

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%**:

Nonminimal interest (7%) – Inflation (26%) = Real interest (-19%)

2

5

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
return on that loan

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

You want to earn a **4% real return** on that loan

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

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%**:

Nominal interest (**7%**) – **Inflation (26%)** = **Real interest (-19%)**

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

Interest Income