

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

If your guess turns out to be correct:

Nominal interest (7%) – Inflation (3%) = Real interest (4%)

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

Nominal interest (7%) – Inflation (5%) = 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%

You want to earn a 4% real
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Interest Income