Reforming money and Banking, How A Full-Reserve System can Eliminate Government Debt, Deficits and Inflation

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Abstract

The paper discusses the shortcomings of the current system of the fractional-reserve banking (FRB) system, and considers the alternative structural solution to the monetary and fiscal stability of Pakistan to full-reserve banking (FRB-100%). The research brings forward the role played by the credit-based generation of money by the commercial banks in fostering inflation, higher levels of debt among the population and putting the economy at the risk of financial instability recurrence. Pakistan, with its long-run inflation rates in the double-digit range, its fast-growing domestic debt, and its tendency to crowd out the private sector investment is a good case study of how the credit-money environment contributes to the increasing fiscal deficit and the destabilizing of the macroeconomic situation. The study follows a qualitative and descriptive research design, which incorporates (i) document review regarding classical and modern monetary reform literature including the Chicago Plan, sovereign-money theory and the principles of Islamic finance; (ii) secondary data analysis of the data obtained through statistical analysis of the State Bank of Pakistan, the World Data and the fiscal reports to see the trend in the debt, money supply, inflation and the distributive credits; and (iii) a comparative analysis of the fractional-reserve and the full-reserve system with their implications on money creation, bank-run.

Results indicate that full-reserve banking in which money creation and the bank lending are separated can re-establish central-bank control over money supply and money inflation, remove the effects of credit inflation on prices, and lower state debt by allowing the state to emit interest-free sovereign money. The systemic stability is also enhanced by the model in the sense that all the demand deposits are fully covered by the central-bank reserves thus eliminating the chances of bank runs. Full-reserve banking is consistent with the Shariah principles in an Islamic finance setting: it eradicates interest-based financing and encourages risk sharing, financing based on assets and economic justice.

Introduction

The current banking system operates primarily as a profit driven businesess, with debt servicing as their core products. Banks design incentive schemes and performance targets motive their staff to ' lend more loans, utilizing marketing and sales techniques to foster households to borrow more. In unison, they compete intensely toother banks, aiming to increase their industry dominance and absolute size on monopoly way. As the banks do not bear the adverse consequences of their credit money creation, they are strongly incentivized to issue the credit money beyond the optimal level and use of this fund in real estate and financial assets rather than productive industrial investment (Turner, 2015).

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Fractional reserve banking is a system that allows commercial banks to take advantage through lending a significant portion of their customers' deposits while keeping just a limited portion as reserve usable for withdrawals. In this mechanism, monetary system able to create funds out of nothing (Sobirjonova, 2024).

In today's banking system money is created through fractional reserve banking by credit creation. When a customer deposit an amount to the bank, bank keep a small portion as a reserve, cash that banks are required to keep on hand in case of unexpected demand, according to the State Bank policy and lend the major amount to the borrowers based on interest. The borrowers repeat the same process numerous times may have a 20x multiplier effect and banks repeatedly generate the credit money. Under the double-entry bookkeeping, credit creation records loan entry to a bank balance sheet, accompined by an equal deposit entry on the liabilities side correspond to the same individual (van Dixhoorn, 2013).

This credit money is the stimulus trigger of fueled inflation, the massive government debts, the unceasing fiscal deficit, the bank runs and the financial panics due to numerous reasons. It can be destructive for public finances and rising inequality. It risks having a bank run in case the large numbers of people go to withdraw their deposits within one time. In technical terms, the bank deposit is a figure in a computer system, in accounting language this is the liability of the bank on your part. The terminology is bit confusing as the bank deposit is not a deposit in a way that you might save a valuable item in a safety deposit box. Rather it is just an electronic number of what the bank owes to you (Ornes, 2018).

In addition to, it has a systemic risk since the money supply is controlled by commercial banks, rather than by central bank. With the existing banking system, there is no control of money supply by the government and the central bank as the real and the government guaranteed money which is printed by central bank is dried up and is very low in circulation. In the UK, only 3% of the money is in the shape of physical notes and coins whereas 97% is credit money or commercial bank deposits. Correspondingly, the same figures for Denmark are 5% and 95%, for Iceland 3% and 97%, and for Switzerland 13% and 87%. Curiously, there is very little research on the seigniorage profits that commercial banks generate from theirpower to generate money. The central bank only determined the policy interest rate. This implies that the money available in the economy is related to the levels of money that commercial banks are ready to lend and the amount that people are willing to borrow. Thus, money supply is not directly controlled by state bank and nearly all the funds are provided by the loans which are returned with interests. This is the foundation of financial instability of the global economy, and the vicious cycle, in the form of unemployment resulting in reduced spending, having bad economies such as that of Pakistan. In debt servicing, the primary issue to consider in the context of Pakistan is the domestic debt issue since 90% of the interest expenses are used in serving domestic debt (Ayub, 2024). Under this unbalanced and inequitable system, the unprogressive economies like Pakistan are facing high inflation, fiscal deficit and massive debt.

This system needs to replace with Full Reserve Banking or Hundred Percent Reserve Banking. Full reserve banking is a system where commercial banks save the deposits of the customers as full reserve and cannot lend it. Unlike the current fractional reserve system. full-reserve banking transfers the power of money creation solely to the state bank. This system aims to stabilize the money supply, prevent credit-driven booms, and reduce public and private debt levels (et al., 2012). In this proposed banking system, commercial banks have to fully reserve the deposits of the customer as trustee or custodian in current account where money must always be available on demand and not allowed to lend it. These reserves will be fully backed by the real money created by state bank. Under this system, therefore, commercial banks are not allowed to make credit money through loans. The current account will work as risk free deposit section and the power of money creation will shift to central bank and will become a sole creator of money. How much money need to flood in economy and to invest will consider by state bank through money growth rule or discretionary policy. On the other hand, investment section of the bank will under the control of state bank directly. This section would be invested by capital and long-term debt for investment in Islamic finance like partnerships, sales and leases-based modes at the customer's risk. Therefore, under the supervision of state bank, there will be no risk of bank runs. So, the bank's liquidity and solvency will completely separate.

Government debt and inflation:

Within debt servicing, the bigger issue for Pakistan is that of the domestic debt being provided by the banks as 90% of interest costs are for servicing domestic debt. Treasury bills and bonds are used to borrow most of the loans by the government in the local commercial banks. Such banks issue credit money to lend to the government i.e. new money is created at the cost of a debt. The government internal debt has been reached to Rs**42587.9** billion till Dec 2023 according to SBP report. The system is extremely expensive as the government continues borrowing at high interest rates to settle past loans which will result in the debt spiral. It also deters the lending of the private sector, since the banks believe that it would be safer and more lucrative to lend to the government. The government borrow from private banks to pay interest on existing loans. This borrowing increases both government debt and the money supply**,** creating a cycle where new loans are taken just to service old ones. The spending on debt servicing has rise sharply from less than **Rs400** billion in 2003-04 to round about **Rs7300** billion in 2023-24. Contrary to common belief that this money goes to the IMF, World Bank, or other foreign lenders; however, 90% of interest costs is actually made on domestic loans. This burden exceeds several times from of government spending on infrastructure and social protection programs.

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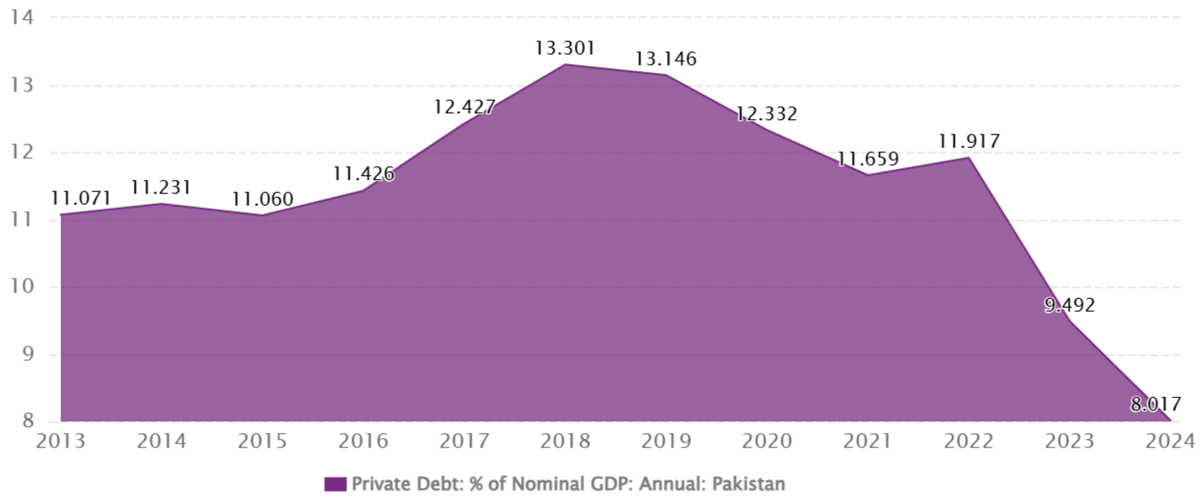
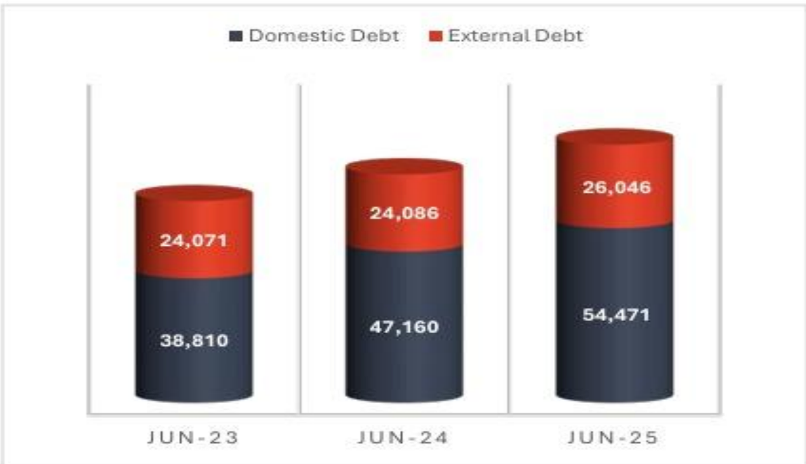
Pakistan's Private Debt: % of Nominal GDP



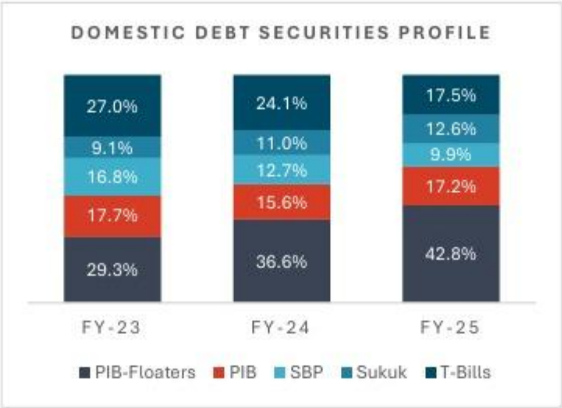
Source: www.ceicdata.com

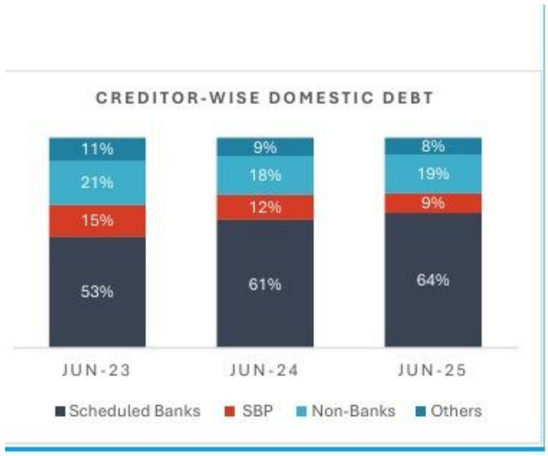
As of June 2025, the total public debt in Pakistan has reached to PKR 80.6 trillion, where domestic debt contributes as PKR 54.5 trillion. Every year, the domestic debt increased by 15%.



Source: State Bank of Pakistan

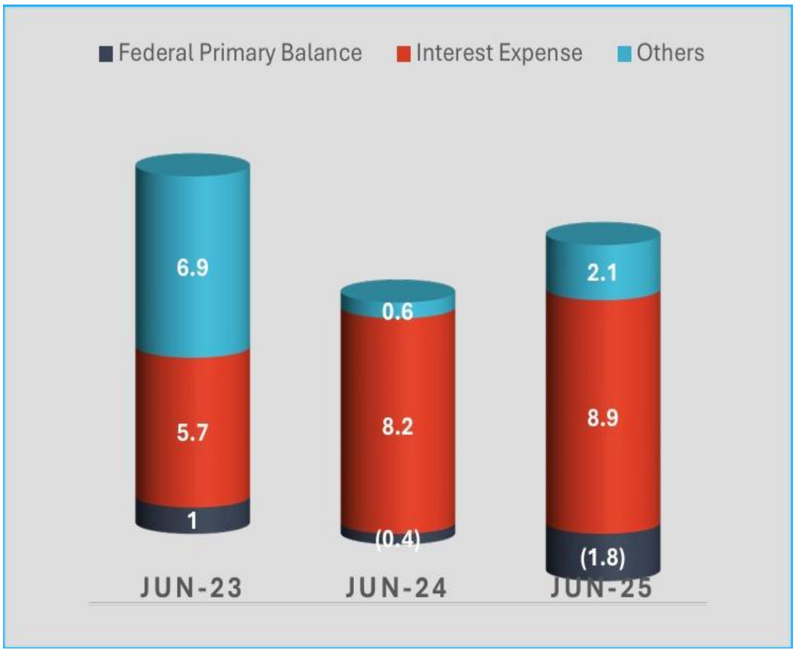
The key domestic debt instruments are investment bonds, sukuk, T Bills and SBP loan. The key creditors of dometic debt are SBP, commercial banks and non banks institutions.





Source: State Bank of Pakistan

The interst payment on debt reached to8.9 trillion increased by 9%. On the other hand, full reserve bank can prevent the economy from any kind of interest.



Source: State Bank of Pakistann

In the last 5 years alone up to the end of 2024, the inflation rate averaged 16.9% in pakistan and the inflation rate was calculated in 2024 as 23.4%. The average depreciation of currency PKR is 0.32 rupees per year. So, according to inflation calculator an average depreciation of 1000 is 322.18 per year. Conversely, in 1960 you could buy as much with 2.52 rupees as you can today with 1000 rupees.

Historical inflation rates in comparison

Year	Pakistan	Ø EU	Ø USA	Ø World
2024	23.40 %	2.60 %	3.00 %	5.80 %
2023	29.20 %	6.30 %	4.10 %	6.70 %
2022	12.20 %	9.30 %	8.00 %	8.60 %
2021	8.90 %	2.90 %	4.70 %	4.70 %
2020	10.70 %	0.70 %	1.20 %	3.30 %
2019	6.80 %	1.40 %	1.80 %	3.50 %
2018	4.70 %	1.90 %	2.40 %	3.60 %
2017	4.80 %	1.60 %	2.10 %	3.20 %
2016	2.90 %	0.10 %	1.30 %	2.70 %
2015	4.50 %	0.10 %	0.10 %	2.70 %
2014	8.60 %	0.40 %	1.60 %	3.20 %
2013	7.40 %	1.40 %	1.50 %	3.50 %

Source: www.worlddata.info

Macro economically, the inflation can be estimated by simply taking the difference between the growth of money supply and the real GDP growth. In the presence of full-reserve banking system where only the central bank has the mandate to create money, money supply growth may be adjusted to productive capacity. As an illustration, when the central bank increases the money supply by **5%** and the real economy increases by **4%,** excess liquidity remains at 1%, which translates to low level and stable inflation. By contrast, in the present fractional-reserve-based banking system in Pakistan, the commercial banks create the bulk of the money by credit creation, leading to a booming and unregulated rapid monetary expansion. In the past, the money supply in Pakistan has been increasing by **14-17%** each year whereas the real GDP has been increasing by about **4%** on an average. This imbalance creates a gap of inflation **10 to 13%,** which is highly similar to the continuous inflation in Pakistan of double digits. The model therefore shows that through coordination of the growth of money supply with the reality output, monetary stability can be realized, but with a fractional-reserve system, money will invariably become the cause of inflation by permitting credit to grow faster than the real economic activity.

In full reserve banking, the target of generating new money align with sustainable rate of growth of economic activity would rest to the central bank. Rather than adjusting the policy rate of interest to influence the borrowing of households and businesses, State Bank will use its authority to create money to influence aggregate demand in order achieve monetary policy objectives. After fixing the targets of monetary policy by the government and calculation of the change in aggregate demand by State Bank for creation new money, it would grant to treasury department to distribute in (1) government expenditure to create jobs, build public infrastructure, encourage investment, (2) decrease taxes using new money to adjust lost revenue, (3) subsidies to citizens, and (4) indirect investment in business using bank investment account as intermediaries (Dow & Montagnoli, 2015).

Literature Review

In fractional reserve banking, central bank mandates for bank to reserve a small portion of deposits for daily withdrawals and can lend remaining amount to the borrower on the bases of interest. There for credit money generate in the market. The concept started with the goldsmiths, where receipts eventually became a medium of exchange and were backed by gold but then subsequently became unbacked. This practice was later spread by repetition, through the development of current banking institution, and the contemporary monetary system was born. In 19th century, the concept of full reserve banking emerged, and Its necessity was felt even more after the financial crises.

The debate on monetary reform and the transition from fractional-reserve banking to full-reserve or "100 percent reserve" banking has been extensively discussed in academic, policy, and institutional research. Early foundations of this debate originate from the Chicago Plan of the 1930s and have been revived in response to recent financial crises. The core idea is to separate the payments system from credit creation, in which central bank issues the money and the commercial banks act as intermediaries for lending using time deposits or equity not demand deposits in order to prevent credit-driven booms and financial crises. The Chicago plan strongly argues that moving to a full-reserve system could significantly reduce private debt, stabilize economic cycles, and eliminate the risk of bank runs by ensuring that deposits are fully backed by central-bank money. Through Chicago plan, the monetary and lending functions in the banking system will separate, that will reduce public debt, and achieve hundred percent output without inflation.

The Great Depression exposed with an improved version of the 100 Percent Money plan, which stated that banks must be obliged to maintain full reserves on the basis of demand deposits. By separating the Credit-based boom and lending functions of money creation, this would increase the stability of the monetary system and eradicate bank runs. Fisher contribution was one of the first systematic theoretical expositions of full-reserve banking, which connects it with macroeconomic stability, moderation in the increase in money supply and the avoidance of cyclic crises. Even though it was not used at that moment, his concepts by Fisher have been revived periodically in later discussions of monetary reform, and are a foundational intellectual resource of modern proposals such as sovereign money and narrow banking models (Ideas, 1993).

The commercial banks, motivated by profit and insulated from the consequences of excessive lending, tend to expand credit beyond productive limits—especially toward real estate and financial assets. Full-reserve banking is acceptable, as deposits which serve as commercial investments should not be insured by the taxpayers. It emphasizes that the interest-earning depositors are actually the appropriate candidates in lending funds, but they are also provided with protection by the government, unlike other investors. Full-reserve banking eliminates the invisible subsidies, financial frailty, and the creation of additional money by only central banks by isolating the really safe deposits and the risk-taking deposits (Ralph & Musgrave, 2018).

Another important stream of literature focuses on seigniorage and the consequences of allowing private banks rather than the state to benefit from money creation. The commercial banks capture substantial seigniorage profits from issuing credit money, while governments are forced to borrow at high interest rates.

The model of the creation of money in a full-reserve banking system illustrates that the differentiation of the deposit-taking and lending activities is basically transforming the flow of money in the economy. As much as credit quality is guaranteed by the central bank's reserves that the deposits fully ensure, the private banks will not be able to create money by issuing credit hence a better and more transparent monetary system. Such an arrangement, however, relocates credit provision to investment banks and further depends on the money creation by central banks to keep the economy going. Full-reserve banking improves the stability of the monetary and hinders credit cycle based on deposits, but it also necessitates a well-coordinated policy to ensure that credit crunches do not happen and that the economy will grow steadily (Lainà, 2019). In developing economies such as Pakistan, these issues are intensified. The domestic debt spiral where government borrowing—funded through credit money created by commercial banks—expands money supply and fuels inflation. The State Bank of Pakistan (2023) similarly shows that domestic debt has increased sharply, crowding out private lending and undermining growth.

In Islamic finance perspective, full-reserve system supports risk-sharing and asset-backed financing, consistent with Sharia principles. Full-reserve banking system follows the goal of Maqasid al-Shariah especially in ensuring economic justice, transparency, preventing Riba and wealth protection. By preventing banks to build money by means of charge-based lending, full-reserve framework minimizes extreme leverage and financial volatility, which are perceived to cause harm in Islamic economic ideas. The system favors ethical financial dealings, discourages speculation and makes money entirely backed and properly handled. On the whole, full-reserve banking is a model that supports Shariah objectives by promoting stability, equity, and the real-sector economic activity (Ahmad & Ismail, 2017).

The Proposals of FRB do not always take into consideration the fact that money creation is strictly connected with the process of lending and financing the real economy. Restricting banks to lend based on the savings they had previously will create a deflationary bias which will decrease investment activities and the economy as a whole. It is also noted that most of the financial instability begins with non-bank intermediaries and shadow banking which FRB does not specifically deal with. Moreover, the absolute separation of transaction and investment accounts is not likely to be effective, because the financial institutions can bring new so-called near-money instruments that would not be regulated. The FRB might not provide the stability it promises and may undermine the flexibility of the economy (Fontana & Sawyer, 2016).

The literature defines full-reserve banking as a reform which isolates money creation and private bank lending in an attempt to establish a more stable and safer monetary system. The article describes that in the existing system, commercial banks issue the majority of money by credit growth, which causes the money supply to be pro-cyclical and susceptible to bank runs. Full-reserve banking is one way of resolving this, where the transactions accounts must be fully covered by the public money, so that no deposit insurance is needed, and the payments system no longer depends on the solvency of the bank. Among the benefits that may arise as a result of it, the report mentions the reduction of both personal and government debt, improved regulation of money supply, and less booms and busts. But it raises significant issues, such as problems in transition, doubts on the availability of credit, and the danger of financial innovation setting up money-like instruments that are not regulated. On the whole, the research paper finds that full-reserve banking is not a complete solution of the fundamental issues of the financial system but could decrease their frequency and intensity.

Full-reserve banking and sovereign-money ideas would improve the count of public debt and interest payments by issuing interest-free money; however, the reforms will not bring anticipated results in an open economy. According to their full-reserve banking is not necessarily going to reduce interest rates since holders of wealth will react to lower returns on deposits by moving their portfolios abroad, putting pressure on the currency, intending to provoke an increase in the interest rates by central banks. Full-reserve or monetary-Keynesian school of thought, debt-free money regimes can thus exacerbate the problem of the interest-rate-growth-differential as opposed to addressing it. This kind of monetary reform is not the panacea to the reduction of the levels of public debt or to a stable low-growth economy, except, perhaps, in closed or dominant-currency economies (Sauber & Weihmayr, 2015)**.**

Full Reserve Banking even though it is touted as a safer method compared to the one in a fractional-reserve system, has substantial misconceptions and practical shortcomings. The insistence on the 100 percent reserves on banks is not an automatic way of removing the risks of financial instability because most crises are caused by assets-related risks and not deposit creation. This is the fact that full-reserve proposals have the effect of limiting the supply of credit, thus potentially halting the economy and transferring risks to other sectors that are not as regulated. In general, the author perceives full-reserve banking as an attractive and simplistic remedy which does not recognize the complexity of the contemporary financial systems (Ricks, 2016).

Full-reserve banking is a structural alternative exists to curtail instability associated with creating money through credit. The system allows no excessive credit growth by forcing the banks to keep 100 percent reserves to deposits, and reducing the chances of a bank run to minimum. But the author further points out that this model will limit the supply of credit and move the financial intermediation to non-bank sectors which would bring about new instability. In general, the paper considers full-reserve banking as a possible stabilizing form of banking, albeit one that necessitates very critical policy formulation to help strike a balance between monetary control and sufficient supply of credit (Krainer, 2017).

Overall, the literature shows that fractional-reserve banking contributes to financial instability, expanding public debt, and weakening monetary sovereignty. In contrast, full-reserve banking offers a structural reform capable of restoring central-bank control over money supply, preventing bank runs, and ensuring long-term stability (Musgrave, 2014).

Discussion

Full reserve banking separates the monetary function from credit creation. The demand deposit would be 100% fully backed by the money created by central bank. There will be a separate investment account for business and investment activities through Islamic way of contract as partnership or ijarah based contract. As banks would no longer able to lend the borrower, interest will not be involved in economy aligning with Islamic economics. Central bank will become independent to create money in economy removing bank's ability to generate credit money. By this public debt can be eliminated and make easier to control inflation.

Key mechanism

The fact that Pakistan continues to move the entire banking system towards Islamic operations also enhances the arrangement of a full-reserve system, in which the deposits of transactions and the investment funds are separated entirely. In this model, banks would keep current accounts as a custody account that would be fully secured by reserves in the State Bank so that customers can have access to their money whenever they require it. The banks would also have their independent investment accounts, where depositors would pool their money so that they would use it to finance their activities using the Shariah-compliant modes of operation like the Mudarabah partnerships, sales that are asset-based, and leases. Since these investment accounts are risky and yield depending on the actual business performance, and not based on a guaranteed interest, they support the Islamic economical concept of risk-sharing and eliminate artificial credit. With the transition of Pakistan towards non-interest-based banking, this division enhances monetary discipline, decreases the amount of pressure applying on the government to borrow using interest bearing instruments and encourages a more stable pattern of financing that is more based on real economic activity. Finally, Islamic banking combined with full-reserve principles will be able to curb credit-related inflation, reduce long-term debts, and create a more robust and just financial system.

Favorable outcomes

A transformation into full-reserve banking with an interest-free monetary system provides a structural way through which Pakistan can end the pathway of increasing government debt, structural fiscal deficit, and endemic inflation. With this type of system, the creation of money no longer depends on the new government borrowing or the growth of credit by commercial banks but rather the State Bank becomes the exclusive issuer of the sovereign money, in which new currency is issued that corresponds to the productive potential of the economy. This also removes the necessity of government issuance of interest-bearing treasury bills and bonds to the banks, the root cause of domestic debt accumulation. Since sovereign money is issued at no interest, some of the fiscal deficits can be financed by controlled state money issue as opposed to expensive borrowing, and debt-servicing costs that currently use a sizeable portion of the Pakistani budget can be relieved. The spiraling of inflationary tendencies, commonly caused by unregulated credit creation and deficit monetization, can be stopped by clear monetary regulations to restrain the growth of money to the actual economic output. Financing in an interest-free economy is no longer based on a debt-based contract, but instead on a profit-and-loss sharing or asset-based basis, as speculative credit booms are discouraged and investment in the real sector will be encouraged. This cohesive framework could thus stabilize the monetary system in Pakistan, minimize the exposures to banking crises, sustain financial operations, and harmonize financial activities with equity-based principles in line with the Islamic economic objectives.

The direction taken recently by Pakistan under the influence of the decision of the Federal Shariat Court in 2022 and the intention of the government to go interest-free in the financial system offers a favorable appropriate moment to shift to the concept of a full-reserve, interest-free banking system. The national shift to Islamize all banks enhances the ideas of equity, real sector financing, and risk sharing that are the key concepts in Islamic economics. As the creation of credit money, which is solely based on debt and interest, is forbidden by Islamic finance, this change is natural to the aims of full-reserve banking, in which the sole role of money creation is played by the State Bank, and lending is organized in terms of asset-backed and partnership formats. When well instituted, the shift in Pakistan to an Islamic banking network is likely to restrain the growth of the speculative use of credit over time, lower the reliance on interest-based domestic debt, and encourage more productive investment behavior.

Such a twin change - to Islamic values and a full-reserve system - can reinforce financial discipline, reduce fiscal disequilibria through a reduction in debt-servicing interests, restrain inflationary pressures caused by money-creating credit, and, in the longer-term lead to a more stable and equitable credit-based financial system, which is fully compatible with the overall purpose of Islamic economic justice and macroeconomic stability.

Effective results

Since the fractional reserve banking has injuries effects on banking sector and the broader economy, full reserve banking emerges as an effective alternative to overcome all these challenges. The practical benefits of FRB boost the economy and contribute significantly country's development.

1. **Elimination of public debt**

Full-reserve banking (FRB) would be able to eradicate the government debt by isolating the money creation and lending by the banks. In FRB, commercial banks must store 100 percent of the demand deposits as reserves and can only loan out in different investment accounts hence do not create money. This means that the government can fund its expenditure by using the central bank where this bank prints new money and puts the money in the government cheque rather than borrowing money via the private banks. This will do away with interest payments on debt as well as dependence on local and foreign borrowing. The money injected goes around the economy and taxes receive aid in controlling the inflation and as a result the government is able to pay back the debt that exists over time. Applying to the situation in Pakistan, where a powerful part of a fiscal budget is spent on the debt payment, FRB would enable the state to finance development projects directly through the State Bank of Pakistan, whereas the private banks would only engage in lending money based on the savings. With time, this system may decrease the debt to GDP ratio, stabilize the financial sector, and be in conformity with the Islamic economic principles by preventing Riba and encouraging ethical finance.

2. **Preventing Bank runs**

Fractional-reserve banking poses a weakness in the financial system as banks reserve a portion of deposits as they make loans out of the rest. Such an imbalance between the money in the banks and the deposits can cause bank runs in case a large number of depositors are attempting to withdraw cash at the same time. In full-reserve banking, there is no such risk as money is kept in reserve by the banks as 100% of the demand deposits that means that the money of all depositors is never lost. Full-reserve banking ensures that the liquidity of banks and consumer confidence do not disappear since lending and deposit accounts are separated, which practically excludes the risk of bank runs (Prescott & Wessel, 2016).

3. **Fiscal sustainability**

Full-reserve banking is a process that is quite basic in averting fiscal deficits since it provides the government with direct access to money that is created by the central bank rather than borrowing it through commercial banks or external lenders. Governments in a fractional-reserve system use the issuance of debts to fund expenditure, which accrues interest and usually causes chronic fiscal deficits. In full-reserve banking, demand deposits are fully secured and the private banks are unable to create money by lending it out and therefore the state is able to finance its government spending through the central bank without any interest-yielding debt being accumulated. The policy allows government expenditure to be allocated in accordance with the real money supply that enhances fiscal discipline and decreases the strain on deficits. In relation to Pakistan, where the historical level of fiscal deficits is high because of the high levels of domestic and foreign borrowing, moving to a full-reserve system can give the State Bank of Pakistan the ability to directly fund development projects and other necessary services, reducing the debt/GDP ratio over a period of time and keeping the economy stable without incurring high costs of debt.

4. **Alignment with Islamic principles**

Full-reserve banking is quite consistent with the Islamic economic concepts of forbidding Riba (interest) as well as the focus on ethical and risk-sharing financial frameworks. With such system, money cannot be created by banks in lending and all demands deposits are fully guaranteed which does away with the need to borrow money on an interest basis. The lending is done on the basis of separate investment accounts where the banks as well as the depositors share the risk and returns of the productive projects which would be in line with Islamic finance principles like Mudarabah and Musharakah. Full-reserve banking also facilitates financial stability, equity and transparency by ensuring that the creation of money is pegged against actual economic activity as opposed to debt creation, which are fundamental aims of Maqasid al-Shariah. When applied within the context of Pakistan, the full-reserve system would enable the banking industry to operate in the manner that will not be in conflict with the Islamic law but at the same time enables the sustainable economic growth by not having to pay exploitative interests.

5. **Inflation control**

Full-reserve banking assists to regulate inflation by creating money very stringently. In contrast to the fractional-reserve banking system, in which the commercial banks increase the supply of money by lending it to the depositors, FRB oblige that the entire demand deposits would be fully guaranteed and that lending to risky investment accounts would be separated. This makes sure that there is a well-timed growth in the money supply in relation to the actual economic output. Moreover, expenditure facilitated by the government may easily be adjusted to productive levels and do not create liquidity overload in the system when it is directly financed by the central bank. By removing the unregulated credit growth, full-reserve banking makes prices stable and lowers the inflationary pressures, which contributes to the general economic stability.

Conclusion

The Pakistan’s economy in terms of finances, endemic inflation, and growing public debt is not a chance event that befalls the economy but a foregone conclusion of the fractional-reserve banking (FRB) model, whereby commercial banks grow credit well above real savings and seigniorage-like profits though the creation of deposit money. Due to the accelerating rate of bank credit growth compared to productive capacity, the money supply has consistently outpaced real output by 10 to 13 percent in history, and hence, real output has never matched the money supply, leading to endless double-digit inflation and currency devaluation. Simultaneously, Pakistan's domestic debt has surged to unprecedented proportions through government borrowing from commercial banks, facilitated by newly created credit money. As a result, interest payments have become the largest portion of the national budget, forcing private sector investment to the sidelines. This system therefore, creates a vicious circle in the sense that the more one borrows, the more credit money will be created, which will cause inflation, and this will further increase the need to borrow money. The historical literature shows that the process of fractional-reserve banking generates pro-cyclical money supply dynamics, which enhance financial booms and busts, exposes depositors to systemic risk, and removes sovereign control of monetary policy. Even such old proposals as the Chicago Plan, 100 Percent Money of Fisher, and modern sovereign-money models demonstrate that the separation of money creation and the issuance of debt by the bank can reduce the bank runs, accumulation of debts, and macroeconomic fluctuations by directly supporting the demand deposit with the central-bank money. The disproportionate amount of money supply created via bank lending is also evidenced in empirical data of various countries including, 97% in the UK, Iceland and Denmark, proving that the role of the money created by public is no longer at the base of the modern monetary systems.

A switch to full-reserve banking (FRB) inverts these dynamics to have the creation of all new money be under the strict control of the central bank to have demand deposits fully secured by sovereign money and credit be provided only by separate, risk bearing investment accounts. Within this context, Pakistan may finance a portion of its governmental expenditure by the direct issue of money as opposed to the high-interest borrowing that will alleviate the domestic debt of the government and decrease the structural fiscal deficit in the long run. Since there would be creation of new money proportional to the actual growth of the economy as opposed to commercial motivation, then inflation would be kept at low and manageable levels. More importantly, there would be no threat of bank runs by depositors, as their transaction accounts would be fully reserved and completely insulated against lending activities.

It is also revealed through the document that full-reserve banking would fit well with the current process of transitioning Pakistan to an interest-free, Shariah-compliant financial system, given that in 2022, the Federal Shariat Court made its decision. The Islamic principles of finance i.e. the sharing of risk, the securing of assets and the forbidding of interest-based lending are all in line with the concept of FRB separation of safe custody accounts with investment accounts and its forbidding of creation of credit by lending based on interests. This mutual enhancement implies the institutional and moral course of Pakistan enhances the argument of sovereign-money, full-reserve. The shortcomings identified in the literature including the risk of credit scarcity, expansion of shadow banking as well as transitional complexity necessitate policy development, robust regulatory regulations as well as coordinated macroeconomic planning. The drawbacks of these challenges do not overcome the structural drawbacks of the existing system, nor do they negate the exhibited advantages of FRB with the help of Islamic finance structure.

In general, the data shows that full-reserve banking provides a systemic and plausible answer to the root-cause systemic level of financial instability, dependence on debts, and inflationary situation in Pakistan. With the sovereign rejection of money making, the non-existence of the interest-based public borrowing, depositor security, and the observance of the Islamic economic principles, a full-reserve system represents a consistent way to achieve monetary stability in the long-term, financial sustainability, and a more realistic financial system.

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