Review Questions: Real vs. Nominal Rates and Inflation

1. Historically, the real rate of interest has hovered around 1.5%. Economists predict that the rate of inflation next year will be 2.5%. What should next year's nominal interest rate be?

2. You have just inherited a fortune, and wish to create a finance award to rival the Nobel Prize awards. You want to create a perpetuity that will pay $500,000 this year (today) to the award winner, and you want the award to grow with inflation. Assume that inflation will be 3% compounded annually. How much would you need to invest in the fund today, given a discount rate of 8%?