

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

Resumen: El objetivo de este artículo es definir apropiadamente el fenómeno económico del ciclo económico. El resto está enraizado en la tradición de la Escuela Austriaca de Economía, y el marco metodológico parte de los conceptos desarrollados por Aristóteles y Tomás de Aquino. Esto conduce al desarrollo de algunos conceptos metodológicos nuevos, tales como la reinterpretación de la «inflación» y la «deflación», y la reintroducción de los «bienes imaginarios» como un fenómeno social importante. La observación central de este artículo es que el ciclo económico es de hecho una subclase de otro tipo de ciclo, el «ciclo del fraude». Nuestra conclusión es que para producir un ciclo económico, la existencia de un fraude institucional en la esfera del dinero y la banca es una condición necesaria y suficiente. El Apéndice I refuta el contra-argumento de que una banca honesta también puede producir ciclos económicos. Creemos que este artículo es significativo por dos motivos: 1) ofrece una receta clara para la eliminación del ciclo económico; y 2) ayuda a expandir el ámbito de la Escuela Austriaca más allá del campo de la Economía hacia los campos del Derecho y la Moralidad.

Palabras clave: Ciclo económico, ciclo del fraude, Escuela Austriaca, dinero y banca.

Clasificación JEL: B53, B49, D01, K13.

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Abstract: The goal of this article is to properly define the economic phenomenon of the business cycle. The text is rooted in the tradition of the Austrian School of Economics, and the methodological framework builds on concepts developed by Aristotle and Thomas Aquinas. This leads to the development of a few new methodological concepts, such as a re-interpretation of «inflation» and «deflation», and the re-introduction of «imaginary goods» as an important social phenomenon. The core observation of the article is that the business cycle is in fact a subclass of another kind of cycle, the «fraud cycle». Our conclusion is that in order to produce a business cycle, the occurrence of institutional fraud in the sphere of money and banking are both necessary and sufficient. The counter-argument that honest banking can also produce business cycles is refuted in Appendix I. We believe this article is significant in two ways: 1) it provides an unambiguous recipe for the long term extermination of the business cycle; and 2) it helps expand the scope of the Austrian School beyond economics into fields of law and morality.

Key words: Business Cycle, Fraud Cycle, Austrian School, money and banking.

JEL Classification: B53, B49, D01, K13.

I 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, and 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 (cyclicity, pervasiveness, recurrence), and by identifying a different social phenomenon at the root of each of these three, we have 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.

II 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.

1. 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». ¹ It is the intention, and the intention only, which initially motivates human choices, and everything that follows from it.

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

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?

Well, I suggest we still can. Though the ultimate intention is indeed the «prime mover», that what gives sense to social phenomena, the aspect of my actions that imparts actual sense (or direction) onto the world are in fact *the 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. 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.

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,

¹ «Intersubjectivity, Subjectivism, Social Sciences, and the Austrian School of Economics», *Journal of Markets & Morality*, Vol. 10, N.º 1 (Spring 2007), p. 118.

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,² 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; those things for which we can hold each other responsible, are not intentions, but rather the actual choices that we make.

Social phenomena can be very complex, as for example the business cycle is. Every boom-bust cycle in history 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 simply describing the combined appearance of a few simple physical principles. So why couldn't we be able to come up with an explanation 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.»³ (italics are our own)

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 explanation for complex social phenomena.

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

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 is besides the point.

³ Ludwig von Mises, *Human Action* (Fox & Wilkes: San Francisco, 1996), p. 42.

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. As Thomas Aquinas said, «we must receive knowledge of the simple from the composite and arrive at what is prior from what is posterior».⁴

2. 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.

a) *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, he 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, but why? 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

⁴ Thomas Aquinas, *Concerning Being and Essence*, George G. Leckie, trans. (Appleton-Century Comp. Inc.: New York & London, 2007), p. 4.

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, 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: this description could just as well be that of a bribe, or of 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.

b) The general explanation

Many things can be said about social phenomena. Of a particular coin for example, we can say that it consists 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* 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.

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 «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.⁵

c) *The definition*

Despite the great value it obviously possesses, the general explanation often fails at explaining why a specific phenomenon

⁵ One could argue that the choices of individuals can also in themselves often be explained, for example by unconscious processes that are at play. However, this would lead us into the field of psychology, which revolves around the question why people tend to make certain decisions, and away from the field of praxeology, which concentrates on the question what the consequences are of the fact that people make certain decisions.

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

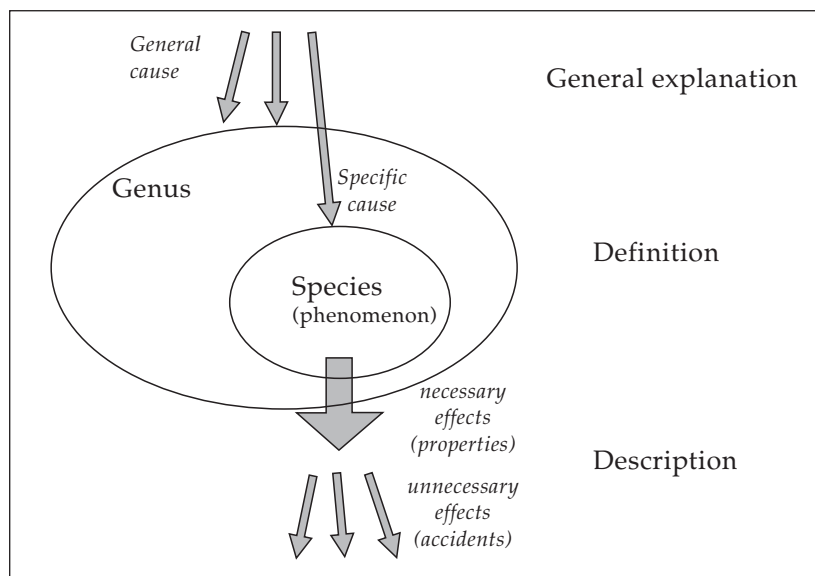
In this way we can define a phenomenon by dividing it into, on the one hand, its genus, which is the «from what», or the «kind» it belongs to; and, on the other hand, in its specific differences, which refer to «how» the phenomenon exists, to what makes it different from other phenomena belonging to 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 it up and find an even more general genus? And then divide that genus up? And so on indefinitely? The reason why we stop at this point is that in the social/praxeological 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.

d) *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.

(i) *What does this mean for our investigation of the business cycle?*

With the above, I think 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 will 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 will 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'll combine the simple social phenomena that have been identified as causes of the business cycle into our definition.

III 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 necessarily 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».⁶

⁶ Another reason why, despite its apparent dullness and superficiality, it is useful to mention this description of the business cycle, is that it seems to reveal already what the business cycle is *not*: the business cycle does not seem to be «a cyclical and recurrent pervasiveness», nor would we call it «a pervasive and cyclical recurrence». This may be some indication already that «cycle» is in fact what the general part of the definition will refer to, and that «recurrence» and «pervasiveness» will be rather

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 cyclicity 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.

IV WHY IS THE BUSINESS CYCLE A CYCLICAL PHENOMENON?

Here, we address the *cyclicity* 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 succinct 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.⁷

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

what is referred to by the specific difference in the definition, in the same way as that in «selling cars», «selling» is the genus and «cars» the specific difference. But later more about this.

⁷ Murray N. Rothbard, *Man, Economy, and State with Power and Market*, p. 852.

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?»⁸

Professor 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.»⁹

So how do we explain the occurrence of these malinvestments?¹⁰ Huerta de Soto, as most Austrian economists from Mises onwards, points at the practice of credit expansion:

⁸ Ibid, pp. 852-53.

⁹ Huerta de Soto, *Money, Bank Credit, and Economic Cycles*, p. 375. Italics in original.

¹⁰ On why it is preferable to use the term «malinvestments» instead of «over-investments», see Steven Horwitz, *Microfoundations and Macroeconomics, an Austrian Perspective*, (London & New York, Routledge, 2003), p. 62.

«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 were 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 (...).»¹¹

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.»¹²

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.¹³ Ludwig von Mises describes the role of fiduciary media (the money substitutes bank credit expansion produces) as follows in his work *Human Action*:

¹¹ Huerta de Soto, *Money, Bank Credit, and Economic Cycles*, pp. 348-51.

¹² *Ibid.*, pp. 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).

«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.»¹⁴

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.»¹⁵

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; and 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 any kind of fiduciary media somehow cause entrepreneurial errors, it seems only logical to assume that it must be *deceptive* fiduciary media that do 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?¹⁶ Let us for example consider

¹⁴ Ludwig von Mises, *Human Action* (Fox & Wilkes: San Francisco, 1996), p. 442.

¹⁵ Ludwig von Mises, *Human Action*, p. 430 of the scholar's edition

¹⁶ As write Selgin and White:

«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, n.º 2: 83-107, pp. 86-87

the case where the banker agrees —ideally, from the outset— with all the owners 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.¹⁷ 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:¹⁸ the clients of a banker who practices honest fractional reserve banking will be *aware* that they are gambling, in the same manner 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 safekept under the good care of another person. Hence, honest fractional reserve banking, by its very nature, cannot produce malinvestments. In other words, fiduciary media that don't deceive do 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 a person or institution 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

¹⁷ See Appendix 1: «On whether honest banking can cause business cycles».

¹⁸ See Appendix 1: «Can honest fractional reserve banking cause business cycles?».

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 leads to crisis, conflict, and social chaos. Do we know of such a phenomenon? Yes, we do: deception leading to crisis, conflict, and social chaos, or in other words, leading to injustice, is what is called *fraud*.¹⁹ 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.

1. 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 as general properties and specific properties of the same phenomenon. In this way, 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'll conduct our investigation: first, we will 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'll 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'll reformulate this theory of the fraud cycle in specific terms, whereby we'll explain how the specific properties of the business cycle —inflationary boom, overconsumption and malinvestment, crisis, deflationary

¹⁹ In the present paper, we define fraud in brief as being «deliberate deception 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*.

correction and depression— relate back to fraud and the fraud cycle.

a) On whether fraud generates cycles

A cycle is a causal chain of events that is repeated or repeatable (the word derives from Greek *kyklos*, circle). It seems that there are two ways in which phenomena can be called cyclical. A first is a logico-sequential cyclicity, a second is cyclicity through time. The logico-sequential cyclicity is a property that all phenomena share: they move from non-existence, over appearance, towards disappearance. In this sense, every individual phenomenon is cyclical in nature. A second way in which a phenomenon may be called cyclical is when the circular sequence of properties of the phenomenon is not only sequential, but also temporal, i.e., stretched out in time. The phenomenon of fraud can be marked as also being cyclical in this second sense. The reason why is that the time element is inherent to 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.

Let us say this in conclusion: since the cyclical effects are a direct and inevitable consequence from a (naturally inherent) property of fraud—namely the fact that its sequence of appearance is stretched out in time—we can say that fraud is not sometimes, but *always and inherently* cyclical in nature. In other words, cyclicity is a property of fraud.

b) On how fraud causes injustice

Fraud is deceit causing injustice. Injustice is the breach of justice, with the latter being, traditionally, the domain in which man acts responsibly, only claims what is his to claim, and where he lives peacefully within his means. 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.²⁰

Now, in order to study the appearance of the fraud cycle, we have to consider the state of affairs in which fraud is *not* present, after which we can study its appearance, its effects, and its disappearance. Given that the essential nature of fraud is injustice (because fraud is aimed at injustice²¹) we depart from a situation where injustice is absent. «*Fraus et jus numquam cohabitant*», as the Latin dictum goes; where there is justice, there is no fraud, and vice versa. Our starting point is thus an orderly state of affairs, which we can call the convivial order²² or natural order. It is a situation in which people live next to one another and respect each other as natural, i.e., reasonable, persons; a situation where

²⁰ 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 writes,

«... 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?»).

²¹ 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 Economía Política», *Revista Libertas* 40 (May 2004), p. 37.

²² On the concept of the convivial order, see the work of Frank van Dun. In his «Concepts of Order» (2006, p. 23), 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.»

each person lives within his own means and where a basic level of trust is cultivated; *bona fides*, *good faith*, or *goodwill*. This means that in their daily dealings, people 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 trust that exists in the convivial society is expressed in trusting relationships between

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 Theologiae*, II-II, 109, art. 3). Toon van Houdt’s comment, describing 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.

²⁴ Frank van Dun, «Concepts of Order», 2006. Cited with the author’s permission.

²⁵ See Tuomela, M., 2003, «A Collective’s Rational Trust in a Collective’s Action», *Understanding the Social II: Philosophy of Sociality, Protosociology 18-19*: 87-126.

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.²⁶ 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*.

c) *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,²⁷ 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»,²⁸ but do not actually: *imaginary goods*. We here use this term in line with Carl Menger's definition: «things

²⁶ Maj Tuomela has done interesting work on trust. See for example his «Rational Social Normative Trust as Rational Genuine Trust», published in *Philosophy and Ethics: New Research*, Laura V. Siegal ed., (New York: Nova Science Publishers, 2006).

²⁷ One could remark here that the word for deception in Germanic languages («bedrog» in Dutch, «Betrug» in German), is related to the on. *draugr* («ghost»), the os. *gidrog* («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.

²⁸ Mises, *Human Action*, p. 93.

that are incapable of being placed in any kind of causal connection with the satisfaction of human needs [that] are nevertheless treated by men as goods».

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 described as determining the goods-character of things, but do so only in the opinions of people.»²⁹

Menger errs, as has been pointed out by Mises,³⁰ 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,³¹ 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

²⁹ Carl Menger, *Principles of Economics*, (Auburn, Ala.: Ludwig von Mises Institute, 2007), p. 53

³⁰ See Mises' 1928 article, translated as «Remarks on the fundamental Problem of the Subjective Theory of Value», in *Austrian Economics: An Anthology*, (Irvington-on-Hudson: Foundation for Economic Education, 1996) ed. Bettina Bien Greaves, p.119-36.

³¹ «. . . an imaginary vision originates from sense; for the imagination is moved by sense to act.»

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

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.»³²

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.³³

³² Mises, «Remarks on the fundamental Problem of the Subjective Theory of Value» (published in *Austrian Economics: An Anthology*, Irvington-on-Hudson: Foundation for Economic Education, 1996; ed. Bettina Bien Greaves, pp. 119-36). Italics in original.

³³ Imaginary goods are an inevitable by-product of fraud. The intimate intertwinement of both phenomena is illustrated by the origins of the word for deception

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 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.

V

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 two general phases: the first is the phase of deception, and the second is the phase of recovery.³⁴ Prior to the first phase, fraud, we find ourselves in an environment where good faith allows for trade and friendly relations: the convivial order.

in Germanic languages («bedrog» in Dutch, «Betrug» in German). These words are etymologically related to the on. *draugr* («ghost», cf. en. «dragon», nl. «draak»), the os. *gidrog* («apparition, illusion»), and the oi. *drogha* («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.

³⁴ 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», pp. 8-9.

1. Phase I: Fraud

a) *The Swindler and the Ungenuine Trust*

The violation of the convivial order by means of fraud begins when a person (we will further refer to him as «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 gain to the detriment of this other person. 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»³⁵) 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 favours from the part of this trustor. The supposed benefits, falsely promised to the trustor, are what we can call imaginary goods.³⁶ 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

³⁵ 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.

³⁶ 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.

title to a good that, given the malafide intentions of the swindler, is doomed to remain imaginary.

The strategical tricks of his fraudulent business partner lead the victim-to-be to the belief that there is a possibility to a genuine trust; a just and mutually beneficial relationship. However, he is mistaken. The trustee who acts in bad faith is now vested with the goods and the trust of his victim, while the fiduciary tokens that are handed over to the latter are empty shells: their title covers less than what should be reasonably expected under the given circumstances.

b) 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. «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*.³⁷

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

³⁷ 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.

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*.

2. 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.»³⁸

³⁸ Guido Hülsmann, «Toward a General Theory of Error Cycles», p. 12.

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.

3. Phase III: 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*.³⁹ In the words of Hülsmann: «[t]he «crisis» marks the point of time when the error is discovered. Then begins the second stage, a phase of reestablished sobriety.»⁴⁰ 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

³⁹ 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 the law». Philippe Bagus, «Deflation: When Austrians Become Interventionists», *The Quarterly Journal of Austrian Economics* vol. 6, n.º 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.

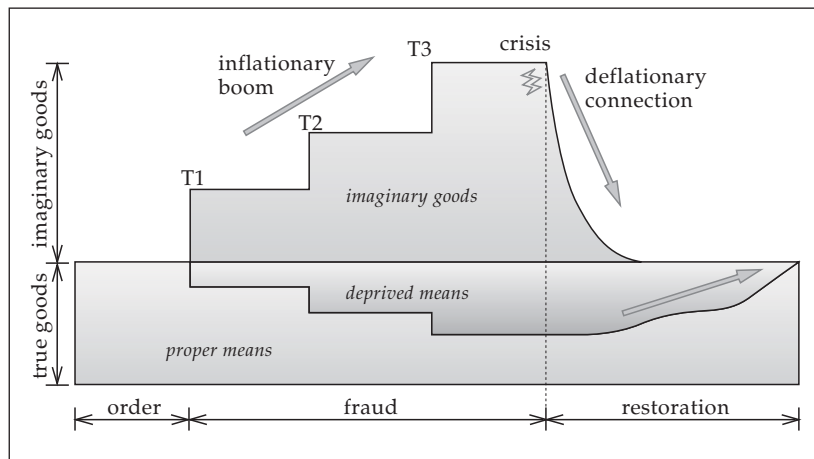
⁴⁰ Guido Hülsmann, «Towards a General Theory of Error Cycles», p. 9.

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.

4. 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 do not 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 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.⁴¹
3. The second and last phase of the cycle is that of the *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.

⁴¹ 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.

5. 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.

6. Phase I: Fraudulent creation of money titles

a) *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,⁴² the formal agreement involved is essentially a *trust*.⁴³ In the case of a depositor-depository relationship, the formal agreement in question is more specifically a *resulting trust*.⁴⁴ In order to make the trust between them and

⁴² 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.

⁴³ «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).

⁴⁴ «... 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

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.⁴⁵ 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.⁴⁶

property, is under an obligation to return it to the original title owner, or to the person who *did* give value for it».

Donovan Waters, «Law of Trusts in Canada», 2.^e ed. (Toronto: Carswell, 1984), p. 300., as quoted in Robert Chambers, *Resulting Trusts* (Oxford University Press: New York, 1984), p. 1. Chambers further quotes the essential characteristic of the resulting trust as being «the person in whose favour the trust arises is the person who provided the property or equitable interest vested in the person bound by the trust»; quoting *ibid.*, p. 302. On the history of the legal institution of the resulting trust, see chapter 14 «Unjust Enrichment» of David J. Ibbetson, *A Historical Introduction to the Law of Obligations*, (New York: Oxford University Press, 1999), pp. 264-284, esp. p. 267.

⁴⁵ 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.

⁴⁶ 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,

b) 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.»

7. Phase II: Crisis

The imaginary good cannot remain undiscovered as such: one day the truth will be revealed. 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.⁴⁷

When it becomes clear how difficult it is for financial institutions to meet their obligations, people start becoming suspicious.

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.

⁴⁷ 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.

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 people rush to seize the gold itself as the only reality left—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.»⁴⁸

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 have discovered.

8. 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

⁴⁸ Garet Garrett, *A Bubble That Broke the World*, (Boston: Little, Brown, and Company, 1932), p. 124.

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 1
COMPARISON FRAUD CYCLE - BUSINESS CYCLE

	<i>Fraud Cycle</i>	<i>Business Cycle</i>
Essential cause	Fraud.	Fraudulent creation of money titles (fractional reserve banking).
Actors	Trustor and trustee.	Depositor and depositary.
Relationship	Trust.	Resulting trust.
Means	Mala fide fiduciary tokens.	Fiduciary media.
Cyclical effects	Inflationary boom of imaginary goods, possibly accompanied by a boom in fiduciary tokens.	Inflationary boom of fiduciary goods, accompanied by a boom in fiduciary media.
	Deflationary correction: imaginary goods are seen as such, mala fide fiduciary tokens become valueless.	Deflationary correction: fiduciary media are seen as such, contraction of the money supply.
	Readjustment of consumption and saving pattern by the victims.	Readjustment of the structure of production, by a shift in demand from the part of the consumers.
	The victim's saving and investment patterns returns to being more in line with the supply of real goods.	Restoration of the structure of production, in line with the real goods present in the marketplace.
	Order is restored (rectification): in so far as possible, damages are repaired and means return to their rightful owners—people live within their means again.	Order is restored (rectification): the assets of the bankrupt banks are returned to their rightful owners; banks stop writing out fiduciary media, and become full reserve banks.

9. 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 an accelerating spiral of inflation, which eventually ends in a much more severe crisis than otherwise would have been the case.

This process is what Garett 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.⁴⁹

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.»⁵⁰

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:

⁴⁹ Garett Garrett, *The Bubble that Broke the World*, (Boston: Little, Brown, and Company, 1932), p. 29.

⁵⁰ Guido Hülsmann, «Toward a General Theory of Error Cycles», p. 18.

«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 ... »⁵¹

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.»⁵²

Now we have an explanation for the «extension» of fraud. But whence the acceleration? Why would *ever more* 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,⁵³ 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»,⁵⁴ 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 obvious 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.

And so we see that, since 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

⁵¹ Quote from Paul R. Ehrlich, *Human Natures: Genes, Cultures, and the Human Prospect* (Washington: Island Press, 2000), footnote 168, p. 390 (Symons, personal communication, 25 January 1999)

⁵² 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 así toda la fábrica es quimera, y como se funda en el aire es preciso venir a tierra ...»

⁵³ Already the Romans knew this, hence their maxim «fraud est celare fraudem» (concealing fraud is an act of fraud).

⁵⁴ Aristotle, *Prior Analytics*, chap. 32 (Oxford: Oxford University Press, 2009), p. 52.

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 a vain attempt to escape the harmful consequences of fractional reserve banking,⁵⁵ 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.»

10. 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 leads to 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.

⁵⁵ See also Huerta 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, N.º 1 (1996), p. 46.

VI
WHY IS THE BUSINESS CYCLE
A RECURRENT 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.⁵⁶ And this recurrence of the business cycle needs to be investigated separately from its cyclicity. 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.

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 production of

⁵⁶ As have argued previously in the text, cyclicity implies reproducibility, not recurrence.

certain social phenomena. Now what does this mean in the case of fraud? Well, given that fraud brings its own rewards, once this crime is declared to be legitimate by certain well-respected institutions, its repetition is already generally assured. Once this is the case, the fraud cycle is bound to recur over and over again. 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.⁵⁷ 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 crisis 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

⁵⁷ 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*)

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».

VII 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 infecting 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 swindler 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 all know, is *money*. If people can be made to believe they are buying from the swindler money, the generally accepted medium of exchange, then indeed will the inflationary boom be a pervasive one.⁵⁸ This is also what Hoppe, Hülsmann and Block observe in their article «Against Fiduciary Media»:

⁵⁸ 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», *Journal of Libertarian Studies* vol. 17, n.º 1 (Winter 2003), pp. 57-102.

«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 property. 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... .»⁵⁹

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 bankers do. 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 in any other place in the economy. This becomes clear if we imagine, on the other hand, a counterfeiter who does not spend a penny of the bogus money he has produced—obviously, the effects of his counterfeit then 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.*

⁵⁹ Hans Hermann Hoppe, with Jörg Guido Hülsmann and Walter Block, «Against Fiduciary Media», *Quarterly Journal of Austrian Economics*, vol. 1, n.º 1 (1998), p. 33.

VIII CONCLUSION

1. 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:

- There are three general characteristics of the business cycle under which all others can be subsumed: *cyclicity*, *recurrence*, and *pervasiveness*.⁶⁰
- The general explanation of the business cycle is that it finds its origins in the simple social phenomenon of *fraud*; the business cycle is in essence a fraud cycle.
- The explanation of the recurrence of the business cycle is that its general cause (fraud) is *institutionalized*; the business cycle is an institutionalized fraud cycle.
- The explanation of the pervasiveness of the business cycle is that its general cause (fraud) is situated in the sphere of *money and banking*; the business cycle is caused by fraud in the sphere of money and banking.

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:

The business cycle is an institutionalized fraud cycle in the sphere of money and banking

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.

⁶⁰ Whereby cyclicity refers to the genus of the business cycle, and recurrence and pervasiveness refer to its specific differences.

2. 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 response, 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 led to central bank mergers, and to the establishment of international monetary institutions such as the Bank for International Settlements, the International Monetary Fund and the Financial Stability Board. What we see here 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, we can expect that 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 and continued support of the electorate, 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 ever more naked emperors.

So how can the reader help change things for the better? We do not 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 personally standing for truth and integrity, and by engendering genuine trust in relationships with others.

APPENDIX I:
ON WHETHER HONEST BANKING
CAUSES BUSINESS CYCLES
WHERE WE REPLY TO THE CONTENTION
THAT «HONEST BANKING DOES ALSO
CAUSE BUSINESS CYCLES.
HENCE, THE IDEA THAT FRAUD LIES AT THE ROOT
OF THE BUSINESS CYCLE IS INVALID.»

Imaginary wealth is exchanged for real wealth;
and the real wealth is consumed by those
who have produced nothing in place of it.

GARET GARRETT

I
INTRODUCTION

The critic who believes also honest banking can cause business cycles would have good reason to use this as an argument against our present thesis; in order to confidently state that fraud is the general cause of *all* business cycles, it must be clear that *only* fraudulent practices, and never bona fide practices, can cause business cycles. We therefore invite the reader to join us in investigating the case in which all parties that are involved with the financial activities of a certain fractional reserve bank are perfectly aware of what happens with the money that is entrusted to that bank, i.e., the case of honest fractional reserve banking.

There are a number of theorists who have already analyzed this possibility. In a 1996 article, Walter Block and Kenneth M. Garschina, discuss the argument that fractional reserve banking can be practiced in an honest fashion. They acknowledge that this is logically possible, but hold that it is nonetheless «implausible».⁶¹

⁶¹ Walter Block and Kenneth M. Garschina, «Hayek, Business Cycles and Fractional Banking: Continuing the De-Homogenization Process», published in *The Review*

Next, Guido Hülsmann discusses the possibility of honest fractional reserve banking in his 2000 article, «Banks Cannot Create Money».⁶² He similarly concludes that the practice is possible, and admissible (since «no law should suppress any foolish activity just because it is foolish»), but nonetheless «would lead a fringe existence in a truly free economy». Jesús Huerta de Soto (1998), as we understand him, holds that «honest» fractional reserve banking can not be justified at all, because even the use of an option clause will never prevent third parties from being affected by the harmful effects of fractional reserve banking.⁶³ Huerta de Soto's argument

of *Austrian Economics* 9 (1)(1996): 77-94. Block and Garshina use the example of the «fractional reserve parking lot», whereby the owner of the parking lot (analogous to the banker working with fractional reserves) does not sell the right to a parking lot, but rather the chance to find a free parking lot where one can park his car; a «lottery ticket for money». In the words of the authors:

«If the «fractional reserve parking lot» were to be an accurate analogy to monetary practice, instead of being called a «demand» deposit, it should be called «purchasing a lottery ticket for money» or some such. Further, in every other way—publicity, explicit contracts, etc.—banking procedures would have to be brought into line with parking lot practice. Then, and only then, could the charge of fraud be dropped. Under such conditions there would still be the empirical question of whether or not anyone would purchase a «lottery ticket money deposit».

In a later article by Walter Block and William Barnett II, where the authors discuss the possibility of the honest fractional reserve bank at length, the notes issued by honest fractional reserve banks are called «play money», and «monopoly money». See «In Defense of Fiduciary Media—A Comment; or, What's Wrong with «Clown» or Play Money?», *The Quarterly Journal of Austrian Economics* Vol. 8, N.º 2 (Summer 2005): 55-69.

⁶² Jörg Guido Hülsmann, «Banks Cannot Create Money», *The Independent Review*, v.V, n.1, Summer 2000, ISSN 1086-1653, pp. 101-110.

⁶³ «However, even if a «safeguard» clause were introduced and participants (bankers and their customers) were fully aware of it, to the extent that these individuals and all other economic agents subjectively considered demand deposits and notes to be perfect money substitutes, the clause referred to would only be capable of preventing the immediate suspension of payments or failure of banks in the event of a bank run. It would not prevent all of the recurrent processes of expansion, crisis and recession which are typical of fractional-reserve banking, seriously harm third parties and disrupt the public order. (It does not matter which «option clauses» are included in contracts, if the general public considers the above instruments to be perfect money substitutes.) Hence, at most, option clauses can protect banks, but not society nor the economic system, from successive stages of credit expansion, boom

is fairly short, and it is hard to figure out whether his analysis is to be considered in a context of centralized planning of money production (legal tender, central bank) or rather in the context of free and decentralized coinage. Still and all, to us it seems only fair not to assume failure, but to grant our adversaries in this issue an fair chance by assuming that the honest businessman who believes in fractional reserve banking can actually find a contract that is indeed harmless both to his contracting clients as well as to third parties. It is with this assumption in mind that we begin our investigation into the nature of such a contract. Once we have more clarity on what that contract entails, we can investigate what the economical effects of its implementation could be (i.e., whether it can cause business cycles).

II REPLY TO THE OBJECTION

For the purpose of clarity, let us restate the objection: «Honest banking does also cause business cycles. Hence, the idea that fraud lies at the root of the business cycle is invalid.»

On the contrary, we hold that truly honest banking can never lead to business cycles. Fractional reserve banking differs from 100 percent reserve banking by the fact that the fractional reserve banker does not safekeep a part of the money that has been entrusted to him, but goes on to use it as if it is his own: speculating, writing out loans, etc. As a consequence, the bank in question cannot at all times repay the agreed upon sum to its customers. The customer of the honest fractional reserve bank is aware of

and recession.» Jesús Huerta de Soto, *Money, Bank Credit, and Economic Cycles* (Auburn, Ala.: Ludwig von Mises Institute, 2006), p. 163.

He reiterates his position in chapter 8 of the same work:

«For even an agreement found satisfactory by both parties is invalid if it represents a misuse of law or harms third parties and therefore disrupts the public order. This applies to monetary bank deposits which are held with a fractional reserve and in which, contrary to the norm, both parties are fully aware of the true legal nature and implications of the agreement.» (Ibid., p. 711-12).

this. This means that the client's entitlement to immediate availability can not be part of the contract between the banker and the client. In other words, the fractional reserve banking contract *cannot be a deposit contract*.⁶⁴ In his article «Should we Let Banks Create Money?», George Selgin recognizes this fact, and uses it to answer his adversaries in the free banking debate:

«In a recent twist on the conventional fraud argument, Hans-Hermann Hoppe and his co-authors (1998) argue that holders of fiduciary media are, in fact, not victims of bank fraud at all but co-conspirators who assist bankers' fraudulent undertakings by misrepresenting themselves «as the owners of a quantity of property that they do not own and that plainly does not exist». Apart from begging the question of who are the victims, this novel fraud argument is based on a simple failure to recognize that redeemable banknotes and deposit credits are not «titles,» as Hoppe and his co-authors claim.»⁶⁵

An additional reason why it is not possible for an honest fractional reserve banker to make use of a deposit contract is the fact that deposit contracts presume no transfer of property; the deposited goods are at all times to be kept safe by the depositary for the depositor. However, precisely by assuming command over his reserves and using them for his own benefit, the honest fractional reserve banker confirms to us that he does not safekeep them at all. In fact, the only possible way whereby a person can justifiably use goods as if they were his own, as the fractional banker does, is by becoming their *actual owner*. Thus, given that in any valid and sound contract the essential facts should be accurately and adequately described, the contract with the honest fractional reserve banker should evidently not be a deposit contract,

⁶⁴ «... if a person knowingly puts money into an interest-bearing account, this contract would *ex hypothesi* not be of the deposit contract type.» van den Hauwe, L. (2009) *Foundations of Business Cycle Research* - Volume II, Saarbrücken: VDM Verlag Dr. Müller, p. 295. For an elaborate discussion, see Jesus Huerta de Soto, *Money, Bank Credit, and Economic Cycles*, chapter 1.

⁶⁵ George Selgin, «Should We Let Banks Create Money?», *The Independent Review*, v. V, n. 1, Summer 2000, ISSN 1086-1653, p. 96. Selgin refers to the article «Against Fiduciary Media», which is mentioned further in the text.

but instead a contract in which the transfer of property is described in clear terms.

Now, in the course of history, people have come up with a classical solution for transfer-of-property agreements whereby one party accepts money or goods from an other, not to safekeep it for the latter, but to put it to use for himself. Given the fact that within such an agreement it is technically impossible that the trustee always keeps the goods required to be returned available to the trustor, another kind of contract was designed to deal with these circumstances: the loan or *mutuum* contract.⁶⁶ This loan or *mutuum* contract requires that both contracting parties agree beforehand on a set term, whereby the debtor commits himself to have the loaned goods, or their equivalents (goods of the same quantity and quality), plus a possible extra fee (the interest) available for the lender by the end of the term. Writes Jesús Huerta de Soto:

«... a *fixed term* is an essential element in the loan or *mutuum* contract, since it establishes the time period during which the availability and ownership of the good corresponds to the borrower, as well as the moment at which he is obliged to return the *tantundem*. Without the explicit or implicit establishment of a *fixed term*, the *mutuum* contract or loan cannot exist.»⁶⁷

Let us consider for a moment the proposal of a proponent of fractional reserve free banking, just to see whether the fractional

⁶⁶ Isidore of Seville, the seventh century church father, wrote in his authoritative work *Etymologies*: «Something borrowed is named *mutuum* because, that which is given to you from me, becomes yours from mine, *ex meo tuum*.» Priscilla Throop, *Isidore of Seville's Etymologies: Complete English Translation*, (Charlotte, Vermont: Medieval MS, 2005), v. 25.13. In so doing, he followed the 2nd century Roman jurist Gaius. The modern interpretation, however, is that *mutuum* derives from «mutare», which means «to change», «to swap», and which is related to «munus», a «friendly turn». For a commentary on the etymology and history of the *mutuum* contract, see Reinhard Zimmerman, *The Law of Obligations: Roman Foundations of the Civilian Tradition*, (New York: Oxford University Press, 1996), pp. 153-187. See also Jesús Huerta de Soto's authoritative *Money, Bank Credit, and Economic Cycles*, pp. 2-4 (section «Mutuum») and pp. 119-146 (section «Why it is Impossible to Equate the Irregular Deposit with the Loan or Mutuum Contract»).

⁶⁷ Jesús Huerta de Soto, *Money, Bank Credit, and Economic Cycles*, pp. 3-4. Italics in original.

reserve contract as he describes it can be classified as a loan contract. In the article we just quoted, George Selgin maintains that fractional reserve bankers in fact engage in an IOU with their customers:

[Redeemable banknotes and deposit credits] are ... IOUs, so there is nothing inherently fraudulent about there being more of them in existence at any moment than the total stock of what they promise to deliver. ... A person who deposits gold in a bank in exchange for a redeemable banknote does not retain ownership of the gold, but instead gives it up, albeit for an indefinite period of time.⁶⁸

George Selgin thus holds that the contract of the fractional reserve banker with his customers is an IOU whereby the trustee can postpone his repayment «for an indefinite amount of time». Selgin's proposal implies, first, that the means given up by the trustor to the trustee are given up by the former «for an indefinite amount of time», and second, that there is no fiduciary duty at all: the banker can freely choose to postpone his repayment indefinitely. This certainly is not a loan contract, because as Selgin acknowledges, in fractional reserve banking there clearly is no fixed term. This illustrates the fact that for our investigation into the possible nature of the honest fractional reserve banking contract, we have to rule out the loan contract as well.

We can now come to a first important conclusion, namely that the bona fide banker who works with fractional reserves is

⁶⁸George Selgin, «Should We Let Banks Create Money?», *The Independent Review*, v.V, n. 1, Summer 2000, ISSN 1086-1653, p. 96. In the IOU («I owe you») as proposed by Selgin, the «debtor» can postpone his repayment indefinitely and thus does not factually owe anything to the beneficiary. Also when seen from a more general judicial perspective, we can say that the contract Selgin describes does not count as a trust, which we defined as an act (or series of acts) that is regarded as beneficial in the eyes of the trustor, in return for one or more favours from the part of the trustor». If the trustee can postpone the favor he owes the trustee indefinitely, there is no (fiduciary) *duty*—and thus no trust. The contract Selgin proposes is a meaningless agreement because it is unrealizable, and thus null and void by means of an *error in negotio*. For a detailed discussion on the *error in negotio* related to deposit and *mutuum* contracts, see again *Money, Bank Credit, and Economic Cycles*, pp. 142-146.

neither a depositary, nor a debtor. The pieces of paper he writes out to his customers in exchange for their money are not directly exchangeable property titles (deposit receipts), nor titles for reimbursement at a previously set term (loan receipts). But what can they be then? Below we show, in line with Huerta de Soto, that the only remaining possibility for a practice whereby both the fractional character of the reserves, as well as the bona fide character of the contract remain intact, is that the paper received by the customers be «gamble tickets».

Let us begin by repeating that a fractional reserve bank is by definition (exactly because it does not hold a 100 percent reserve) not able to repay at all times the sums of money that appear on the banknotes. This means that customers of this «honest» bank, when they close an agreement with the bank, must be fully aware that they not only give up the full ownership of the money handed over, but moreover that they explicitly, *embedded in the agreement*, acknowledge that there is a real and significant chance that they will not see the sum of their investment again. If the banker fares well and if the customer exchanges his bank note in time, the latter can make a good profit. However if the banker ends up in dire straits or if the customer in question is preceded by too many others in exchanging his notes, then he will lose his entire investment. Given the fact that we here assume full transparency, both possibilities must also be clearly described in the contract between the honest fractional reserve banker and his customers. In other words, it should be perfectly clear for the customer that he does not buy the service of safekeeping (that would be a deposit), and neither does he buy future goods (this is the case with a loan), but rather what is bought is the *chance* to win back a larger sum than his original investment. This should be made clear to him in what is commonly called an «option clause».⁶⁹

It should be clear that a bank such as we've just described would be (as far as we know) an unseen anomaly. However, it is only in this way that a banker operating with fractional reserves can remain an honest businessman: neither the deposit contract nor

⁶⁹ For Jesús Huerta de Soto's discussion of the option clause, see his *Money, Bank Credit, and Economic Cycles*, pp. 710-712, and the passage quoted above in footnote 63.

the loan contract suffice to describe the practice of fractional reserve banking. An idealistic or foolhardy entrepreneur that would attempt to establish a bank on the basis of the contract as described above, would probably, sooner rather than later, find himself tempted to draw a veil over the contents of the contract, to minimize the risks in its description, or to unjustifiably present the seemingly permanent availability of the goods entrusted to him as real. However, by doing so, he would immediately end up joining his mala fide colleagues who choose to not reveal their customers the truth of the matter, with the familiar consequences of malinvestment, overconsumption, and the inevitable boom, crisis, and depression.

When we take a closer look at the contract of our honest fractional reserve banker, we in fact note, concurring with Huerta de Soto, that it is an *aleatory contract*, whereby the services delivered by the bank are «in any case an uncertain event which depends upon circumstances particular to each case».⁷⁰ From this it follows that the banker, as long as he gives an «honest chance» (according to the rules of «the game») to his customers, for example by not dishonestly giving privileges to certain among them, *cannot go bankrupt* if all or a lot of his customers at the same time decide to exchange their bank notes. After the «bank run» the counter is reset to zero, and customers have to wait until enough people have bought new gambling tickets and enough time has passed to take their chance to reap a profit. And so in the case of honest fractional reserve banking we are dealing with a situation where, analogous with the world of casino's, «the bank always wins». Of course, our bank can go bankrupt because of bad management, but the point of importance is that it is not *inherently* bankrupt: there is no stock of goods the customers of the bank can justifiably claim as «theirs», because they've clearly given up their initial ownership in exchange for a *chance* to win it back at some future point in time. In an honest fractional reserve bank as described above, the banker is never obliged to hold reserves beyond the amount he himself chooses (and/or the customer allows him)

⁷⁰ *Money, Bank Credit, and Economic Cycles*, p. 142.

to hold. We can even state, in line with Ludwig van den Hauwe, that in this case there are no reserves at all, because «[a] bank cannot hold «fractional reserves» if the money it is not holding in reserve is money the bank isn't supposed to hold in reserve in the first place».⁷¹

The nature of the only possible contract between a fractional reserve banker and his customers, as described above, is specific enough for us to come to a conclusion *vis-a-vis* the effects it can produce in the economy. The situation is as follows: the transparent operation of the honest fractional reserve bank allows its customers to know very well which risks they take by buying bills from the bank; they buy reliable fiduciary tokens, tokens with a title that describes the conditions of the formal relationship between the banker and his customer in an adequate way. These conditions are that the customer has the right to an «honest chance» in winning back the sum of his investment, plus a premium. Customers of the honest fractional reserve bank thus know perfectly well that this bank is not the best place to rely on for their old day, in the same way as that people usually do not put all their life savings on the betting table in the next casino. Because the customers of our bank are not deceived or misguided, there are also no deceitfully inflated expectations and no malinvestments (on top of the usual entrepreneurial errors) that take place. At the point of a general «bank run», the losers may be disappointed,

⁷¹ van den Hauwe, L. (2009) *Foundations of Business Cycle Research - Volume II*, Saarbrücken: VDM Verlag Dr. Müller, p. 295. This is the full quote:

«One can even argue that it is nonsensical to speak of the keeping of «fractional» reserves on which contracting parties would have agreed. How can a bank keep «fractional» reserves if it keeps exactly the amount of reserves it is supposed to keep by the customer (because this is what they both agreed to)? A bank cannot hold «fractional» reserves if the money it is not holding in reserve is money the bank isn't supposed to hold in reserve in the first place.»

Van den Hauwe further states, on the same page:

«Only if the bank and its client have —*ex hypothesi*— concluded a deposit contract does it make sense to impose and enforce a prohibition on fractional-reserve banking by force of law. This prohibition amounts to no more than that the bank should honour its contractual obligations.»

but they are not experiencing anything beyond their reasonable expectations. In short, *honest fractional reserve banking does not produce the familiar effects that lead to boom, crisis, and depression; it does not bring about business cycles.*

Now, how likely is it that, in a free market environment, this kind of «banking» would become widespread? We hold that it is very small.⁷² In a free market, honest fractional reserve bankers would find it very hard to compete with the bills written out by their competing «full-reserve» bankers. The fractional reserve bills will have a low relative saleability on the market (most people do not have a high preference for gambling), which is why the chance that these bills will at a given point be seen and used as real money, which is exactly defined by its high saleability, becomes very small.

Finally, after having analyzed the nature of the only honest contract thinkable between a fractional reserve banker and his customers, after having established that such a practice would not lead to business cycles, and after having demonstrated the low likelihood of such a model becoming widespread in a free market, we may question the name «honest fractional reserve bank» itself: is it suitable to use the word «bank» for an institution that is no financial intermediary nor a safekeeper of deposits, and whose core activity consists of writing out gambling tickets? This, we'll leave for the reader to decide.

⁷² See also the paper of Ludwig van den Hauwe, «The Uneasy Case for Fractional-Reserve Banking», where he states:

«In fact, for several reasons it cannot be credibly maintained that fractional-reserve free banking would pass the market test; in other words, fractional-reserve banking cannot be conceptualized as belonging to the set of institutions which would emerge as the outcome of an invisible-hand process, that is, a process in the course of which the individual rights of property and contract of all market participants would be correctly defined and strictly enforced.»
van den Hauwe, L. (2006) «The Uneasy Case for Fractional-Reserve Free Banking», *Procesos de Mercado - Revista Europea de Economía Política*, Volumen III, Número 2, p. 177.

APPENDIX II:
A NOTE ON THE ACCELERATION THEOREM
WHERE WE COMMENT ON HOW THE THEORY
OF POLITICAL UNIFICATION
CAN BE INTEGRATED INTO THE ACCELERATION
THEOREM.

For many year, my friend, the fact is
That honesty is out of practice
And honey'd words and fawning smile
Are ever mixed with fraud and guile.⁷³

ANONYMOUS LATIN RHYME

In our article «Defining the Business Cycle», we formulated the acceleration theorem as follows: «the inevitable crisis [of the fraud cycle] can be temporarily, but never indefinitely, delayed by creating fiduciary tokens at an ever accelerating pace.» Here we wish to comment briefly on how this theorem remains valid outside the context of the business cycle (which concerns fraud strictly in the domain of money and banking), and how it can also provide insights in the domain of political science, more specifically in the theory of political unification.

In this respect it is well worth analyzing the contributions of Guido Hülsmann. In his remarkable 1997 article «Political Unification: A Generalized Progression Theorem», prof. Hülsmann gives an exposition of how and why the progression of ever increasing monetary planning and growing government takes place. He begins

⁷³ This is a translation by nineteenth century «scholar and wizard» Charles Leland, of this anonymous Latin rhyme:

Multis annis jam transactis
nulla fides est in pactis
Mel in ore, verba lactis,
Fel in corde, fraus in factis.

Charles G. Leland, *Meister Karl's Sketch-Book* (Parry & McMillan: Philadelphia, 1855), p. 335.

with the statement that «[t]he growth of government ... can be explained by the change of opinion among the ruled,» and continues by recounting how throughout history citizens have been convinced of the alleged virtue of monetary unification (being a form of political unification in order to secure continuous government revenues). Hülsmann lays emphasis on the fact that every time a general crisis of confidence looms, a new and larger *deus ex machina* is invented to ease the concerns. In the domain of money, he shows how taxation is followed by inflation generated by fractional reserve commercial banks, which in turn is followed by central bank generated inflation:

«The fractional-reserve commercial banks are inherently bankrupt, and sooner or later this becomes obvious. Then they abdicate, and the central banks take over. As the latter are structurally bankrupt as well, it is but a question of time until they also voluntarily abdicate.»⁷⁴

Hülsmann makes a similar analysis on why on the political level one can observe a seemingly continuous progression into ever larger and more encompassing political entities. The starting point in the article is the point where the inflationary policies have driven governments towards bankruptcy and the only viable solution left is the provision of «liquidity from other governments that are not yet bankrupt.»

Hülsmann continues:

«The price to be paid for the assistance is, of course, in terms of political favours. Let us point out again that here, as in the case of fractional-reserve banking, *each* government has an interest in this deal. It is obvious that the bankrupt governments have incentives to pay the political price. The not-yet-bankrupt (but already highly indebted) governments have an incentive to bail them out, too. As a consequence of the high degree of international division of labour, the bankruptcy of one government has immediate repercussions on the budgets of all other governments. Therefore, highly indebted

⁷⁴ Guido Hülsmann, «Political Unification: a Generalized Progression Theorem», *Journal of Libertarian Studies* 13:1 (Summer 1997), p. 90. (italics in original).

governments have an interest in avoiding the slightest disruption on the international financial markets, as this could precipitate their own fall. Even the bankruptcy of a small government would threaten them. This has to be avoided.»⁷⁵

He concludes:

«All kinds of breakdown or uncontrolled sudden change are a nightmare for the establishment. The paramount interest of today's politicians and bureaucrats is *to make the show somehow go on*. Therefore, bankrupt governments want to be bailed out and not-yet-bankrupt governments are ready to help them. The result is political unification. This is the mechanism at work that incites political unification in modern democracies.»⁷⁶

We can relate this conclusion back to a statement from the same author's 1998 article on error cycles:

«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.»⁷⁷

Hülsmann, in our mind, in fact shows in his brilliant analysis of political unification how government officials (trustors), who want to «make the show somehow go on», i.e., who want the inflationary boom of the fraud cycle to last, necessarily have to extend, at an ever accelerating pace, the already existing institutions, i.e., how they have to extend the fraud by creating more imaginary goods. In doing so, he describes an accident of the fraud cycle, a cycle we could call the «fraud cycle of government».

⁷⁵ Ibid, pp. 91-92.

⁷⁶ Ibid, pp. 91-92. Italics are our own.

⁷⁷ Guido Hülsmann, «Toward a General Theory of Error Cycles», *The Quarterly Journal of Austrian Economics* vol. 1, n.º 4 (Winter 1998), p. 18. Italics are our own.