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Assignment: Week 1 Homework

(Real interest rates: approximation method) You are considering investing money in Treasury bills and wondering what the real risk-free rate of interest is. Currently, Treasury bills are yielding 9.0% and the future inflation rate is expected to be 5.3% per year. Ignoring the cross product between the real rate of interest and the inflation rate, what is the real risk-free rate of interest?

STEP 1: FORMULATE A SOLUTION STRATEGY

Ignoring the cross product between the real rate of interest and the inflation rate, the real risk-free rate of interest is defined as:

$$\text{Real rate of interest} = \text{nominal rate of interest} - \text{inflation rate}$$

STEP 2: CRUNCH THE NUMBERS

The real risk-free rate of interest is computed as follows:

$$\text{Real rate of interest} = 0.090 - 0.053 = 0.037 = 3.7\%$$

STEP 3: ANALYZE YOUR RESULTS

The real rate of interest represents the rate of increase in your actual purchasing power after adjusting for inflation. In this case, the real risk-free rate of interest is 3.7 percent.

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