CENTRAL BANK OF ARMENIA

THE BETTER POLICY PROJECT
GREAT THINGS ARE COMING

Lessons from the 1970s: The "Great Inflation"

Hi, I'm Douglas Laxton — but you can call me Doug.

In this video, we're going to take a step back in time — to the 1960s and 1970s — to understand one of the most important periods in the history of modern central banking: *The Great Inflation*.

Why does this matter today?

Because most of what we now take for granted in monetary policy — from inflation targeting to credibility and expectations management — was born out of the lessons learned from failure. And the 1970s were full of them.

Let's start with the dominant thinking at the time.
In the 1960s, many economists and policymakers believed in a simple idea: the Phillips Curve trade-off — the belief that you could achieve lower unemployment by accepting slightly higher inflation, and vice versa.

But then came the warnings, particularly from **Milton Friedman** and **Edmund Phelps**.

Friedman argued that there was *no* long-run trade-off. He said that if central banks tried to keep unemployment too low, inflation would continue to rise. He introduced the concept of the *natural rate of unemployment* and emphasized the critical role of expectations.
Phelps made similar arguments, showing that workers and firms would adjust their behavior once they realized what policymakers were doing.

These ideas became known as the **Natural Rate Hypothesis** — or, as we often call it, the **Long-Run Natural Rate Hypothesis (LR-NRH)**. It's a foundational concept for modern monetary frameworks.

Unfortunately, policymakers at the time didn't listen.
In the U.S., monetary policy remained too loose for too long. Inflation crept up through the late 1960s and then surged in the 1970s.

Some of this was made worse by external shocks — notably the oil price shocks of 1973 and 1979.
But the real problem wasn't the shocks themselves — it was the policy response.
Policymakers tried to fine-tune the economy using outdated models, failing to see how quickly expectations were shifting.

By the late 1970s, inflation had become entrenched — and the only way out was a painful correction.

That correction came under **Paul Volcker**, who became Chair of the Federal Reserve in 1979. Volcker sharply raised interest rates, triggering a deep recession — but he ultimately restored credibility. Inflation expectations were brought back under control.

It wasn't easy. And it wasn't popular. But it worked.

Here's the big takeaway:

Modern monetary policy was not born from academic theory — it was forged through hard experience.
We learned that expectations matter. We learned that credibility is essential. And we learned that trying to fine-tune the economy without anchoring inflation leads to instability.

The lessons of the 1970s continue to shape the frameworks we use today — including the one we've developed here at the Central Bank of Armenia.

I'm Doug — and in the next video, we'll look at what came next: the era of **monetary targeting**, and why it was a necessary — but incomplete — step in the evolution of modern central banking.

See you there.