Solution to Cyprus's Money Debacle of 2013 —
Underlying complexity is simplicity

By Michael Schemmann, 22 March 2013[1]

In times of old things were simple. Money was metallic; either gold or silver, sometimes copper. Since the times of the London Goldsmith bankers, money has become paper. Today, money is bookkeeping, namely a credit entry on a bank's customer deposit account. Money today is an abstract, a creation of the mind.

I understand the German Minister of Finance, Wolfgang Schaeuble, quite well when he says that Cyprus's economy is based on a bloated banking sector that stands in no relation to the tiny island nation's real domestic production. I can sympathize with his refusal to come to the rescue of speculation gone wrong only because Cyprus uses the same money as Germany… and that Cyprus should not take Germany's self-interest for granted that the nest be kept clean, but contribute to its own rescue. And I can understand Cypriots's misgivings in having to suffer a haircut on their money in their insolvent banks because they have done nothing wrong.

The question is, however, does Herr Schaeuble, who is only a lawyer walking in big bankers' boots, understand what is bailout money for which he demands a Cypriot bail-in haircut?

Money is simply that which the *State declares* from *time to time* to be a good legal discharge of *money* contracts, writes John Maynard Keynes (1924) in his *A Tract on Monetary Reform*. And the 70 billion Euros deposited in the 130 some Cypriot banks and credit unions are only that: "deposits" created by bookkeeping entries, but not money. Money is legal tender either in the form of cash or deposits at the central bank, and that money the Cypriot banks don't have, or don't have anymore, and in actual fact never had!.

The terms of the European bailout of 16th March 2013 do not destroy Cypriot bank depositors' claims against their banks. They only change them from money claims into the claims of shareholders in times of liquidation plus a voting right, if any. In accounting we call this change a slowing of maturities on the banks' liability sides, reducing the banks' current liabilities while increasing the banks' capital equity. But how this created equity will strengthen the banks' financial positions is Herr Schaeuble's invention, presumably based on the misconception underlying the Basel capital accords. Only liquid assets make banks solvent to redeem customers' deposits, not an increase of a capital buffer to absorb losses from worthless assets following a process of valuation.[2]

Underlying this man-made complexity based on simple accounting misconceptions remains the fact that money, at least in the form of legal tender, the Cypriot banks never had. The Europeans, including the British, the Americans, the Canadians, and wherever one looks in this moneyed world it's the same thing: legal tender NO bank has (except for maybe five percent of deposits). As a result there is effectively NO common Euro currency. There are Deutsche Bank Euros, Commerzbank Euros, HSBC Euros, BNP Paribas Euros, Banco Santander Euros, Robobank Euros, etc. to name a few of the large private commercial banks in the Eurozone. They transfer in the daily payment clearing by way of offset: what comes in is compensated by what goes out. In the present case of Cyprus's banks, too little is coming in to compensate for what is wanting to go out.

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[2] Michael Schemmann. 2010. "Misconceived Men of *Très Haute Banque*: Our Central Bankers. The Basel III Capital Accord - Another Misapplication of GAAP." ISBN 978-1453853030 available online.

If the Parliament of the Republic of Cyprus accepts the European bailout's so called "haircut" on its Cypriot bank deposits, switching the amounts to equity in the total amount of some 5.8 billion Euros, which does NOT increase the banks' liquidity and solvency one iota, then the Europeans make 10 billion Euros of their bank book money available to the Cypriot banks which they can use to effect money transfers until those are used up because they represent only 14% of the Cypriot banks' total deposits of some 70 billion Euros and are therefore evaporated in a day or two if Cypriot depositors decide to move their deposits from Cyprus to another Eurozone country, or wherever.

By joining the Eurozone, the Republic of Cyprus has ceded its money creation power to the Eurosystem headquartered at the European Central Bank in Frankfurt. The Central Bank of Cyprus is a part of the Eurosystem much like a branch of the bank in Frankfurt, and so are all of the national central banks of the 17 member nations constituting the Eurozone, including the Deutsche Bundesbank, the Banque de France, De Nederlandsche Bank, Banco de España, and so forth.

What the Republic of Cyprus has NOT given away is the ability of its central bank to open and maintain bank accounts for deposits and withdrawals by the people of Cyprus and their businesses.

In other words, it is open to the Central Bank of Cyprus to extend its services not only to private commercial banks but to the entire business community of the island by allowing persons to open and maintain deposit accounts directly at the central bank instead of indirectly through the now insolvent Cypriot private commercial banks. (To what extent the many local credit unions are solvent or insolvent is a small matter.)

All deposits held at the ECB or any of the national central banks of the Eurozone are so called "high-powered money" in the form of legal tender in that the deposits can be withdrawn in the form of cash or transferred anytime anywhere without the much feared capital controls that would kill the banking sector and cripple the economy by effectively creating a new type of restricted Euro — the *Cyprus Euro*..

The big question remains, how to transfer the deposits at the insolvent commercial banks of Cyprus to the Central Bank of Cyprus? In normal circumstances they can be transferred only to the extent that the private commercial banks have credit balances at the Central Bank of Cyprus, and if not, then only if the Central Bank of Cyprus agrees to accept the transfer anyway by becoming the substitute depositor at the private commercial banks. The private commercial banks would be crediting the Central Bank of Cyprus as the substitute depositor on their books of account… and the private commercial banks go out of the business of creating and holding deposits. Result: Liquidity of deposits restored, European bailout not needed.

What would be the ECB's objection in Frankfurt to such a maverick maneuver at the Central Bank of Cyprus by "safeguarding the Euro with whatever it takes" to use its President's, Mario Draghi's, words? There should be none under the condition that the money supply in Cyprus does not increase as a result of the Central Bank of Cyprus's creation of deposits. Since the deposits in the private commercial banks are now those of the Central Bank of Cyprus, they are no longer available to the public and therefore NOT money supply.

The mechanism to freeze the level of the current 70 billion Euros of bank deposits on Cyprus which constitutes the island nation's money supply is simply by requiring 100% reserves on any bank deposits to be held at the national central bank. The 100% reserve requirements would restrain any private commercial bank from creating book-money by making loans, as they have done, in part, in the past.

Any deposits at the national central bank could be transferred back to the private commercial banks for credit to an investment account and lent out by the commercial banks acting as financial intermediaries at the risk of the investor who would not be a depositor.

Any deposit at the national central bank could be transferred back to a private depository institution and kept in trust as a deposit with 100% reserve requirement and thereby ring-fenced against a bank's risky lending and investing activities. Such a division of banking is at the heart of reforms currently underway in the United Kingdom based on the recommendations of the Independent Commission on Banking under Sir John Vickers of September 2011.

Details of the plan are discussed in my booklet entitled **"**Liquid Money — The Final Thing. Federal Reserve and Central Bank Accounts for Everyone."[3]

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[3] Michael Schemmann. 2012. Liquid Money — The Final Thing. Federal Reserve and Central Bank Accounts for Everyone." IICPA Publications ISBN 978-1478312239 available online.