How a Full-Reserve, Interest-Free System can eliminate Government Debt, Deficits and Inflation in Pakistan

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Abstract

Pakistan's persistent challenges of high public debt, chronic fiscal deficits, inflationary pressures, and recurring balance-of-payments crises reflect deep structural weaknesses in its interest-based, debt-driven monetary and fiscal framework. This paper critically examines the role of the fractional reserve banking system in amplifying these challenges through credit-based money creation and fiscal dependence on interest-bearing debt. The study analyzes recent public debt trends, external financing flows, domestic debt composition, and inflation dynamics in FY 2025, highlighting improvements in debt maturity and inflation outcomes alongside continued structural vulnerabilities. It then explores the potential macroeconomic implications of a gradual transition toward a sovereign money framework, under which commercial banks operate as financial intermediaries rather than money creators, public debt is progressively retired, and monetary expansion is aligned with real economic capacity. The paper further situates this reform within the principles of Islamic finance, emphasizing the prohibition of riba, the promotion of asset-backed and risk-sharing instruments, and the objectives of economic justice and social welfare. It argues that Islamic public finance instruments—particularly Ijarah-based Sukuk, Musharakah, and Mudarabah—offer pragmatic alternatives for debt management and development finance without exacerbating inflationary bias. While acknowledging the risks of abrupt monetary restructuring, the paper advocates a phased, institutionally grounded approach that integrates Islamic finance with prudent monetary control.

Keywords: Interest free system, government debt, deficits and inflation

Type of study: Original research Article

1. Introduction

Pakistan operates under a fractional reserve system. According to fractional reserve system, Commercial banks keep only a fraction 5-10% of deposits as reserves in Pakistan. The rest is loaned out for creating new money through credit. The State Bank of Pakistan (SBP) can also create money to finance government deficits directly by purchasing government securities or indirectly via commercial banks. This system expands money supply quickly — often without matching growth in real output — causing Persistent inflation, Fiscal dependence on debt (internal and external), and Currency depreciation. Government borrows by issuing bonds or taking loans from banks.

- Banks create money "out of nothing" to buy those bonds.
- The government repays with interest — increasing debt perpetually.

Adair Turner a former head of the UK's Financial Services Authority, he has discussed the concept full reserves system. The Institute of Chartered Accountants of Pakistan (ICAP) has presented full reserve banking as a potential solution to economic instability, proposing a system with zero debt, zero interest, and zero inflation. Modern Monetary Theory (MMT) have also engaged with full reserve concepts. MMT views commercial bank money creation as an inherent part of the current system, which the government must manage. A full reserve system views this private money creation as a source of financial instability that should be abolished.

The financial sector in Pakistan plays a critical role in mobilizing savings and allocating them to productive investment, thereby supporting economic growth and capital formation. However, Pakistan's financial system is characterized by excessive reliance on interest-based credit expansion, high government borrowing from commercial banks, persistent inflation, and chronic public debt accumulation. Rapid credit growth, particularly toward government securities rather than productive sectors, has contributed more to financial deepening on paper than to real economic development.

2. Background

Economists have highlighted the role of banks in not only promoting economic growth but also in driving innovation and providing a stimulus to the economy by funding productive investments. The growth in public debt during the first nine months of FY 2025 was 6.7 percent. This was lower as compared to the growth of 7.4 percent in the same period of the preceding year. Inflows In the first nine months of the FY 2025 from external debt disbursements amounted to US$ 5,066 million. Multilateral sources contributed the largest US$ 2,797, followed by commercial/other US$ 2,011, and bilateral sources US$ 258 million. There were no bond issuances during this period. Outflows Repayments totaled US$ 5,636 million, with multilateral creditors receiving the largest portion US$ 2,828 million, followed by bilateral creditors US$ 1,565 million, and commercial/other sources US$ 1,243 million. Interest payments amounted to US$ 2,660 million, with the bulk of these payments directed towards multilateral creditors US$ 1,315 million. The interest payments to bilateral creditors US$ 745 million, and commercial/other sources US$ 277 million were lower in comparison. Interest payments on Bonds amounted to US$ 322. Despite the marginal net outflow of US$ 571 million in FY 2025 (Jul–Mar), compared to a net inflow of US$ 1.15 billion in FY 2024 over the same period, the overall external debt profile remained stable. The primary objective of public debt management is to ensure that the Government's gross financing needs are met at the lowest possible cost over the medium to long run with a prudent degree of risk. Within the domestic debt portfolio, the Government primarily relied on long-term instruments such as

Pakistan Investment Bonds (PIBs) and Sukuk (Islamic Bonds) to finance the fiscal deficit and meet debt repayment obligations. This strategic shift enabled the retirement of Treasury Bills amounting to Rs 2.4 trillion, thereby reducing the volume of short-term securities and improving the debt maturity profile. In addition to the existing 3-year and 5-year Ijarah Sukuk, the Government also introduced a 10-year Sukuk, both variable and fixed rate, with a target to diversify Shariah-compliant instrument base. During the first nine months of the FY 2025, the Government successfully raised approximately Rs 1.6 trillion via Shariah compliant Sukuk issuances. Consumer Price Index (CPI) inflation decreased to 4.7 percent during July-April FY 2025, down from 26.0 percent in the same period last year. The drop in inflation from 23.4 percent in FY 2024 and 29.2 percent in FY 2023 is a testament to the government's effective strategy.

3. Theoretical framework and literature alignment

David Ricardo argued for a system that separates commercial banking from money creation date back to the 19th century. Irving Fisher proposed a "100% reserve" system in the 1930s to prevent bank runs and economic crises. Henry Simons also advocated for a banking system with 100% reserves for demand deposits. In the latter half of the 20th century, the economist Friedman became a notable advocate for full reserve banking. Conventional scholars Simon (1934), Fisher (1935), Freidman (1948), Latin (1987), Pierce (1991) and Hillinger (2010) assert that fractional reserve system creates economic disorders such as inflation and Seigniorage. Fractional reserve system also created s depreciation of currency value and inflationary pressure.

Zuriyati Ahmad and Abdul Gafar Ismail (2017) observed that fractional reserve banking is often criticized for creating money without a corresponding increase in real economic value, which can lead to various economic problems. Among these issues are inflationary pressures that cause the depreciation of currency value. Furthermore, the liquidity generated by the fractional reserve system can contribute to instability and vulnerability within the banking sector, increasing the risk of financial crises. The inherent flaws of the fractional reserve banking system have therefore prompted the search for viable alternatives. One such alternative is the full reserve banking system, which has been advocated by several prominent conventional and Islamic economists. Based on its underlying principles, analytical assessments, and supporting evidence from the Qur'an and Hadith, the full reserve system appears to better fulfill the objectives of *Maqasid al-Shariah*. Consequently, the adoption of a full reserve banking system is recommended for implementation within an Islamic monetary framework.

Dr. Zaman (2025) has studied that the objectives of full reserve banking can be achieved through simpler and more context-appropriate reforms already available within Pakistan's legal and institutional framework, such as credit guidance, development finance windows, transparency requirements, and SME guarantees. Leveraging the moral and cultural legitimacy of Islamic finance—supported by constitutional provisions, Supreme Court rulings, and the authority of the ʿUlamāʾ—can help advance meaningful reform while overcoming elite resistance and external pressure. Ultimately, effective monetary reform requires not only technical solutions but also credible institutions that represent the public interest, redefining the relationship between finance, the state, and society through moral clarity, political will, and institutional creativity.

Syed Hassan Jamil (2024) has observed that the 26th Constitutional Amendment places Pakistan on a bold path toward a more equitable and sustainable economic model by emphasizing justice and social welfare. Financial intermediaries are expected to link savers with businesses and productive units in a way that ensures wealth is distributed fairly according to capacity. Alongside this, the FSC Judgment (2022) represents a significant judicial step toward the Islamization of Pakistan's financial system, clearly directing the elimination of *ribā* and *gharar* in all forms, in line with the Principles of Policy of the Constitution. By addressing existing challenges and leveraging the strengths of Islamic finance—particularly through Islamic social finance institutions, fintechs, MFIs, and start-ups grounded in mutual cooperation—Pakistan has a real opportunity, with state and regulatory support, to establish a ribā-free and inclusive financial system aligned with its faith and constitutional values.

4. How full reserve or interest free system eliminate government debt, deficits and inflation

If the State Bank of Pakistan (SBP) were to gradually move toward a **100 percent reserve requirement system**, commercial banks would be required to hold full reserves against demand deposits. Government securities currently held by commercial banks would be transferred to the State Bank of Pakistan (SBP). The State Bank of Pakistan (SBP) could then cancel these securities, effectively reducing public debt without imposing additional taxation or default. Over time, public debt would be retired as maturing bonds are replaced with newly issued, debt-free sovereign money.

Under this framework, the State Bank of Pakistan (SBP) would directly control the money supply rather than relying primarily on interest rates. This is particularly relevant for Pakistan, where frequent interest rate hikes have failed to control inflation effectively but have significantly increased debt-servicing costs and crowded out private investment. By eliminating interest-based money creation, inflationary pressures arising from credit expansion could be reduced.

The State Bank of Pakistan (SBP) would become the sole issuer of money, while commercial banks would function strictly as financial intermediaries, lending only from existing savings rather than creating money through fractional reserve banking. This would limit speculative lending, reduce asset price bubbles, and redirect credit toward productive sectors such as agriculture, manufacturing, and exports.

The government of Pakistan would no longer need to rely on interest-bearing domestic debt or external borrowing to finance fiscal deficits. Instead, it could inject newly created sovereign money into the economy, provided such issuance is strictly aligned with real output growth and productivity improvements. This would help finance infrastructure, social development, and industrial expansion without exacerbating inflation.

By tying money supply growth to real economic capacity, this system could stabilize prices, reduce exchange rate volatility, and strengthen the Pakistani rupee. In the long run, it would enhance macroeconomic stability, reduce dependence on IMF programs, lower debt-servicing burdens, and support sustainable economic growth.

The proposed sovereign money system is strongly aligned with the core principles of Islamic finance, making it particularly relevant for Pakistan, where the Constitution mandates the elimination of riba (interest) from the economy and the State Bank of Pakistan (SBP) is pursuing full Islamic banking. A fundamental principle of Islamic finance is the prohibition of riba, which includes interest-based money creation. In the current fractional reserve banking system, commercial banks create money through interest-bearing loans, generating income without corresponding real economic activity. This practice conflicts with Islamic principles that require money to serve as a medium of exchange, not a commodity that earns a guaranteed return. By imposing a 100 percent reserve requirement, money creation would be removed from commercial banks and centralized at the SBP, effectively eliminating interest-based credit expansion.

Islamic finance also emphasizes asset-backed and risk-sharing financing. Under the proposed system, commercial banks would operate as true financial intermediaries, channeling existing savings into productive ventures through Islamic modes such as *Musharakah* (equity partnership), *Mudarabah* (profit-sharing), *ijarah* (leasing), and *Murabaha* (trade-based financing). This ensures that financial returns are linked to real economic activity and shared risk, rather than guaranteed interest payments. The elimination of interest-bearing government debt further supports Islamic principles. In the current system, the Government of Pakistan finances deficits through treasury bills and bonds that pay interest, which constitutes riba. By allowing the SBP to retire public debt through the issuance of debt-free sovereign money, the government would no longer rely on interest-bearing borrowing. This aligns with the Islamic objective of avoiding unjust enrichment and reducing the transfer of wealth from taxpayers to financial institutions.

Another key Islamic finance principle is the avoidance of gharar (excessive uncertainty) and maysir (speculation). Credit-driven asset bubbles and speculative financial activity create instability and injustice in the economy. By restricting money creation to real output growth and eliminating leveraged credit expansion, the proposed system would reduce speculative behavior, promote price stability, and support economic justice. Moreover, Islamic economics places strong emphasis on social welfare (maslahah) and equitable distribution of wealth. Sovereign money issuance allows the government to finance public infrastructure, health, education, and poverty alleviation without increasing debt or imposing heavy taxation. When carefully managed and aligned with productive capacity, this approach promotes inclusive growth and economic stability, consistent with the Islamic objective of *falah* (overall well-being).

Pakistan's persistent challenges of high public debt, chronic fiscal deficits, and recurring inflation are rooted in an interest-based, debt-driven fiscal and monetary framework that encourages borrowing for consumption rather than investment, disconnects finance from real economic activity, and amplifies inflation through monetary expansion. Large portions of government revenue are absorbed by debt servicing, crowding out spending on education, healthcare, infrastructure, and productive investment. As a result, public borrowing increasingly generates paper liabilities without corresponding increases in productive capacity, leaving the economy vulnerable to inflationary shocks and external financing pressures.

Islamic public finance offers a coherent alternative framework that emphasizes asset-backed financing, risk-sharing, and a direct linkage between finance and the real economy. Rather than relying on interest-bearing loans, Islamic instruments require that public financing be tied to identifiable assets or productive projects. The objective of this framework is not to eliminate government obligations or deficits through accounting changes, but to improve the quality, transparency, and economic impact of public liabilities while reducing structural inflationary bias.

One of the most practical instruments for sovereign financing is Ijarah-based Sukuk. Under this structure, the government transfers the usufruct, or use-rights, of public assets such as airports, highways, ports, or power infrastructure to investors in exchange for upfront funding. The government then leases the assets back and makes rental payments instead of interest payments, with ownership reverting to the state at maturity if structured accordingly. This approach converts unsecured sovereign debt into asset-linked obligations, improves fiscal transparency, and enforces greater discipline in asset valuation and management. While Ijarah does not eliminate fiscal obligations—since rental payments remain mandatory—it improves debt sustainability when used primarily to refinance existing interest-based debt rather than to fund recurrent expenditures.

For development finance, Musharakah and Mudarabah provide equity-based alternatives to sovereign borrowing. In Musharakah arrangements, the government or a state-owned entity enters into a joint venture with investors, sharing profits and losses according to pre-agreed ratios. In Mudarabah, the government acts as the managing entrepreneur while investors provide capital and share in the project's returns. These structures eliminate guaranteed repayment obligations and function as automatic fiscal stabilizers during economic downturns, as returns adjust to actual performance. Their effectiveness, however, depends on limiting their use to revenue-generating projects such as energy, transport, industrial zones, and export-oriented industries. They are not suitable for financing general budget deficits or recurrent social spending, where risk-sharing is neither feasible nor credible.

Murabaha financing can support government procurement by facilitating the acquisition of machinery, equipment, and strategic imports through cost-plus trade transactions with deferred payment terms. Although Murabaha creates payment obligations, these arise from genuine asset purchases rather than the lending of money for interest. When used judiciously, Murabaha supports fiscal operations without encouraging speculative credit expansion. Excessive reliance on Murabaha, however, risks replicating conventional debt dynamics and should therefore remain limited to clearly defined trade and procurement needs.

The inflation-mitigating potential of Islamic public finance lies in its insistence on linking financial expansion to real output. By channeling funds into productive infrastructure, industry, and services, these instruments help increase the supply of goods and services, counteracting demand-side inflationary pressures. Moreover, the absence of interest-based financing reduces cost-push inflation transmitted through rising borrowing costs. Nonetheless, asset-backed finance alone cannot prevent inflation if fiscal discipline is absent, projects are unproductive, or government liabilities are monetized by the central bank. Inflation control ultimately depends on ensuring that real economic growth outpaces monetary expansion.

Contrary to some interpretations, Islamic finance does not require the abolition of fractional reserve banking or the adoption of a full-reserve monetary system. Abrupt implementation of a 100 percent reserve requirement would likely cause severe credit contraction, economic slowdown, and expansion of informal finance, particularly in a developing economy such as Pakistan. A more pragmatic approach involves retaining fractional banking while gradually reducing speculative credit, expanding central bank refinancing through asset-backed instruments, and shifting from interest-rate signaling toward profit-based benchmarks aligned with real economic activity. An integrated Islamic fiscal framework is further strengthened by the role of Zakat, which discourages hoarding of idle wealth and incentivizes productive investment. When effectively administered and coordinated with taxation and social spending, Zakat reduces reliance on deficit financing for redistribution while promoting more efficient circulation of resources within the economy.

For Pakistan, a realistic policy path involves a phased approach. Existing interest-based debt can be progressively refinanced through Ijarah Sukuk backed by public assets, supported by the creation of a transparent national asset registry. Development spending should increasingly rely on Musharakah-based Sukuk and project-specific special purpose vehicles, particularly in infrastructure and export-oriented sectors. Monetary policy should be aligned with asset-backed finance through profit-based instruments, while strict limits are placed on monetization of government liabilities. Over time, the integration of Zakat, tax incentives, and investment policy can reinforce a shift away from debt-driven growth toward productivity-led development.

5. Conclusion

In conclusion, Islamic public finance offers Pakistan a structurally superior approach to managing debt, deficits, and inflation by anchoring public finance in real assets, shared risk, and productive investment. Its effectiveness, however, depends not on ideological commitment but on disciplined implementation, institutional capacity, and credible governance. When applied pragmatically and gradually, this framework can enhance fiscal sustainability, reduce inflationary pressures, and redirect national resources toward long-term economic development. Adopting a sovereign money framework in Pakistan would not only address chronic issues of inflation, debt, and currency instability but would also represent a structural reform consistent with Islamic finance principles. It would support a just, stable, and real-economy–oriented financial system, fulfilling both economic and religious objectives. Overall, it concludes that a sovereign money–oriented, asset-backed fiscal framework can enhance macroeconomic stability, reduce debt dependence, and support sustainable, productivity-led growth in Pakistan.

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