Proceedings of ICFTBA 2026 Symposium: Digital Government, Finance, Accountability, and Sustainable Economic Development
DOI: 10.54254/2754-1169/2026.AB38908

Federal Reserve Dual Objectives and Conventional Monetary Policy Tools: A Review of Theory, Practice and Limitations

Ruiwen Bi

School of Finance, Shandong University of Finance and Economics, Weihai, China
13336241017@163.com

Abstract. After the 2008 financial crisis, the Federal Reserve gradually refined its statutory dual-mandate framework of price stability and full employment, adopted a single inflation target and later an average inflation target, and returned to a traditional balance framework in 2025. Conventional interest rate tools have always been the core of its macroeconomic adjustment. At present, the global economy is increasingly volatile, and liquidity traps, high inflation and employment imbalances appear alternately. The regulation efficiency and application boundary of conventional benchmark interest rate regulation have become the focus of macro financial research. This paper adopts a literature review approach to systematically trace the evolution of the Federal Reserve's dual-mandate system, dismantle the operation logic of conventional monetary policy tools such as the federal funds rate, and review the practice of three rounds of target framework reform in 2012, 2020 and 2025 in stages to compare the regulatory effects of conventional interest rate tools under different economic cycles. The findings are as follows: conventional interest rate tools can effectively balance dual targets in the stage of moderate inflation and stable economic operation, but there are significant regulatory weaknesses in the scenario of zero lower bound interest rate and supply-shock inflation, compared with the policy objectives of major central banks in the world, there is a significant institutional difference between the Dual employment-first target mode of the Federal Reserve and the single inflation target of many countries. This paper summarizes the policy practice experience and system defects of the Federal Reserve, clarifies the applicable conditions and limitations of conventional monetary policy tools, and provides theoretical and practical reference for China to improve the framework of monetary policy regulation and stabilize prices and employment.

Keywords: The Federal Reserve, Dual monetary policy objectives, Conventional interest rate instruments, Average inflation target, Monetary policy framework

1. Introduction

Price stability and full employment, as the dual statutory objectives of the Federal Reserve, have long guided U.S. macro-control practices. Since its creation, conventional monetary policy tools have been central to the Fed's efforts to balance its two objectives and smooth out economic fluctuations. Across economic cycles, such as booms and recessions, the Fed raises or lowers interest rates by adjusting the benchmark rate and managing its balance sheet. However, when the

© 2026 The Authors. This is an open access article distributed under the terms of the Creative Commons Attribution License 4.0 (https://creativecommons.org/licenses/by/4.0/).

DOI: 10.54254/2754-1169/2026.AB38908

economy falls into the liquidity trap, the regulatory effectiveness of traditional conventional policies is significantly restricted. At the same time, there are significant differences in the monetary policy target frameworks of central banks around the world, which provides a basis for horizontal comparative research. Against this background, this paper takes the Dual objectives and conventional monetary policy tools of the Federal Reserve as the research topic, and intends to focus on the following issues: the meaning and origins of the Fed's dual mandate, the operational logic of conventional monetary policy tools, the advantages of conventional interest rate policy in macroeconomic management, and the limitations of liquidity traps.

At present,scholars in China and abroad have produced a substantial body of work on the Fed's interest rate regulation and previous monetary policy cycles, and much of this literature has examined the Fed's historical policy operations. However, based on the perspective of dual objectives, the systematic integration of advantages and boundaries of conventional monetary policy tools is still relatively limited. In this paper, literature review method is adopted to summarize, compare and summarize the existing related research. The Dual Target Framework of the Federal Reserve and the Evolution of Monetary Policy

1.1. Formation and practice of single inflation targeting framework in 2012

After the subprime mortgage crisis in 2008, the United States experienced a long-term dilemma of low inflation and high unemployment. Markets lacked an anchor for stable inflation expectations, and the public and financial markets lacked a unified benchmark for judging Federal Reserve policy. In 2012, when the Fed introduced a single inflation-targeting framework, PCE inflation was 1.78% and unemployment was 7.8%.The average PCE inflation from 2012 to 2019 was only 1.4%, and the unemployment rate continued to fall from 7.8% to 3.5% [1]. In order to reduce policy uncertainty and anchor long-term inflation expectations, the Federal Reserve officially launched the 2% single inflation target system in 2012, with PCE price index as the core measurement index [1]. The system's design logic was as follows: 2% is set as the long-term balanced inflation center, price stability is assumed as the primary policy goal, and employment is only taken as a subsidiary observation indicator, Conventional interest rate operations are assisted by forward guidance, and policy decisions are made with long-term inflation converging to 2% as the core scale, and employment gap only as a short-term auxiliary reference, forming a dual target execution mode of "inflation first and employment second".

From 2012 to 2019, the U.S. economy recovered slowly, inflation remained below the 2% target for a long time, and the unemployment rate continued to decline. The Fed follows the rule of a single inflation target: it keeps interest rates low until inflation reaches a 2% ceiling and slowly shrinks its balance sheet to tighten liquidity. The policy logic at this stage is: 2 percent inflation as a hard constraint, if inflation continues to be below the target, continue to ease to stimulate employment, If inflation nears 2 percent, it will start raising interest rates, even if there is room for improvement in the labor market. Practical limitations gradually emerge: In the latter stage of the recovery, employment has continued to improve, but inflation has remained weak for a long time. As a result, the fixed 2% rigid target has failed to fully absorb idle capacity in the labor market, exposing the weakness that a single inflation target is insufficiently inclusive of employment.

1.2. Background and implementation path of 2020 average inflation targeting reform

Under the impact of COVID-19, the unemployment rate in the United States soared to a short-term record high. In April 2020, the unemployment rate in the United States soared to the post-World War

DOI: 10.54254/2754-1169/2026.AB38908

II peak of 14.7%, while PCE inflation dropped to a phased low of 0.5% in the same period [2]. Combined with the long-term deflationary pressure of the previous decade, the disadvantages of the rigid 2% single target are completely exposed: the inflation gap built up in past low-inflation cycles cannot be filled, and the Fed's rapid tightening of monetary policy once inflation picks up a bit could suppress job recovery too soon. The traditional single target only pays attention to the current inflation and ignores the cross-cycle inflation average, so it cannot take into account the long-term full employment target. The institutional defects force the framework reform.

In 2020, The Federal Reserve launched the average Inflation Targeting system (AIT), with the core mechanism as follows: Instead of anchoring 2% inflation in the current period, allowing inflation to be moderately above 2% for a period of time, hedging the inflation gap caused by the previous long-term inflation below 2%, and achieving a return to 2% average inflation over a period of time. Its practical operating rule is that before the labor market achieves broad and inclusive full employment, the Fed will not rush to raise interest rates even if inflation briefly exceeded 2%. Regular interest rate tools put more emphasis on job recovery and significantly increased the weight of employment targets. From 2020 to 2022, the Federal Reserve maintained the near-zero federal funds rate for a long time and stimulated the recovery of the labor market by cutting interest rates and forward guidance. However, the prolonged easing cycle combined with global supply shocks eventually led to the most serious inflation in the past 40 years [3].

1.3. Restore the pre-epidemic balancing framework adjustment logic by 2025

From 2022 to 2024, aggressive interest rate hikes gradually brought down high inflation. In 2025, PCE inflation in the United States is expected to remain in the 2.1%–2.3% range, and the unemployment rate in the 4.1%–4.4% range. Wages pushed up by previous ultra-loose policies remained sticky, and labor market heat declined without large-scale unemployment. The risk of inflation overshoot caused by long-term easing under the framework of average inflation target persists, the cross-cycle average easing rule is no longer suitable for moderate inflation environment, and the original system is mismatched with the current equilibrium economic environment.

In this context, the Federal Reserve completed a new round of monetary policy framework review in early 2025 and officially announced the adjustment framework in the statement of Jackson Hole Annual Meeting of Global Central Banks and related rate-setting meetings [4]: it abolished the average inflation targeting (AIT) rule that "fills the inflation gap" and returned to the traditional dual-mandate model, anchored to current 2 percent inflation and giving relatively balanced weight to price stability and full employment. In terms of the nature of the policy, this adjustment is not a temporary interest rate cut or interest rate hike in response to short-term economic fluctuations, but an institutional revision of the Long-term strategic framework of monetary policy by the Federal Reserve [4]. It redefines the operating rules of inflation target and the relative weight of employment and price target. It is a long-term binding institutional arrangement and will have a lasting influence on the interest rate decisions in subsequent cycles. To be specific, the conventional interest rate decisions after adjustment will no longer unilaterally accommodate the employment repair, but take whether the current inflation is close to 2% as the core constraint. The Fed also stressed that it would remain flexible to adjust the path of policy in response to economic data, but that the average inflation compensation mechanism itself had been abolished. This adjustment marks the formal withdrawal of the unilateral easing policy of "putting employment first and allowing inflation overshoot" during the pandemic, and the return of U.S. monetary policy to the relative balance between prices and employment.

DOI: 10.54254/2754-1169/2026.AB38908

2. Advantages and limitations of the federal reserve's conventional interest rate monetary policy tools

2.1. Advantages of conventional interest rate policy tools

Conventional interest rate policy is a core countercyclical regulatory tool under the Federal Reserve's dual-mandate framework. It has multiple natural efficiency advantages in the cycle of stable economic operation and moderate fluctuations, and its value is concentrated in four dimensions: transmission efficiency, expected management, target adaptation and policy withdrawal. The transmission path of conventional interest rate policy is direct and the control operation is highly flexible. As a core operating tool, the federal funds rate can directly affect the inter-bank borrowing costs, and quickly transmit to the real economy deposit and loan rates, corporate financing costs and household credit costs. At the same time, interest rate adjustments can be made dynamically at rate-setting meetings, and the policy time lag is relatively short, which is convenient for the Federal Reserve to flexibly fine-tune the policy intensity according to monthly inflation, employment and other high-frequency data [5], to meet the realistic demand of short-term counter-cyclical adjustment.

2.2. Limitations of conventional interest rate policy tools

Conventional interest rate regulation is constrained by the zero lower bound of interest rates. When an economy encounters a deep recession and deflationary pressure is significant, the policy interest rate will be lowered to near zero, leaving no room for further easing. After an economy falls into a liquidity trap, it is difficult to keep social financing costs down by cutting interest rates, and conventional interest rate tools are basically ineffective. At this point, quantitative easing and other unconventional monetary policies must be used as a supplement [6]. Conventional interest rate tools are difficult to deal with supply-side driven inflation. When inflation is triggered by supply shocks such as energy crisis, supply chain rupture and labor supply shortage, interest rate hikes can only restrain aggregate demand, but cannot repair the supply shortage. Forced and drastic tightening of monetary policy will significantly suppress output, push up unemployment rate, and leave the central bank in a policy dilemma between stabilizing prices and ensuring employment. The Conflict between Russia and Ukraine combined with global supply chain bottlenecks brought supply-side inflation. The PCE inflation in the United States once exceeded 7%. The Federal Reserve kept raising interest rates sharply to lower inflation, but it also caused rapid cooling of the real estate industry and the labor market, with the unemployment rate rising from 3.5% to 3.8%. It reflects that it is difficult for interest rate regulation to take into account the two objectives of price stability and full employment at the same time in the environment of supply shock [7].

The transmission of interest rate policy is characterized by significant structural differentiation. Interest rate hikes and cuts have a strong impact on real estate and consumer credit industries but only weakly constrain large monopolies with low debt, at the same time, interest rate adjustment has a greater impact on low-income groups, which can aggravate income inequality and undermine the goal of inclusive employment [8]. Conventional interest rate regulation is biased towards short-term current macro data and lacks cross-cycle adjustment ability. A single short-term interest rate operation is prone to policy lag, excessive easing or excessive tightening. During the epidemic period, long-term low interest rates lead to high inflation, which is the reality that conventional interest rate tools are biased towards short-term indicators and lack cross-cycle balance ability.

DOI: 10.54254/2754-1169/2026.AB38908

3. Comparative analysis and policy implications of monetary policy objectives of central banks and federal reserve in the world

3.1. Differences between monetary policy objectives of central banks and the federal reserve

Due to differences in legal responsibilities, monetary status, economic structure and degree of openness, the monetary policy target framework of major central banks in the world is markedly differentiated. To present these differences clearly, this paper compares the policy frameworks of the Federal Reserve, the European Central Bank and the People's Bank of China from the core dimensions of target weight, inflation rules and employment positioning, as shown in Table 1 below.

Table 1. Horizontal comparison of monetary policy target frameworks of major global central banks

Contrast dimension	Federal Reserve	European Central Bank	People's Bank of China
Target patterns and weights	Dual goals, price stability and full employment	Single inflation target with priority given to price stability	A multi-objective system that takes into account currency stability, economic growth, employment and financial stability
Core inflation measures	PCE Personal consumption expenditure price index	HICP harmonizes the consumer price index	CPI Consumer price index
Employment objective positioning	Statutory objectives, directly into the policy trade-offs	There is no independent employment target, only as auxiliary observation	Important livelihood objectives, serving economic growth and social stability
External constraint	Dollar reserve currency status is strong, the external constraints are relatively weak	Equilibrium constraints within the eurozone are strong	As an open economy with distinct characteristics, it is necessary to take into account exchange rate stability and international balance of payments

The comparison shows essential differences in how central banks distribute target weights, rooted in differences in legal mandates and economic fundamentals. The Fed's dual objectives place equal legal importance on price stability and full employment, and the trade-off between inflation and employment needs to be constantly weighed in policy making, the ECB takes price stability as the only primary objective and employment as an auxiliary indicator of economic prosperity. The People's Bank of China implements a multi-target framework, which simultaneously serves multiple objectives such as economic growth, job security and financial stability on the basis of price stability [9, 10].

3.2. Policy implications from the federal reserve's conventional monetary policy practices

Monetary policy should reasonably balance the weights of multiple targets and avoid extreme bias towards a single target. Combined with the Federal Reserve's policy practice of giving priority to inflation in 2012 and employment in 2020, China needs to dynamically adjust the policy focus of

DOI: 10.54254/2754-1169/2026.AB38908

stabilizing prices, employment and growth according to the economic cycle, at the same time, it should clarify the applicable boundaries of conventional interest rate tools and build a layered policy tool system. Conventional interest rates are more suitable for demand-side economic fluctuations. In the face of supply shocks and zero lower bound of interest rates, structural monetary policies should be used to avoid one-size-fits-all regulation of benchmark interest rates. In addition, China should improve the anchoring mechanism for inflation expectations, optimize cross-cyclical regulation, hedge the impact of structural differentiation caused by interest rate adjustments, and ensure employment and financing for small and micro businesses through structural credit instruments, as a large open economy, China's monetary policy also needs to coordinate internal and external equilibrium, take cross-border capital flows and RMB exchange rate stability into account in interest rate regulation, and prevent internal and external equilibrium conflicts caused by the single interest rate policy [11, 12].

4. Conclusion

The Federal Reserve's monetary policy practice from 2012 to 2025 shows that conventional interest rate policy remains an important tool for central banks to adjust to macroeconomic fluctuations, but its effect is affected by the economic cycle, sources of inflation, employment structure, the external environment and other factors. In the low inflation environment before the pandemic, the Federal Reserve stimulated demand by lowering interest rates and guiding market expectations, and promoted the steady repair of employment. However, in the post-pandemic environment of high inflation caused by supply shocks, continuous interest rate hikes have played a role in falling prices, but they have also brought about problems such as adjustment of the real estate market, increased pressure on financial institutions and slowing employment. This shows that conventional interest rate policy is not a panacea, and its effectiveness depends on the causes of inflation, economic structure and policy transmission mechanism.

For China, the Fed's monetary policy practice provides enlightenment mainly reflected in three aspects. First, monetary policy should adhere to the dynamic balance of multiple targets, avoid excessively favoring a single target, and flexibly adjust the policy focus between stable prices, stable growth and stable employment in light of changes in the economic cycle. Secondly, China should reasonably understand the applicable boundaries of conventional interest rate tools, use interest rate adjustment for demand-side fluctuations, and employ structural monetary policy tools when supply shocks, structural contradictions, and external risks rise significantly. Finally, as a large open economy, China's monetary policy should also coordinate internal balance and external balance. While promoting interest rate regulation, it should also take cross-border capital flows, RMB exchange rate stability, and financial risk prevention into account to improve the stability and sustainability of policy.

References

[1] FRED. (2025, December 10). U.S. economic data: PCE inflation and unemployment rate [DB/OL]. https://fred.stlouisfed.org.

[2] Clarida, R. (2021). The Federal Reserve's new framework: Context and consequences [R]. Federal Reserve Board, Washington D.C..

[3] Li, R. Y. (2023). The gains and losses of average inflation targeting in practice and its implications for China. *Macroeconomic Management*, (2), 85–93.

[4] Powell, J. H. (2025, August 22). Monetary policy and the Fed's framework review. Jackson Hole: Federal Reserve.

DOI: 10.54254/2754-1169/2026.AB38908

[5] Liu, B. (2020). Taylor rule and the Federal Reserve's interest rate adjustment practice. *World Economy Study*, (3), 47–57, 136.
[6] Liu, B. (2021). The effectiveness and limitations of conventional monetary policy tools at the zero lower bound. *World Economy Study*, (6), 56–66, 136.
[7] Xing, W. (2023). The Federal Reserve's aggressive interest rate hikes: Motivations, effects and risks. *China Finance*, (10), 62–64.
[8] Wu, H. L., Guo, H. Y., & Liu, H. R. (2024). Research on the asymmetric effects of the Federal Reserve's monetary policy shocks. *Studies in International Finance*, (7), 73–84.
[9] Chen, Y. L. (2021). A comparative study of inflation targeting in major advanced economies. *Finance & Trade Economics, 42*(4), 5–20.
[10] Li, B., Lei, Y. R., & Wang, J. (2024). Federal Reserve monetary policy spillovers, central bank expectation management and China's asset prices. *World Economy Study, 47*(1), 57–85.
[11] Mertens, K., & Williams, J. C. (2022, January). Average inflation targeting in the financial crisis recovery. *FRBSF Economic Letter, San Francisco.*
[12] Zhang, X. J. (2022). The internal and external equilibrium coordination of monetary policy under open conditions. *Economic Perspectives*, (5), 4–18.