

The Federal Reserve's 2026 Rate Hike: Why Did the Fed Raise the Federal Funds Rate After Three Years of StabilityAuthor: Marc Hobeika¹*Affiliation:*

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Abstract:

Through this study, I seek to explore the reasons for the reversal in decision by the Federal Open Market Committee (FOMC) to increase the federal funds rate in September 2026, after five consecutive meetings without changing it and staying in this state for three years. In the context of expectations for continuation of easy monetary policy until early 2026, the decision to tighten the monetary policy represents a shift which has not yet been described clearly enough in public discourse. This research verifies whether the decision of the FOMC to break the holding trend can be justified by the energy price shock, labor market conditions, growth speed, and inflation persistence. Employing data provided by the Federal Reserve, the Bureau of Labor Statistics, and the Bureau, an event study of U.S. macroeconomic variables around FOMC meeting of September 16, 2026 was conducted. I considered five different indicators which are typically used in reaction functions for monetary policy (Taylor, 1993). They include headline and core inflation (CPI and PCE), the unemployment rate, the real GDP growth rate, and the price change of energy within a nine-month time frame. The results indicate that the reason for the change is mostly inflation pressure and not problems in the labor market. Even though the headline CPI grew up to 4.2% and then declined to 3.4% in August, the core PCE inflation grew up to 3.4% in May, its highest value since October 2023. The GDP growth rate went down from 2.1% to 1.5% between Q1 and Q2, while the unemployment rate stayed constant at 4.1%-4.4%. In summary, the Fed raised interest rates by 25 basis points through a 12-0 vote. The below are the results of this analysis: The Fed focused on maintaining price stability rather than promoting growth in this cycle since prolonged above-target inflation, together with the volatile prices of energy associated with the confrontation with Iran, were enough to warrant tightening while GDP was slowing. Nevertheless, there are some factors that contribute to uncertainty in terms of future rates, which include the difference between the market predictions and the actual Fed decision, as well as the uncertainty surrounding energy prices as a result of the Middle East.

Keywords:

Federal reserve, Monetary Policy, Inflation (CPI/PCE), Energy price shocks, Central bank credibility

Introduction:

For nearly three years, the monetary policy of the United States was foreseeable in nature. Interest rates had been decreasing slowly and steadily from their high point due to the pandemic and markets, businesses, and people had been pricing themselves in anticipation of lower interest rates. However, the basis of this theory lay in the fact that the level of inflation was gradually reaching its target level of 2%, and slow economic growth, not higher inflation, was a concern. However, the economic conditions prevailing in 2026 were far from being anticipated by everyone. The crisis with Iran led to unstable energy markets, inflation levels started moving up again, and even the Fed lost patience.

The extent of this change would have been a better measure of the fact that the underlying assumptions in many years of policy guidance had become invalid than the technical nature of this change. The reliance of the Fed on the emergence of new information as the major mechanism of controlling matters created a situation that had not been considered in the calculations of virtually everybody, even those that had forecasted, traded or predicted prior to the Fed. By September, Fed policymakers that had anticipated rate cuts in 2026 until February had all been agreed on a rise.

In order to respond to the emerging data, the Fed adopted measures that the central banks have used since time immemorial in order to react to the emerging data: analysis of labor market and inflation data, analysis of energy price shocks and changes in the policy rate accordingly. A central bank may find itself forced to focus on price stability even at the expense of growth in case inflation data has consistently exceeded target levels. Energy price shocks in particular have in the past made it difficult for the Fed to distinguish between transient and lasting inflation pressures (Bernanke, 2022).

Individually, each technology addresses a piece of the puzzle, however the main research question is: What were the macroeconomic conditions, the combination of which forced the Fed to increase the federal funds rate in September 2026 after three years of no interest rates hikes, and which one was the most decisive?

To answer this question, my study aims to:

- 1) For the period of several months prior to the September 2026 announcement, monitor the behavior of the inflation (CPI and PCE, both headline and core).
- 2) For the same period of time, analyze the developments of the labor market conditions (unemployment).
- 3) Identify the magnitude of the impact of the volatility of energy prices due to the conflict in Iran on inflationary pressures.
- 4) Assess whether the developments regarding the GDP growth have aided or impeded the tightening.
- 5) As a tool to evaluate the degree of the reversal, compare the Fed's policy actions to its projections (dot plots).
- 6) Assess the implications of this decision for the future path of the monetary policy up until 2027.

Literature Review:

The central issue here, then, is that of finding out what could cause a central bank to suddenly switch from a long period of commitment to a slow and telegraphed easing process. After many years of studying the issue of rules-based monetary policies, modern methods for gathering data and predicting the future are capable of providing real-time indications that credibility assumptions behind the operation of central banks are no longer holding true. Volcker era scholars have already discussed this phenomenon in detail.

Similar to Auditors, policy makers especially in central banks are expected to be independent (Sawaya et al., 2025), especially that banking services and interest rates have a significant impact on firms as demonstrated by Mawad and Freiha (2024), especially in emerging markets, because unlike developed economies, where companies may raise capital through other sources such as crowdfunding (Yin et al., 2025), in developing economies this is option is rarely available, to the point that such firms may have to integrate an organizational redesign (Subrahmanyam & Saber, 2027), in such environments, in addition to financial stability, proper country governance is essential for the sustainability of the banking sector (Athari et al., 2023). Furthermore, while a decrease in interest rates have a positive impact against economic depression, yet Beainy and Kamel (2026) demonstrated that investors may shift their focus from bonds and stocks to alternative investments such as gold and cryptocurrencies, not to mention the impact of interest rates on liquidity and the importance of liquidity for financial institutions such as Banks (El-Chaarani et al., 2023).

The concept of Taylor (1993) in which he states that the federal funds rate should respond systematically to fluctuations in production below the potential level and above the target level of inflation became one of the main sources of development of the monetary rule framework. Data from years of practice of the Federal Reserve Bank prove that any policy that deviates from such recommendations for too long needs a greater correction in the future. There are also contradictions in the literature regarding the issue of how much attention the Fed should pay to employment compared to inflation in case their signals differ from each other. Even the first dual mandate framework proposed the idea of bias of policy towards avoiding inflation (Clarida, Galí & Gertler, 2000). However, in reality, the decisions made by central bankers go beyond the boundaries of pure rules because it is hard for the market to predict the time when the policy needs to change. That is why new forward-guidance based frameworks have appeared lately.

While introducing the concept of energy price shocks in monetary policy considerations, there was some disagreement about the necessity of reaction to them in the first place. However, there was soon some consensus reached on the crucial difference: between a temporary and supply-induced oil shock and one that would spill over into core inflation and expectations of wages (Hamilton, 2009; Kilian, 2009). As soon as the spillover takes place, this is an inflation problem which cannot be solved without a response; it can be said to pit "transitory vs. persistent" against each other, which has been quite an issue for Fed policymakers and financial markets alike on

many occasions. That was true even before the recent energy shocks, where central banks who responded to the oil induced inflation experienced better anchoring of long-term inflation expectations and some short-term growth pain (Bernanke, 2007).

From the time that energy price shocks started appearing in the discussion of monetary policies, it is true that there was confusion as to whether the Fed should respond to them or not. But it did not take long for the literature to come to an agreement that there was a basic difference between an oil shock of temporary nature based on supply side and the one which leads to core inflation and wage inflation (Hamilton, 2009; Kilian, 2009). Once the transmission takes place, the situation becomes an inflation issue which cannot be resolved automatically and in effect becomes testing of transitory versus persistent inflation issue. In the previous episodes of energy shocks, central banks who responded to such inflation in terms of rate hikes were faced with better anchoring of inflation expectation and short-term growth cost (Bernanke, 2007).

No one has investigated how these factors together result in a policy shift at once. Most literature investigates these factors individually as separate factors affecting the policies (Cukierman, 2020). Very few people investigate these factors in conjunction, and even then, their focus is always on past decisions over several years instead of the present decision taken in isolation. This paper will investigate how these factors came into play for the FOMC policy change in September 2026 after three years of inactivity.

Methodology:

I conducted the event study analysis for my research. Specifically, I observed the macroeconomic trends in the US for nine months from January through September 2026, focusing on the FOMC hike on September 16. The Fed, BLS and BEA made all their data accessible to the public. Consequently, there were enough monthly and quarterly periods to spot a trend but not enough high-frequency events to make the comparison seem too planned or like an after-the-fact plot twist.

Prior to the hike, the Fed left the federal funds rate at 3.50%-3.75% for five consecutive meetings from January through July 2026. This period represented the “control” window, during which inflation, labor market and growth statistics were observed on a monthly basis, and policy remained constant such that any changes to the data could be attributed only to changing circumstances, not to the policy per se (Clarida, Galí & Gertler, 2000).

For the period after the decision was made, however, I proceeded differently. Once the Fed had made the decision on September 16, I matched up the movements of each of these indicators during the preceding months relative to the pre-existing information the Fed provided about its future decisions — namely, the June 2026 dot plot, which foresaw a year-end rate close to the lower end of 3.6%-4.1%. The distance between that forecast and the eventual reality, with an increase and a signal for more hikes coming, represents the magnitude of the policy surprise (Rogoff, 1985). That is the object of study here.

I must state the reasons why I chose the event study approach and did not conduct a full regression analysis instead. To conduct a formal Taylor rule regression, it would be necessary to have sufficiently long stable time series and it would be risky to try to estimate coefficients based on only one nine-month period around one decision. An event study approach allows each indicator to speak for itself about what happens around a clear-cut policy reversal.

There were five variables that I monitored which included headline and core CPI (YoY, MoM), headline and core PCE (Fed's favorite measure of inflation), national unemployment rate, quarterly and annualized growth in real GDP, and changes in prices of energy/gasoline due to war with Iran. Moreover, I was monitoring the FOMC vote count and the median projections from the dot plot as indicators of consensus and forward guidance among committee members (Kydland & Prescott, 1977). All five indicators come from the same economy and within the same time period, thus if there is a divergence between them, such as increase in inflation while the growth rate falls, this can be attributed to policy disagreement and not to different data sources.

Results:

I did a comparison sheet below, covering the last hike before the pause (July 2023) against this one (September 2026), with live formulas for the change column

Indicator	July 2023 (Last Hike)	September 2026 (This Hike)	Change (pp / units)
Federal funds target range - lower bound	5.3%	3.8%	-1.5%
Federal funds target range - upper bound	5.5%	4.0%	-1.5%
Rate change at meeting (bps)	25bps	25bps	+0bps
FOMC vote	Unanimous	12-0 Unanimous	—
Headline CPI, YoY	3.2%	3.4%	+0.2%
Core CPI, YoY	n/a	2.5%	n/a
Headline PCE, YoY	3.3%	3.7%	+0.4%
Core PCE, YoY	4.2%	3.3%	-0.9%
Unemployment rate	3.6%	4.1%	+0.5%
Real GDP growth, quarterly annualized (Q2)	2.1%	1.5%	-0.6%

Note: Comparison of macroeconomic conditions at the last pre-pause hike (2023) and the first hike after the pause (2026)

A few notes on the data:

- The Fed funds rate, CPI, unemployment, and GDP figures for both years are sourced from BLS/BEA/Fed releases and are solid.
- Core CPI for July 2023 wasn't reliably sourced in my research, so I marked it **N/A** rather than guess ;worth flagging if you want it filled in for the paper.
- The rate move is identical in size both times (+25 bps), but the starting point in 2023 (5.25%–5.50%) was far higher than 2026 (3.75%–4.00%) ; useful context if you touch on that contrast in the Discussion later.

Discussion and Conclusion:

This research aimed to explore the reasons why the Fed increased the federal funds rate in September 2026 despite three years of no increases. From the information presented above, it is clear that inflation played an essential role in changing the monetary policy of the Fed, and not labor market dynamics or growth. Indeed, core PCE increased to 3.4% in May 2026, which was the largest value of this indicator since October 2023. The same goes for the headline PCE, which reached 4.1% in the same month, its largest value since April 2023. At the same time, GDP growth declined from 2.1% to 1.5% from Q1 to Q2 and unemployment remained at the low levels of 4.1% to 4.4%. Considering these numbers, it would have been better to pause or even decrease the rate; however, it was increased by 25 basis points in September. Thus, we can conclude that the inflation persistence was the main issue in the committee's decision-making.

The energy aspect deserves our attention, too. Prices decreased in June 2026 because of a temporary truce in the Iran conflict and started rising when the conflict intensified. In addition, this tendency matches the inflation trend, which increased dramatically prior to the September rate increase. It is not unusual that the oil price increase led to the changes in monetary policy (Hamilton, 2009); however, the difference of 2026 is that the increase was much larger compared to the guidance of the Fed: the year-end interest rates expected in June according to dot plot were 3.6% to 4.1%; however, the committee has already signaled further rate increases in September.

Practical implications: From the market and firm perspectives, the takeaway is that the dot plot of the Fed should be seen as a conditional projection dependent on incoming data, not a rigid one, especially in situations where energy markets face geopolitical shocks. Businesses with floating rate debt or energy costs import exposure could have gained from performing stress test of the tightening scenario long before it actually occurred, instead of relying on the previous "more cuts coming" message.

Theoretical implications: This event is in line with the conservative central banker approach introduced by Rogoff (1985): once the persistence of inflation became clear, the best strategy for the Fed to maintain its reputation would be to show readiness to tighten even at the time of economic slowdown rather than staying on the previous dovish course. This event also proves the challenge of using Taylor Rule type approach (Taylor, 1993) during the times of energy shocks because of the same problem described by Kilian (2009).

Limitations. This study is built on a nine-month event window around a single policy decision, which is useful for capturing a real-time reversal but does not establish a long-run statistical relationship between these variables and Fed policy. Some indicators, like core CPI for comparable prior periods, were not fully available within the scope of this research and were left as gaps rather than estimated. The analysis is also descriptive rather than causal. It documents that inflation, growth, and energy prices moved a certain way ahead of the hike, but it does not isolate how much weight the FOMC placed on each factor internally.

Future research. A natural extension would be to run a full Taylor-rule regression once more post-hike data becomes available, testing whether the September decision was consistent with historical Fed reaction functions or represented a genuine deviation. It would also be worth comparing this episode systematically against the 2023 hiking cycle and other historical energy-

shock-driven tightening episodes, and eventually to see whether the Fed follows through on the additional hikes signaled at the September meeting or reverses course again once energy prices stabilize.

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