

Abstract

In the past decade controversy arose concerning the cyclical behavior of prices. An issue that had appeared settled for many years was re-opened when Kydland and Prescott (1990) and Cooley and Ohanian (1991) presented evidence that prices were counter-cyclical. This evidence has stood up, but its interpretation has varied. Hall and Judd and Tehran argued that the contemporaneous correlation between output and prices reflects the source of the current shock as well as the nature of the adjustment process from short-run to long-run equilibrium; and the adjustment to the long-run imparts a bias toward finding a negative price-output correlation. In this paper we control for the long-run adjustment in a general way and find evidence that supports the HJT hypothesis. Indeed, for the U.S. controlling for the long-run adjustment switches the correlation of the shocks from negative to positive. Controlling for the long-run adjustment alone is insufficient to reveal the source of shocks. However, if in the initial period prices are equally sticky in response to demand and supply shocks, then the correlations do have something to say about the nature of the disturbances. Under the assumption of equal initial price stickiness, the data suggest that economies are buffeted by both demand and supply shocks in about equal portions.