What is Deflation?

Worksheet

Deflation is a sustained decrease in the average price level, causing each unit of currency to buy more over time. It discourages spending because consumers expect prices to fall further, leading to reduced investment and hiring.

Questions

1. Deflation means…

A) Prices fall
B) Inflation rises
C) Currency weakens
D) Interest rates drop

2. In deflation, why do consumers spend less?

A) Wages drop
B) Cheaper prices incentivize waiting
C) Banks fail
D) Unemployment rises

3. A $100,000 debt in 5% deflation becomes…

A) Easier to repay
B) Harder to repay
C) Equal to repay
D) Erased

4. Japan experienced deflation from the 1990s–2010s. The result was…

A) Boom years
B) Lost decade
C) High inflation later
D) Growth surge

5. Japan's average price level fell from 100 in 1990 to 95 in 2000. What was the deflation rate?

6. With deflation at −2%, a $10 item today will cost how much next year?

7. A worker earns $50,000 in deflation where prices fall 3%. What happens to real wages?

8. Define: What is deflation?

9. Define: Why is deflation bad for the economy?

10. Define: Who benefits from deflation?

Answer Key

1. A) Prices fall — Deflation is a drop in average price level.
2. B) Cheaper prices incentivize waiting — Waiting for cheaper prices reduces immediate demand.
3. B) Harder to repay — The dollar's value rises, so the debt is harder to repay with deflating wages.
4. B) Lost decade — Deflation stalled Japan's economy for years.
5. Deflation rate = (New level − Old level) / Old level Deflation = (95 − 100) / 100 = −0.05 = −5% Prices fell 5% over the decade.
6. New price = Old price × (1 + deflation rate) New price = 10 × (1 − 0.02) = 10 × 0.98 = $9.80 The item is 20 cents cheaper.
7. Real wage = Nominal wage / (1 + deflation) Real wage = 50,000 / (1 − 0.03) ≈ 51,546 Real purchasing power RISES.
8. A sustained fall in the average price level of goods and services; currency's purchasing power increases.
9. It encourages people to delay spending (waiting for cheaper prices), reducing investment, hiring, and economic growth.
10. Savers and people on fixed income benefit (money is worth more), but borrowers and workers hurt (wages fall harder than prices).