

On Cyprus and the fact there's no money in the bank: a ...

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A great many people in Cyprus and beyond are suddenly realising that there is no such thing as money in the bank. Although it should be glaringly obviously untrue to everyone it still seems to be the case in popular perception that bank balances are made up of wads of cash sitting in a safe.

So let me be unambiguous: they're not.

In fact, there's no such thing as 'money in the bank'. That's just a myth.

When you deposit funds in a bank what they give you in exchange is an IOU. That entry in your bank statement saying you're in credit means just that - the bank owes you money. It does not mean they have the money to pay.

And so it came to pass that Cypriot banks did not have the means to pay. And as there are almost no bondholders to take a haircut in Cypriot banks and bank capital is, as ever, too small, those banks can't make good on their IOUs. And people are enraged.

Of course, rational economists in state ministries wonder why they should be. Cypriot people (and others) lent money without security to a commercial operation undertaking an inherently risky business (especially so in tax haven Cyprus) and demanded a risk free return. Welcome to the market folks. This is the free enterprise you all so believe in. And when the IOU's proved worth less than full value what those depositors demand is that someone literally pick up the IOU and pay them even though they don't have obligation to do so. What's more, if no one does agree to pay the depositors threaten, by undertaking a run on the bank, to commit an act of collective economic suicide to undermine any remaining value in the IOU they have. Such is the rationality of economic agents.

What the EU tried to impose on Cyprus looks rational. Except rationality in the face of irrational agents called frightened small depositors, and powerful agents, called

Russians with big bank balances, did not work.

And in that case what the EU should have done is permit the issue of new debt - yes, another IOU - to resolve the situation because that would have worked and at almost no cost. QE would have immediately cancelled the new issue if that was desired. But rationality got in the way in a wholly irrational situation and so the right course of action - the one that reflected the fact that those in the know always knew there was no money in the bank - did not happen.

And now Cyprus will pay the price for this confusion on just what money and banking really is.