“An Insight to an interest-free, full reserve banking model”.

Debt, Inflation, deficits and ultimately financial crisis, this is the modern world of banking. The banking system of today’s world is stuck in the vicious loop of lending more than what they hold resulting in acute financial crisis. This article will look at full reserve, interest-free banking as an effective solution to combat this financial crisis.

There are two components to this banking model it being “full reserve “and “interest- free”. First, let's discuss Full Reserve Banking. A full reserve banking system is such a system in which banks are required to keep all their customers’ deposits as reserves either in cash or in their accounts at the central bank. Moreover, ICAP.org.pk states that “under the full reserve banking system, banks would operate as true intermediaries, facilitating investments without creating new money". Furthermore, Bancoli states that “full reserve banking offers a beacon of stability, providing a more predictable and reliable financial landscape for businesses to navigate". Now how does this model of banking cause debts to run low and inflation to decrease? In her article “an analysis of four monetary reform planes” Charlotte Van Dixhoorn states that in a full reserve banking model, money creation would be centralized under a public institution, separating safe payment deposits from risky lending, so that banks can no longer create money through debt this ultimately would lead to debt reduction .While a full reserve banking system relies on high interest rates to combat government deficits in an interest free full reserve banking system this would not be implemented as it further leads to recession. Zenus.com states that “full reserve banking allows customers to diversify their financial portfolio with very little risk”.Wall Street Mojo states that in the 19th century, trials of full-reserve banking occurred, primarily in response to the prevalence of privately issued banknotes as the main payment method. The National Acts of 1863 and 1864 introduced full-reserve banking in the US. Although these experiments were not formally abandoned, banks found ways to evade regulations by shifting from issuing notes to deposits, ultimately undermining the reform and leading to the establishment of our current monetary system.It further states that “Despite this, the government, including the central bank, has managed to maintain a monopoly on issuing notes ever since. It is noteworthy that macroeconomic indicators generally trend upward following the implementation of the reforms. While it is challenging to attribute these positive developments to the full-reserve banking experiments directly, it is evident that they did not have a destabilizing impact on the economy”.

Moving on to an interest free system it is defined by www.igi-global.com as “the banking system where interests are not used. In this system, banks do not offer a fixed rate of return on deposits and do not charge interest on loan”. Moreover tskb.com.tr states that interest free banking is “based on the Islamic prohibition of Riba, this type of banking operates on fair and ethical principles in financial transactions and products". In an interest-free banking model, one would not have to pay more than what one owes contributing to the reduction of overall expected debt if interests were applied. In Emerald Insight's article "interest free monetary policy and its impact on inflation and unemployment rates", it is shown that countries that implement interest free policies have lower inflation to unemployment ratio than countries which do not. It also states that interest free policies "lower the overall costs of financing, resulting in the rightward shift of the aggregate supply curve, and thereby increases real gross domestic product and reduces the price level. It is to be understood that interest free banking follows many types in Islamic financing the most known are Murabaha (cost-plus sale), Ijarah(leasing) and Mudarabah and Musharaka(profits and loss sharing partnership). How does interest free banking provide a deficit free system? Well, the answer is that in an interest free system debt financing is replaced with equity based or asset backed instruments like sukuk, where returns depend on real profits this reduces fixed interest obligations, meaning less recurring deficit pressure on the budget.

Aside from the positive outlook of the full reserve and interest-free banking model, criticism does come in play. Since in such a system one would not earn interest on money support.oro.bank states "since the bank is not using your money to make loans or investments, it is not making money from your deposit, which means less profit to share with you". It is critiqued by Sheffield university authored by Sheila Dow, Guorun Johnsen and Alberto Montagnoli that full reserve banking embeds the idea that it is socially unacceptable to have a money supply which is almost determined entirely by the private sector and hence is considered bold and skeptical. Moreover, it is critiqued that "it advocates decisions on money creation to be taken by a monetary committee independent of the government, the aim to control rather than influence heightens issues raised by the current policy framework". It is criticized by Muhammad Kashif and Dr P. Sridharan in an interest free system that "in case of failure to repay fixed obligations by the client to an interest free bank on due date damagers are permitted under interest free banking system" furthermore there is lack of human resource management they state that "Nor do Islamic establishments have such a wide scope so that a professional in conventional banking may comfortably look towards a future career in the same sense as he looks to conventional ones". Also, it is criticized "Interest free banks and financial institutions cannot procure or place funds from among themselves on an established pattern due to lack of inter Islamic bank markets". There may be legal differences between Islamic and local laws as Muhammad Kashif and Sridharan state "a contract between parties may be legal according to Islamic rules while the same may not be legal as per the court where the institution renders its services".

After discussing criticism and its positive outlooks now, let's focus on how a full reserve interest-free system is implemented. First, it will be needed to segregate bank functions into a deposit bank and lending bank. Hundred percent of reserves will be held in proportion to transaction deposits. To incorporate interest – free banking the lending portion of the bank would be based on interest free principles like Mudarabah and Musharakah this could then result in eliminating public debt and interest costs associated with it without causing inflation as government debt would be exchanged for sovereign money. Moreover to promote Islamic banking in Pakistan specifically the finance minister in his budget speech for FY02 said "government is committed to eliminate Riba and promote Islamic banking for this a number of steps are underway" according to State Bank of Pakistan these steps include; a legal framework is designed to encourage practice of Islamic banking by banks and financial institutions as subsidiary operations of their main operations, Consultations and exchanges are undertaken with brother Islamic countries and renowned institutions of Islamic learning such as middle eastern countries and Al-Azhar University of Egypt, to learn more about their experiences and practices, Shariah compliant modes of financing like Musharaka and Mudarabah will be encouraged so that familiarity and use of such products is enhanced and their adoption at a wider scale made possible.

Overall, it can be concluded a full reserve, interest-free banking system is especially reformative for countries like Pakistan who hold Islamic beliefs and believe in ethical banking. As backed by the Quran in Surah Al-Baqarah (2:279-280)"O you who have believed, fear Allah and give up what remains [due to you] of interest, if you should be believers. And if you do not, then be informed of a war [against you] from Allah and His Messenger." Moreover, in surah al Baqarah verse 275 Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like interest." But Allah has permitted trade and has forbidden interest. So, whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury] - those are the companions of the Fire; they will abide eternally therein". A more severe reference is from the Prophet Muhammad {may peace be upon him) he says "a dirham which a man consumes knowingly is worse before Allah than thirty-six acts of zina "as documented in Musnad Ahmad hadith 21450.

Full reserve and interest- free banking is the thing for the future a system that could truly revolutionize the banking system as wallstreetmojo states that it creates a diverse banking system reducing the risks associated with banking crises and financial instability. "Money becomes independent of interest-bearing bank credit, through which the levels of public and private debt are expected to decrease. It helps in alleviating the pressure of reduced growth imperative". In conclusion an interest- free full reserve system is backed by research and theoretical analysis it is ready to be implemented in countries prone to abide by ethical banking and in a need of a new financial banking system which is more stable , has less deficit, less debt ,less inflation and no interest.