Sample essay on nominal interest vs. real interest rate

[Finance](), [Investment]()

Essay

The term “ interest rate” is one of the most widespread in the present financial sphere. There are several types of this index, and the differences between those are usually based on the fixed set of economic factors.

The nominal interest rate is the percentage growth of funds that creditors take from borrowers for their services (using borrowed money). The nominal interest rate is the basic type of interest rate, and is the stated rate on a given bond or loan. In essence, the nominal interest rate is the actual price that borrowers pay to creditors to use their money. But the nominal interest rate does not take into account one essential factor, and that is inflation, in other words, it is unadjusted for inflation. Because of inflation, the value of the borrowed money will eventually go down, and in order to cover that gap, creditors always use real interest rate when doing business. The real interest rate is a little more complex concept, as it requires the inflation index to be factored in, while calculating the interest rate so that the interest rate exceeds the inflation rate. It is done so that the creditors’ money does not lose their purchasing power with time (inflation growth). Both of these concepts can be explained by Fisher equation according to which the real interest rate equals the nominal interest rate less inflation (or expected inflation): Nominal interest rate – Inflation = Real interest rate.

Even though this concept may seem easy to understand great number of people still have no such knowledge, which allows lending institutions and retailers to take advantage of it, and make hundreds of billions of dollars in profits over the years.

References

Brigo, D. (2001). Interest Rate Models. New York, NY: Springer.