

NOTES AND REPLIES

## The Use and Abuse of Equilibrium Analysis: A Response to Jonathan Newman

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Jonathan Newman (2025a, 2025b) recently criticized monetary disequilibrium theory (MDT) in two articles. According to proponents of MDT, an excess demand for money causes a monetary disequilibrium, which leads to decreased sales, generates market-wide disequilibrium, and ultimately lowers production and employment, leading to recession. Supporters of MDT argue that this mechanism arises due to the existence of sticky prices. If prices were perfectly flexible, firms would adjust prices rather than output, so an excess demand for money would influence only the price level rather than the level of overall economic activity (Yeager 1956; Horwitz 2000, chap. 5; Davidson 2012). Newman rejects this line of reasoning, contending—as the title of one of his papers states—that “there ain’t no such thing as a sticky price.”

In his recent articles, Newman (2025a, 2025b) employs the concepts of demonstrated preferences, the plain state of rest, and total demand analysis to argue that “all realized prices in unhampered markets represent a momentary clearing of the market; there are no excess demands for or supplies of goods or money after successful trades” (2025b, 2). Since in the plain state of rest all prices are by definition market-clearing prices, Newman concludes that prices cannot be considered sticky. Instead, they are fully determined by demonstrated preferences, which directly reflect the intentional actions of buyers and sellers. Individuals purchase or sell goods and services according to their subjective valuations. If an entrepreneur chooses not to lower a price, it is because he prefers retaining the marginal unit of the good to the money he would obtain by selling that additional unit.

Putting aside the issues with the concept of sticky prices—which I also consider problematic in macroeconomics—Newman misuses the concepts of demonstrated preferences, total demand analysis, and the plain state of rest in his attempt to critique MDT. The consequences for economics and economic analysis of Newman’s use (and abuse) of these concepts are potentially

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misleading and even dire. If we were to accept Newman's reasoning, we would have to conclude that entrepreneurial plans and expectations are irrelevant for determining equilibrium. We would also have to consider entrepreneurial errors of minor importance, since markets are assumed to always clear. Furthermore, we would be forced to reject the Austrian business cycle theory (ABCT). According to Newman, the market is always in equilibrium in the sense of the plain state of rest, implying that shortages of resources cannot occur. Yet, resource shortages are a critical component of the ABCT, as they constrain entrepreneurs from completing their investment projects. Additionally, if the economy were always in equilibrium, it would be impossible for interest rates to fall below their equilibrium levels, since in contemporary monetary systems interest rates in financial markets are determined through voluntary transactions.

### **First Problem: Excessive Focus on Demonstrated Preferences and the Plain State of Rest**

Newman focuses on the concept of the plain state of rest. This state is established daily based on the preferences of buyers and sellers. Whenever economic conditions—for example, the supply or demand for money—change, these changes are reflected in the actions of individuals. Consumers adjust the quantities of goods they purchase and the money they save according to their preferences. Similarly, entrepreneurs determine, based on their preferences, how much of their goods they wish to sell and how much to retain. From these individual decisions, a short-term equilibrium emerges, understood as the plain state of rest. This type of equilibrium is assumed to be reached every day, and in unhampered markets it consistently reflects the demonstrated preferences of both buyers and sellers, since all participants voluntarily decide on their actions in the current situation.<sup>1</sup> Newman (2025a, 62) provides an example of the application of the plain state of rest:

A change in the money relation is brought about by changed demands for goods and services, which result in a succession of plain states of rest. For example, an increase in the supply of money results in a decrease in the marginal utility of money for the first receivers of the new money. This decrease in the marginal utility of money can only be demonstrated in action and exchange. These first receivers may now outbid other demanders for specific goods and services, resulting in market-clearing plain states of rest at higher prices in those markets. The process continues as the suppliers of those goods and

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<sup>1</sup> For discussion of equilibrium concepts used by Austrian economists, see Salerno (2010) and Klein (2008). Glasner (2022) also offers interesting discussion on different equilibrium constructs and the role of expectations in equilibrium analysis.

services increase their demands for other goods and services, and on and on until the later receivers of the new money face an array of generally higher prices (due to the bidding of the earlier receivers). The process reaches a point where the reduced marginal utility of money relative to specific goods and services on the later receivers' value scales is not sufficient for these individuals to outbid others at higher realized prices.

This fragment is not controversial in itself. In fact, it is correct. In the case of an increased money supply, the additional units are spent in the market. Individuals decide for themselves whether they value more the additional units of money earned due to the increase in supply or the additional units of goods they can purchase. This decision ultimately determines when the process of inflation will stop in the case of an increased money supply.

The same reasoning applies when the demand for money increases and the supply of money remains constant. Buyers increase their money holdings, and entrepreneurs decide whether they prefer to sell more goods at lower prices or to increase their stock of goods carried over to future periods. Regardless of their choices, market equilibrium is still reached if we understand equilibrium in terms of the plain state of rest. If entrepreneurs choose to hold higher reserves of their goods, we cannot conclude that a disequilibrium exists in the market. Instead, what has occurred is the absence of a double coincidence of wants, as Newman (2025a, 62) states outright:

The problem is that divorcing money demand from demonstrated preference results in an inappropriate diagnosis of disequilibrium in the market-clearing sense. Consider an individual who wakes up one morning with the hare-brained desire to sell paper clips for \$1 million each. At the end of the day, his desire is not realized, as the market price for paper clips has remained at one cent per paper clip; but “paper clip disequilibrium theorists” might conclude that there was an excess supply of paper clips— . . . “he found himself with larger paper clip balances than he wishes to hold.” While this example is fanciful, it reveals that we cannot conclude that a surplus or shortage exists based on frustrated plans. When the constraint on the fulfillment of transactions is other people's preferences, it represents a lack of a double coincidence of wants.

This is where the problem begins. While Newman's description of individual actions is correct, he simultaneously downplays the importance of plans and their frustration by using the example of a mad entrepreneur. Plans previously made by the paper clip seller appear to be unimportant for Newman when he's analyzing the process of reaching equilibrium. The quote suggests that the consequences of frustrated plans aren't important for determining equilibrium—only demonstrated preferences are important. If

individuals choose not to purchase paper clips at an insane price and the seller decides to retain the goods rather than lower the price, the plain state of rest is considered to be achieved at the end of the period. The entrepreneur may decide to purposefully hold on to some of his goods until the next period instead of changing the price, which can be less problematic, thus creating demand for his own goods (Newman 2025b, 10).

And since the entrepreneur may have a reason to increase his reserve, Newman (2025b, 12) accuses proponents of MDT of assuming the irrationality of sellers, since “claiming that an unhampered market does not clear while holding on to rational market participants is a contradiction—it implies that market participants are acting against their own interests.” Newman dismisses the frustration of plans and the disparity between quantity supplied and quantity demanded, which has important consequences, by referring to demonstrated preference. Since the entrepreneur voluntarily decided not to lower prices and to carry goods over to the next period, Newman reaches conclusion that there is no disequilibrium.

In his analysis, Newman employs a total demand approach (popularized among Austrian school economists by Murray Rothbard 2009, 137–42, 247–49) in conjunction with the concept of the plain state of rest. In the total demand framework, sellers’ demand for inventories is also taken into account. For various reasons, sellers may wish to retain part of their stock, and this can be conceptualized as a form of demand for the good. Each seller must decide what portion of their stock to sell and what portion to retain. Sellers will continue offering additional units of a good until the utility gained from the additional money earned is less than the utility gained from adding another unit to inventory. In the total demand approach, the quantity demanded always equals the total stock of the good, since any unsold units are voluntarily retained by the sellers. While sellers could lower prices to sell additional units in the market, they may choose not to do so. Instead, they may increase inventories, reflecting a rise in reservation demand. Thus, in the total demand approach, when inventories increase while the price remains unchanged, this indicates a lower quantity demanded by buyers and a higher quantity demanded by sellers at the prevailing price.

From the perspective of the total demand approach and the plain state of rest, Newman is technically correct. When the reservation demand of sellers is taken into account, the quantity demanded at the end of each period equals the total stock of the good in every market, so a form of the “plain state of rest” is achieved both at the level of individual markets and across the economy as a whole. That’s true. All decisions are made according to the preferences of participants, which are formed under current circumstances and expectations. However, as new information becomes available or is discovered, the decisions of buyers and sellers may change. The total demand

approach Newman employs in his articles teaches us an important lesson, expressed succinctly by Rothbard (2009, 141): “[The total demand approach] focuses more sharply on the fundamental truth that price is determined solely by *utility*. The supply curve is reducible to a *reservation demand curve* and to a *quantity of physical stock*. The demand-stock analysis therefore shows that the supply curve is not based on some sort of ‘cost’ that is independent of utility on individual value scales. We see that the fundamental determinants of price are the value scales of all individuals (buyers and sellers) in the market and that the physical stock simply assumes its place on these scales.”

But total demand analysis has its shortcomings. Rothbard (2009, 141), who elaborated so extensively about it, points out the most important one: “One relative defect of the total demand-stock analysis is that it does not reveal the differences between the buyers and the sellers. In considering total demand, it abstracts from actual exchanges, and therefore does not, in contrast to the supply-demand curves, determine the quantity of exchanges. It reveals only the equilibrium price, without demonstrating the equilibrium quantity exchanged.”

Newman’s analysis thus necessarily implies that equilibrium is reached at the end of each period and that changes in buyers’ demand or sellers’ reservation demand are irrelevant for reaching equilibrium. The consequence of Newman’s analysis is that he dismisses the problem the MDT proponents are trying to address. After pointing out that there is a plain state of rest equilibrium at the end of every period, he concludes that there can be no excess demand for the money. While an increase in money demand could lead to changes in prices, if entrepreneurs choose not to lower prices and instead increase inventories, this behavior is consistent with their demonstrated preferences and results in higher reservation demand. In the case of Newman’s paper clip seller example, there is no issue of an excess supply of paper clips. In both scenarios, he finds, the underlying issue is the absence of a double coincidence of wants.

But what MDT proponents are doing is not just an exercise in economics. They are trying to explain what causes recessions, and they propose a somewhat New-Keynesian explanation where exogenous shock in form of increased demand for money has negative consequences if it’s not accommodated with expansion of the money supply. In the case of increased demand for money without expansion of the money supply, because prices are sticky, entrepreneurs do not fully adjust prices to the levels necessary to establish a new equilibrium (Gordon 1990; Galí 2018). Instead, sellers initially respond by increasing inventories, lowering production, and only partially adjusting prices. Newman, however, overlooks the problem identified by proponents of MDT, substituting the discussion of the causes of recessions with an analysis of microeconomic equilibrium concepts. He employs the plain state of rest to argue that, even if entrepreneurs choose

to cut production and maintain prices at the same levels, equilibrium is still achieved. And since there is an equilibrium, the excess demand for money isn't a cause of recession.

I am not defending MDT here, nor do I take a strong position on its explanation of recessions. I am showing that Newman dismisses the problem stated by proponents of MDT by simply asserting that there is always an equilibrium in the economy in some sense. But this is not a proper way to criticize MDT. It's an abuse of the concept of the plain state of rest. A proper critique should, rather, show why a scenario in which excess money demand causes recessions is improbable, or point out market self-correcting mechanisms which would work at the same time as demand for money rises. But Newman doesn't do that. He only uses the construct of the plain state of rest and total demand analysis to show that by definition there is no disequilibrium in the money market.

## **Second Problem: Downplaying the Role of Plans and Expectations**

As noted in the previous section, Newman's critique of MDT is problematic for economics as a whole because he downplays the role of entrepreneurial plans and expectations in the market process. This issue is particularly significant, as erroneous expectations and plans are a primary source of the losses experienced by firms.

Entrepreneurs form expectations regarding the dynamics of costs and prices of their products and services. They develop plans based on these expectations. If these plans are frustrated, the consequences can be severe, as entrepreneurs may incur losses that have broader economic repercussions. Entrepreneurs forecast—or at least estimate—future prices and quantities of the goods and services they expect to sell. They also consider current and expected production costs, which are essential for calculating potential profits. Based on their expectations about prices and costs, they formulate production plans, including decisions about the quantity of materials to order, the number of machines to purchase, and the number of employees to hire. They also plan the level of output of their products and the prices they will set for them.

If the quantity demanded by customers at the planned price is lower than an entrepreneur expected, he will need to adjust to the new situation. Initially, he may increase his inventory if he believes that the shortfall in demand is only temporary. Over time, the entrepreneur will determine whether this expectation is correct. If it is not, his reservation demand will decline, resulting in an increase in the supply offered to potential buyers and a reduction in the market price of the good. This, in turn, will lead to lower profit margins or even losses if the price must fall below the unit cost of production.

Over time, the frustration of his plans will compel the entrepreneur to adjust his strategies, particularly in the case of losses. He cannot maintain production and prices at the same levels indefinitely. At some point, he must adjust both prices and production in response to lower demand. If costs do not fall simultaneously and to the same extent as demand, the entrepreneur will ultimately reduce production and employment, which will have further side effects.<sup>2</sup> In the case of a sudden decline in demand for most goods in the economy—a scenario analyzed by proponents of MDT—it is reasonable to expect an overall contraction in economic activity. Importantly, this conclusion does not require prices to be sticky; it can be explained by the role of wrong expectations and frustrated plans.

These kinds of issues arising from wrong expectations and plans can also be dismissed the same way Newman dismissed the issue of excess demand for money. We can imagine that in some economic sector entrepreneurs, expecting high demand for their products in the future, offer too-high prices for factors of production in the first period. Later, in the next period, when production and the distribution of goods to shops is completed, they will suffer losses, since actual demand is much lower than expected. The prices at which entrepreneurs can sell the whole quantity supplied are below the unit costs of production. Entrepreneurs decide not to carry over part of stock to the next period, but to lower their prices so they can sell the whole stock. In this example, prices are elastic. But even when prices are elastic, entrepreneurs' wrong expectations about the future lead to lower-than-expected earnings, or even to losses.

According to Newman, however, there is no disequilibrium in the example above. The market cleared. Are there losses in the economy? Yes. Will the economy need to make costly adjustments, which will take time? Yes. But did we have a disequilibrium? Apparently not, since we should not mistake “frustrated plans for genuine market disequilibrium (in the sense of a lack of market clearing)” (Newman 2025a, 61) and “we cannot conclude that a surplus or shortage exists based on frustrated plans” (62). Newman (2025b, 9) would say that there was no surplus forcing entrepreneurs to lower their prices to the point of suffering losses; entrepreneurs just decided to sell their goods at lower prices out of their own volition:

Thus, any frustration on the part of buyers or sellers in cases like these is merely due to hindsight (“Now that I know the market conditions that actually transpired, I wish I had not made the contract in the way I did”). It is the same as any entrepreneurial error realized *ex post*. These errors do not indicate that the

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<sup>2</sup> Those side effects may be both positive and negative. On one hand there is lower employment or demand for some factors of production. But on the other hand those employees and factors of production can now be used to expand production of different goods without outbidding the former employers and users of those factors of production.

market in question is not clearing, only that the outcomes are not what the actor had hoped for. This is not the sort of frustration that economists say is the result of an uncleared market, in which there are mutually beneficial exchanges that could occur but do not, due to some external constraint (typically government force).

Erroneous expectations and plans often result in surpluses or shortages of goods. In the simple example above, there was a surplus because the quantity supplied at the price expected by entrepreneurs exceeded the quantity demanded. This surplus compelled entrepreneurs to lower prices below the unit cost of production to avoid further inventory accumulation. Importantly, a surplus does not necessarily take the form of unsold stock sitting in warehouses; from the perspective of entrepreneurs, surpluses arise whenever sales plans are frustrated due to demand being lower than expected.

In the case of shortages, the actual quantity demanded at the planned price exceeds the expectations of sellers. From the buyers' perspective, the actual quantity supplied at the current price falls short of expectations. A shortage of goods typically drives both the price and the quantity supplied upward. Shortages do not pose a problem for sellers, but they do create difficulties for buyers. For entrepreneurs, a shortage of a production factor increases costs and necessitates adjustments to their plans. Consumers, on the other hand, are forced to purchase fewer goods. Thus, both surpluses and shortages have a significant impact on both buyers and sellers.

Once again, Newman downplays the importance of plans and expectations, which are crucial for the market process and for determining whether surpluses or shortages arise in the economy. His analysis, however, leads to a counterintuitive conclusion: The economy constantly moves from one equilibrium to another without ever experiencing surpluses or shortages in any market. Regardless of the errors committed by entrepreneurs, surpluses and shortages never occur. Using the plain state of rest framework, one could argue that the losses incurred by many entrepreneurs during a recession do not result from surpluses or shortages arising from erroneous plans. Consequently, surpluses did not compel entrepreneurs to lower prices below unit costs; instead, entrepreneurs voluntarily sold goods at a loss, acting in accordance with their own best interests, since their errors are identifiable only *ex post*.

Maybe technically these descriptions of actions undertaken by actors are correct from a specific point of view (i.e., total demand approach and plain state of rest), but they do not help us analyze and explain the problems MDT is trying to address (causes of recessions) or the nature and consequences of entrepreneurial errors.

### **Third Problem: Consequences for the Austrian Business Cycle Theory**

Newman's analysis is also problematic for the ABCT. First, his dismissal of the importance of shortages and surpluses (even short-lived ones) leads also to the downplaying of malinvestments. Second, his approach to equilibrium analysis opens the door to dismissing the possibility of the banking sector (including the central bank) pushing interest rates below their equilibrium levels.

According to Friedrich von Hayek (2008), lowering interest rates and providing additional credit incentivizes entrepreneurs to invest in more roundabout projects, leading to relatively higher investment and expansion in stages of production more remote from consumption (higher stages of production). This often translates into higher production of capital goods, particularly more durable and specific ones, as entrepreneurs attempt to expand production of consumption goods for the more distant future. However, if the new credit is not backed by savings (i.e., if there is a disequilibrium between savings and investment), the money newly created by banks increases people's incomes, and the demand for consumption goods also rises. As a result, during the boom phase, entrepreneurs are additionally incentivized to expand production of consumption goods for the immediate future. The demand for resources—mostly nonspecific—is therefore too high, and some production plans must be modified, while certain production processes may need to be abandoned. Because resources are insufficient, *there is a shortage of those necessary to complete investment projects on time.* The economy cannot expand the production of both capital goods and consumption goods to the extent attempted under the influence of credit expansion.

Shortages of resources are an important aspect of malinvestments in the standard exposition of the ABCT. Entrepreneurs need access to a certain amount of resources to execute their production plans. Also, each particular entrepreneur needs sufficient demand for his goods. But later in the business cycle, two important things happen: (1) nonspecific resources are in shortage; and (2) demand for current consumption is too high. These conditions lead to a situation in which some entrepreneurs experience losses because the growth of their costs outpaces the growth of demand for their products.

It is hard to conceive of an ABCT without shortages of resources. Such shortages occur relative to the plans of entrepreneurs, who anticipated greater resource availability. If the expectations of entrepreneurs were accurate, there would be no malinvestments at the macroeconomic level—that is, no unsustainable expansion of the structure of production—because the quantity of resources demanded would equal the quantity supplied. However, according to Newman (2025a, 61), we should not mistake “frustrated plans for genuine market disequilibrium (in the sense of a lack

of market clearing)” and “we cannot conclude that a surplus or shortage exists based on frustrated plans” (62). This makes it challenging to assert that malinvestments occurred in the Hayekian sense.

Now let’s turn to the second issue—the artificial lowering of interest rates. In the contemporary financial markets of developed countries, there are no interest rate controls analogous to a minimum wage. Commercial banks and other financial institutions participate in voluntary exchanges, with borrowers and lenders voluntarily entering into credit contracts. The same principle applies to central banking. The central bank does not control interest rates in the economy. It’s only setting its own interest rates, which are used in transactions with commercial banks. Transactions between those entities are in fact voluntary. Therefore, if the central bank wants to drive short-term market interest rates down to a desired level, it cannot simply lower its own interest rates. Instead, it must forecast the quantity of reserves required to achieve the desired market rate at the announced policy rate. If the central bank fails to provide sufficient reserves, short-term interest rates in the financial market will rise due to excess demand for those reserves. Therefore, in order to conduct its operations successfully, the central bank must take prevailing market conditions into account (Bindseil 2014, chaps. 1 and 4; Papadia and Välimäki 2018, 56–57).<sup>3</sup>

In times of normal economic activity, there is no coercion exerted by the central bank. The central bank merely adjusts its own policy rates, which are used in voluntary transactions with commercial banks. Changes in the central bank’s policy rates do not dictate, but only influence market interest rates, which are ultimately determined through voluntary exchanges among commercial banks, other financial institutions, and nonfinancial actors.

If we apply Newman’s analysis to this issue, we must conclude that all interest rates in the economy are market-clearing rates. Transactions are voluntary, and there are no interest rate controls analogous to minimum wage laws or price controls on particular goods in some countries. Consequently, according to Newman’s framework, there is no artificial lowering of interest rates in the economy.

This presents another challenge for the ABCT. If a business cycle begins with credit expansion by the banking sector and the supposed lowering of interest rates below their equilibrium levels, yet all interest rates are market-clearing

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3 This is because of the downward-sloping demand for reserves curve: “The core of any operational framework is the central bank’s supply of reserves, which ranges from a low level, or ‘scarce,’ to ‘ample’ and ‘abundant.’ The ‘price’ of reserves is the spread between the market interest rate and the rate earned for holding reserves at the central bank. When reserves are scarce, the slope of the demand curve for reserves is steep. . . . A small change in the quantity of reserves results in a meaningful change in the spread. When reserves are ample, the slope of the demand curve flattens but still slopes downward, so that small changes in the quantity of reserves have modest effects on the spread. And when reserves are abundant, the demand curve is essentially flat” (Williams 2025).

and the economy reaches a plain state of rest equilibrium each period, we cannot assert that interest rates have been reduced below their equilibrium levels.<sup>4</sup>

A notable side effect of Newman's analysis is that it calls into question the very foundations of the ABCT. If we cannot assert that there are shortages of nonspecific resources, or that interest rates can be artificially lowered in the modern economy, then it follows that an Austrian-style business cycle would be impossible in the current economic environment. But such a conclusion would be highly counterintuitive for an economist of the Austrian school.

## Conclusion

Economists of the Austrian school employ several different concepts of equilibrium for various analytical purposes, each with its own limitations. Newman's (2025a, 2025b) analysis highlights the shortcomings of the construct of the plain state of rest. While his technical analysis is correct, the way he applies it to criticize MDT has significant implications for economic theory. By attempting to demonstrate that excess demand for money never occurs and by asserting that plan frustration is irrelevant for equilibrium, Newman effectively provides a framework for dismissing crucial economic issues. According to his approach, the consequences of entrepreneurs' erroneous expectations or frustrated plans are not important, because markets always clear and entrepreneurs make the best decisions possible given current economic conditions. Even if losses occur, they are considered voluntary and cannot result from surpluses or shortages. Furthermore, since interest rates today are determined through voluntary market exchanges, his analysis raises questions about the foundations of the ABCT. The central bank does not disrupt this process, as it only sets its own policy rates, and commercial banks may choose whether or not to engage in transactions with it.

Newman's critique of MDT is an example of how negative consequences come from abusing economic concepts by applying them only to constrained and simplified issues. His analysis also demonstrates that not only is it important to reason correctly within a specific analytical framework, it is also important to consider the broader implications of an analysis for the discipline as a whole.

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<sup>4</sup> This issue with interest rates is important not only for the Austrian school, but also for mainstream economists, who also say that too-low interest rates can cause trouble (e.g., Kahn 2010; Taylor 2008).

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