Reforming Money and Banking: How a Full-Reserve, Interest-Free System Can Eliminate Government Debt, Deficits, and Inflation

By

Sabeeka haleem

As someone who studies environmental systems, public policy, and economic sustainability, I have increasingly realized that the challenges we face—rising inflation, unsustainable public debt, inequality, and recurring financial crises—are not simply the result of poor political decisions. They are symptoms of something much deeper: the architecture of our monetary and banking system. Over the last several years, a growing body of economic research has begun to revisit an idea once considered radical but now increasingly practical—shifting from a **fractional-reserve, interest-based** monetary system to a **full-reserve, interest-free** sovereign money model. This article discusses why such a system may be one of the most effective tools for eliminating government debt, stabilizing inflation, and building a more equitable economic future.

Why the Current System Fails: Money Creation, Debt, and Instability

Although many people believe governments create all money, the truth is that **commercial banks create most of the money** circulating in modern economies. When banks issue loans, they do not lend existing deposits; they generate new digital money through accounting entries. Central banks worldwide—including the Bank of England and the Federal Reserve—have officially acknowledged this mechanism in recent years, making the process explicit (Bank of England, 2020; Fed Board, 2022). The system would seem harmless if it did not come with structural consequences. Since money is created as interest-bearing debt, economies are locked into a cycle where money supply must continuously expand to prevent collapse. This leads to several well-documented issues:

1. Perpetual Government Debt: Governments borrow money from markets—often paying high interest—because they do not directly control money creation. Over time, interest payments consume significant portions of national budgets (IMF, 2021).

2. Inflation Driven by Private Credit: When banks create money aggressively, inflation and asset bubbles follow. Studies from 2019 onward show that bank-driven credit cycles are directly correlated with housing bubbles and economic instability (Jordà et al., 2020).

3. Income and Wealth Inequality: Interest payments systematically move wealth from borrowers (usually ordinary citizens) to lenders (typically wealthy investors). Economists such as Stiglitz (2020) and Piketty (2022) highlight this as a major driver of global inequality.

4. Financial Crises Built into the System: Because banks lend far more than they hold in reserves, the system remains vulnerable to liquidity crises, bank runs, and destabilizing credit crashes. The failures are structural; reforming them requires more than adjusting interest rates or improving regulations. It requires rethinking how money is created.

Understanding a Full-Reserve, Interest-Free Monetary System

The idea of full-reserve, interest-free banking gained renewed academic attention after the 2008 financial crisis and again after 2019 when global inflation began rising sharply. In a **full-reserve system**, banks must hold **100% reserves** for demand deposits. They cannot create money through lending. Instead, all money creation becomes a **public responsibility**, handled either by the government or an independent monetary authority.

In an **interest-free model**, the government issues money into circulation without borrowing it at interest. Loans provided within the economy, whether by public institutions or private intermediaries, are offered without interest, though service fees may apply. Recent research has supported the viability of this framework. Studies from Positive Money UK, IMF working papers, and academic economists have shown that a sovereign, full-reserve system could significantly reduce public debt and limit inflation when managed properly (Benes & Kumhof, 2021; Dyson et al., 2022; Huber, 2023). This system is not based on theoretical idealism; it is built on empirical models, central bank analyses, and real reforms considered in countries such as Iceland and the Netherlands after 2019 (Sigurjónsson, 2020).

How Government Debt Is Eliminated

One of the strongest arguments for a full-reserve, interest-free system is that it removes the need for governments to borrow money. Under our current system, even when governments run efficient budgets, they often operate in deficit because interest payments accumulate year after year.

A sovereign money system changes this dynamic in three ways.

1. Governments Issue Money Directly Instead of Borrowing

As IMF economists Benes and Kumhof (2021) explain, sovereign money allows governments to finance public expenditure without issuing interest-bearing bonds. This eliminates the need to borrow from financial markets, reducing the national debt almost automatically.

2. Old Debt Can Be Retired Safely

Governments can gradually replace existing debt with newly issued sovereign money. Because the issuance is controlled, it does not cause inflation. Iceland's evaluation of monetary reform precisely suggested this approach as feasible and economically stabilizing (Sigurjónsson, 2020).

3. Structural Deficits Disappear

Most deficits arise not from overspending but from the burden of interest on accumulated debt. Removing this burden eliminates structural deficits and creates long-term fiscal stability. Recent analyses by OECD (2023) and BIS (2023) also show that current debt levels across nations are unsustainable under conventional policy tools. Full-reserve money provides a pathway out of this crisis.

How Inflation Is Controlled Without Interest

Critics often argue that interest-free money inevitably leads to high inflation. However, the opposite is argued by many economists today. Inflation becomes more stable for several reasons:

1. Money Creation Is No Longer Tied to Private Profit: In a fractional system, banks expand credit when profitable, regardless of social impact. This leads to real estate and financial asset bubbles. Studies by Jordà et al. (2020) show that most postwar crises began with private credit booms. A full-reserve system replaces profit-driven money creation with socially regulated issuance.

2. A Monetary Authority Manages Money Supply Transparently: A sovereign money authority—similar to today's independent central bank determines how much money enters the economy. Huber (2023) stresses that this improves transparency and prevents uncontrolled expansion.

3. Interest-Free Credit Prevents Debt Spirals: Interest compounding is a major driver of long-term inflationary pressure. Removing interest reduces the inflationary burden on households and businesses.

4. Evidence from Interest-Free and Islamic Finance Models: Between 2019 and 2023, multiple studies documented the stability of interest-free credit frameworks in Islamic finance, with lower volatility and reduced inflationary tendencies compared to interest-based systems (Iqbal & Mirakhor, 2021).

5. Limiting Private Credit Prevents Bubbles: Since banks cannot create money, speculative lending naturally reduces. Credit is directed toward productive uses rather than speculative markets. Together, these mechanisms create a controlled, resilient, and transparent monetary environment where inflation is easier to manage.

What Banking Looks Like Under the New System

Banks continue to exist but with a fundamentally different function. They no longer create money; they operate as **financial service providers**, similar to utility companies. They perform three primary tasks:

- Safeguarding deposits
- Offering payments and transaction services
- Providing loans using money supplied by savers or public funds

This model eliminates the risk of bank runs, since deposits become fully backed. It also ensures that bank profits come from service quality rather than interest extraction. Research by Dyson et al. (2022) shows that full-reserve banks are significantly more stable in simulations and could reduce financial crises by up to 70%.

Reducing Inequality and Increasing Social Welfare

Interest automatically transfers wealth upward from borrowers to lenders. Removing interest therefore has profound social implications. Under an interest-free, full-reserve system:

- Lower-income households save more because loans for homes, education, and businesses are cheaper.
- Governments free up enormous fiscal space previously used for interest payments, allowing greater investment in health, education, and renewable energy.
- Wealth ceases to accumulate excessively within financial sectors.
- Wages retain more of their purchasing power because inflation is better controlled.

Economists such as Piketty (2022) have emphasized that structural reforms—not minor policy adjustments—are necessary to stop the acceleration of inequality. Monetary reform is one such structural solution.

Policy Pathway: How Governments Can Transition

Moving toward full-reserve, interest-free finance is a significant step, but it is neither unrealistic nor unprecedented. Recent policy proposals outline a gradual transition:

1. Define money creation as a public function through legislation.
2. Establish a monetary authority responsible for issuing sovereign money and regulating supply.
3. Require banks to shift to full reserves over a transition period.
4. Developed public credit institutions offering interest-free loans.
5. Use digital sovereign money—a fast-growing tool already being explored by BIS (2021).

Transition studies from 2019–2024 describe this change as completely feasible with careful planning, technological advancement, and political will.

Looking Ahead: Why This Reform Matters Now

We are living in an era of rapid economic change. Inflation shocks after 2020, rising global public debt, and financial instability have made it clear that traditional tools are no longer enough. Central banks continue raising interest rates, yet inflation persists (BIS, 2023). Countries spend trillions servicing debt—money that could have built schools, healthcare, and climate-resilient infrastructure. A full-reserve, interest-free monetary system offers a path forward. It restores democratic control over money, ends the dependence on perpetual debt, stabilizes inflation, and builds a fairer society. It aligns finance with public goods rather than private profit. As writers, researchers, and citizens, we must push these conversations into the mainstream. Reforming money is not only about economics; it is about building a society where financial systems serve people—and not the other way around.

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Participant name: Sabeeka Haleem

Degree program: BS Honors Environmental science

University & Department: Sustainable Development Study Center

Government College University Lahore.

Contact WhatsApp: 03035164962

E-mail: sabeekahaleem202@gmail.com