Question Number 2

Boris Borrower and Lynn Lender agree that Lynn will lend Boris $10,000 and that Boris will repay the $10,000 with interest in one year. They agree to a nominal interest rate of 8%, reflecting a real interest rate of 3% on the loan and a commonly shared expected inflation rate of 5% over the next year.

a)      If the inflation rate is actually 4% over the next year, how does that lower-than-expected inflation rate affect Boris and Lynn? Who is better off?

b)      If the actual inflation rate is 7% over the next year, how does that affect Boris and Lynn? Who is better off?

1. If the actual inflation rate is 4%, Lynn is better off and Boris is worse off. Boris had expected to pay, and Lynn had expected to receive, a real interest rate of 3%. However, with an actual inflation rate of 4%, an 8% nominal interest rate yields a real interest rate of 4% (8% − 4% = 4%). So, in real terms, Boris pays more, and Lynn receives more, than was expected.
2. If the actual inflation rate is 7%, Boris is better off and Lynn is worse off. Boris had expected to pay, and Lynn had expected to receive, a real interest rate of 3%. However, with an actual inflation rate of 7%, an 8% nominal interest rate yields a real interest rate of 1% (8% − 7% = 1%). So, in real terms, Boris pays less, and Lynn receives less, than was expected.