

**You Guess Inflation
will be 3% during the
life of a loan**

- If your guess turns out to be **correct**:

$$\text{Nominal interest (7\%)} - \text{Inflation (3\%)} = \text{Real interest (4\%)}$$

- If your guess turns out to be **wrong** and **inflation was 5%:**

$$\text{Nominal interest (7\%)} - \text{Inflation (5\%)} = \text{Real interest (2\%)}$$

- If your guess turns out to be very wrong and inflation was 26%:

$$\text{Nominal interest (7\%)} - \text{Inflation (26\%)} = \text{Real interest (-19\%)}$$

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**Borrower pays you back less money in real
terms than what s/he borrowed!**

You should Charge a Nominal Interest Rate = 3 + 4 = 7%

**Your want to earn a
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Inflation Costs