment, the crisis, deflationary correction and depression—how all these properties are caused by the general phenomenon of the fraud cycle.

Phase I: Fraudulent creation of money titles

The Banker and the Resulting Trust

Bankers, at least traditionally, are entrepreneurs who operate in the market and who offer certain services to the people. More specifically, bankers are entrusted with money by their customers, and promise to handle this money in specific ways. There is thus a relationship of trust between bankers and their customers, in the context of which they enter into formal agreements with one another. When customers hand over money to their banker in the form of a loan or a deposit,\textsuperscript{43} the formal agreement involved is essentially a trust.\textsuperscript{44} In the case of a depositor-depositary relationship, the formal agreement in question is more specifically a resulting trust.\textsuperscript{45} In order to make the trust between them

\textsuperscript{42} The victim of the fraud considers these imaginary goods to be of higher value than the means he forsakes or allows to be manipulated, which is why we have made the volume of the figure representing the imaginary goods with a bigger volume than that of the figure representing the corresponding deprived means. The exact volumes are of course merely arbitrary.

\textsuperscript{43} For an elaborate discussion on the traditional legal nature of the loan contract and deposit contract, as well as for a detailed historical account of the separate use of these two contract in banking, see Jesús Huerta de Soto, Money, Bank Credit, and Economic Cycles, chapters 1 and 2. See also Jörg Guido Hülsmann, “Banks Cannot Create Money”, The Independent Review, v.V, n.1, Summer 2000, pp. 101–110.

\textsuperscript{44} “trust, n. 1. The right, enforceable solely in equity, to the beneficial enjoyment of property to which another person holds legal title; a property interest held by one person (the trustee) at the request of another (the settlor) for the benefit of a third party (the beneficiary). For a trust to be valid, it must involve specific property, reflect the settlor's intent, and be created for a lawful purpose.” (Black's Law Dictionary (7th ed. 1999), p. 1513).

\textsuperscript{45} “...a resulting trust arises whenever legal or equitable title to property is in one party's name, but that party, because he is a fiduciary or gave no value for the property, is under an obligation to return it to the original title owner, or to the person who did give value for it”.

and their customers formal and binding, bankers have traditionally formalized and made explicit their fiduciary duties by writing out money titles, which are essentially fiduciary tokens that confirm that a certain customer X is entitled to receive a certain amount of money from the banker, either at wish (deposit) or after an agreed upon period of time (loan).

Now if the banker writes out money titles in excess of the actual money he has in his own possession (i.e., money lent to or owned by him), he commits the crime of fraud, since he gives away something that does not belong to him, thus depriving the original owner from his property, while pretending that is not the case. The money titles that are not backed by actual money are what in the Austrian tradition is called “fiduciary media”. These fiduciary media make the people who receive and use them believe they own or control certain goods which they in fact do not: imaginary goods.

Inflationary boom, malinvestment and overconsumption

With the money supply thus inflated by fiduciary media, actors in the economy will proceed to consume more than they otherwise would have (overconsumption) and to invest in different places in the structure of production than they otherwise would have (malinvestment). From the general perspective of the fraud cycle, we can describe this phase, which is fueled by fraudulently created imaginary goods, as the inflationary boom. Of course, the inflationary boom cannot last forever. Ludwig von Mises explains why:

“… it is not possible to make the boom last forever because the boom is built upon paper, on banknotes and checkbook money. It is based on the assumption that there are more goods available than there really are.”

Phase II: Crisis

The imaginary good cannot remain undiscovered as such: one day the truth will come out. The inevitable crisis sets in when a certain threshold of people call upon their bank in order to have it meet its fiduciary duties. Often the initial reason for this is not a sudden loss of confidence in the banks (though it may), but rather the fact that the stock of real savings in the market place has been depleted to such an extent that it starts becoming apparent in rising prices of capital and consumer goods.

When it becomes clear how difficult it is for financial institutions to meet their obligations, people start becoming suspicious. Garet Garrett describes it vividly, referring to the crisis following a debasement of a gold standard based currency:

“Suddenly doubt, then coming awake and panic. The spirit of gold has been debased by senseless inflation. The faith is lost. All with one impulse rush to seize the gold itself, not only people as individuals; banks, also, and the great banking systems and governments do it, in competition with people. This is the financial crisis.”

The crisis is the moment of awakening and panic. The next phase of the business cycle sets in when people start acting on what they’ve discovered.

It is important to note that the institution of fractional reserve banking, whereby customers are falsely lead to believe they have immediate access to their demand deposits, is inherently injurious. It has been said that when fractional reserve banking is practiced “in moderation”, the detrimental effects will not be that great, nor will they become immediately apparent. However, this is no ground to justify the practice; stealing a thousand monetary units from a millionaire will also not likely produce great damage to the person, but that does not justify the institution of stealing. One could also hold that today’s bankers “know of no better”. That is to some extent true, fractional reserve banking is common practice and has been institutionalized to a great extent. However, that does not detract from the deceitful nature and harmful effects of this practice, as the current state of the economy tragically illustrates. A thief who “knows no better” is still a thief.

Note that hereby it does not matter essentially whether this happens in the form of writing out “circulation credit” (credit merely based on the trust in the bank, not directly covered by the bank’s assets) or in the form of mere embezzlement of deposits. One could imagine a bank (for example a central bank) that writes out circulation credit without any actual assets at all to cover it. This practice would set in motion a business cycle. On the other hand, one could also imagine a bank or financial institution (the investment firm of Bernard Madoff comes to mind) whereby lent or deposited money is systematically embezzled on a large scale. Also this would lead to malinvestment, overconsumption and the inevitable crisis and recession in the economy.

For a detailed discussion of the different phases of the business cycle, see Huerta de Soto’s Money, Bank Credit, and Economic Cycles, pp. 347-395.

Phase III: Deflationary Correction

In the panic of the crisis, consumers collectively call upon their banks to meet their financial obligations or fiduciary duties (bank run), which results in bank failures. These consumers will consequently change their consumption patterns, which leads to a painful readjustment of the structure of production during which capital goods are re-allocated from the stages far removed from consumption, towards the stages closer to consumption. The effect is widespread failures in the economy and temporary unemployment. In addition, a deflationary correction will take place in the form of a contraction of the (fiduciary) money supply. Translated in terms of the more general fraud cycle: an increasing amount of fraudulent practices are being uncovered, and as a consequence, a deflationary correction takes place which diminishes the supply of mala fide fiduciary tokens (fiduciary media) in circulation. This contraction of the money supply, in turn, is in fact how the deflationary correction of goods, a move from a supply fraudulently inflated by imaginary goods towards a supply ridden from these imaginary goods, becomes apparent in the economy. The recovery phase of the business cycle is set in motion when entrepreneurs, now empowered by a more realistic assessment of their means, start providing goods and services to meet the readjusted, more realistic demands of their fellow men.

The following table gives an overview of the most important properties of the fraud cycle and their corresponding, more specific, properties of the business cycle.

<table>
<thead>
<tr>
<th>Table 1: Comparison Fraud Cycle - Business Cycle</th>
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<tbody>
<tr>
<td><strong>General cause</strong></td>
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<td>Fraud</td>
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<td><strong>Actors</strong></td>
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<tr>
<td>Trustor and trustee</td>
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<tr>
<td><strong>Relationship</strong></td>
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<td>Trust</td>
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<tr>
<td><strong>Means</strong></td>
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<td>Fiduciary media</td>
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<td><strong>Cyclical effects</strong></td>
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<tr>
<td>Inflationary boom of imaginary goods, possibly accompanied by a boom in fiduciary tokens</td>
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<tr>
<td>Crisis: imaginary goods are seen as such.</td>
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<td>Deflationary correction: contraction of the money supply</td>
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<tr>
<td>Readjustment of consumption and saving pattern by the victims</td>
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<tr>
<td>The victim's saving and investment patterns returns to being more in line with the supply of real goods.</td>
</tr>
<tr>
<td>Order is restored (rectification): in so far as possible, damages are repaired and means return</td>
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The acceleration theorem

There is one more property of the business cycle we have not discussed as of yet. Here is the place to do so, because it is very much related to the fraud cycle. It is the property whereby, in order to sustain the inflationary boom and to postpone the crisis, ever more inflationary measures must be taken, leading to a accelerating spiral of inflation, which eventually ends in a much more severe crisis than otherwise would have been the case.

This process is what Garet Garrett calls the mechanism of “credit delusion”. Here is how he describes its fundamental weakness:

The fatal weakness of the scheme is that you cannot stop. When new creditors fail to present themselves faster than the old creditors demand to be paid off, the bubble bursts. 50

Indeed, the harmful effects of monetary inflation can only be postponed by more, and ever faster inflation. However, the bubble will inevitably burst at some point, as economic history has illustrated again and again. But why is this? What is the explanation for this acceleration theorem? Guido Hülsmann hints at the answer in his 1998 article “Towards a General Theory of Error Cycles”. He identifies fractional reserve bankers as embezzlers, and describes their main strategy for avoiding to get caught:

“Although an embezzler cannot avoid that the nature of his activities will sooner or later be detected, he can try to keep the show going for a while by extending the illusion on which his activity is based. This endeavor is central to the development of monetary institutions for the last three centuries.”

The reason why this extension of the embezzlement is necessary becomes clear when we recognize that fraud is really a lie, and that a lie can only be concealed by more lies. As anthropologist Donald Symons put it:

“The truth fits seamlessly into the world, and doesn’t require managing. Lies don’t, and constantly need superintending so that other supporting lies can be told …”

And also Balthasar Gracian:

“One deceit needs many others, and so the whole house is built in the air and must soon come to the ground.”

Now we have an explanation for the “extension” of fraud. But whence the acceleration? Why would ever larger fraud be needed in order to “keep the show going”? The explanation is quite simple: one needs to deceive in order to hide fraud; but then that deception is fraudulent in itself, 54 and so even more fraudulent deception is needed to hide this fraud. And so on indefinitely. And given that “all that is true must agree with itself in every way”, 55 the crisis is inevitable: one day the injustice, institutionalized though it may be, will reach a place that is so painfully in contradiction with the most self-evident truths and virtues that it will lead the victims of fraud to start questioning and holding responsible the persons who deceived them into the fraud.

53 Baltasar Gracian, Art of Worldly Wisdom, as translated by Joseph Jacobs (London: Macmillan and Co., Limited, 1892), p. 105. The original quote reads as follows:

“Un embeleco ha menester otros muchos, y assí toda la fábrica es quimera, y como se funda en el aire es preciso venir a tierra…”

54 Already the Romans knew this, hence their maxim “fraud est celare fraudem” (concealing fraud is an act of fraud).
And so we see that, since one deceit needs “many others”, the only action a swindler who wants to avoid the truth from surfacing (i.e., the crisis to hit) can resort to, is further deception.

Let us now look a little closer at the mechanics of this process: how can fraud be extended? A typical and first “new fraud” to hide the initial fraud is the creation of a fiduciary token that fools the victim into trusting the swindler more than he otherwise would have. Within the context of fractional reserve banking, we could name the option clause, the pooling of money reserves, deposit insurance schemes and the establishment of new institutions such as central banks as examples of how, in an attempt to hide the harmful consequences of fractional reserve banking, fraudulent behavior is extended into other areas.

In conclusion we can say that the acceleration theorem of the Austrian Business Cycle, according to which the inevitable crisis can only be delayed for a limited period of time by creating fiduciary media at an ever accelerating pace, is in fact a specific instance of a more general theorem that can be deduced from the theory of the Fraud Cycle, a theorem which can be formulated as follows: “the inevitable crisis can be temporarily, but never indefinitely, delayed by creating fiduciary tokens at an ever accelerating pace.”

The general explanation of the business cycle.

We have now seen that the business cycle is essentially a fraud cycle; it is a specific instance of the more simple, more general social phenomenon of fraud. And so when someone asks “What is it that essentially brings about the business cycle?”, we can answer “fraud”. If we want, we can add some descriptive flavor to it and say that “the business cycle is a fraud cycle that is pervasive and recurrent”. This is the general explanation.

6. Why is the Business Cycle a Recurring Phenomenon?

The business cycle as we know it today does not appear to be a unique, one of a kind sort of event. Rather, it is a phenomenon that regularly recurs. And this recurrence of the business cycle needs to be investigated separately from its cyclicality. As Ludwig van den Hauwe states:

An explanation of why, given a credit-driven or policy-induced boom, a subsequent bust is inevitable, that is, explaining what makes a boom unsustainable, is distinct from an explanation of why the recurrence of boom-bust cycles itself is-or is not- inevitable.

The reason why is that a cyclical phenomenon is by definition reproducible, but not by definition recurrent. If we want to understand the recurrence of the business cycle, we have to find a separate explanation of why this phenomenon is being, and has been, reproduced over and over again. In what went before, we have assumed that the business cycle is a complex social phenomenon, the effects of which can be understood by decomposing it into the simple social phenomena that necessarily precede it. And so there must then be one or more simple social phenomena that cause the specific difference of recurrence in that business cycle.

56 See also de Soto: “...the more banks merge and the larger their subsequent market share, the greater the possibility that the citizens who receive the bank’s fiduciary media will be their own customers.” Jesús Huerta de Soto, Money, Bank Credit, and Economic Cycles, pp. 203-204. This process is not sustainable, as is indicated by Hülsmann:

“However, one must not overlook that these effects are caused by the pooling of money, not by money pools as such. They are merely temporary. Pooling, therefore, cannot avoid bank runs forever. Because there are now greater facilities to provide liquidity the banks will expand their fiduciary credits, thus reducing the reserve ratio again. Only for the time needed for this expansion can the pooled stock of money suffice to help even the biggest banks out of liquidity problems.” Guido Hülsmann, “Free Banking and the Free Bankers”, The Review of Austrian Economics Vol 9, No. 1 (1996), p. 46.

57 For more on this, see Appendix II, “A Note on the Acceleration Theorem”.

58 As have argued previously in the text, cyclicality implies reproducibility, not recurrence.

Now given that the human will is free, we cannot postulate an indomitable external principle that compels people to act in ways that bring about business cycles; i.e., to commit fraud. This means the phenomenon we are looking for will have to influence the circumstances in which people make their choices, in such a way that they are then more likely to make certain choices over others. The social phenomena that establish these laws, practices or customs, are what we call institutions.

An institution can take many forms, but its main function is that it facilitates, encourages, or advances the occurrence of certain social phenomena. Now what does this mean in the case of fraud? How can fraud be encouraged by institutions? Well, given that fraud brings its own rewards, it really does not need much encouragement. Once certain well-respected declare this crime to be legitimate, then already its repetition is generally assured. In such a case, the fraud cycle is bound to recur over and over again. And the more fraud is legitimized, i.e., institutionalized, the more the fraud cycle will be seen to recur.

In the context of the business cycle, the institutional framework supporting the fiduciary tokens of the banks is composed of the central bank and the government. This is supported by historical evidence: in the sphere of money and banking, we have seen the official legitimation of fraudulent fiduciary tokens increase over the centuries, reaching a historic global height in the period stretching from the early 20th century to the present day. The first step has been to institutionalize (legalize) fraudulent fractional reserve banking, the second to establish central planning agencies with a monopoly on the mint, that actively (and literally) lends support to banks. And with this increase in institutionalization, we have indeed seen a parallel increase in the recurrence of the business cycle. The most noted crises have been the collapse of the Weimar Republic in Germany, the Great Depression of the 1930s, the Argentina hyperinflationary depression from 1975 onwards, and the current global economic crisis.

We can conclude that the explanation for why the business cycle is a recurrent phenomenon lies in the fact that its general cause, fraud, has been institutionalized. We can now push our general explanation a little closer towards a comprehensive definition by stating that “the business cycle is an institutionalized fraud cycle that is pervasive”.

7. **Why is the Business Cycle a Pervasive Phenomenon?**

After having explained why the business cycle is a cyclical phenomenon, and why it is also recurrent, all that rests us is to find good reasons why the business cycle is so very pervasive. Why is it, that economic crises and depressions snowball so effortlessly across geographical boundaries, throughout social strata, until they end up even devastating entire continents?

We know by now that the general cause of the business cycle is fraud, and so it must be that somehow, the fraud involved in the business cycle is of a kind that many people are likely to be contaminated by. Now, as we have seen, the way the swindler convinces his victim to enter into an exchange with him, is by means of fiduciary tokens, which symbolize an alleged relationship of trust between him (as trustor) and his victim (being the trustee). Whether the swinder succeeds in his attempted fraud depends on whether he manages to convince his victim to buy his fiduciary tokens. And so it follows that the more a particular kind of fiduciary token is desired in society, the more easily will it be bought and sold further. Now the most saleable good in any society, as we know, is money. If people can be made to believe they are buying from the swindler money, the generally

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60 As Murray Rothbard wrote:

“A Central bank attains its commanding position from its governmentally granted monopoly of the note issue. This is often the unsung key to [the] power [of the central bank] … an institution invested with the majestic aura of the government itself.” (quoted from his “What Has Government Done to Our Money?”)

And Mises agrees:

The governments alone are responsible for the spread of the superstitious awe with which the common man looks upon every bit of paper upon which the treasury or agencies which it controls have printed the magical words legal tender.

(quoted from his “Human Action”)

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accepted medium of exchange, then indeed the inflationary boom will be a pervasive one.\textsuperscript{61} This is also what Hoppe, Hülsmann and Block observe in their article “Against Fiduciary Media”:

"As in every other case of counterfeiting (forgery)—of stock and commodity certificates, banknotes, land titles, original art, etc.,—will physically diminish or despoil the original money—stock, commodity, land, or art—owner's propriety. But a counterfeiter of money is particularly dangerous and invasive because money's defining characteristic as the most easily saleable and widely acceptable of all goods; that is, because money-counterfeits open to their seller the widest possible range of objects for undue appropriation..."\textsuperscript{62}

Further, it is important to recognize the role banks play in this process. Banks are the places in the economy where money is being dealt with the most: they keep it safe, they borrow it, they lend it out. No actor in the economy deals more with money than the banker does. In this sense the banking system is really the monetary heart of society; it is the place where most of the money flows towards before it is pumped to those places in the economic body where it is needed (as ordered by its respective owners). It is clear that if monetary fraud were to take place right in that heart, that place through which the money flows so rapidly, that the total money supply would be corrupted faster than should the fraud occur in any other place in the economy. This becomes clear if we contrast the counterfeiting bankers with a hermit counterfeiter, who does not spend a penny of the bogus money he has produced—obviously, the effects of the hermit's counterfeit will not at all be widespread.

We can conclude that the reason why the business cycle has effects on a scale that surpasses those of any other sort of fraud, i.e., why it is so pervasive, is first, that it involves the fraudulent issuance the most saleable good in the economy—money—, and second, that this fraud is committed in the places where most money is pooled and through which money flows the most rapidly—the banks. Put briefly, the explanation for why the business cycle is such a pervasive phenomenon is that it is spawned in the sphere of money and banking.

8. \textbf{Conclusion}

\textbf{A Definition of the Business Cycle}

So then, we have now analyzed the main characteristics of the business cycle and traced them back to their causes. These are the conclusions reached so far:

\begin{itemize}
  \item There are three general characteristics of the business cycle under which all others can be subsumed: \textit{cyclicality}, \textit{recurrence}, and \textit{pervasiveness}.
  \item The general explanation of the business cycle is that it finds its origins in the simple social phenomenon of \textit{fraud}; the business cycle is in essence a fraud cycle.
  \item The explanation of the recurrence of the business cycle is that its general cause (fraud) is \textit{institutionalized}; the business cycle is an institutionalized fraud cycle.
  \item The explanation of the pervasiveness of the business cycle is that its general cause (fraud) is situated in the sphere of \textit{money and banking}; the business cycle is caused by fraud in the sphere of money and banking.
\end{itemize}

We suggest that the above are all the building blocks needed to construct a definition (genus + specific difference) of the business cycle. The definition we suggest runs thus:

\begin{quote}
The business cycle is an institutionalized fraud cycle in the sphere of money and banking
\end{quote}

\textsuperscript{61} In the counterfactual sense of the word: more pervasive than would have been the case if a less saleable good were to be used as fiduciary token. See Jörg Guido Hülsmann, “Facts and Counterfactuals in Economic Law”, \textit{Journal of Libertarian Studies} vol. 17, no. 1 (Winter 2003), pp. 57-102.

Based on this definition, a succinct specific explanation of the business cycle would be that the business cycle is caused by institutionalized fraud in the sphere of money and banking. This concludes our attempt to define the business cycle.

Some concluding thoughts

It is now clear that the phenomenon of the business cycle finds its origins in a simple act of injustice: fraud. Indeed, it is fraud that causes unwise speculation and widespread malinvestments; fraud that brings about the poverty, disillusion and despair we all associate with economic crises.

In a process spanning many generations, this fraud in the sphere of money and banking has become thoroughly institutionalized: in virtually every nation in the world, fractional reserve banking has over time been declared legitimate. When in times of economic hardship or social unrest it became clear that fractional reserve banks were in fact not solvent at all, central banks were established to ease this problem by means of money certificates (fiduciary tokens) produced out of thin air. In this way, the existing fraud was extended further. But over time, this alleged solution also proved problematic: in some countries, people started noticing how much new money was put into circulation every year and how this lowered the purchasing power of their savings. In answer, they decided to sell their bank notes, which lead to even more devaluation, until at some point it became clear that hardly anyone trusted the currency and the central bank that issued it. This was the scenario of hyperinflation. The logical reaction from the part of the people profiting of the counterfeiting scheme was, predictably, a further extension of the fraud: central banks would make agreements to inflate in concert, and more trusted fiat currencies and institutions were used to inflate the confidence in less trusted fiat currencies and institutions. This lead to the establishment of international monetary institutions such as the International Monetary Fund and the World Bank, and to central bank unifications, such as for example what happened in Europe with the replacement of the national central banks by one European Central Bank. This is the acceleration theorem at work: the only way to keep the show going is to extend the existing fraud at an ever faster pace.

In the future, this trend will continue: the political and monetary forces of the world, deeply invested in keeping afloat a fraudulent system the collapse of which would wipe out large monetary profits, destroy the reputation of the ruling class (trustees), and crush the support of voters and depositors (trustors), will attempt to push expansion and centralization to their limits. We can expect attempts to further inflate existing bubbles, and to reflate bubbles that have already collapsed. We can expect the establishment of new governing and monetary institutions with expensive names and lofty mission statements, institutions that are in fact nothing more than new clothes for naked emperors.

Eventually however, the current crisis will gain momentum and a real deflationary correction will set in. That will be the long journey towards a world that is rooted in reality, with the chance to build sound monetary institutions such as full reserve banks and honest money. So what can be done to contribute to this process? We don't have the final answer to this question. However, the moral origins of the business cycle suggest that its eradication will also have to be a moral quest. Fraud, i.e., deceit leading to injustice, can only be conquered if replaced by its opposite: honesty and truthfulness, which leads to justice. And so we believe that ridding the world of the heinous business cycle is only possible as part of a larger project, that of strengthening and restoring the just society by condemning deceit, trickery and false appearances, by standing for truth and integrity, and by engendering genuine trust in relationships with others.