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

The problem with the current global economic system is that it is built on interest, debt, and fractional reserves. A banking system where banks keep only a fraction of their customers' deposits on hand as cash reserves and lend out the rest. This system allows banks to create money through the process of lending out a portion of deposits, as the loaned money is then re-deposited and further lent. Money is created as interest-bearing debt, which forces perpetual inflation and government deficits.

A full-reserve, interest-free Islamic model can help stabilise this money creation problem and help in eliminating artificial debt, which in turn would lead to ensuring real economic growth.

Fractional-reserve banking is the main banking system that the world uses now. It involves keeping 5-10% of the banks' money as a reserve and then further loaning out the rest, leading to the creation of new money from nothing, thus expanding the money supply, which leads to inflation. This problem becomes worse once we account for the fact that governments also tend to borrow from these banks; the cycle repeats itself, and it leads to the creation of a debt spiral.

A debt spiral is a cycle of increasing debt where payments are primarily applied to interest, causing the total debt to grow or stay the same despite making continuous payments. It is the reason why we see a growing trend of people on social media complaining about "paying" off their student loans for a majority of their life, only for the total to still end up being almost equal— sometimes even more —than the original loan that they had got. They were paying off the *interest* in those monthly payments and not the actual debt itself.

This is why Riba (Interest) is the core driver of instability; interest makes the total debt always bigger than the total money, which leads to inequality in wealth, crisis, inflation, and speculative bubbles.

This is what a full-reserve, Interest-free system aims to counter: a system where banks would keep 100% reserves of deposits. They will not be able to create money by lending, and the job of money creation falls to the state or a central monetary authority, not private banks. There are even certain Islamic principles that interest-free systems can start implementing as opposed to using loans.

Mudarabah, a profit-sharing partnership where one party provides the capital and the other provides effort/management. It is a system which encourages entrepreneurship and eliminates the issue of guaranteed interest, since the returns depend on actual business success instead. The profits are shared according to a pre-agreed ratio, and if there are any losses, then those are borne only by the capital provider, unless the manager has been negligent. Instead of giving loans with high interest rates to small businesses, startups, or entrepreneurs, the system of mudarabah encourages risk-sharing, not risk-shifting.

Musharakah, a joint-ownership/partnership where both parties contribute capital, share profits, and share losses. The profit-sharing ratio is first agreed upon; however, the losses themselves are strictly proportional to investment. There are two types of Musharakah: Permanent and Diminishing. The former is a long-term joint ownership and while the latter is used for home financing: the bank gradually sells its share to the customer. Musharakah removes the concept of "creditor-debtor exploitation" and instead promotes shared responsibility and shared benefit.

Murabaha, a trade-based contract. One where the bank buys an item that the customer needs (Car, equipment, etc) and then sells that item to the customer at cost with a known profit margin. The profit margin itself is not interest and is the bank's legal profit from a real asset sale. There is no hidden compounding like interest, and it avoids uncertainty because all the costs and profits are disclosed beforehand. Instead of taking loans with interest out for such goods and financing, the concept of Murabaha shows practical asset-based financing and demonstrates an interest-free system that can replace conventional lending. Credit becomes tied to *real* economic activity and not just artificial money creation.

Thus, if the state controls money creation, then there would be no need to borrow money from banks. The government itself would create money, which would be backed by real output, and has the potential to dramatically reduce public debt. Money supply would grow only when production increases, or real demand rises, which in turn would help in preventing currency devaluation, price bubbles and systemic inflation. The interest-free systems would get rid of payment plans that are spiked with interest as well, and without those interest payments, the government budgets would stabilise.

According to A Review on Fiscal and Debt Policies in Pakistan by Karim Khanm, the existing costs of debt servicing are around 50% of Pakistan's total budgetary outlay, implying larger burdens for future generations. This, in other words, implies that unsustainable debt is costly not only in terms of the current budgetary process but also in terms of worsening future economic growth. The Full-Reserve system would help to eliminate this problem and free Pakistan from all the revenue it spends on debt servicing.

One report that was endorsed by the IMF, known as The Chicago Plan, proposed full-reserve banking, where they predicted that it would lead to 100% elimination of public debt, zero inflation and would lead to no bank runs. It also showed the system could achieve higher long-run output and even zero inflation because the government fully controls the money supply. Similarly, the GCC (Gulf Cooperation Council) countries, such as Saudi Arabia, UAE, Qatar, etc, have consistently demonstrated low public debts compared to Western economies and spend far less on interest payments as a percentage of GDP, and it is because their economies naturally align with Islamic Financial Principles. They rely more on asset-backed financing, sovereign wealth, and real economic activity, which has led them to achieve low inflation and greater macroeconomic stability.

In April 2022, the Federal Shariat Court of Pakistan ruled that all forms of Riba (interest) must be removed from the country's financial system. The court set a five-year deadline for the government, which is December 2027. The ruling affected government borrowing, commercial banks, the State Bank of Pakistan, financial contracts, and more. In 2023, the Ministry of Finance and the State Bank withdrew their appeals against this ruling and committed to working towards transformation, showing political and institutional willingness to transition to interest-free banking. Pakistan's legal system has now formally acknowledged that interest-free finance is both necessary and achievable, with a national deadline set for 2027.

The main reason we should adopt a Full-Reserve, Interest-Free System is the same reason Islam forbids riba (Interest): it leads to the concentration of wealth and the destabilisation of society. Zakat, on the other hand, is the complete opposite; it promotes a lifestyle of circulating wealth, and Islamic finance further promotes that lifestyle by linking money to real assets. It prevents speculation and allows society to achieve financial stability.

The State Bank of Pakistan (SBP) can be the first to start this reform by leveraging higher reserve ratios, shifting from a loan-based to a partnership-based form of finance and integrating Muadarabah / Musharakah in its systems. By gradually stopping earning or paying interest in its own operations and replacing internal lending mechanisms with profit-sharing arrangements, it can be the leading example for change. This is a change that would increase trust in the Islamic banking system and help to stabilise the economy. Because the current problem that Pakistan has— as mentioned before in this article —is that, like a majority of other countries, it too spends a huge percentage of its budget on interest payments in an increasing debt cycle. What Pakistan can instead do is follow what Malaysia and the UAE have done, and pursue an asset-backed economy. Not only would it help to free the government from compounding interest, but it would also link borrowing to real development.

As previously discussed, private banks mainly create money through loans or interest, which in turn fosters inflation and inequality. The proposal here is that only the state should be responsible for creating money, and that it should be created only when a genuine project begins, goods are produced, or jobs are generated. Consequently, wealth would be linked to productivity, leading to a reduction in inflation, because ultimately, money must represent real economic activity, not debt.

A full-reserve public banking model gives us a good solution to our problems; implementation of such a system would prevent banks from creating money through debt. This is not the case for the fractional reserve system; this approach would help to ensure that loans are only from existing deposits, and no money is created through lending. This leads to an elimination of instability and bank runs. At the same time, the government could establish a National Investment Fund that uses only Mudarabah and Musharakah, prioritising the energy, agriculture, and infrastructure sectors, and allowing citizens to invest in them. Profits generated from all of these sectors could be used to fund social welfare, public services, or even be used for further development, helping to cement a better relationship between the state and its citizens.

For Pakistan to successfully shift towards an interest-free economic model, there needs to be several legal and regulatory reforms that must occur in a clear and gradual manner. Firstly, Article 38(f) of the Constitution of Pakistan, which already mandates the elimination of interest, should be more strictly enforced, and its implementation timeline should be legally binding. Government institutions like the State Bank of Pakistan should be given a fixed roadmap in order for them to transition their financial frameworks into Shariah-compliant models such as Mudarabah and Musharakah by the target year.

Secondly, already existing banking laws such as the Banking Companies Ordinance (1962), which regulates commercial banks, and the State Bank of Pakistan Act (1956), which provides the legal foundation for the central bank, would need revision to remove legal backing for interest-based transactions in order to make profit and loss sharing the default method of financing. Providing banks with a clear legal framework instead of just ambiguity about what is allowed.

The legal system would need to support Islamic commercial dispute resolution mechanisms.
These include **Sulh** (amicable settlement), **Tahkim** (arbitration), and **litigation** in courts. Sulh is a process of good-faith negotiation and compromise, while Tahkim is the voluntary submission of a dispute to one or more arbitrators (hakam) for a decision based on Sharia principles. Specialised Islamic finance courts could be created that are staffed by experts in both Shariah and economics to handle cases that are related to profit-sharing, partnership disagreements or even investment disputes. Such changes would ensure that the path is not only religiously aligned but also legally sustainable. Critics may argue that a full-reserve system could reduce short-term credit availability and slow down economic activity. However, this temporary contraction would be replaced by healthier, more sustainable growth driven by equity investment, entrepreneurship, and real asset expansion rather than debt dependency.

The current financial system that Pakistan has is known as a fractional-reserve, interest-based banking system, a system that is known for its inherent instability and debt dependency. The economy that is built under such a system is driven by debt rather than real productivity, which results in recurring financial crises. In contrast, a full-reserve, interest-free, and partnership-based system allows for money to be generated from real assets, genuine work, and actual production. Reducing exploitation and encouraging national development based on shared risk and shared profit. Through the creation of a National Investment Fund that is rooted in the Islamic principles of Mudarabah and Musharakah, the government can direct funds towards essential sectors such as energy, agriculture, and infrastructure, leading to long-term economic strength. Despite such a change requiring time, effort, and strong governance, a carefully managed transition can help to lead Pakistan towards a more stable and sustainable economic future.