Funding the Future

Article URL
https://www.taxresearch.org.uk/Blog/2025/12/19/88558/

Published: January 12, 2026, 7:42 pm

I received this email this week:
Dear Prof. Murphy, I have been watching a great number of your videos on YouTube to clear up my understanding of economics, how it functions, and what can be done. One thing I thought would be very interesting to hear a bit about, would be what you think about playing with the required reserves of banks. I am aware that most don't have any reserve requirements at present. I read that Switzerland had a ballot measure that got about a quarter of the vote, for enforcing full reserve banking. I imagine this could be a way of limiting the power of finance over the rest of economy, but there must be some tradeoffs to this. If you could make a video talking a bit about why or why not that is a good idea, I'd be very grateful. Again, thank you for all the educational material you put out, it has allowed me to make quite a bit more sense of the world around me than before happening upon your channel.
I admit that this does not feel like a video idea to me: YouTube rewards excessive techniques with low views. But it did feel worth answering, so I have written two glossary entries on full reserve banking (which is currently technically Green Party economic policy) and on reserve requirements. They are as follows, nd please note all the hyperlinks in this post are to glossary entries:

Full reserve banking

Full reserve banking is the proposal that banks should be required to hold reserves equal to 100 per cent of their customers' demand deposits, preventing them from creating money through lending. Deposits would be fully backed by central bank -created money, and banks would only be able to lend money that already exists.

In a modern fiat monetary system, this proposal is not coherent.

The reasons are structural rather than technical.

First, it misunderstands how money is created in a fiat economy.

In a fiat system, money is created by the state through spending and by banks through lending, within a framework set by the central bank and regulators. Bank lending does not “use up” deposits; it creates new deposits. Requiring full reserves against deposits, therefore, does not control lending in the way proponents imagine, because reserves are supplied elastically by the central bank. What it might do is transfer credit risk to the state.

Second, reserves are not a funding constraint.

Banks do not lend out reserves, and reserves are not the scarce resource that limits lending. Capital adequacy, creditworthiness and profitability matter. A full reserve requirement would simply force the central bank to supply whatever reserves are required, turning the rule into an accounting exercise rather than a real constraint.

Third, it confuses payment safety with credit control.

Safe payment systems can be achieved through deposit guarantees, central bank settlement and regulation without dismantling credit creation. Full reserve banking treats money safety as a balance-sheet ratio problem rather than as an institutional design issue.

Fourth, it would require permanent state intervention to function at all.

If banks cannot create money, the state must continuously inject new money or credit to prevent contraction. The system would therefore depend on discretionary public **money creation and credit allocation on a scale far larger than its advocates currently acknowledge. The state might not want to take on the micro decision-making involved, leaving a shortage of credit availability in the economy and creating the sort of crises seen in the gold standard era, e.g., the 1930s.**

Fifth, it offers false certainty.

Financial instability arises from **asset bubbles, leverage, poor regulation and speculative behaviour, not from fractional reserve accounting. Full reserve banking targets a bookkeeping identity rather than the real drivers of crisis.**

From a Funding the Future perspective, full reserve banking is a relic of commodity-money thinking applied to a fiat system where it no longer fits. It promises control and stability, but only by ignoring how modern money actually works.

The real task is not to abolish bank money creation, but to govern it: through strong regulation, public banking options, capital controls where necessary, active fiscal policy and democratic oversight of credit allocation.

In a fiat economy, money creation is already a public function. The question is not whether it should exist, but in whose interests it is exercised. Good governance and not rules that deny the nature of fiat money are required to

address this issue.

Reserve requirements

Reserve requirements are rules that require banks to hold a specified proportion of their customer deposits as reserves, typically at the central bank, before or alongside lending.

In the UK, there are no formal reserve requirements of this kind.

1 . The UK does not operate a reserve-ratio system

UK banks are not required to hold a fixed percentage of deposits as reserves at the Bank of England **in order to make loans. The idea that banks must “have the money first” before lending is a legacy of outdated textbook models and does not describe how modern UK banking works.**

2 . Lending creates deposits, not the other way round

When a UK bank makes a loan, it simultaneously:

*
records a loan asset **on its balance sheet, and**

*****
creates a matching deposit in the borrower's account.

This process creates new money. Reserves are not checked or “drawn down” in advance. Any reserves required for interbank settlement are obtained after lending has occurred.

3 . Reserves are supplied elastically by the Bank of England

Reserve balances on central bank reserve accounts **held at the Bank of England exist to ensure the smooth functioning of the payments system and to support monetary policy implementation. The Bank of England will supply reserves on demand to maintain its policy interest rate and does not allow shortages of reserves to constrain lending.**

Since the financial crisis, UK reserve balances have been:

*****

voluntary (at least technically) rather than mandatory,

*****
remunerated (interest-bearing), and

*****
unrelated to lending volumes.

4 . What actually constrains bank lending in the UK

Instead of reserve requirements, UK banks face three binding constraints:

*
Capital requirements, which limit lending relative to shareholders' equity.

*
Liquidity requirements, such as the Liquidity Coverage Ratio and Net Stable Funding Ratio, which ensure resilience under stress, and

*
Profitability and risk considerations, including credit risk, funding costs, and regulatory oversight.

These constraints operate continuously, but none require reserves to exist prior to lending.

5 . Why the reserve-requirement myth matters

Belief in reserve requirements:

*
obscures the money-creation role of banks,

*
misrepresents how monetary policy works,

*
encourages false claims that governments are financially constrained in the same way as households, and

*
diverts attention from the real regulatory levers that shape credit allocation.

In the UK context, reserve requirements are not a policy tool and not a limit on lending.

In short:

UK banks do not lend out reserves. They create money by lending, and the central bank ensures the reserves needed to support the payments system are always available.

Comments

When commenting, please take note of this blog's comment policy, **which is available here. Contravening this policy will result in comments being deleted before or after initial publication at the editor's sole discretion and without explanation being required or offered.**