Funding the Future

The Fed Just Raised Interest Rates. Recession is next

Published: September 27, 2026, 6:37 am

I have a new podcast out with Prof. Radhika Desai:

https://www.youtube.com/watch?v=pbLO_n1wOa0?si=dVe4vTXY9yVDZto6

I really enjoyed this conversation.

Like my conversations with John Christensen, I think this is developing into something really useful.

There is no transcript for this video, but this is my summary of what we said.

I recently joined Prof Radhika Desai for an extended discussion on her Geopolitical Economy Hour about inflation, interest rates, central banking and the increasingly obvious failure of conventional economic policy.

Radhika and I agreed on a fundamental point: central banks are using the wrong tool to tackle the inflation we now face.

The conventional central bank argument is that inflation indicates excess demand. On that basis, interest rates must rise to reduce spending, weaken the labour market and ultimately increase unemployment. With less money being spent, inflation is supposedly brought under control.

That argument might make sense if inflation were actually being caused by excess demand. If an economy were operating at full capacity, with resources fully employed and demand continuing to increase, there could be a case for restraining it.

But that is not the situation we face.

The inflationary pressures now affecting many economies arise predominantly from supply constraints. Energy disruption, war, food shortages, climate change, drought, damaged supply chains and inadequate productive capacity all play a part. These are real-world shortages. Increasing interest rates cannot produce more gas, electricity, food or other essential resources.

Worse, higher interest rates can actually increase inflationary pressure. Interest costs are embedded throughout modern economies. They affect mortgages, rents, car finance and business costs, which ultimately feed through into prices. Raising rates therefore imposes another cost on households already struggling with higher prices for essentials.

The result is not the elimination of excess demand. Instead, households are forced to reallocate their constrained incomes towards food, energy, housing and other essentials, leaving less to spend elsewhere. Higher interest rates intensify that process.

The danger is obvious. Central banks could turn a supply-driven inflation into recession, and potentially something worse.

Radhika and I also discussed why central banks persist with this policy. The answer cannot be separated from politics.

Central bank independence is itself a political construction. In the UK, the Bank of England only acquired operational independence over interest rates in 1998. The idea that monetary policy should be removed from democratic government and entrusted to supposedly neutral experts is a central feature of neoliberal economic thinking.

But those experts are making profoundly political decisions.

Modern monetary policy explicitly assumes that unemployment can be used to control inflation. Concepts such as the non-accelerating inflation rate of unemployment, or NAIRU, embody that assumption. If wages rise too quickly, unemployment is supposed to discipline workers and reduce wage demands. In other words, unemployment is not simply an unfortunate side effect of this policy. It is part of the mechanism through which the policy is supposed to work.

That matters. There is a deliberate policy operating now to increase unemployment as a mechanism for controlling inflation. But it is not the unemployment of central bankers, senior economists or those making these decisions that is at stake. It is somebody else’s unemployment.

This reflects a much deeper problem in economics. Macroeconomics has increasingly been built upon microeconomic assumptions. Governments are treated as though they were households. National economies are imagined as though they were businesses.

The state is consequently denied its unique macroeconomic role, including its capacity to create money, invest, coordinate resources and build economic resilience.

Radhika and I therefore discussed the alternative.

If inflation is caused by inadequate supply, the appropriate response is to increase supply and resilience. In the UK that means investing in renewable energy, electricity networks, food security, flood defences, water infrastructure, skills and the other resources required to make the economy less vulnerable to external shocks.

This is what genuine inflation management should look like.

The obsession with efficiency has instead created extraordinarily fragile economies. Just-in-time production may reduce apparent costs, but it also removes spare capacity and resilience. When supply chains fail, there is nothing available to take their place. The resulting shortages then create inflation, to which central banks respond by increasing interest rates, even though doing so cannot solve the underlying shortage.

We also discussed financialisation and the extraordinary role that interest now plays within the economy. Money is not a commodity that has to be dug out of the ground or manufactured. Modern money is created through accounting entries. It records economic relationships. Yet economic policy increasingly treats money itself as though it were the central objective of economic management rather than a tool that should facilitate real economic activity. That misunderstanding has helped create an economy in which those who possess money expect a return simply for holding it.

I questioned whether there is any justification for a positive real risk-free interest rate. The long-run historical trend in interest rates has been downward. My argument is that we have reached the point where the appropriate real risk-free interest rate should normally be around zero. Savers could maintain the real value of their money, but merely possessing money would not generate an additional real return.

There are circumstances when even that may be inappropriate. During periods of major external shock, negative real interest rates can make sense because they encourage the investment required to increase productive capacity and resilience. Instead, central banks are now trying to create significantly positive real interest rates.

Radhika and I discussed why this might be happening. One interpretation is that inflation provides the justification for restoring returns to financial capital. The neoliberal transformation that began in the late twentieth century involved a substantial redistribution of economic returns away from labour and towards capital. High interest rates formed part of that process.

The period after the 2008 financial crisis appeared different because interest rates were extremely low. But the accompanying quantitative easing programmes largely supported financial liquidity and asset prices rather than directing investment towards productive capacity. House prices and other asset values increased substantially while productive investment remained inadequate.

The problem was not simply that interest rates were low. It was that the financial system had not been restructured to ensure that the money being created supported productive investment. That remains the challenge.

We need a financial system that directs resources towards useful investment rather than speculation.

We need governments willing to use fiscal policy rather than pretending monetary policy can solve every economic problem.

We need investment designed to increase resilience.

And we need to recognise that deliberately creating unemployment is not an acceptable substitute for addressing the real causes of inflation.

Above all, we need to stop pretending that economic policy is merely technical.

Interest rates determine who receives income and who loses it. Unemployment determines who bears the cost of economic adjustment. Investment decisions determine whether societies are resilient when the next crisis arrives.

Those are questions about power, distribution and political choice.

They are questions of political economy.