

Technocratic Dreams, Political Realities: Evaluating Full Reserve Banking for Pakistan

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This paper critically examines a recent proposal advocating full-reserve banking in Pakistan, inspired by modern revivals of the Chicago Plan. While such proposals are motivated by legitimate concerns about financial instability, excessive debt creation, and the social consequences of private money creation, the paper argues that they are best understood as institutional power-sharing arrangements rather than purely technical reforms. Using a historical–institutional methodology, the analysis examines the causal mechanisms through which monetary systems evolve and the political constraints shaping reform feasibility. Drawing on historical experience in Pakistan and international cases—including Japan’s window guidance system and China’s state-led financial institutions—the paper shows that proposals such as full reserve banking typically require a rare balance of power between governments, financial institutions, and external actors. In Pakistan’s current institutional context, where domestic financial interests and IMF programmes constrain monetary sovereignty, such conditions are unlikely to emerge. The paper therefore proposes a set of more feasible reform pathways, including credit guidance, development of finance mechanisms, and greater transparency in credit allocation. It also argues that deeper reforms may gain political traction when framed within Pakistan’s constitutional commitment to Islamic finance, which provides a powerful source of social legitimacy for monetary reform. More broadly, the paper illustrates how historical and institutional analysis can be used to evaluate counterfactual policy proposals that cannot be analysed using conventional data-driven empirical methods.

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1. INTRODUCTION

In response to the persistent economic instability afflicting Pakistan—inflation, public debt, financial exclusion, and repeated banking crises—Qanit Khaleelullah & Sohaib Umar (2026) have proposed the adoption of a full reserve banking system. Their proposal—referenced as QK-SU hereafter—is rooted in a desire for financial justice and macroeconomic stability. It draws upon modern revivals of the Chicago Plan, a 1930s-era blueprint that sought to eliminate private banks’ ability to create money and assign this role solely to the state (Phillips, 1995). The proposal reignites an important debate about sovereign monetary authority, central to broader global explorations of reform in the aftermath of the 2008 Global Financial Crisis (GFC).

Far from being an isolated or uniquely local intervention, QK-SU’s proposal sits at the tail end of a global wave of interest in sovereign money systems. This renewed

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interest was sparked by the systemic failures of financial deregulation exposed during the GFC, which severely damaged the ideological credibility of mainstream monetary systems. Key contributions include the New Economics Foundation's *Creating New Money* by Huber & Robertson (2000), Benes & Kumhof's (2012) IMF paper, *The Chicago Plan Revisited*, Cooley's *Currency Wars* (2008) on monetary sabotage and warfare, and Sigurjonsson's (2015) report commissioned by Iceland's Prime Minister proposing sovereign money reform. These works collectively argue that the unchecked power of private banks to create money lies at the root of modern financial fragility, inequality, and state fiscal weakness. My own contribution, *Islamic Banking after Financial Crises* (2020a), supplements the sovereign money idea by adding elimination of interest, to make it conform to Islamic principles.

Critically, however, the resurgence of full reserve proposals must be understood not just in technical or ethical terms, but in light of the global political economy of monetary power. As I argued in *The Battle for the Control of Money* (Zaman, 2016), the history of money is marked by an enduring struggle between the state and private financial institutions over control of money creation. When governments hold a dominant position, they opt for outright nationalisation of banks. When financial institutions dominate, they firmly resist any constraints on their credit-creating powers. Full reserve banking thus emerges as a compromise—a power-sharing agreement, viable only in rare moments when neither side can fully impose its will. The Chicago Plan was precisely such a compromise, with its chief proponent, Irving Fisher (1936, p. 15), stating: “*In short: nationalise money, but do not nationalise banking.*” The fact that full reserve systems have never been implemented—even though banks have often been nationalised—is not an accident, but a reflection of how fragile and transient the conditions required for such a compromise truly are.

In the sections that follow, this paper critically assesses the QK-SU proposal by first summarising its main features, then situating it within the historical evolution of monetary reform, and finally explaining why it is politically unworkable in Pakistan's present institutional setting. It concludes by outlining more pragmatic alternatives grounded in both international experience and Pakistan's own historical and political realities.

The central methodological premise of the paper is that monetary systems are not merely technical devices for managing macroeconomic aggregates; they are political and moral institutions shaped by struggles over power, legitimacy, and public purpose. For that reason, the analysis developed here is historical, institutional, qualitative, and explicitly normative. The following section explains why this approach is necessary for the question at hand, and why the standard data-driven methods that dominate contemporary economics are not sufficient for analysing the feasibility of a monetary regime that has never been implemented. Thus, in addition to evaluating the full-reserve banking proposal, the paper also illustrates the usefulness of a historical—institutional methodology for addressing policy questions that cannot be resolved through conventional data-driven empirical methods.

2. MECHANISM-BASED CAUSAL INFERENCE AND HISTORICAL INSTITUTIONAL ANALYSIS

The question examined in this paper—whether a full-reserve banking regime could be implemented and sustained in Pakistan—is a question of institutional feasibility. It asks whether a particular monetary arrangement could realistically be created and maintained

within Pakistan's political and administrative system. Answering such questions requires counterfactual reasoning: we must consider what would happen if such a regime were introduced and whether the conditions necessary for its survival actually exist. Because the regime under discussion has never been implemented in the proposed form, the question cannot be addressed by comparing observed outcomes across different systems. For the same reason, the standard empirical strategies of modern economics—based on statistical analysis and regression estimation—cannot be applied directly. Instead, the analysis must examine the causal processes through which monetary institutions evolve and the power relations that shape their adoption and survival.

This section explains the methodological approach used in the paper. It proceeds in three steps. First, it explains the close connection between causality and counterfactual reasoning, a point emphasised in recent work on causal inference in econometrics. This literature clarifies that statistical methods such as regression do not reveal causal structure on their own; they operate under causal assumptions introduced—often implicitly—through theoretical reasoning and knowledge of how the data are generated. Second, the section introduces mechanism-based causal inference, drawing on the work of Heckman and Pinto, which emphasises that causal explanation requires understanding the mechanisms producing observed outcomes. Third, it explains how historical and institutional analysis can reveal such mechanisms, especially when the institutional arrangements under study have not yet been observed. The final subsection describes the kinds of evidence used in the analysis that follows.

2.1. Causality and Counterfactual Reasoning

To say that X causes Y is to claim that if X had not occurred, Y would have been different. Consider a familiar example: does additional schooling increase earnings? To answer this question, we would need to know what a person's wages would have been if a high school graduate had gone on to college. The causal claim therefore requires a counterfactual comparison between the wages we observe and the wages that would have been earned if the person had received more education.

Recent work in econometrics has clarified this point. Modern research on causal inference, especially associated with Angrist & Pischke (2009), emphasises that causal questions are inherently counterfactual: they ask what would happen under an alternative intervention. This insight has an important implication. Statistical methods such as regression do not discover causal relationships on their own. Instead, they estimate the size of a causal effect after the researcher has already made assumptions about the causal structure of the problem. Regression can measure the magnitude of an effect, but it cannot determine whether X causes Y . That judgment must come from theoretical reasoning and knowledge of the processes generating the data—an insight now widely recognised among econometricians, though not yet fully reflected in popular textbooks.

In regression models, economists typically describe some variables as exogenous and others as endogenous. The exogenous variables are treated as causes, while the endogenous variables are outcomes determined within the system being studied. The critical point—rarely stated clearly—is that this causal structure is assumed, not discovered by the regression itself. The data alone do not determine which variables must be treated as causes and which as outcomes. Researchers choose this structure when specifying the model, usually guided by economic theory and institutional knowledge. Statistical analysis can then estimate the magnitude of causal effects once the causal

structure has been specified, but it cannot establish that structure on its own (Heckman & Pinto, 2021).

Modern causal methods make this logic explicit. As the philosopher of science Nancy Cartwright has put it: “no causes in, no causes out.” Statistical analysis cannot produce causal conclusions unless causal assumptions have already been introduced into the analysis. Randomised experiments illustrate this clearly. When treatment is assigned by a coin flip, researchers assume that the outcome of the flip is not caused by any factors related to the experiment. Similar assumptions underlie other causal methods such as instrumental variables or regression discontinuity designs. In every case, causal inference becomes possible only when the researcher can argue that the observed variation in the supposed cause is generated by a causal mechanism that is independent of the outcome being studied.

2.2. Mechanism-Based Causal Inference

Consider the causal claim that increases in the money supply raise prices. The natural question is how this occurs. One possible mechanism is:

Central bank creates money → governments increase spending or banks expand credit → household income rises → spending increases → excess demand emerges → prices rise.

This sequence traces the process through which monetary expansion can affect prices. Importantly, the steps in this mechanism do not come from statistical data. They reflect knowledge about how monetary institutions operate and how households and firms respond to changes in income and credit. Understanding the mechanism also clarifies what a regression coefficient on money represents. A statistical estimate of the effect of money on prices summarises the combined influence of several links in this causal chain. Changes in any part of the mechanism—such as government fiscal policy or how households respond to income—can strengthen or weaken the observed relationship.

This emphasis on mechanisms also appears in modern work on causal inference in econometrics. Heckman & Pinto (2021) argue that causal analysis ultimately requires knowledge of the data-generating process—the real-world processes that produce the outcomes observed in the data. Statistical methods can summarise patterns in the data, but interpreting those patterns causally requires understanding the mechanisms that generate them. Econometric models therefore do more than summarise statistical relationships; they attempt to represent the causal processes operating in the real world. As Heckman & Pinto emphasise, specifying such models requires scientific knowledge about institutions, policies, and behavior. Without this knowledge, statistical relationships alone cannot establish causal conclusions.

In this paper, historical and institutional analysis is used to identify the causal mechanisms shaping monetary institutions and thereby enable the counterfactual analysis required to answer the central question under study.

2.3. Historical–Institutional Analysis of Causal Mechanisms

Historical–institutional analysis investigates causal mechanisms by tracing how economic decisions are made and implemented within specific institutional settings. Instead of treating policies as abstract variables, it examines the processes through which governments, financial institutions, and other actors interact to produce economic outcomes. Historical records—such as policy debates, central bank documents, legislative discussions, and institutional reports—often reveal the motivations, constraints, and strategies of the actors involved. Such evidence allows researchers to follow the sequence

of decisions and responses linking policies to outcomes. In this way, historical analysis makes it possible to reconstruct the mechanisms through which economic change occurs.

In the context of monetary reform, the relevant mechanisms are institutional and political. They include the allocation of authority over money creation, relationships between governments and banking systems, the administrative capacity of the state to implement reforms, and the influence of external actors such as international financial institutions. These mechanisms shape whether proposed reforms can be implemented and sustained. The analysis that follows therefore focuses on identifying the institutional processes through which monetary systems are created, maintained, and contested. By examining these processes in the Pakistani context, the paper evaluates whether the institutional conditions required for a full-reserve banking regime plausibly exist.

By tracing these institutional processes, historical analysis can reconstruct the causal mechanisms through which monetary institutions evolve.

2.4. What Counts as Evidence in This Paper

Within this methodological framework, causal claims are evaluated through triangulation—that is, by examining the same causal mechanisms using several different kinds of evidence rather than relying on statistical tests of an unobserved regime. Because the question concerns the feasibility of institutional reform rather than the measurement of parameters, the analysis draws on several complementary forms of evidence.

- Historical reconstruction of how monetary and banking institutions emerged in response to political and fiscal pressures, rather than as purely technical solutions to problems of economic optimisation.
- Comparative institutional reasoning, using near analogues—such as crisis-era reform proposals, episodes of credit guidance, or banking nationalisations—to clarify the political and institutional conditions under which large-scale financial reforms become feasible.
- Interpretive political economy, examining mechanisms of resistance and compliance within the financial system, including rent channels, legal constraints, credibility concerns, and external conditionalities.
- Explicit normative analysis, recognising that monetary constitutions inevitably involve distributive and ethical choices even when presented as purely technical issues (Myrdal, 1953; Hausman & McPherson, 2006).

Taken together, these forms of evidence enable the counterfactual analysis required to evaluate the coherence and plausibility of the causal mechanisms through which monetary reforms might be implemented and sustained.

3. FULL RESERVE BANKING: A FAMILY OF PROPOSALS

Proposals to eliminate private banks' ability to create money and vest that power exclusively in the state have resurfaced repeatedly since the Great Depression. Known collectively as *full reserve banking* or *sovereign money* proposals, they constitute a diverse family of reform ideas aimed at severing the link between money creation and private lending. In what follows, the central question is whether such a system could be implemented and sustained within Pakistan's historically evolved institutional constraints. As explained in Section 2, answering this question requires counterfactual reasoning about institutional feasibility.

Although QK-SU have recently advanced such a proposal for Pakistan, their version is one among many. Most modern iterations trace their lineage to the Chicago

Plan, developed in the 1930s by economists such as Henry Simons & Irving Fisher. More recent versions include the Iceland Sovereign Money Proposal Sigurjonsson (2015), Benes & Kumhof's (2012) simulation-based update of the Chicago Plan (2012), the UK's Positive Money initiative, and various contributions from heterodox economists and think tanks, such as Huber and Robertson's *Creating New Money* (2000).

A useful clarification is that not all heterodox traditions interpret this revival in the same way. Modern Monetary Theory (MMT), along with the broader "endogenous money" tradition, agrees with the descriptive claim that commercial banks create deposits in the act of lending; but it rejects the inference that this fact alone explains instability or that eliminating deposit creation is the master key to monetary reform. In this view, the decisive causes of crisis lie in deregulation, asset-speculation, and the transformation of banks into shadow-banking entities, not in the basic accounting fact that loans create deposits. Hence, several MMT contributors have been openly critical of "sovereign money" proposals advanced in the wake of the GFC, including the Icelandic proposal, arguing that the relevant policy task is to discipline and reorient credit through institutional design, regulation, and public purpose—not to imagine that a technical redesign of the payments-credit boundary can substitute for political control over finance. For deeper discussion, see Mitchell (2015a, 2015b).

Returning to the Full Reserve Proposals, these fall into two main categories:

1. Centralised Sovereign Money Models –
These involve a new public institution, such as a *Money Creation Committee*, which creates new money based on macroeconomic needs. Private banks are prohibited from creating money but may lend using funds obtained from savers or central sources.
2. Dual-System or "Narrow Bank" Models –
In these systems, full reserve institutions hold transaction accounts with 100 percent reserves, while separate investment banks handle lending using time deposits. This creates a legal and operational firewall between payments and credit.

In both frameworks, the defining goal is to restore public control over the quantity of money in circulation, while still allowing credit allocation to remain in (regulated) private hands. The technical architecture of these proposals varies significantly across jurisdictions, but all rely on institutional innovations that distance money creation from private profit motives.

Although the proposals differ in design, one commonality runs through them: they attempt to correct the problems of private money creation—including instability, excess debt, and asset bubbles—without resorting to outright nationalisation. The complexity of the entire family of proposals leads to the natural question: Isn't there a simpler and more transparent way to achieve these goals? What is the magic ingredient within these complex technical proposals which makes them produce the claimed miracles? These questions are important, and we will return to them later, when we evaluate these proposals in greater depth by examining the institutional mechanisms through which monetary systems actually operate.

4. WHAT THE PROPOSAL GETS RIGHT

While this paper offers a structural critique of full reserve banking proposals, it is important to acknowledge their significant ethical and systemic appeal. These proposals are motivated by a powerful dissatisfaction with the current financial system—one that

concentrates wealth, amplifies economic volatility, and undermines democratic control over money creation. In this respect, QK-SU's proposal, like others in this tradition, emerges from a deeply felt concern for justice, transparency, and macroeconomic stability. Because proposals of this kind arise from ethical concerns about justice and the public control of money, evaluating them necessarily involves normative reasoning in addition to institutional analysis.

Technically, full reserve banking offers a compelling alternative to the fractional reserve system. One of the most influential defenses of this system is found in Benes and Kumhof's (2012) *The Chicago Plan Revisited*, a simulation-based study published by the IMF. Using a DSGE model calibrated to the U.S. economy, they argue that full reserve banking would:

- Eliminate bank runs,
- Reduce both public and private debt,
- Improve monetary control and macroeconomic stability,
- Lower inflation volatility, and
- Increase long-term output and employment.

These projections have played a key role in the revival of interest in sovereign money systems and provide a sense of technocratic credibility to proposals that might otherwise be dismissed as utopian.

Beyond modeled benefits, many full reserve proposals also reflect a valuable institutional insight: that money creation and credit allocation should be functionally separated. The government may be well positioned to manage the money supply in line with the public interest, but it is typically not equipped to evaluate credit risk or allocate loans efficiently. The private sector, with its localised knowledge, competitive pressures, and risk-bearing incentives, is often better suited to perform this function.

Historical experience reinforces this point. In the 1970s, Pakistan's nationalised banking system frequently blurred the lines between political loyalty and financial creditworthiness. Lending decisions were often shaped more by political affiliations than by commercial viability, leading to widespread inefficiencies and a surge in non-performing loans. This erosion of financial discipline ultimately weakened the banking system and discredited the broader project of public sector control. This episode highlights an important causal mechanism: when political authorities control the allocation of credit, lending decisions often become instruments of patronage rather than economic judgment. Recognising this mechanism allows us to evaluate the counterfactual implications of proposals that place money creation under government control.

By creating an institutional firewall between public money creation and private lending decisions, full reserve banking offers a structure that may reduce rent-seeking, politicised lending, and systemic risk. If implemented with strong governance and oversight, such a system could reclaim monetary sovereignty while avoiding the pitfalls of full-scale state control over credit.

In short, full reserve banking proposals get three major things right:

1. A moral and systemic critique of the existing financial order,
2. Technically modeled benefits, including debt reduction and macroeconomic stability,
3. Institutional clarity about the dangers of concentrated monetary and credit powers.

These are significant achievements—and they merit serious engagement, even from those who may doubt the feasibility or underlying logic of these proposals.

5. FULL RESERVE BANKING AS A RESPONSE TO THE NATIONALISATION DILEMMA

Having acknowledged the ethical foundations and technical merits of full reserve banking, we now confront a natural question: *If the goal is to bring money creation under public control, why not pursue a simpler and more direct solution—nationalisation of the banking system?* Unlike full reserve banking, nationalisation is a straightforward institutional model with deep historical precedent and broad public intelligibility. It eliminates private money creation, ensures state control over credit flows, and does so without requiring complex institutional engineering.

Indeed, many of the benefits attributed to full reserve banking—reduced systemic risk, public debt reduction, greater monetary sovereignty—could in principle be achieved through nationalisation. But this raises a deeper issue: why has nationalisation failed in so many cases, and why have reformers instead turned to the more complex architecture of full reserve banking?

The answer lies not in the concept of nationalisation itself, but in how it is implemented. For nationalisation to work, the state must exercise ownership without operational interference. In practice, this is extremely rare. In Pakistan, the nationalisation of banks during the 1970s under the Bhutto government quickly devolved into a patronage system. Credit was extended based on political affiliation rather than commercial viability. As discussed earlier, lending decisions often rewarded loyalty, not investment merit, leading to inefficiency and long-term institutional decay. But this outcome was not inevitable—it reflected broader weaknesses in public sector governance.

In contrast, nationalised financial institutions in China have demonstrated that it is possible for state-owned banks to operate with professional standards and deliver impressive developmental outcomes. China's state banks account for the majority of industrial production financing and have supported sustained, high-growth development for over four-decades. These institutions operate under clear strategic mandates, but with relatively autonomous internal management insulated from short-term political pressures. Their success demonstrates that state ownership does not necessarily imply inefficiency or corruption provided institutional safeguards are in place.

Even within Pakistan, we have seen shifts in public sector performance over time. For example, the national carrier PIA was long regarded as an efficient and respected institution, operating effectively from its early decades through much of the 20th century. Its decline in performance began only when political interference became pervasive, eroding meritocracy and professional standards. This reinforces the idea that the failure of nationalised institutions is not inherent, but contingent upon political and institutional contexts.

Taken together, these comparisons illustrate the triangulation approach described in Section 2. By examining contrasting historical cases, it becomes possible to isolate the causal mechanisms shaping institutional outcomes. The comparison between China and Pakistan shows that state ownership of financial institutions does not inherently lead to inefficiency or corruption. The historical evolution of institutions within Pakistan, such as the trajectory of PIA, further shows that institutional decline is not inevitable within the country itself. These comparisons point to a common causal factor: the degree to which political interference displaces professional management and institutional

safeguards. Identifying this mechanism allows us to reason counterfactually about proposed reforms to the monetary system.

From this perspective, full reserve proposals can be seen not as rebranded nationalisation, but as a technocratic workaround—an attempt to design systems that *simulate* the benefits of nationalisation without triggering the risks associated with state ownership. These proposals aim to shift the power of money creation from private hands to public institutions but do so by placing that power in nominally independent committees or agencies, insulated from both private capture and political meddling.

This approach reflects a lack of confidence in the state’s ability to manage credit institutions directly, especially in environments plagued by corruption, weak rule of law, and institutional fragility. In such settings, full reserve banking appears as a second-best solution—complex by necessity, not by choice. It seeks to protect the monetary system from both market excesses and political interference by erecting technical barriers and new governance structures.

But once we recognise full reserve banking as a power-sharing formula rather than a purely technocratic reform, we are forced to ask a different set of questions—questions that QK-SU’s proposal, like many others in this space, leaves largely unanswered. How exactly will this power-sharing be structured? Who will sit on the money creation committee? Who will nominate them, who will oversee them, and who—if anyone—will have the authority to remove them? What role, if any, will elected representatives play? Will central bank independence be strengthened or diluted?

Proponents of these proposals treat these issues as peripheral technicalities, when in fact, they are the core of the proposals, the institutional heart of the reform. Without a clear and credible answer to these questions, the proposal remains suspended in abstraction: it outlines a desirable goal but provides no plausible roadmap for implementation.

In the next section, we turn to precisely this problem: the political and institutional feasibility of implementing such a power-sharing arrangement within Pakistan’s current governance structure. We argue that the very conditions which make full reserve banking attractive—a mistrust of both market-led and state-led finance—are also the reasons such reforms are politically unworkable in practice.

6. WHY FULL RESERVE BANKING IS POLITICALLY UNWORKABLE

The preceding analysis has examined the intellectual appeal and institutional logic of full reserve banking proposals. Yet their persistent absence in practice suggests that the decisive obstacles are not technical but political. To understand why such proposals—despite their ethical appeal and theoretical coherence—remain unimplemented, we must shift our focus from institutional design to the causal mechanisms through which real-world power structures shape institutional outcomes. This section therefore examines the political economy of monetary reform in Pakistan. It first identifies the key actors and the balance of power among them, then explains how existing institutional arrangements shape their incentives, and finally evaluates how these mechanisms constrain the feasibility of full reserve banking.

6.1. From Institutional Design to Power Structures

Most discussions of full reserve banking treat the proposal primarily as a question of institutional design. Analysts debate how accounts would be structured, how money creation would be regulated, and how the transition from the current system might be

managed. These technical questions are important, but they do not address the central issue: whether such reforms are politically feasible. Monetary institutions allocate power over the creation and distribution of money. Any attempt to redesign the monetary system therefore alters the balance of power among governments, financial institutions, and other stakeholders. Evaluating the feasibility of full reserve banking consequently requires examining the power structures within which monetary institutions operate.

6.2. The Triangular Power Structure: State, Finance, and the IMF

In many discussions of banking reform, the political conflict is portrayed as a binary struggle between the state and the private financial sector. Governments are assumed to represent the public interest, while private banks seek to preserve their privileged role in money creation. In Pakistan, however, the relevant power structure is more complex. The configuration is not simply a contest between public and private actors, but a triangular relationship involving three powerful participants: the national government, the domestic and international financial sector, and the International Monetary Fund (IMF).

Each of these actors exerts influence over the structure of the monetary system. The government is formally sovereign and responsible for macroeconomic management but is frequently constrained by fiscal pressures and dependence on external financing. The private financial sector—comprising both domestic banks and international financial institutions—has strong incentives to preserve the current system, which allows private actors to create money through lending and earn interest on government debt. The IMF, meanwhile, plays a decisive role in shaping the policy space available to borrowing countries. Through lending programmes and conditionality agreements, it can exert substantial influence over fiscal policy, monetary institutions, and financial regulation. For example, it recently enforced Central Bank Independence in Pakistan (International Monetary Fund, 2022) against government resistance and popular disapproval, as a condition for further loans.

This triangular configuration significantly constrains the range of feasible monetary reforms. Governments must balance domestic political pressures with the interests of the financial sector and the conditions attached to international financial assistance. As a result, proposals that appear attractive at the level of institutional design—such as full reserve banking—must ultimately be evaluated in terms of how they affect this underlying balance of power.

6.3. Central Bank Independence and Fiscal Dependence

A central feature of Pakistan's current monetary framework is the legal independence of the State Bank of Pakistan (SBP) and the prohibition on direct government borrowing from the central bank. Under reforms adopted as part of IMF-supported stabilisation programmes, the government has effectively been barred from financing its expenditures through central bank money creation (Government of Pakistan—2021). Instead, it must borrow from private financial institutions by issuing government securities that are purchased by commercial banks. These banks, in turn, finance much of their lending through the creation of new deposits within the banking system (McLeay, et al. Bank of England, 2014).

This institutional arrangement creates a structural form of fiscal dependence. Rather than drawing directly on its own central bank for development finance, the government must rely on private lenders who earn interest on public debt. The fiscal scale of these payments is extraordinary. In recent years, interest payments on Pakistan's public

debt have reportedly absorbed more than half of government revenue, leaving limited fiscal space for development spending or social programmes. This burden illustrates the structural power of the financial sector and helps explain why reforms that threaten these revenue streams are likely to encounter intense resistance.

Prohibition of government borrowing from the central bank → fiscal dependence on private banks → large interest transfers to the financial sector → strong political resistance to reforms such as full reserve banking.

This configuration also helps explain a persistent puzzle in Pakistan's monetary policy debates. Critics often argue that the SBP maintains interest rates that are excessively high relative to domestic economic conditions, interpreting this as evidence of hidden IMF pressure. A mechanism-based perspective suggests a different interpretation. Once the central bank is institutionally insulated from the elected government and embedded within a financial system dominated by private banking interests, its policy orientation naturally aligns more closely with the priorities of financial stability, creditor confidence, and banking-sector profitability. In this institutional setting, relatively high interest rates are not necessarily the result of secret external instructions but emerge as a predictable outcome of the balance of power among the central bank, the financial sector, and international creditors.

These institutional constraints have important implications for monetary reform. Because governments must rely on private financial institutions to finance public expenditure, the financial sector acquires both economic leverage and political influence. Any reform that threatens this arrangement, including proposals that significantly reduce the role of private banks in money creation, will encounter strong resistance from actors who benefit from the existing system.

6.4. Why This Structure Blocks Full Reserve Banking

The institutional configuration described above has direct implications for the feasibility of full reserve banking. At its core, the proposal would significantly reduce the role of private banks in money creation and allow the state to reclaim greater control over the issuance of money. In practical terms, this would weaken the system of fiscal dependence through which governments currently rely on private financial institutions to finance public spending. Such a shift would inevitably alter the distribution of economic rents generated by the monetary system.

From the perspective of the domestic financial sector, full reserve banking would threaten a highly profitable arrangement. Commercial banks currently benefit from both credit creation and the substantial interest payments generated by government borrowing. Any reform that allowed governments to finance development directly through central bank money would reduce the volume of government securities held by banks and diminish a major source of financial-sector income. Strong resistance from financial institutions can therefore be expected.

The international dimension further strengthens this constraint. The IMF has consistently promoted a policy framework emphasising central bank independence, fiscal discipline, and market-based financing of government deficits. Within this framework, direct government access to central bank financing is viewed as a major source of macroeconomic instability, particularly in countries with histories of fiscal mismanagement. Policies that restore government control over money creation are therefore typically discouraged or prohibited within IMF-supported reform programmes.

As experience in Pakistan and other IMF-programme countries repeatedly demonstrates, attempts to expand government control over money creation tend to provoke strong reactions from international creditors. Such reforms would likely be interpreted as a departure from prevailing monetary orthodoxy and could trigger consequences such as the suspension of IMF lending programmes, credit-rating downgrades, or capital outflows. Even if carefully designed, the perceived risk of inflationary financing would make it difficult to sustain international financial support.

In this context, the political infeasibility of full reserve banking becomes easier to understand. The reform would simultaneously threaten the revenue streams of domestic financial institutions and challenge the policy framework promoted by international financial actors. Reforms that expand government control over money creation therefore tend to encounter resistance from this combined constellation of domestic and international financial interests.

7. ALTERNATIVE INSTITUTIONAL PATHWAYS

A key strength of QK-SU's proposal is that it opens space for rethinking the deeply flawed architecture of modern banking. However, a critical oversight is the assumption that replacing private banks with full-reserve institutions will automatically lead to more just and efficient outcomes. In this section, we examine two historical alternatives that pursued the same broad objective—restoring sovereign influence over money creation and aligning credit with social priorities. Following the historical–institutional approach outlined earlier, these cases help illuminate the institutional conditions under which such reforms succeed or fail.

7.1. Nationalisation of Banks: The Bhutto Experience

One conceptually straightforward alternative is nationalisation: bringing all banks under state ownership, thus enabling the government to direct lending in line with developmental priorities. Pakistan has already experimented with this path during the Bhutto era in the 1970s. While the idea aligned with socialist ideals of redistributing wealth and empowering the state, the implementation proved disastrous. Political elites used control over public banks to secure loans for themselves and their allies, which were rarely repaid.

This historical experience highlights an important causal mechanism: changing ownership structures without transforming the norms and accountability mechanisms governing political power can simply redirect opportunities for corruption rather than eliminate them.

7.2. The Japanese Window Guidance System

A more sophisticated and instructive model is found in post-war Japan. As described in *Princes of the Yen* by Richard Werner (2003), the Ministry of Finance (MoF) and the Bank of Japan (BoJ) operated a "window guidance" system. Instead of letting market forces or private banks determine the flow of credit, central planners set detailed credit growth targets for each economic sector. Banks were instructed to lend accordingly, creating money in the process. This system enabled the Japanese government to channel credit toward industrial sectors critical for development, while preventing speculative lending.

The effectiveness of this system depended on a set of institutional conditions that cannot be taken for granted. Two factors were particularly important:

1. Technical competence. A highly skilled bureaucratic apparatus was able to develop coherent long-term industrial strategies and translate them into credit allocation targets.
2. Institutional insulation. While not immune to political pressures, the Ministry of Finance and the Bank of Japan maintained sufficient autonomy to prevent systematic capture by political elites or private financial interests.

Under these conditions, this form of guided capitalism contributed to rapid industrial development without relying on gold standards or full-reserve banking models. Yet, as Werner emphasises, the system eventually collapsed—not because it failed economically, but because powerful interests pushed for liberalisation and deregulation, aiming to restore market dominance and central bank independence.

7.3. Lessons for the Full Reserve Proposal

The comparison of these historical experiences highlights a key lesson: controlling the money supply alone is not sufficient. The crucial question is: Who decides where the money goes?

QK-SU's proposal remains vague on this point. They suggest delegating the task to a team of experts, but this overlooks the tremendous political pressures such teams would face. If placed under direct state control, the same risks seen during Pakistan's Nationalization era would likely re-emerge. If kept independent, as in the Japanese case, the challenge becomes how to prevent elite capture and ensure accountability.

Furthermore, the full reserve model requires the same expertise in economic planning as the Japanese system. Even if we could control money creation, we would still need:

- Sectoral allocation targets,
- Monitoring systems,
- A buffer against political manipulation,
- And public trust in institutions.

In the absence of these supports, control over money creation is likely to be abused rather than used for public welfare.

These historical experiences suggest that redesigning the monetary system is not simply a matter of choosing the right institutional blueprint. The effectiveness of any such system depends on the political and administrative capacities of the institutions that operate it. Large-scale structural reforms such as full reserve banking therefore require institutional conditions that may be difficult to establish in the short run. This observation invites a more pragmatic question: what reforms could improve the functioning of the existing monetary system while remaining feasible within current institutional constraints?

8. PRAGMATIC REFORMS WITHIN EXISTING CONSTRAINTS

The preceding analysis has shown that monetary institutions evolve within specific political and institutional constraints. The question, therefore, is not whether reform is possible, but which reforms are feasible within the current configuration of power, institutions, and policy commitments. There remains significant room for incremental, yet impactful policy changes that can improve the stability, inclusivity, and developmental orientation of Pakistan's financial system. Drawing inspiration from successful models abroad—particularly Japan's postwar experience, as documented in *Princes of the Yen*—as well as Pakistan's own institutional history, this section outlines a set of policy

interventions that can be implemented without structural overhaul, and in many cases, without confronting current political constraints head-on.

Recognising that not all reforms are equally feasible, the proposals below are presented in approximate order of political viability, beginning with measures that could be implemented within the existing institutional framework.

8.1. Increasing Transparency in Credit Creation

One of the simplest and most politically viable reforms is to increase the transparency of how banks create and allocate credit. Public understanding of the money-creation process remains low—not only in Pakistan but globally—and commercial banks face little scrutiny over their role in directing financial flows. The State Bank of Pakistan (SBP) could require banks to regularly disclose how much credit they are creating, in which sectors, and under what terms. Such reporting could be published in sectoral “credit maps” and included in SBP’s monetary bulletins. These measures would not only improve accountability but also empower citizens, journalists, and civil society to monitor whether finance serves the public interest.

8.2. Reinstating Window Guidance for Commercial Banks

A more proactive step—also well within SBP’s existing regulatory authority—would be the revival of “window guidance”, a tool once central to Japanese economic planning. This involves setting informal but powerful credit allocation targets for commercial banks, encouraging them to lend to priority sectors such as agriculture, SMEs, exports, and green energy, while discouraging speculative or consumption-driven lending. SBP already influences bank behavior through reserve requirements and liquidity operations; window guidance would simply add a developmental lens to these tools, encouraging credit where it is socially valuable.

8.3. Reforming and Expanding State-Owned Financial Institutions

Rather than embarking on new institutional experiments, Pakistan could revive and reform its existing public sector financial institutions, which have long been part of its development finance landscape. In previous decades, organisations such as the Agricultural Development Bank and the Industrial Development Bank of Pakistan played key roles in channeling investment into strategic sectors. However, due to a combination of weak governance, political interference, and shifting economic ideologies, many of these institutions were sidelined or dismantled. Yet the legal frameworks, institutional memory, and physical infrastructure remain in place. With reforms focused on depoliticising management, strengthening oversight, and aligning mandates with national priorities, these institutions could once again become engines of inclusive and sustainable growth.

8.4. Expanding Credit to SMEs Through Public Guarantee Schemes

Small and medium enterprises (SMEs) are widely recognised as vital to Pakistan’s economic dynamism and employment generation, yet they remain severely underfinanced. A politically palatable and fiscally responsible strategy would be to expand credit guarantee schemes, allowing the state to absorb part of the risk in SME lending. These guarantees would incentivise private banks to lend to riskier but economically productive sectors, without placing the full burden on the public budget. This model has been successfully used in many developing and advanced economies and enjoys broad support across political lines.

8.5. Creating a Development Finance Window within SBP

A more ambitious, but still feasible, reform would be to create a dedicated development finance window within the SBP itself. Inspired by Japan's Fiscal Investment and Loan Programme (FILP), this unit could channel long-term, concessional financing to projects aligned with national development plans. It could work directly with public banks or on-lend to private institutions for targeted programmes. While SBP independence poses constraints, such a window could be designed as a non-fiscal, quasi-market instrument within SBP's broader monetary policy toolkit — especially if backed by clear rules, transparency, and parliamentary oversight.

8.6. Piloting Central Bank Digital Currency (CBDC) Initiatives

Though technologically and administratively demanding, Pakistan could begin laying the groundwork for a central bank digital currency (CBDC) through staged research, limited pilots, and public consultation. A retail CBDC is often framed by “sovereign money” proponents as “digital cash”—a digital form of risk-free public money that citizens can hold directly, reducing reliance on private bank deposits for everyday payments and potentially supporting financial inclusion as cash use declines (Dyson and Hodgson, 2016).

At the same time, proponents emphasize that a CBDC is not automatically transformative: its implications depend heavily on design choices (e.g., access model, holding limits, convertibility with bank deposits, and whether CBDC balances are remunerated), including how those choices interact with bank-run dynamics and the continued role of commercial banks in credit creation (Huber, 2019). Even within the sovereign money community, CBDC is debated as either a stepping-stone toward a safer public money architecture or a distraction/power shift that could leave core monetary arrangements unchanged (Alliance for Just Money, 2021).

Accordingly, Pakistan's near-term objective should be modest but strategic: develop the legal and operational architecture, run tightly scoped pilots (e.g., low-cost retail payments and government-to-person transfers), and use public consultation to build legitimacy and trust—so that any CBDC initiative strengthens inclusion and resilience without becoming a purely technological showcase.

8.7. Revisiting the Ban on Government Borrowing from the SBP

Of all possible reforms, the most contentious—yet potentially most impactful—would be to reconsider the legal and institutional ban on direct government borrowing from the SBP (Government of Pakistan, 2021). Currently prohibited under IMF conditionalities and possibly constitutional or legislative mandates, this restriction forces the government to borrow from private banks at interest, despite the fact that these banks fund their lending with state-created money. This architecture not only deepens public debt but also transfers unearned rents to financial intermediaries.

In principle, allowing the SBP to finance development—within strict, transparent, and accountable limits—would restore a degree of monetary sovereignty and resolve many of the fiscal constraints that QK-SU's proposal attempts to address. However, given widespread fears of inflation, mismanagement, and political abuse, this reform would require a profound shift in public trust, institutional safeguards, and the national development narrative. It is the least politically feasible of the options presented here, but also perhaps the most transformative if it could be responsibly implemented.

This is also the point at which the MMT vocabulary becomes directly relevant. MMT's core descriptive claim is that a monetarily sovereign government is not

operationally revenue-constrained in its own currency; its binding constraints are inflationary, institutional, and political (Wray, 2015). Read through that lens, the IMF-driven prohibition on direct SBP financing is not merely a prudential rule, it is a deliberate narrowing of fiscal-monetary policy space that forces the state to behave like a currency user and channels rents to the domestic banking system. Once this is understood, the attraction of full-reserve banking changes character: it is not a technological fix but rather a contested attempt to claw back degrees of sovereignty within an externally enforced settlement. This supports our central thesis that the dispute is fundamentally about power—who governs money and credit—rather than about an empirically testable efficiency claim.

8.8. Conclusion and Transition

The reforms outlined above demonstrate that many of the goals of full reserve banking—financial discipline, sovereign money, development-oriented credit—can be achieved incrementally within the existing institutional framework. Some of these reforms are readily implementable; others require stronger political backing, bureaucratic capacity, and public understanding.

In the next section, we explore an additional avenue for making ambitious reforms more viable: strategic framing through Islamic mandates and institutional camouflage. In Pakistan's unique political and legal environment, Islamic finance offers a powerful—and underutilised—channel for reforming money and banking in ways that align with constitutional principles, public sentiment, and long-term developmental goals.

9. STRATEGIC REFORMS THROUGH ISLAMIC FRAMING AND INSTITUTIONAL CAMOUFLAGE

While technocratic reforms offer one pathway toward financial transformation, their feasibility is often limited by entrenched power structures, ideological constraints, and external surveillance—particularly from institutions like the IMF. In such contexts, successful reform strategies must go beyond technical design. They must also engage with cultural legitimacy, legal precedent, and strategic narrative framing. As the historical analysis in earlier sections suggests, institutional change often occurs through adaptation within existing legal and cultural frameworks rather than through abrupt structural redesign.

In Pakistan, one of the most underutilised levers of reform is the country's Islamic constitutional framework. Specifically, the ongoing project of Islamic banking. Islamic finance is a constitutional and legal mandate in Pakistan, as well as a popular aspiration of the public. A 2022 Supreme Court decision reaffirmed the state's obligation to eliminate *riba* (interest) and transition toward a fully Islamic financial system. This directive enjoys widespread public support and is backed by both religious sentiment and national identity. Unlike full reserve banking—which appears abstract, foreign, and technocratic—Islamic finance carries deep social and cultural legitimacy. This provides an opportunity: to use the language and framework of Islamic banking to advance pragmatic development finance goals, while disarming resistance from both domestic elites and international institutions.

9.1. Islamic Banks as Development Partners

One concrete strategy is to reposition Islamic banks as developmental institutions, similar in function to Japan's postwar banks under state guidance. This can be operationalised through the State Bank of Pakistan's regulatory authority. Legally and

institutionally, the SBP has immense power over the banking sector. It can dictate the terms of licensing, liquidity access, and compliance—and it can do so quietly, through administrative discretion.

The SBP could offer zero-interest liquidity facilities to Islamic banks—framed as support for Shariah-compliant operations—under the condition that they:

- Extend zero-interest or participatory financing (e.g., *musharakah*) to priority sectors,
- Allocate a credit quota to government-identified development projects, and
- Operate under a “development partnership” charter aligning profitability with public service.

This approach would repurpose Islamic banking—currently focused on form-compliant profit maximisation—into an engine for social transformation, while remaining within existing constitutional and regulatory frameworks.

9.2. Public Interest through Religious Framing: Mobilising the ‘Ulamā’

A critical, often overlooked actor in this transformation is the ‘Ulamā’—religious scholars whose authority remains deeply rooted in public sentiment. Unlike the government, the financial elite, or even the IMF, the ‘Ulamā’ possess the ability to mobilise mass support and influence public narratives. If they can be persuaded to adopt a simple and powerful proposition—that an Islamic bank must serve the public good, by virtue of the term “Islamic” in its name—then a grassroots moral movement becomes possible.

This would reintroduce a missing element in all monetary reform proposals: a representative of the public interest. The ethical framing of Islamic economics, reinforced by jurisprudential authority and moral clarity, can reclaim public trust, shape institutional expectations, and anchor reform efforts in a broader social vision.

Zaman (2020b) articulates this point in “Reclaiming Economics as a Moral Science”, introducing the concept of a triangular architecture:

1. Islamic Banks: Agents of money creation.
2. The State: Provider of regulatory scaffolding and macroeconomic coordination.
3. The ‘Ulamā’: Moral overseers who ensure alignment with public welfare and *maqāṣid al-sharī‘ah*.

Without the third pillar, all reform efforts remain vulnerable to elite capture. By restoring the ‘Ulamā’ to their traditional role as institutional stewards and ethical guardians, the Islamic financial system can gain both moral legitimacy and political viability. This legitimacy can be further strengthened by linking financial reforms to institutions capable of articulating and embodying public values—including community-based structures and socially embedded networks aligned with Islamic principles.

9.3. Extending the Offer to Secular Banks

To ensure equity and avoid backlash, the same developmental incentives can be offered to conventional banks. Those willing to adopt “public-interest lending” mandates could gain access to SBP zero-interest liquidity or development finance guarantees—effectively creating a public-private partnership model for national development.

This would reposition banks not merely as profit-maximisers but as collaborative agents of public policy, with a diverse range of operational models that remain compatible with Pakistan’s constitutional ethos and financial needs.

9.4. Institutional Camouflage and Counter-Deception

This approach exemplifies what we might call institutional camouflage—using legitimate frameworks (Islamic banking, public interest mandates, Supreme Court rulings) to advance development goals that would otherwise face resistance. IMF opposition to full reserve banking or direct money creation would be difficult to mount in the face of an Islamic revival framed around the ethical obligations of banking institutions.

Here, we echo a principle from *Princes of the Yen*: when reform is difficult to implement head-on, it may succeed if cloaked in familiar institutional clothing, guided by publicly acceptable narratives. Just as postwar Japan used Western rhetoric to mask an interventionist developmental state, Pakistan can use Islamic finance to quietly reorient its monetary institutions.

9.5. Conclusion: The Real Battle is for Moral Legitimacy

The reforms proposed in this section do not rely on confrontation, legislation, or external funding. They rely on something more powerful and more difficult: a reawakening of moral purpose in institutions designed to serve the public. The inclusion of the ‘Ulamā’ as ethical stewards offers the only viable route to representing the people’s interests, anchoring reforms in both legitimacy and mobilisation potential.

The discussion in this section highlights a central theme of the paper: meaningful monetary reform cannot be achieved through technical design alone. It must also draw on institutional legitimacy, cultural authority, and politically viable pathways for implementation. In the final section, we bring together the threads of this analysis—evaluating the QK-SU proposal in light of historical experience, contemporary monetary theory, and the institutional realities of Pakistan’s political economy, and outlining a path forward that is both ethically grounded and politically feasible.

10. CONCLUSION

The full reserve banking proposal advanced by Qanit Khaleelullah and Sohaib Umar is motivated by a powerful and widely shared concern: the need to reclaim control over money creation, align finance with the public good, and protect the economy from cycles of speculative excess and financial instability. These concerns are not only valid but deeply important, particularly in countries such as Pakistan, where financial systems often operate in ways that exclude large segments of the population from meaningful access to credit and opportunity.

However, as this paper has argued, full reserve banking is best understood not primarily as a technical innovation but as a power-sharing arrangement within the monetary system. Historically, such arrangements have emerged in periods when neither the state nor private financial institutions could fully dominate the process of money creation. The Chicago Plan and its modern variants illustrate this pattern. These proposals were never implemented not because they lacked intellectual merit, but because they depended on a delicate balance of power that rarely exists in practice. In contemporary Pakistan—where IMF programmes constrain monetary sovereignty, domestic financial interests benefit from the existing system, and the state itself faces limitations of capacity and credibility—the political conditions required to implement full reserve banking are unlikely to arise.

The analysis developed in this paper therefore suggests that the central obstacle to full reserve banking is not technical feasibility but political legitimacy. Technocratic

proposals for monetary reform often fail not because their institutional design is flawed, but because they remain disconnected from the social and institutional sources of legitimacy required to mobilise political support.

At the same time, the objectives motivating full reserve banking can often be pursued through simpler and more context-appropriate institutional reforms. As the preceding sections have shown, a wide range of pragmatic policy tools—such as credit guidance, development finance windows, greater transparency in credit allocation, and targeted support for SMEs—already exist within Pakistan’s legal and institutional framework. These measures do not require sweeping institutional redesign; rather, they depend on administrative competence, regulatory leadership, and sustained political commitment.

Beyond such technocratic reforms, Pakistan also possesses an important and underutilised source of institutional legitimacy: its constitutional commitment to Islamic finance. Because Islamic banking is embedded in the country’s legal framework and supported by widespread public sentiment, reforms framed within this tradition can mobilise moral authority and social legitimacy in ways that purely technocratic proposals cannot. When combined with institutional reforms that align banking practices with public welfare, this framework offers a pathway for monetary reform that is both politically feasible and ethically grounded.

Ultimately, the central challenge of monetary reform lies in the representation of the public interest. Many reform proposals, including full reserve banking—focus primarily on institutional design while leaving unresolved the question of who will ensure that monetary institutions serve society rather than narrow financial interests. By incorporating the ethical oversight of the ‘Ulamā’ and reorienting Islamic financial institutions toward public purpose, it may be possible to reconstruct a monetary system in which finance once again serves the broader community.

This paper also illustrates the value of an alternative methodological approach to political economy. Instead of relying on statistical correlations or regression-based inference, the analysis proceeds by identifying the institutional mechanisms through which monetary systems evolve and operate. By examining historical experience, institutional arrangements, and the balance of power among key actors, it becomes possible to conduct the counterfactual reasoning required for policy evaluation even in cases—such as full reserve banking—where no direct empirical comparisons are possible. In this sense, the paper demonstrates how historical and institutional analysis can complement, and in some contexts substitute for, conventional data-driven methods in the study of economic policy.

Wrapping up, we see that monetary reform is not merely a technical adjustment to the banking system. It is a redefinition of the relationship between finance, the state, and the society they are meant to serve. Pakistan already possesses many of the legal, institutional, and moral foundations required for such reform. The challenge lies not in discovering new tools, but in mobilising the vision, leadership, and institutional creativity needed to use them.

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