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Analysis of today
Assessment of tomorrow

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How Do Countries Fall into Debt Spiral?

It is known that there are errors made in calculating real interest rates everywhere in the world. Even those who define themselves as "experts" calculate real interest rates by subtracting the current inflation rate from the current nominal interest rate.

This is a fundamentally flawed approach. It stems from a misconception arising from the fact that inflation and interest rates have been very low and have remained stable for years.

Let’s try to explain why real interest is important with the help of some equations. First and foremost, looking back, real interest is a comparison of nominal interest and inflation for the same period.

If we are looking forward, we can say it is a comparison of the proposed nominal interest for one year with the expected inflation at the end of that period. First, let’s share the definitions and equations related to nominal and real interest:

Nominal Interest is a parameter we refer to as the "price of capital," which arises from adding inflation and significant risks in the country. If central banks are realistic, they do not intervene in the price formation that is developing in the market; however, they can provide guidance.

Trying to keep interest rates low as if inflation and risks do not exist is dangerous, and rapidly increasing rates do not always resolve issues. It is essential that central banks operate in a listening, rationally guiding manner.

The equation for Real Interest requires a bit of mathematics:

Real Interest Rate = [(1 + Nominal Interest Rate) / (1 + Inflation Rate)] - 1

Why is real interest important?

However, for those who enjoy what is referred to as "grocery shop accounting" (simple bookkeeping), we can roughly gauge real interest by subtracting the expected inflation from today’s nominal interest. So why is real interest important? It is important for two reasons:

Understanding whether nominal interest rates meet expectations is crucial to prevent investors' savings from eroding due to inflation.

Determining whether a country is overstepping in its borrowing and falling into a spiral.

If we accept that investors approach a country's debt securities based on their previous experiences, the nominal interest proposed by the country must produce satisfactory real interest in light of inflation expectations.

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However, having a real interest rate at a certain level can lead a country into a debt spiral. Sometimes, a country's conditions and the size of its debt can also create excessive levels of real interest. Still, it is crucial to maintain the balance indicated in the following equation:

Real Interest = Growth Rate + Primary Surplus / National Income

This equation simply states that the real interest a country proposes must equal the ratio of the growth rate and the primary balance it can create, to national income. This is where governments’ illusions begin. First, let me start with the most unrelated issue.

The mismanagement of good times

Sometimes, due to things going well in the country, real interest might be low while the growth rate is high.

For instance, in a country growing around 5%, if the real interest is around 4 points, governments might think, “There is no need to generate a primary surplus.”

The fundamental cause of the high real interest and debt spiral is the "mismanagement of good times"

However, this is a significant oversight. If the primary deficit becomes chronic, it may lead to a debt spiral where much higher real interest must be offered in the future.

The cause of this would be the lack of discipline in public spending. In summary, the fundamental cause of the high real interest and debt spiral is the "mismanagement of good times."

Hopeless state of covering debts with more debts

Now let’s move to a more critical issue: A country that cannot generate a primary surplus has evidently lost discipline in its public spending. Therefore, it offers high interest rates when borrowing to finance public spending.

If the growth rate of this country is low, the above equation signals a significant danger. The country resembles a company that has fallen into a hopeless state of covering its debts with more debts. Sustaining this situation for a long time is impossible. Companies go bankrupt, but countries do not. The bankruptcy of a country effectively means the bankruptcy of its citizens.

Economic administrations have become like explorers trying to carry significant weights over a very thin layer of ice - Emre Alkin

In dollarized countries, the calculation of real interest is usually made according to exchange rates rather than inflation, so investors look at the dollar amount they will earn at maturity. They want to exchange their national currency for dollars to gain interest and ultimately convert that gain back to dollars.

As no one believes in countries’ official inflation figures anymore, I must admit that I find investors' approach reasonable. However, what I do not find reasonable is the governments’ disregard for the enormous damage they inflict on the economy while trying to maintain balance through high interest rates and controlled low dollar exchange rates.

In many countries, inflation rates that are 10-15 points higher than official announcements actually show that investors are not being offered real interest.

Therefore, investors pressure economic administrations by saying, "Forget inflation; how much will we earn in dollars?" They will leave the moment they are dissatisfied.

Economic administrations have become like explorers trying to carry significant weights over a very thin layer of ice. While navigating a path they have never experienced before, economies are constantly at risk of hitting rock bottom.

As a citizen of a country that experiences these mistakes repeatedly, I wrote this to leave a note in history to prevent other countries from making the same errors.