Money Illusion Matters for Consumption-Saving Decision-Making: An Experimental Investigation*

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Abstract

With an economic experiment, this paper examines effects of money illusion on consumption-saving decision-making. In the experiment, each subject makes a sequential consumption-saving decision in a situation where values of economic variables are identical in real terms but are displayed differently in nominal terms due to distinct levels of inflation. Despite no difference in real terms among the situations, the experimental results show that a nominal difference arising from higher positive inflation causes subjects to consume more in early periods of the experiment and less in later periods relative to a consumption path chosen by subjects who face a situation with zero inflation. Moreover, such money illusion results in a higher level of utility of a subject who confronts a situation with higher positive inflation. In deflationary situations, a nominal difference stemming from a lower negative rate of inflation generates a similar effect to that from a higher positive rate in terms of the consumption path and the utility level. A lower negative inflation rate leads to, *ceteris paribus*, a lower nominal interest rate and thereby subjects consume more in early periods and less in later periods. This suggests that in making consumption-saving decisions, subjects tend to pay special attention to the level of inflation in inflationary situations and to the level of the nominal interest rate in deflationary situations.

Keywords: Consumption-saving decision-making; Money illusion; Economic experiment

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