**Full reserve banking: Part - II**

Qanit Khalilullah

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An innovative economic solution to Pakistan's grave problems is the implementation of full reserve banking. The proposed system seeks to eliminate the colossal government debt burden and huge interest costs through a more streamlined financial system.

The plan aims to ensure financial stability, control inflation, and promote economic prosperity. The fractional reserve system, responsible for money supply fluctuations and economic instability, can be efficiently replaced with a full reserve system, creating a stable economic environment.

The new system would operate on a straightforward principle – completely segregating money/deposits from credit/loans. By doing so, as mentioned above, it aims to eradicate all of Pakistan's domestic debt residing on bank deposits and significantly reduce the substantial interest burden, which currently consumes over 60 per cent of government revenue. With the State Bank of Pakistan (SBP) gaining complete control over money creation and supply, the need for a monetary rather than interest rate policy of the SBP, which is a main issue, would cease to exist. This proposed system offers comprehensive protection for monetary holdings and promises financial stability for our economy.

Full reserve banking advocates a reform to the banking system that would prevent banks from being able to ‘create money’ in the form of bank deposits whenever they issue loans. In this reform, known as a ‘Sovereign Money or full reserve system’, the power to create money would be removed from the banking sector and transferred to a public body, such as the SBP. New money would be created only by the SBP, up to the level of GDP growth to avoid inflation, and then transferred to the government, which could then use this money to finance public spending primarily to remove unemployment.

The full-reserve banking system is based on two fundamental and simple principles: one, banks cannot invest or lend the funds held for safekeeping, which may be reimbursed by the depositor anytime. Instead, banks must first acquire funds transferred to them for investment in businesses. And, two, individuals will not earn a profit on the amounts deposited by them for safekeeping and available for their payment at all times. They must invest their savings and assume the associated risks to earn a profit.

In the current fractional reserve system, commercial banks retain sovereign or SBP-created money in two forms: cash in the vaults to pay to their customers on demand and reserves in digital form with the SBP for inter-bank settlements when their customers issue cheques to the customers of other banks. They retain just a fraction of the deposits (around 10 per cent) in these two forms, and the remaining is passed on to their customers for loans.

In the proposed system, the SBP will enhance the reserve requirement of sovereign money to 100 per cent against depositors’ money entrusted to banks. To meet the 100 per cent reserve requirement, they would need sovereign money equal to their deposits. They would then raise the requirement from the SBP, and further reserve/sovereign money would be created and issued to them to equal the current level of deposits.

This additional money will not result in inflationary pressure because it will exclusively be in the hands of banks for inter-bank settlements and not in the hands of the general public for purchasing goods and services.

Against the SBP-created reserves for deposit accounts, the current government debt/securities on the balance sheets of commercial banks will be taken over by the SBP. After the taking over of government bonds and treasury bills by the SBP, they will either be canceled or their interest rate will be set to zero, thereby eliminating the total government debt currently residing on the banks' balance sheets.

To explain it simply, the SBP will create and issue sovereign money to replace the interest-based debt currently held by the banks. Subsequently, the status and treatment of both bank money (deposits) and banknotes will be the same as the state will create both without any corresponding debt and interest obligation.

Technically, implementing full reserve banking and eliminating government domestic debt is a straightforward and seamless process. According to existing laws and procedures, the State Bank of Pakistan (SBP) would need to increase the reserve requirement on deposits from six per cent to 100 per cent. The Nobel laureate and the most renowned monetary economist, Milton Friedman, saw little difficulty in converting to the Full Reserve system. As he put it: “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.” As for Friedman’s use of the word “speedily”, he was correct in saying that the conversion could be done more or less overnight.

Banks could still invest, but they would do so by first receiving pre-existing Sovereign Money from savers for investment purposes without creating any new money in the process. Banks would then become true intermediaries (intermediaries between savers and businesses) rather than the creators of new money.

The banks currently perform two conflicting functions simultaneously: money deposit for safekeeping and transaction purposes; and investment to earn profits and returns on behalf of the investors as an intermediary. Full Reserve Banking would remove the conflict that is inherently built into the current system. The separation of core functions (payment services and Investment/lending) would allow specialized institutions/sections to focus on each, potentially increasing competitiveness in the sector.

Investment banks/trusts will earn profit/commission on their desired work – to act as true intermediaries between actual savers and businesses.

Deposit banks will provide all other services to their customers except lending. Banks' significant control over payment functions offers ample opportunities to earn commissions from retail customers during transactions. They may be allowed to charge around a one per cent annual fee on deposits either from the depositors or the SBP to ensure their commercial viability. Anyway, it will not be a material amount compared to the enormous benefits the system is promising.

In the current system, approximately 70 per cent of bank investments and loans extended to the government of Pakistan are not accessible to private businesses due to a crowding-out effect, leaving only 30 per cent available to them. Further, a major part of lending to the private sector across the world does not contribute to GDP, and much of it may be harmful to the economy – unconstrained lending for property was a prime cause of the housing bubble that triggered the 2007-08 in the US.

With the introduction of Full Reserve Banking and the segregation of deposit and credit functions, alongside existing credit available to the private sector, a significant additional sum from depositors seeking profit-driven investment opportunities is anticipated to become available. This proactive step will effectively increase the pool of funds accessible for private investment by more than 50 per cent.

In the current fractional reserve system, depositors are gaining profit and interest without parting with their money or taking any risk at the cost of overall instability and inherent risks within the system. Although banks offer profits on deposits, the return on deposits is invariably lower than the inflation or depreciation in the money's value.

More than 50 per cent of depositors in Pakistan are keeping their money in non-remunerative current accounts, causing them to lose a significant amount of money value in the current system. In a full reserve system, the money value of bank depositors will be protected against depreciation caused by private banks' ongoing expansion of the money supply in the form of loans.

To be continued

The writer is director of a corporate and management

consulting firm, and writes on economic and public policy matters.