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EDITORIAL

Money Creation: Need for Adopting 100 Percent Reserve System

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In the current fractional reserve banking system, new money is created when banks give loans, and banks' lending decisions determine the total quantity of money that circulates in the economy. It is the root cause of instability in the global economy, and the vicious circle facing poor economies like that of Pakistan. Interest payments are eating up around 60% of government revenue. 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. This system has to be replaced with the Hundred Percent Reserve System (HRS) by separating deposit banks from financing/investment entities to create a stable economic environment. The Chicago Plan and the Sovereign Money approach were proposed to prohibit private banks from creating money by abolishing fractional reserve banking.

After the '*Chicago Plan*', the discussion on HRS re-emerged after the publication of the IMF Working Paper (WP/12/202) by Benes and Kumhof, in 2012. Benes and Kumhof found support for all positive points indicated by Fisher about the *Chicago Plan*. However, the system could not be changed as explained by Milton Friedman[1], "*The vested political interests opposing it are too strong, and the citizens who would benefit both as taxpayers and as participants in economic activity are too unaware of its benefits and too disorganized to have any influence*" (1960). There was institutional resistance, and the groups with vested benefits didn't let it be implemented. In the USA, at the time of President Roosevelt, the Plan lost in political expediency with the attempts of the banking lobby (Akin and Dolgun, 2015)

The primary distinction between known versions of 100% reserve banking and Islamic finance lies in the concept of interest and interest-bearing lending by investment banks. This drawback of HRS can be eliminated through the application of the principles of Islamic law of contracts and exchange (partnership, sales, and leases) in letter as well as in spirit. This similarity has two-sided benefits and deserves closer attention. When combined with the

[1] In "A Program for Monetary Stability (1960)," Friedman wrote: There is no technical problem in achieving a transition from our present system to 100% reserves easily, fairly speedily, and without any serious repercussions on financial or economic markets.

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prohibition of interest and *gharar*, the result is a stable financial system for proper linkage between the real sector of the economy and finance.

The transition to the HRS will start with the change in the banking sector balance sheet by introducing 100% reserve requirement and netting out of the public debt held by the banks with deposits. Benes and Kumhof (IMF, WP/12/202) recommended two conditions for transition to the HRS; i) The liability side of the banking sector must be fully backed by State-issued money; and ii) On the asset side, the assets must be funded by non-monetary liabilities. Commercial banks would open checking/safe-keeping accounts for customers and make all payment services as they do now.

The deposit banks would hold 100% reserves and provide payment services, while the Investment section would be funded by equity and long-term debt (term funds for investment in Islamic finance). Deposit banks will provide all other services to their customers except lending. It would make the money debt-free and independent of banks' performance in the credit/investment part of their business. Banks' debt liabilities are held by the government, so there would be no bank runs (Benes and Kumhof, 2012; Akin and Dolgun (2015).

In the HRS, the central bank would independently determine the quantity of money based on the current money stock, goods and services in the economy, the potential of the economy, and the documented needs of the economy (in terms of the relevant exchange contracts like that of sale, *ijārah, Salam,* etc). Any money growth rule or the basis must be followed meticulously, and that could be the GDP growth and growth potential represented by *Salam*, *Istisnā'a* and *Jo'alah* based contracts, if any. To avoid a credit crunch, the authority may also provide funds to banks based on the principle of *Mudārabah*.

The policymakers have to start from the current position of money supply in the economy, as allowed by the Sharīʿah (Qur'ān, 2:275; *Whoever refrains—after having received warning from their Lord—**may keep their previous gains**, and their case is left to Allah*). So, the money in the start will be as at present (M2 + plus public deposits or investment in national saving schemes, deposits with post offices, and non-bank financial institutions.)

Banks would serve as intermediaries for investment, rather than money creators. While financing, banks will not create new money, but simply transfer existing money (and purchasing power) from one person to another. The investment division of any bank, like fund managers, will receive savings and channel them into investments in businesses. The foundation of this system is profit and loss sharing, where no nominal return is guaranteed and is based on taking business risk and value addition.

The customers are to choose to put their money either for safekeeping and payments or for investment in which case return will depend on the result of the business activity by the bank. Different people have different risk and reward profiles and, therefore, deposits would continue to be given for both purposes –

safekeeping as *Wadiah* in Islamic terms, and as investment plan as per the *Mudārabah* system. Finance will be available from the investment accounts only for the real productive, business and entrepreneurial activities adding value to the economy and socio-economic development. Banks will do business from their capital/equity or make investments from investment deposits on debt-creating (murābaḥah, ijārah, etc) and PLS modes.

In Pakistan, the solution adopted over the last couple of years to ensure financial stability in the country through high interest rates didn't work, it rather worsened the country's economy by reducing economic activity. The HRS would ensure economic and financial stability, along with other major economic objectives such as the elimination of domestic debt and huge interest costs. Of course, it represents a significant departure from traditional fractional reserve banking. If the IMF considers it in the long-term perspective of the economy caught in the vicious circle, it might support or even advocate for the adoption of full reserve banking as suggested by its economists (WP/12/202).

Based on the data of the end of December 2023, the SBP could create reserves of PKRs 24 trillion to equal the level of deposits with banks. Subsequently, the status and accounting treatment of both bank money (deposits) and banknotes will be the same. As such, the government debt/securities of Rs 22 trillion on the balance sheets of commercial banks will be taken over by the SBP. After taking over the Government bills/bonds by SBP, they will either be cancelled, or their interest rate will be set to zero, thereby eliminating the total Government debt shown on the balance sheets of the banks. The same will be the treatment of the SBP debt payable by the government that will be cancelled out. Further, it will also generate a credit of Rs 2 trillion on a net basis payable to the SBP/GOP by the commercial banks. It will enable the government to settle the other domestic debt taken from the public through the national savings scheme (Qanit, 2024).

The Central Bank and the Ministry of Finance may like to consider it by constituting a committee of economists, finance experts, an economist from the IMF[2], and other relevant professionals from the accounting and financial reporting fields. Although not being practiced anywhere in the world, the system suggested by economists of the past as well as the present must be implemented for the stability of national and global economies.

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[2]It's not something new. In the year 2000, the Commission for Transformation of the Financial System (CTFS) constituted in the SBP under the Chairmanship of the Late SBP Governor, I. A. Hanfi, two economists/experts were invited from the IMF who visited Pakistan for some weeks and submitted their report to the CTFS. A brief on their report has been given in the SBP History (Chapter 14), compiled by M. Ashraf Janjua former Dy Governor, Policy, SBP,

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