Reforming Money & Banking

How a full-reserve, interest-free system could eliminate debt, deficits, and inflation

M. Arslan
School of Economics, Punjab University
Business Economics
RBB25-14

November 30, 2025

Introduction

Banking crises, public debt, and episodic inflation are not issues but facts affecting employment, pension, and expenditure. The 2023 bank failures (Silicon Valley and others) and a series of incidents worldwide since then brought a simple question back to front pages: is the system of money creation and allocation appropriate for the digital age? One of the bold answers states: "Uncouple the creation of money from the lending operations of private banks (100% or 'full' reserves) and make issuance of money a public function" remove interest from the system and adopt profit-sharing finance. In other words: socialise money as a public utility rather than private profit.This article takes a look at what that means, how it could be possible (Case study of Pakistan) and what benefits and challenges accompany this idea.(See [Figure 1: Money Flow — current vs reformed]).

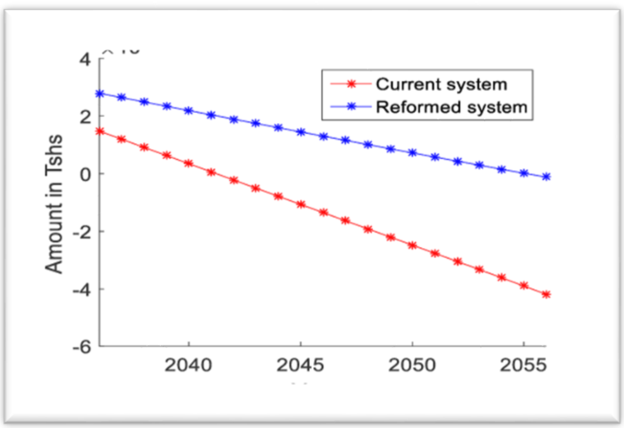

Figure 1: This graph compares how long pension contributions can support retirement benefits under the current and reformed pension systems from 2036 to 2056.

Key Concepts

1. **Full-reserve banking (100% reserve):** Demand (transaction) deposits are backed 100% by the central bank money, which may be in the form of cash or digital currency issued by the central bank (CBDC). Commercial banks cannot create new deposit money through lending; they can only lend what is already in circulation, for example, time deposits, bonds, or shares.
2. **Interest-free finance:** Lending and saving operate without interest (riba). Rather, the financing arrangement is based on sharing profits and losses, leasing, or outright selling

of assets backed by certain contracts (Islamic finance instruments) such as mudarabah, musharakah, and ijara..

3. **Sovereign money / CBDC route:** The state (via the central bank) issues the only legal money — preferably in a digital form (CBDC) for speed, inclusion and control — and uses rule-based issuance rather than private banks' endogenous creation. For a non-technical summary of the mechanisms suggested by the modern proponents see Benes & Kumhof's modeling of the Chicago Plan revision.. IMF

Figure 2: The graph compares the growth of the U.S. M2 money supply with the price of gold from 1970 to 2025.

Three Influential Works

Below are quick, readable summaries of three major works that shape contemporary debate.

1. **Benes & Kumhof — "The Chicago Plan Revisited" (2012)**
   This leading IMF/NBER-style working paper models a 100% reserve system and concludes that under rule-guided conditions, full reserve banking can dramatically reduce private and public debt, bailout requirements, and stabilize the financial system – at least in the modelled cases. The paper presents the Chicago Plan as "a separation of money

(public) and credit (private)", and demonstrate potential macro benefits – which are critically conditioned by the governance framework of money issuance. IMF

2. **Anat Admati & Martin Hellwig — The Bankers' New Clothes (2013, updated)**
   Although they do not advocate for the full-reserve doctrine, Admati & Hellwig offer a strong critique of banking fragility and make a strong case for massive capital (equity) buffers and stringent supervision. Their centerpiece: de-lever and de-risk the systemically important financial institutions within the banking sector — however, they remain doubtful that extreme structural reforms can rid the political economy of its systemic risks (e.g., advocating for full reserve 'overnight' structural reforms). Their work is a fundamental for reformers seeking to advance the resilience of banks.. LSE Blogs
3. **Joseph Huber — Sovereign Money: Beyond Reserve Banking**
   Hubers (and the "sovereign money" camp like him) advocate for the state to retake money creation as a public good and suggest institutional designs to do that (money-control bodies, legal alterations). The book provides pragmatic institutional steps and conceptual arguments for why making money sovereign can help to control rent extraction and result in stable economies, if governance is strong.. Research Gate

Laying out the Mechanism

How full reserve + interest-free could cut debt, deficits and inflation?

1. **Debt:** Under the current fraction system banks create money when they issue loans; a great majority of public and private debt is linked to interest payments of money created in private hands. If central bank is made the sole issuer, and state uses some issuance for financing public expenditure (not as interest bearing debt), then the explicit interest bearing public debt stock declines. Benes & Kumhof demonstrate through models how the stock of government debt can be converted into a much smaller stock under certain conversion rules.. IMF
2. **Deficits:** Without interest liabilities, a recurring item that inflates fiscal deficits disappears. Governments could still run primary deficits — but the budget burden is lighter if interest costs vanish. Public investment could be financed by sovereign money issuance tied to output and investment needs rather than by selling interest bonds. Care: irresponsible issuance is inflationary; rule-based issuance is essential.

3. **Inflation:** On the contrary, proponents of issuance of money strictly in line with real output (Issuance of money growth rules tied to GDP or output tied to productivity), argue that excess demand inflation can be avoided. However, central banks require a credible form of governance and data to appropriately align issuance with supply. The modeling indicates potential for stable prices, however, empirical success depends on institutions and discipline. [IMF]

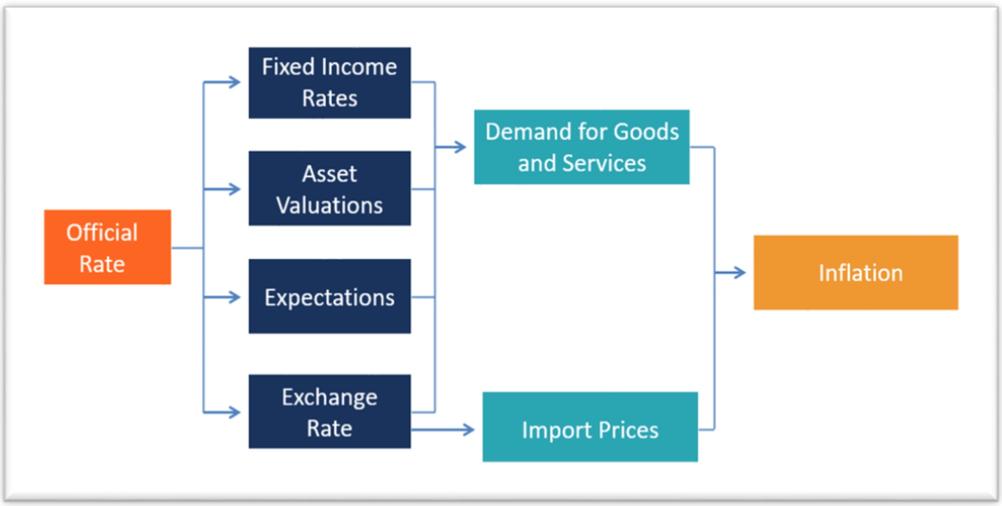

Figure 3: This flowchart shows simple Monetary Transmission mechanism.

Pakistan as a case study

Pakistan faces a tough fiscal position, high interest payments and recurring balance-of-payments stress. Two contextual facts matter:

1. Pakistan has ongoing policy/legal discourse (including court directives and SBP roadmaps in the recent years) around compliant banking, which offers political/institutional momentum to the interest-free models.interest-free / Shariah-

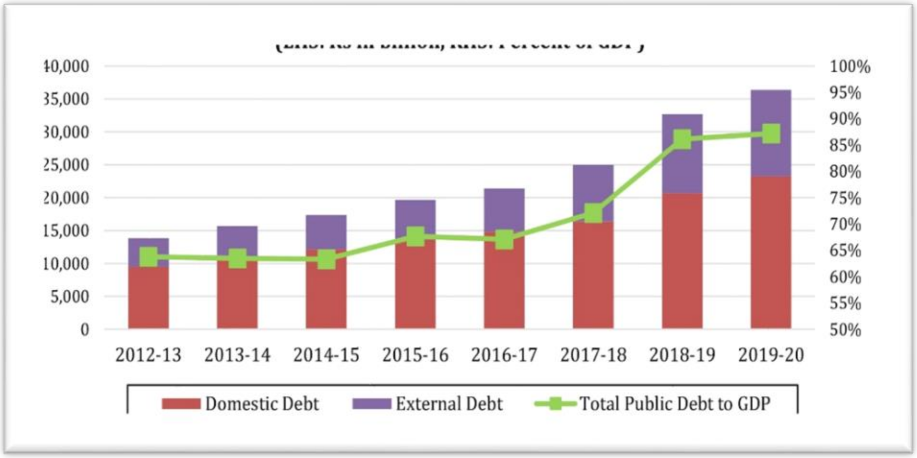

Figure 4: shows Pakistan Government Debt Trend from 2012 to 2020.

2. The State Bank of Pakistan (SBP) is also active in CBDC technology explorations and pilots reportedly partnering with firms such as Soramitsu on a digital rupee pilot – a technological enabler of sovereign money. Profit by Pakistan Today

Figure 5: Shows the prediction of Islamic Banking Growth Trend from 2024 to 2029

These two strands — political will for riba-free finance and interest in CBDC pilots — make Pakistan a compelling candidate to study carefully.

Implementation roadmap

Phasing of large structural change is necessary and following is a practical sequencing balancing ambition and risk:

1. **Design & legal groundwork (year 0–1):** Amend the central-bank and banking laws to designate CBDC as legal tender, and reserve requirements. Convert existing government bonds and bank deposits into”
2. **Technical pilot (year 1–2):** Conduct CBDC pilots in limited areas / sectors (Soramitsu pilot by SBP is a pilot to learn from). Test retail wallets, payment interface providers (PIPs), AML/KYC flows, and privacy protection measures.
3. **Parallel operation & gradual reserve tightening (years 2–5):** Let the CBDC adoption play out, with gradual raising of reserve requirements on transactional accounts (e.g., from present low percentages to eventual 100%). Provide incentives for transactional balances to move into CBDC wallets.
4. **Debt conversion and fiscal transition (years 3–6):** Thus, convert short-term interest instruments into sukuk or other non-interest instruments, negotiate IMF/donors’ understanding on transition mechanics, and phase government financing to sovereign money flows linked to GDP/rules.
5. **Full operation & safeguards (years 5+):** After the wide acceptance of CBDC and banks have adjusted business models, the finalization of reserve rules should be done, accompanied by enhanced oversight of shadow banking to prevent circumvention. Form a Money Control Committee with open mandate and oversight.

How credit intermediation and the banking business would change

Banks would become pure intermediaries in the sense that they would have to finance loans from term liabilities, equity and capital markets instead of creating demand deposits as loanable funds. This changes incentives: credit will price risk more accurately (no artificial cheap short term deposit funding) and credit lines will need prefunding or committed collateral. Critics fear that this could cause a temporary credit squeeze and increase costs of funds on SMEs and the policy response will be to phase change, capital market deepening and broadening of non-bank equity and risk sharing financings (mudarabah /musharakah). Admati & Hellwig’s capital buffers logic is in line with this new logic banks are going to need more equity capital and much different risk management. LGS

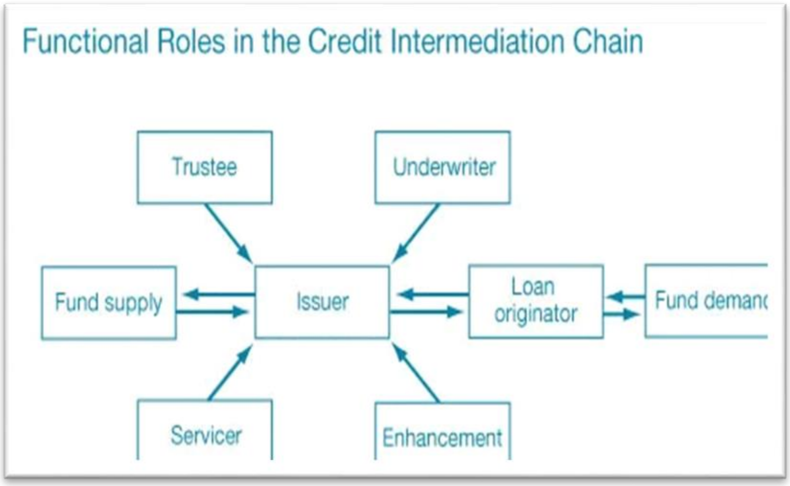

Figure 6: This flowchart shows simple credit Intermediation Process

Criticisms and How to Answer Them

Risks,

1. **Credit crunch during transition.** If banks can't lend freely, SMEs may struggle. *Mitigation:* phased reserve increases, temporary targeted credit windows, development banks, stronger equity markets.
2. **Political misuse of money creation (fiscal dominance).** If governments print for electoral spending, inflation follows. *Mitigation:* legal safeguards (independent money-control body), rules linking issuance to GDP/objectives, external oversight
3. .**Shadow banking migration.** Private actors might recreate near-money instruments outside regulated banks. *Mitigation:* extend regulation to close regulatory arbitrage, supervise MMFs, and limit narrow liabilities that mimic CBDC.
4. **Operational and cybersecurity risks for CBDC.** A large-scale electronic money system must be secure and private. *Mitigation:* incremental pilots, strict cybersecurity standards, robust privacy law and contingency plans.

Multiple scholars debate these trade-offs; the literature shows model-dependent gains and warns that governance is the key variable (not the mechanical rule itself). IMF

Recent Evidence and Why the Timing Feels Right

Digital Bank Runs (SVB's 2023 Fall and Associated Strains)

proved that deposits disappear as soon as trust is broken – a design fragility that advocates of full reserve point out (McLeay et al. Regulatory post-mortems (BIS / central bank reviews) focus on how liquidity mismatch and concentration risk magnified SVB's troubles which validates the need to rethink the link between money and deposits.. Bank of International settlements

At the same time, CBDC pilots around the world and Pakistan's own technology projects create a feasible pathway to implement a sovereign retail digital currency — something that was technically hard a decade ago. Profit By Pakistan Today

Actionable takeaways

1. **Pilot, don't plunge.** Start with CBDC pilots and targeted trials before moving reserve ratios.
2. **Build institutional walls.** Create a transparent, rule-based money-control committee with legal insulation from politics.
3. **Protect credit for the real economy.** Simultaneously deepen capital markets and scale-up non-bank finance for SMEs and housing.
4. **Align with cultural/legal context.** In Pakistan, design must integrate Shariah governance to avoid legal clashes and build public legitimacy.
5. **Prepare communications and social protections.** Educate the public, phase transitions to avoid shocks, and use savings from eliminated interest to fund inclusion programs.

Conclusion

A full-reserve, interest-free system is a structural redesign that has the potential to remove explicit interest burdens, lessen some forms of financial instability, and provide governments with more fiscal flexibility—but only if issuance is controlled, governance is unwavering, and credit channels are meticulously safeguarded. Pakistan is a perfect laboratory because of its unique combination of political will for interest-free finance and emerging CBDC pilots. However, success demands humility: manage pilots, establish institutions, and create backup plans for both known and unknown situations.

References

1. Benes, J. & Kumhof, M., The Chicago Plan Revisited (IMF working paper). IMF
2. Admati, A. & Hellwig, M., The Bankers' New Clothes (2013 & updates). LSEB logs
3. Huber, J., Sovereign Money: Beyond Reserve Banking. Research Gates
4. BIS, *Report on 2023 banking turmoil* (summary of SVB/related events). BIS
5. News on Pakistan CBDC pilot and SBP partnership with Soramitsu. Profit by Pakistan