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# *Twenty-five years of inflation targeting and the new inflation target*

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# Twenty-five years of inflation targeting and the new inflation target

Vincent Dadam<sup>1</sup> and Tumisang Loate<sup>2</sup>

## Abstract

This paper reviews South Africa's experience with inflation targeting since its adoption in 2000 as the South African Reserve Bank (SARB) enters a new era, switching to a 3 percent target. The literature broadly concludes that the framework has succeeded in lowering inflation, reducing its volatility, and strengthening the credibility and transparency of the SARB. Empirical evidence shows declines in inflation persistence, a flattening of the Phillips curve, and a reduction in exchange rate pass-through over time, alongside a clearer and more rules-based monetary policy stance. This is an indication of well anchored inflation expectations which is vital for the credibility of the institutions. However, the review also highlights persistent structural constraints—high unemployment, weak potential growth, fiscal instability, and deep inequality—that have limited the broader developmental impact of the framework. Critics argue that inflation targeting may constrain policy space, though evidence suggests that these socioeconomic outcomes largely reflect structural rather than monetary factors. The paper concludes by examining current debates on lowering the inflation target and shows that future gains depend critically on fiscal coordination and progress on structural reforms, rather than on monetary policy adjustments alone.

**Keywords:** inflation targeting, monetary policy, credibility, structural challenges, South Africa

**JEL classification:** E31, E52, E58, E61, E65

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## Executive Summary

When the apartheid regime ended in 1994, South Africa found itself at the crossroad of both opportunities and challenges. The reintegration in the global economy also came with the objective of stabilising an economy battling with high and volatile inflation, fiscal imbalances and currency instability. There was therefore a need for a transparent and credible framework to anchor international and domestic investors' expectations. To strengthen policy credibility and anchor investor expectations, the South African Reserve Bank (SARB) formally adopted inflation targeting (IT) in February 2000 after experimenting with alternative monetary policy frameworks. This followed a trend set by the central bank in New Zealand that would soon spread to advanced and emerging economies. Although the country did not fully satisfy the conventional preconditions for IT—owing to external vulnerabilities, high unemployment, and episodes of fiscal dominance—the framework offered a transparent and credible approach to managing inflation and strengthening institutions in a young democracy.

Since its introduction, IT has been tested by a series of major global and domestic shocks against a backdrop of persistent structural challenges, notably rising unemployment, weak economic growth, and increasing domestic constraints. Despite these pressures, the SARB has maintained its focus on long-term macroeconomic stability and preserving policy credibility. Twenty-five years later, South Africa's inflation-targeting regime has entered a new phase with the adoption of a 3 percent target with a tolerance band of 1 percentage point.

### Monetary policy empirical literature review and meta-analysis

The empirical literature on IT in South Africa is vast and multifaceted but can be summarised in the following three themes:

**The Phillips curve:** The first feature in assessing the early success of the framework focused on investigating whether monetary policy succeeded in managing inflation volatility and persistence. As such, research supports the view that since the adoption of IT, inflation not only significantly declined but became less volatile – a testament to the anchoring of inflation expectations. Simple data analysis shows that during IT, inflation volatility decreased from an average of 3.8 percent before the 2008 global financial crisis to less than 2 percent after. Furthermore, an estimation of a time-varying Phillips curve shows that inflation persistence fell as well as shocks dissipated far quicker after 2000, therefore consolidating the SARB's credibility as a price stabiliser.

**Exchange rate pass-through rate:** Since then, empirical literature has evolved to explore further aspects in its assessment of the IT regime. One body of work has focused on the transmission of monetary policy in the context of exchange rate volatility to show that monetary policy credibility since the adoption of IT has helped reduce second-round effects of the rand depreciation in containing imported inflationary pressures. First-round effects remain however strong.

**Monetary policy rule:** Another strand of the literature has estimated the SARB policy reaction function under the IT regime. The snapshot of the findings can be summarised as follows: a strong anti-inflation stance in the early 2000s followed by a more accommodative response during and after the 2008 financial crisis; and a renewed tightening cycle in the wake of the post-Covid-19 pandemic inflation surge which was aggravated by the war in Ukraine, subsequent supply-side shocks and geopolitical tensions particularly in the Middle-East. We find that average estimates of the inflation and output

coefficients sensitivity in the Taylor rule from the literature show that while output elasticity remained constant at around 0.45, the inflation sensitivity to the monetary policy instrument decreased from 2.8 to about 1.6 during the 2020-2025 period. This coefficient remained higher than pre-IT levels, highlighting the importance of price stability in line with the core objective of the framework.

Looking at the meta-analysis of the empirical literature, the picture that emerges from it is that of noticeable heterogeneity in the findings that is justified by the use of different models and sample periods. Further criticism of the empirical literature is supported by populist calls that monetary policy success in South African should be measured in terms of real economy and social welfare metrics given the significance of structural constraints. Given these premises, we explore how the SARB navigate this environment to achieve successfully the anchoring of inflation expectations using transparent communication in its pursuit of central bank credibility.

### **Inflation expectations, communication and central bank credibility**

IT relies on well-anchored inflation expectations, as expectations play a key role in shaping actual inflation outcomes. To achieve this, central banks require both credibility and effective communication. The communication strategy by the SARB can be classified as a “layered communication strategy” that targets different groups, such as households, firms, financial markets, and professional forecasters. While the effectiveness of these initiatives in anchoring expectations is difficult to measure, they have enhanced the SARB’s transparency and credibility. However, there are arguments that its communication could also be improved by publishing the minutes of the meetings of the MPC and engagement by senior SARB officials with National Treasury.

Research on inflation expectations in South Africa shows that economic agents form expectations differently. Trade unions and firms, as key price setters, generally have higher and more backward-looking inflation expectations, adjusting them slowly over time. In contrast, financial analysts’ expectations have been more firmly anchored, although historically at the upper limit of the inflation target range. Following the SARB’s emphasis on anchoring expectations at the 4.5% midpoint from 2017 onwards, inflation expectations across different groups gradually converged towards this “de-facto” midpoint target between 2016 and 2020. This convergence suggests that the SARB’s communication efforts and policy credibility were effective in influencing expectations.

Although the SARB successfully guided inflation expectations towards the “de-facto” midpoint target before the COVID-19 pandemic, these expectations shifted upward during the 2022 inflation surge. The increase was relatively modest among financial analysts but significantly larger among price setters, whose expectations deviated by nearly two percentage points at the peak. Nevertheless, compared with previous inflation shocks, such as those in 2002 and during the 2008 global financial crisis, the rise in inflation expectations was smaller, reinforcing perceptions of the SARB’s credibility.

### **Structural weaknesses and socioeconomic critiques of the framework**

Despite these achievements, structural economic challenges continue to complicate monetary policy implementation in South Africa and contribute to ongoing socioeconomic criticism and populist calls for the nationalisation of the SARB. The regime has faced criticisms regarding its lack of compatibility with the country's most pressing developmental needs, especially when looking at them through the lenses of economic growth, employment and inequality. In particular, with IT focusing primarily on

price stability, critics have argued that this has come at the expense of sizeable socioeconomic objectives and effectively constrained policy space needed to address the country's structural issues.

The best personification of these structural challenges arises from the performance of the labour market since the implementation of IT. Particularly in the early 2000s when South Africa experienced strong growth, unemployment did not decline significantly. This was exacerbated by the 2008 global financial crisis when the labour market quickly shed more than a million jobs and never fully recovered during the recovery.

Another area of criticism focuses on the distributional effects of monetary policy and how the distributive effects of inflation are non-neutral. For instance, research shows that poor households are particularly affected by rising basic good prices because they represent a big chunk of their expenditure income. As such, IT has often been criticised in inclusion debates especially in a highly unequal society. Furthermore, the SARB has often grappled with the issue of fiscal dominance and political/social contestation, particularly during the recovery following the 2008 global financial crisis when domestic shocks became more dominant. These domestic shocks are best embodied in the tragic events unfolding in Marikana in 2012 and the surprise dismissal of Finance Minister Nhlanhla Nene in 2015. Although "Nenegate" showcased the limits of monetary policy to insulate the economy from political shocks, research shows the SARB kept a bold approach to preserve its credibility and remained focused on achieving long-term macroeconomic stability despite criticisms that the SARB decisions exacerbated the stagnation at the time while failing to address underlying fiscal risks.

Issues of fiscal dominance almost perfectly mirror the dynamics between the SARB and trade unions' objectives when it comes to anchoring inflation expectations. The former constantly reiterates the macroeconomic benefits of a stable and low inflation rate while the latter is less averse to higher inflation in wage negotiations. These issues overall highlight the challenges of conducting monetary policy in a country where deeply rooted issues keep resurging. It is also an important reminder that structural challenges require structural reforms which fall under the category of fiscal policy while monetary policy focuses on providing an environment in which these adequately implemented reforms bear the desired fruits for the economy to thrive.

### **The road ahead: enter the new target era**

In October 2025, the finance minister announced the lowering of the inflation target from the 3-6 percent band to the 3 percent target with a 1 percentage point tolerance band. The current debate over lowering the inflation target highlights the extent to which IT in South Africa is still evolving. We narrow the survey of the literature to the following:

**Lowering the target will be harmful to the economy:** This argument is based on the premise that monetary policy has contributed to the low economic growth, high unemployment, and inequality. In contrast to this narrative, there is empirical evidence that the SARB overestimated the real-time estimates of the output gap, rendering monetary policy accommodative, at least up until 2017. The source of this overestimation is the miscalculation of potential output ex-ante. In addition, the argument that monetary policy alone will have negative consequences to growth overestimates the power of IT while underestimating the role of fiscal policy. The overestimation of the output gap was also a fiscal policy mistake, leading to an increase in non-transitory and non-productive spending such as wages. Lastly, monetary policy can control inflation if it is able to have an effect on the output gap,

a relationship captured by the Phillips curve. As already discussed, there is empirical evidence of the weakness in this relationship.

**Lowering the target will increase the risk of hitting the ZLB:** Lowering the inflation target will result in a downward shift of both inflation and nominal interest rate over time, reducing the policy space for responding to adverse shocks. This then puts monetary policy in the country into the realm of unconventional monetary policy tools, such as QE, to stimulate growth. Proponents argue that since the country has neutral real interest rate of about 2 percent (compared with about zero for several advanced economies), there is policy space to avoid hitting the ZLB with an inflation target of 3 percent per year.

**Lowering the target will increase government debt:** The critics of the lower target argue that lowering the inflation target whilst government is also implementing a spending-based fiscal consolidation would lead to deeper economic woes. On the other hand, proponents argue that over time, a lower inflation target will lower the cost of borrowing for government. There is consensus in the emerging literature of lowering the target that there is an output loss in the near to medium terms and benefits in the long-term. Empirical literature points to:

- The substantial contribution of government debt to either the term structure or the yield spreads.
- Government debt has a negative relationship with economic growth when the debt-to-GDP is over 40%.
- A “credible disinflationary process” requires fiscal policy support. Fiscal consolidation helps reduce the risk premium further, leading to a larger reduction in it than if the inflation target change is implemented alone. This amplifies the effects of the target change, resulting in lower sacrifice ratios.

Ultimately, the South African case illustrates both the resilience and fragility of IT in an emerging market setting: it is a framework that has provided stability and credibility, but its long-term effectiveness hinges on complementary reforms and the resolution of deep-seated structural weaknesses.

# 1 Introduction

The formal adoption of the inflation targeting (IT) framework by the South African Reserve Bank (SARB) in February 2000 represented a pivotal moment in the country's macroeconomic policy history. Following the abolishing of the apartheid regime, South Africa soon grappled with the sizeable challenge of reintegrating into the global economy while stabilising an economy struggling with high and volatile inflation, fiscal imbalances, and recurrent currency instability which presented significant impediments to the conduct of monetary policy. Traditional monetary anchors, such as monetary aggregates, had become unreliable in the 1990s as financial liberalisation, capital account openness, and the end of sanctions rendered money demand unstable (Aron and Muellbauer, 2007). At the same time, the transition to democracy placed new demands on economic governance, underscoring the need for a credible, transparent, and rules-based framework to anchor expectations and reassure both domestic and international investors. The urgency of achieving such an objective required a framework that could achieve rapid credibility for an efficient transmission of monetary policy (Viegi, 2025). The opportunity presented itself in IT and against this backdrop, the SARB's decision to adopt the framework aligned South Africa with a growing international consensus that had begun with New Zealand in 1990 and subsequently spread to both advanced and emerging economies.

The appeal of IT in South Africa was not only purely technical but also institutional and political. Mishkin (2000) emphasises that a successful IT requires certain preconditions, including central bank independence, fiscal discipline, a deep financial system, and effective communication. South Africa in the late 1990s met these conditions only partially. The country remained vulnerable to external shocks, faced persistently high unemployment and inequality, and was still grappling with episodes of fiscal dominance. Yet IT promised a relatively quick route to credibility, offering a clear numerical anchor for inflation expectations, enhancing transparency through explicit communication, and constraining the discretion of policymakers. For the SARB, IT became not only a tool of macroeconomic management but also a mean of institutional consolidation in a young democracy.

Since its adoption, IT in South Africa has been subject to extensive scholarly scrutiny. Early studies focused on evaluating whether the framework had succeeded in reducing inflation volatility and persistence relative to the pre-2000 era. Burger and Marinkov (2012), for instance, find that inflation declined significantly after the adoption of IT and became less volatile, supporting the claim that the regime helped anchoring expectations. Additional studies using time-varying Phillips curve estimations further found that inflation persistence also fell, with shocks dissipating more rapidly after 2000 (Kabundi et al., 2016). These findings suggest that IT has played a role in consolidating SARB's credibility as a price stabiliser. Beyond the dynamics of inflation itself, another strand of the literature has examined the transmission of monetary policy under IT, particularly in the context of South Africa's volatile exchange rate. The rand is among the most volatile emerging market currencies, and exchange rate pass-through into domestic prices has long been a concern for policymakers. Studies such as Kabundi and Mbelu (2016) highlight the significance of exchange rate shocks for inflation outcomes, though more recent work suggests that improved monetary policy credibility has reduced the second-round effects of depreciation (Kabundi and Mlachila, 2019). This literature points to a gradual strengthening of the IT framework's effectiveness in containing imported inflation pressures, even as first-round effects remain strong.

Another area of inquiry has focused on monetary policy rule estimations, providing insight into the policy reaction function of the SARB under IT. These studies generally show that the SARB has

responded more aggressively to inflation since 2000, consistent with the priorities of the IT framework. At the same time, the literature highlights variation across periods: a strong anti-inflation stance in the early 2000s, a more accommodative response during and after the 2008 global financial crisis, and a renewed tightening cycle in the wake of the post-Covid-19 pandemic inflation surge and aggravated by the war in Ukraine, and subsequent supply-side shocks. These findings underscore the flexibility embedded within the IT framework and the challenges of conducting monetary policy in an emerging economy exposed to both domestic structural weaknesses and global volatility.

The literature has also turned increasing attention to the importance of anchoring expectations through effective and transparent communication to enhance the credibility of the SARB. Anchoring expectations is widely regarded as central to the success of IT, based on the assumption that economic agents are forward-looking in setting inflation expectations. However, in South Africa, Kabundi, et al (2015) find heterogeneity in expectation formation across different economic agents, with financial analysts more forward-looking while price-setters such as firms and trade unions more backward-looking. More recently, Pirozhkova and Viegi (2023) argue that the SARB's de facto shift toward a midpoint target of 4.5 percent since 2017 has strengthened the anchoring of expectations, with convergence evident across economic agents. This body of work highlights the importance of communication strategies and credibility in sustaining IT, particularly in the context of an economy characterised by high inequality and vulnerability to shocks.

IT in South Africa has not been without its critics. A prominent strand of the literature questions whether the framework is compatible with the country's developmental needs, particularly in relation to growth, employment, and inequality (Epstein, 2007; Maduku and Kaseeram, 2018). Critics argue that IT prioritises price stability at the expense of other pressing socioeconomic objectives, effectively constraining the policy space needed to address South Africa's structural challenges. The labour market provides a particularly stark example: despite a period of strong growth during the early 2000s, unemployment remained stubbornly high, suggesting that IT did little to alleviate one of the country's most pressing economic problems. Moreover, the distributive consequences of inflation are not neutral: poorer households are disproportionately affected by increases in the price of basic goods which represent a sizeable chunk of their expenditure (Dadam et al., 2019). This raises questions about the inclusivity and legitimacy of IT as a monetary policy framework in a society marked by deep inequalities. The tension between credibility and distributional outcomes has been further complicated by episodes of fiscal dominance and political contestation. The "Nenegate" crisis of 2015, in which the dismissal of Finance Minister Nhlanhla Nene precipitated a sharp depreciation of the rand and a spike in bond yields, highlighted the fragility of investor confidence and the limits of monetary policy in insulating the economy from political shocks. In such contexts, the SARB's insistence on preserving credibility through interest rate hikes has been criticised for exacerbating stagnation while failing to address underlying fiscal risks (Loate et al., 2021). This points to the limits of IT in environments where monetary and fiscal policy are not well coordinated.

Given these debates, a more recent focus of the literature has been the potential recalibration of South Africa's inflation target. The SARB has suggested lowering the target band, or shifting more explicitly to the midpoint, as a means of reinforcing credibility, lowering borrowing costs, and enhancing competitiveness (Loewald et al., 2025). Proponents argue that such a move would strengthen South Africa's macroeconomic fundamentals, while critics caution against the risks of short-term output losses, heightened vulnerability to the zero lower bound, and further constraints on policy space. This evolving debate underscores the continuing salience of IT in South Africa's

economic discourse and the need for a careful evaluation of its costs and benefits. Nevertheless, the SARB officially adopted a 3 percent inflation target rate in late 2025 with a one percentage point tolerance band.

This paper contributes to the literature by offering a review of the evolution of IT in South Africa over more than two decades. It situates the framework within its historical context, synthesises empirical findings on inflation dynamics, exchange rate pass-through, Taylor rule estimations, and expectation formation, and engages with the broader critiques concerning structural weaknesses, fiscal dynamics, and socioeconomic outcomes. In doing so, the paper seeks not only to document the achievements and limitations of IT, but also to illuminate the trade-offs and tensions that continue to shape monetary policy in South Africa. By critically engaging with recent debates on lowering the inflation target, the paper also highlights the prospective challenges and opportunities for the framework in the years ahead.

The rest of the paper is organised as follows. The first section discusses the motivations behind the implementation of IT and probes the early evaluation of the framework while assessing its outcomes. This is followed by a section on the empirical literature on IT in South Africa structured as a meta-analysis on body of works on inflation volatility and persistence nested in the estimation of the Phillips curve, research on the exchange rate pass-through and finally the assessment of the monetary policy rule. In the third section, we focus the discussion on the credibility of the SARB during the IT era centred around the anchoring of inflation expectations and the importance central bank communication in achieving such credibility. The fourth section discusses the impediments to the conduct of monetary policy in which structural weaknesses, which are the legacy of the past, play a central role. Before concluding the paper, we contribute in the last section to the debate on the adequate level of the inflation target as the SARB proceeded in formally switching from the 3 to 6 percent band target to a point target of 3 percent, close to their previously desired midpoint of 4.5 percent which the institution has often implied in their recent communications.

## **2 Motivations for inflation targeting: early evaluations and outcomes**

In the 1980s, South Africa experienced severe inflationary pressures, and the SARB opted for the control of money growth in order to address them. However, the task was rendered difficult to achieve due to economic sanctions against the apartheid regime in place combined with financial liberalisation and the opening of capital markets. By the 1990s, monetary aggregates as intermediate targets to stabilise inflation and support economic growth became unreliable. This was further emphasised by the reintegration of South Africa in the global economy that came with significant benefits but also exposed several challenges such as high inflation, fiscal deficits and a highly volatile rand. The need for macroeconomic policy reforms was made abundantly clear and even though the SARB did not have a formal framework at the time, the emphasis was made by the institution on their commitment to pursue a stable inflation in line with the post-apartheid Constitution of the Republic. This planted the seeds for the adoption of the IT framework.

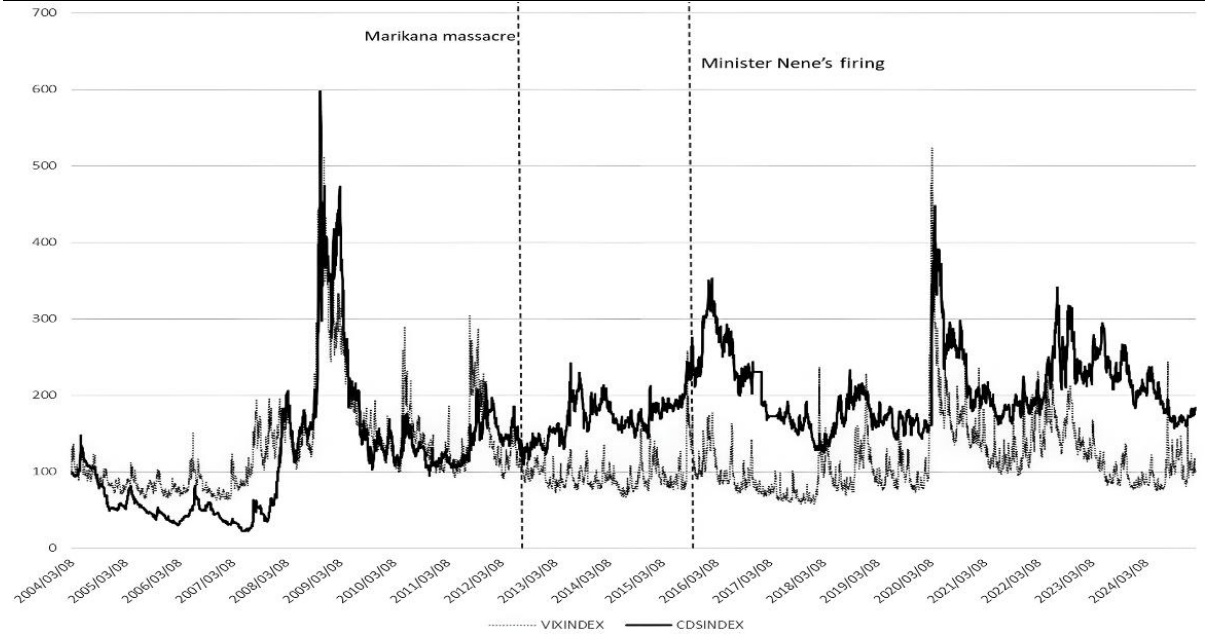
Mishkin (2000) defines the pre-requisites for a successful implementation of the IT framework which includes central bank independence, price stability as its core objective, the absence of fiscal dominance, a deep and liquid financial system, data-driven inflation forecast, communication and transparency to build and support central bank credibility and finally, a commitment to exchange rate

flexibility. The decision to adopt IT in South Africa was therefore far from obvious given that in the late 1990s, the country battled with external shocks vulnerability, fiscal deficits and raging fiscal debts. Nevertheless, a framework that can provide quick credibility, transparency and accountability was the priority and the SARB found in IT a quick path to achieving these goals. We split in what follows the IT into four phases in which we evaluate the framework and assess its outcome at each one of the phases.

The first phase begins with the implementation of the regime itself. In February 2000, the SARB formally adopted IT with a target lying between 3 and 6 percent. The first test came after 9/11 when the exchange rate depreciated sharply, which further emphasised the vulnerability of the young democracy to external shocks. The SARB did not respond dramatically and chose to focus on second round effects which turned out to be the appropriate mitigating approach. Aron and Muellbauer (2007) argue that this episode was perhaps one of the early wins of the adoption of the IT regime supported by transparent policy decisions that became predictable to economic agents. Following that event, the early years of the regime remained an overall success. This was further supported by the Great Moderation when global demand was high, and South Africa reaped the benefits of the commodity boom at the time, which helped fiscal policy create some space and achieve relative fiscal sustainability. However, leading to the 2008 global financial crisis, oil prices began to surge which in turn resulted in inflationary pressures rising in the economy due to its supply-side weakness.

The second phase came in the form of the toughest test to IT since its implementation as the 2008 global financial crisis propagated worldwide. The shock was of a magnitude that set back the economy decades and wiped out some of the gains that South Africa had accumulated over the Great Moderation. What complicated further the task of the SARB was that, leading to the crisis, fuel and food prices soared and the economy was battling with episodes of high inflation. The dramatic response of the unemployment rate further consolidated the magnitude of the challenge. The response of the SARB was rapid and decisive by cutting the interest rate and committing to not intervening in the forex market, therefore sticking to the exchange rate floating regime. Furthermore, two instruments in the toolkit of central bankers were suddenly available as the response to the crisis, namely forward guidance and quantitative easing (QE). The SARB prioritised the use of forward guidance and successfully managed to keep inflation expectations well anchored, which further sustained its credibility. The counter-cyclical actions of the SARB without un-anchoring inflation expectations were one of the positive highlights of IT during that phase.

**Figure 1: The decoupling between VIX (global risks) and CDS for South Africa debt (domestic risks)**



Source: Viegi (2025).

The third phase is highly defined by the decoupling of the sensitivity of the South African economy to shocks of external and domestic nature. Suddenly, the economy responded more to home grown risks as argued by Viegi (2025) who believes it started with the tragic events of Marikana. This phase showed that what was believed to be the trend during the Great Moderation was in fact transitory. Fiscal space eroded and structural weaknesses resurfaced. Tension between fiscal policy and monetary policy became palpable as populist calls for the nationalisation of the SARB became louder. Added to this, the surprise dismissal of Finance Minister Nhlanelhla Nene, triggered a sharp depreciation of the rand, while bond yields spiked as investors' sentiment shifted, which eventually led to the downgrade of the South African economy by rating agencies. Inflation pressures began to mount soon after and the SARB often called for the consolidation of fiscal policy to support macroeconomic stability, which is a clear indication of the disconnect between fiscal and monetary policy. Additionally, as a response to 'Nenegate', the SARB raised the interest rate unexpectedly amid outlook risks. This decision significantly reduced the country's risk premium and further emphasised the credibility of the institution but on the other hand, it could not prevent the stagnation that followed.

The fourth and final phase revolves around the Covid-19 pandemic and the resurgence of inflation following expansionary macroeconomic policies to support economic recovery. The pandemic's devastating effects were unprecedented and required a response of a similar magnitude. In response to the Covid-19 pandemic shock, the SARB announced the purchase of government bonds in March 2020, marking an unprecedented use of QE by the SARB. Up until Covid-19, the experience by advanced countries during the 2008 global financial crisis was to use QE to lower long-term rates, and thus stimulate economic growth, when short-term rates were at their effective zero lower bound. However, the objective of the SARB, and central banks in other emerging markets, was to use QE to ensure the well-functioning of the financial markets by providing liquidity. This approach, together with the monetary and fiscal coordinated responses from advanced countries, helped ease the

pressure on the country's risk premium.<sup>3</sup> Havemann et al. (2022) show that SARB's QE programme improved market liquidity by narrowing the bond spreads, and also reduced yields across all maturities. Furthermore, the authors show that while the objective of QE was not to reduce long-term rates, and thus stimulate demand, the policy had a bigger effect on long-term rates compared to other emerging markets.

However, the first use of QE in South Africa was preceded by the 2019 debate of whether the SARB should use QE to lower long-term rates? The short answer from Loate et al. (2021) and Fowkes (2022) is no for the following interrelated reasons. Firstly, this will interfere with long-term inflation stability. Reducing long-term rates will raise inflation expectations, and thus expectations of future short-term rates. This policy is appropriate when short-term rates are at the zero-lower bound (ZLB) and inflation below the target. However, if that's not the case, as in South Africa, then it goes against the objective of anchoring inflation expectations. Thus, Loate et al. (2021) suggest that QE should be reserved to deal with transitory external shocks, such as Covid-19, without risking de-anchoring inflation expectations. Secondly, reducing the trend of long-term interest rate is best left to the fiscal authority through a credible debt-reduction strategy. The fiscal authority can achieve the "QE effect" by issuing short-term bonds instead of long-term bonds, Fowkes (2022). Lastly, QE will not signal debt sustainability to the market but simply shift the fiscal risk from the fiscal authority to the SARB.

The economic recovery from the Covid-19 driven recession was marked by rising inflationary pressures. When findings suggested the contraction in South Africa's GDP was less severe than anticipated, inflation soon began to surge driven by constant supply chain disruptions, energy price volatility and the war in Ukraine. While central banks in advanced economies were caught in the debate surrounding the response, the SARB was quick to act as soon as inflationary pressures began to materialise, and the rewards were evident. This was a solid success for the IT framework in emerging economies. By ensuring its commitment to the framework, the SARB made use of qualitative forward guidance by communicating and explaining the future path of the policy stance through monetary policy committee (MPC) statements. As such, the institution managed to clearly convey that policy decisions were made through data driven models and in response to domestic and international markets developments<sup>4</sup>. This transparency bred accountability and consolidated the credibility of the SARB and as a response, inflation expectations were well kept in the target bound.

It emerges from the experience of the SARB with the IT regime that the gains of its implementation allowed the institution to build credibility based on its tunnel vision approach to reach and not lose sight of the long-term target that is macroeconomic stability. However, the challenges met in this quest are myriad. A recurrent theme is structural weaknesses that are the legacy of the past and seem to have resurgence episodes whenever a shock of significant amplitude surfaces. An example of the importance of these weaknesses was that: (i) during the Great Moderation, unemployment did not register the expected decline, therefore signalling serious challenges in the labour market; and (ii) the gains during the Great Moderation were in fact transitory and not structural benefits that failed to

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<sup>3</sup> See Loate et al. (2021) and Havemann et al. (2022).

<sup>4</sup> South Africa's inflation is broadly demand driven and dominated by domestic shocks which added to the effectiveness of monetary policy in addressing rising inflationary pressures. Dery et al (2025) find that domestic shocks average 78 percent of the inflation historical decomposition during the 2 decades leading to the Covid-19 pandemic – of which 44 percent originated from domestic demand shocks. This pattern remained consistent post Covid-19 pandemic, although slightly decreasing in magnitude with domestic shocks accounting for 65 percent of changes in inflation, from which 49 percent emanated from domestic demand shocks.

elevate the economy’s potential output, and the 2008 global financial crisis was a stark reminder of that.

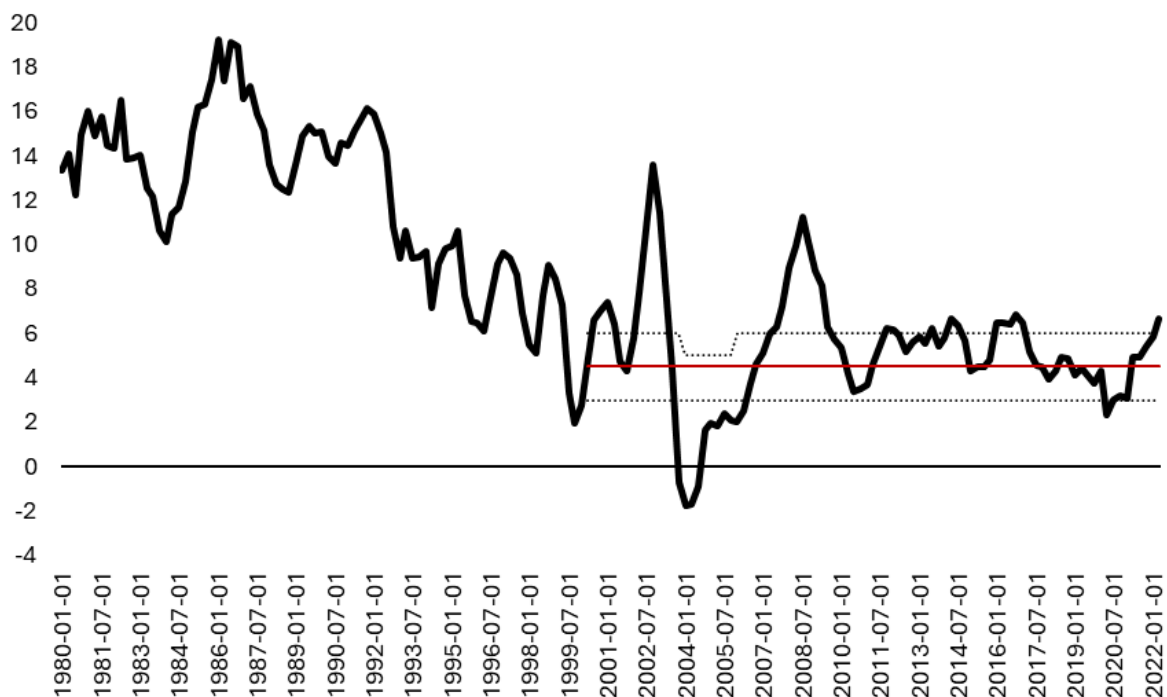
### 3 Monetary policy empirical literature review and meta-analysis

Over two decades since the formal adoption of the IT framework, substantial empirical literature emerged to assess its performance in South Africa. On the backdrop of macroeconomic instability before the adoption of the regime, this assessment in the literature focuses on how IT mitigated inflation volatility, impacted the transmission of monetary policy, helped in managing external shocks, and solidified the credibility of the SARB by anchoring inflation expectations. The literature – quantitative and qualitative – includes various methodologies and approaches to answer these questions. In this section, we review it focusing on the themes of inflation volatility and persistence which allows us to dive into a meta-analysis of the estimation of the Phillips curve. We follow this up with the literature on the exchange rate pass-through rate and the Taylor rule in South Africa.

#### The Phillips curve: volatility and persistence in inflation

Prior to the IT era, the SARB struggled with high and persistent inflation. As shown in Figure 2, since the adoption of the regime, the inflation rate has stayed vastly within the desired target range. It is worth noting that between 2004 and 2005, the SARB experimented with a narrower band between 3 and 5 percent (Burger, 2025). However, the institution reverted to the initial target following rising inflationary pressures at the end of 2005.

Figure 2: Inflation volatility

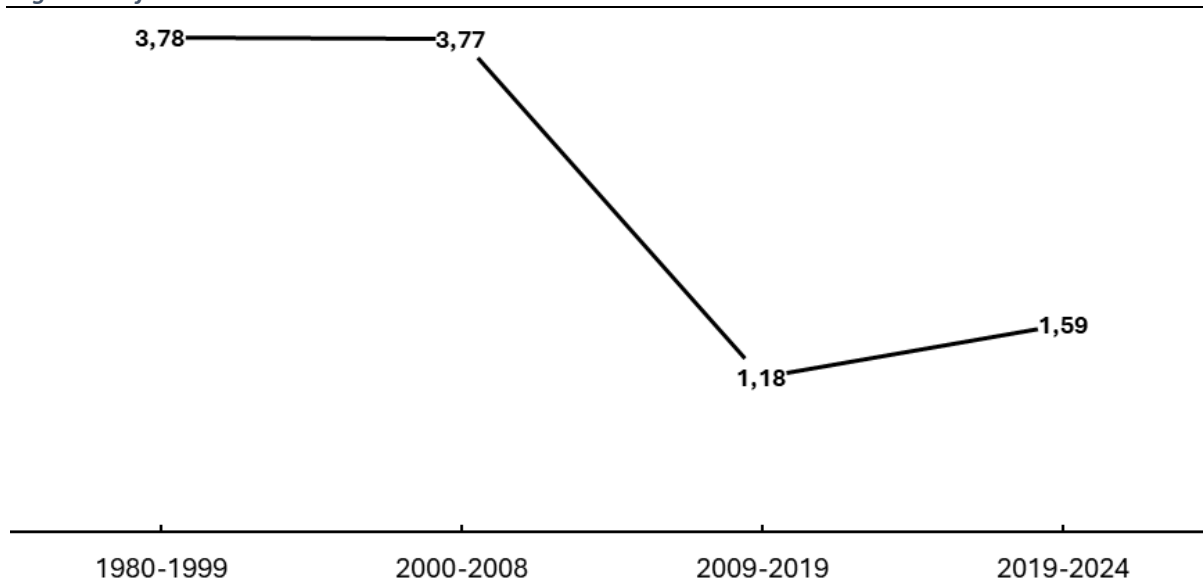


Source: Authors’ calculation on St Louis Fed’s FRED database.

Studies that compare pre and post IT such as Aron and Muellbauer (2007), reach the same conclusion that since its adoption, the inflation rate significantly decreased and showed noticeably lower volatility. This is easily visible if we calculate a simple standard deviation of the inflation series at

different points in time. Figure 3 clearly shows a decrease in variations in inflation since the adoption of IT. This is more prominent following the 2008 global financial crisis, although driven by a period of low inflation owed to the slowdown in economic activity as a result of the crisis.

**Figure 3: Inflation standard deviation**



Source: Authors' calculation on St Louis Fed's FRED database.

This finding validates the idea that IT is associated with a credible anchor but does not however answer the question of whether IT created an environment where inflation became less persistent. Kabundi et al. (2016) address the subject by estimating a time-varying Phillips curve and find that inflation shocks dissipated quicker post IT adoption suggesting that inflation persistence declined since 2000. In particular, the persistence of inflation shocks increased before and during the first year of the adoption of IT between 1994 and 2001 – which could be considered a period of transition. It subsequently remained constant during the Great Moderation between 2001 and 2008 before decreasing in 2008, partly due to the 2008 global financial crisis. This is supported by their finding of the flattening of the slope of the Phillips curve under IT since the mid-2000s. As such, the trade-off between output and inflation weakened, therefore reinforcing the credibility of the SARB.

Given the aforementioned, it is worth having a closer look at the literature on the Phillips curve in South Africa. We summarise the findings on this topic in the table that follows.

**Table 1: Phillips curve estimates in the literature**

STUDY	TYPE / SOURCE	SAMPLE	PHILLIPS-CURVE SLOPE	INFLATION PERSISTENCE	KEY TAKEAWAYS
<b>FEDDERKE &amp; SCHALING (2005)</b>	SAJE; cointegration markup	1970–2002	1.31 (ULC→P, LR)	0.21	Large long-run pass-through from unit-labour cost; moderate adjustment speed.
<b>BURGER &amp; MARINKOV (2006)</b>	SAJE; Gordon triangle PC	1970–2003	0.11 (single gap) to 0.21 (overheating)	0.71–0.72	Weak/fragile slope; very high inertia.

STUDY	TYPE / SOURCE	SAMPLE	PHILLIPS-CURVE SLOPE	INFLATION PERSISTENCE	KEY TAKEAWAYS
<b>NELL (2006)</b>	CEP; nonlinear/state-dependent PC	1971–2001	Early: $\sim 0.55$ ; later: $\sim 0.03$ (upswing) / $\sim 0.80$ (downswing)	0.25 $\rightarrow$ 0.78	Strong asymmetry; persistence higher post-mid-1980s.
<b>STEINBACH, MATHULOE &amp; SMIT (2009)</b>	SARB WP 09/01; NK-DSGE	1994–2007	$\approx 0.02$ (derived)	$\approx 0.5$	Very flat NKPC; moderate persistence from indexation.
<b>REID &amp; DU RAND (2015)</b>	SAJE / ERSA WP 22/2013; SIPC	1995–2010	0.08–0.12	0.75–0.80	Flat slope; high info rigidity $\rightarrow$ high persistence.
<b>KABUNDI, SCHALING &amp; SOME (2016)</b>	ERSA WP 620; time-varying PC	1996–2014	$\sim 0.10 \rightarrow 0.35 \rightarrow 0.22$	$\sim 0.60 \rightarrow 0.70 \rightarrow 0.58$	Slope steepened to mid-2000s then flattened; persistence eased after 2008.
<b>FEDDERKE &amp; LIU (2016)</b>	SARB WP 7275; hybrid NKPC	1994–2014	0.021	0.53	Flat slope; $\sim \frac{1}{2}$ of $\pi$ from lag — moderate persistence.
<b>KABUNDI, SCHALING &amp; SOME (2019)</b>	IICB; bounded RW PC	1994–2018	$\sim 0.12 \rightarrow 0.30 \rightarrow 0.20$ (time-varying)	$\sim 0.55 \rightarrow 0.73 \rightarrow 0.55$	PC flattened post-2008; persistence declined as credibility improved.
<b>BOTHA, KUHN &amp; STEENKAMP (2020)</b>	SARB WP 10211; hybrid PC	2000–2019	0.04–0.07	0.67–0.71	Shallow slope; high inertia; expectations sizeable.
<b>FORESTO, REID &amp; RAKGALAKANE (2025)</b>	SARB WP 11080; state-dependent PC	1995–2023	$\sim 0.05$ (low- $\pi$ ) $\rightarrow$ $\sim 0.20$ (high- $\pi$ )	$\sim 0.5$ (low- $\pi$ ) $\rightarrow$ $\sim 0.8$ (high- $\pi$ )	Clear regime dependence: steeper & stickier in high-inflation states.

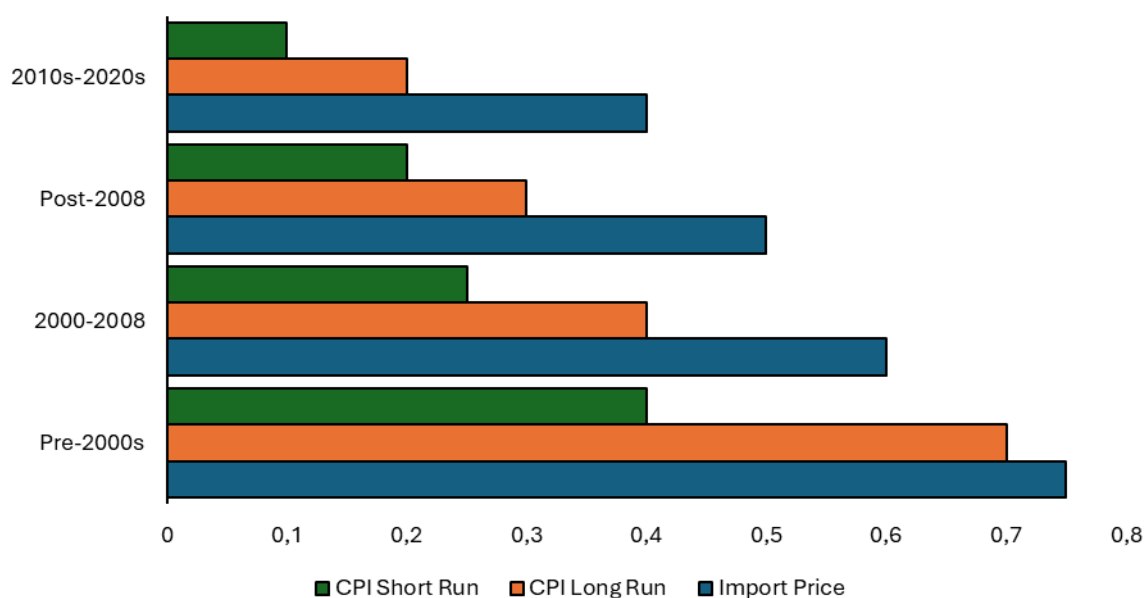
What emerges from this literature is a picture characterised by a strong and unstable Phillips curve slope estimates most likely justified by significant structural breaks and therefore nonlinearities. We can however conclude that in the pre-IT era, the trade-off between inflation and the real economy is overall weak in the short run due to poorly anchored inflation expectations amid recurrent supply and external shocks. The post-IT era is dominated by the findings of a flatter slope of the Phillips curve and a decline in inflation persistence, especially following the 2008 global financial crisis.

### Exchange rate pass-through rate

The South African rand is one of the most volatile currencies among emerging economies. It is therefore relevant to assess the performance of IT in influencing the degree of the exchange rate pass-

through rate to consumer prices. This issue has been extensively covered in the literature and focuses on multiple round effects with a section of that focusing on first round effects – implying the direct effects through import prices (specifically through firms importing intermediary goods in their final goods production processes) – while another strand of the literature focuses on how exchange rate shocks feed into consumer prices, *i.e.* the second round effect (Bhundia, 2002, Bhundia and Ricci, 2005, Kabundi and Schaling, 2013). Figure 4 summarises the average findings in this empirical literature.

**Figure 4: Exchange rate pass-through rate estimates in the literature**



Source: Authors' calculation based on the literature.

It appears that since the adoption of IT, the SARB has successfully managed to mitigate the effects of exchange rate shocks with the most challenging part following the inflation shock that resulted from the recovery of the Covid-19 driven recession, amplified by the war in Ukraine. We disaggregate these findings in Table 2 that summarises the literature on the topic.

**Table 2: Meta-analysis of the literature on exchange rate pass-through rate in South Africa**

STUDY	SAMPLE PERIOD	METHODOLOGY	PRICE MEASURE	SHORT-RUN ERPT	LONG-RUN ERPT	KEY FINDINGS / NOTES
<b>KARORO, AZIAKPONO &amp; CATTANEO (2009)</b>	1980s–2000s	Cointegration / ECM	Import prices	≈ 0.39	≈ 0.78	Incomplete but high ERPT to import prices; stronger for depreciations.
<b>ARON, MUELLBAUER, FARRELL &amp; SINCLAIR (2014)</b>	1980–2009	VECM + single-eqn	Import CPI	0.30 (6 m) → 0.50 (12 m)	0.55 – 0.75	Large first-stage ERPT; second-stage to CPI incomplete.
<b>PARSLEY (2012)</b>	1990–2009	Panel (micro CPI)	Consumer goods	—	≈ 0.16 (2 yr)	Low CPI ERPT; strong product-level heterogeneity.

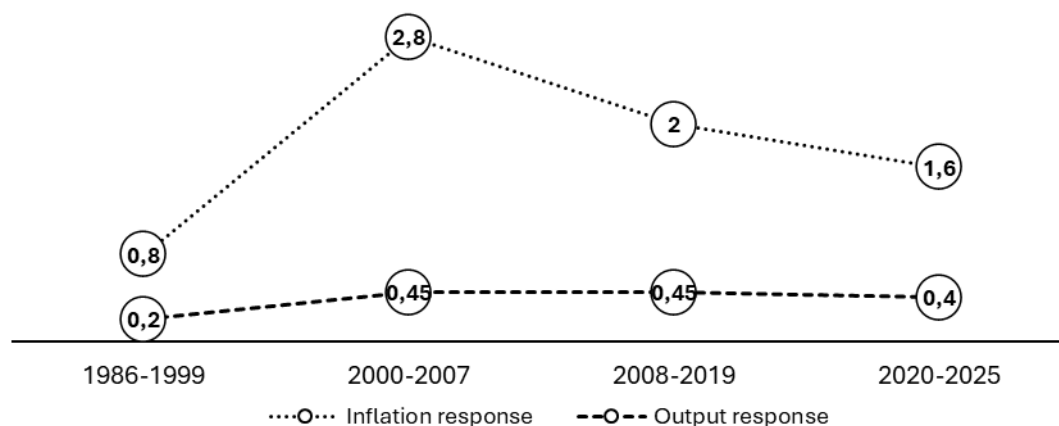
STUDY	SAMPLE PERIOD	METHODOLOGY	PRICE MEASURE	SHORT-RUN ERPT	LONG-RUN ERPT	KEY FINDINGS / NOTES
<b>OCRAN (2010)</b>	2000 M01–2009 M05	VAR + IRF	Import, PPI, CPI	CPI 0.012 (3 m) → 0.115 (12 m)	≈ 0.12 (CPI 24 m)	Low CPI ERPT; import-price ≈ 0.40 (8 m).
<b>KABUNDI &amp; MBELU (2016)</b>	1980–2012 (Q)	Two-stage ECM + Asymmetry	Import → CPI / Core CPI	0.54 (first-stage SR)	0.93 (first-stage) → 0.29 (CPI stage)	Decline in ERPT post-2008; asymmetric (higher in upturns).
<b>KABUNDI &amp; MLACHILA (2018)</b>	1994–2017 (Q)	Time-varying ERPT vs credibility	CPI (pass-through index)	— (time-varying)	Fell ≈ 0.5 (1998) → ≈ 0.2 (2002 onward)	Credibility coeff ≈ –0.004 to –0.012; higher credibility → lower ERPT.
<b>MADUKU &amp; KASEERAM (2018)</b>	2002–2016 (M)	Recursive VAR / Variance Decomp.	Import, PPI, CPI	— (PPI ≈ 0.22 avg.)	— (qualitative)	≈ 22 % of FX fluctuations passed to prices; stronger for import & PPI than CPI.
<b>MIYAJIMA (2019)</b>	2002 Q1–2018 Q2	ARDL / rolling regressions	Core & Headline CPI	“Yearly” 0.078 (core), 0.088 (headline)	0.186 (core), 0.124 (headline)	Adding volatility lowers ERPT to 0.035–0.056; volatility ↑ core $\pi$ by ≈ 0.04 pp.
<b>GEREZIHER &amp; NURU (2023)</b>	1970 Q1–2020 Q1	Threshold VAR (TVAR)	CPI (inflation regimes)	0.07 (low $\pi$ regime); 0.18–0.21 (high $\pi$ regime)	0.10 (low $\pi$ ); 0.26–0.30 (high $\pi$ )	ERPT ≈ 3× higher in high-inflation regime; asymmetric (depreciations > appreciations); incomplete overall.
<b>CHOUDHRI &amp; HAKURA (2006)</b>	1979–2000 (Q)	Panel VAR (52 countries)	CPI	0.26 (SA)	0.53 (SA)	Cross-country benchmark: SA ≈ 0.5 LR ERPT; moderate inflation regime.
<b>JONSSON (1999)</b>	1970–1998 (Q)	VAR / Cointegration	CPI	0.30	0.88–1.00	Near-complete LR pass-through; PPP not rejected (pre-IT).
<b>MIHALJEK &amp; KLAU (2008)</b>	1995–2007 (Panel EMs)	Panel OLS / RE	CPI	≈ 0.25	≈ 0.45 (SA subset)	SA below EM average; stable under inflation targeting.

Overall, the exchange rate pass-through is incomplete but remains significant. When looking at it from different stages, it appears that import prices pass-through rates are higher in both short and long runs compared to CPI pass-through rates – a reflection of weak nominal anchors and high inflation volatility. However, the degree of the pass-through is on a decline pattern throughout time, especially after the adoption of IT, signalling an improvement in monetary policy credibility.

### Monetary policy rule

The estimation of the monetary policy rule in South Africa has generated great interest pre and post IT era. In Figure 5, we summarise the average findings of these sensitivity coefficients as found in the literature between the 1980s to the Covid-19 pandemic and subsequent recovery.

**Figure 5: Average inflation and output gap sensitivity coefficients to the monetary policy instrument**



Source: Authors' calculation based on the literature.

A couple of points are worth taking a closer look. First, the gap between the coefficient on inflation pre-IT and in the early years of the implementation of the regime is remarkable. The SARB shifted toward a more aggressive approach on price stabilisation following the high volatility and level of inflation between the 1980s and the late 1990s. This is consistent with a stronger focus on inflation which shows a strong commitment to IT in order to rapidly enhance the credibility of the SARB. It also marks a clear departure from the discretionary monetary policy approach of the previous years. Similarly, more attention is given to a stable output gap showing the need of long-term macroeconomic stability.

Following the 2008 global financial crisis which was characterised by a significant drop in prices due to a decline in economic activity, the SARB is less sensitive to prices relative to the early years of the implementation of IT. However, the average response to prices is still significantly higher than pre-IT levels therefore emphasising the commitment to price stability. The sensitivity to output gap developments on the hand remain relatively unchanged. The environment then was characterised by low growth performances due to high uncertainties in global and domestic outlooks and to a certain extent to the difficulty of accurately determine the potential growth of South Africa. We discuss the miscalculation of the output gap at length in section 5 of this paper. Nevertheless, the decisions taken then were data driven and the SARB was transparent in their communication to explain the actions taken. Finally, the Covid-19 pandemic driven recession is particularly characterised by the response to inflationary pressures that rose during the recovery and were amplified by supply chains disruptions and the war in Ukraine. Particularly, the aggressive and rapid response of the SARB to resume monetary policy normalisation by increasing the interest rate help mitigate the negative effects.

We follow this bird's eye view analysis with a more disaggregated list of studies that have estimated monetary policy rule in South Africa and the results are summarised in Table 3.

**Table 3: Meta-analysis of the literature on monetary policy rule in South Africa**

STUDY / SOURCE	SAMPLE PERIOD	INTEREST SMOOTHING	INFLATION GAP /EXPECTATION	OUTPUT GAP/UNEMP	FINANCIAL OTHER TERM	NOTES / MODEL TYPE
ARON & MUELLBAUER (2002)	1986 Q2– 1997 Q4	0.32	0.23	0.07	US rate = 0.40; M3 = 0.07; Liberalisation = 0.11	Extended (IV/LIML) linear
ORTIZ & STURZENEGGER (2007)	1983– 2002	0.73	1.11	0.27	0.11 (exchange rate change)	Bayesian policy rule DSGE
NARAIDOO & GUPTA (2009)	1986– 2008 / 2000– 2008	1.18–1.26	7.81–9.01	1.13–2.10	—	Linear / nonlinear learning rule
NARAIDOO & RAPUTSOANE (2010)	2000– 2008	≈ 0.90	0.80–1.00	0.60	0.10 (Financial Index)	Nonlinear (zone-targeting)
ELLYNE & VELLER (2011)	2000 Q1– 2011 Q1	—	0.24	≈ 0.50	—	Low inflation weight; stronger output response
KASAI & NARAIDOO (2012)	1986– 2010	0.82	1.16–1.62	0.00–0.12	—	Markov-switching rule
NARAIDOO & PAYA (2010)	1986– 2008 / 2000– 2008	1.04–1.26	4.20–9.01	0.70–2.10	0.10–0.31 (Financial index)	Linear & Smooth-Transition Nonlinear
BOLD & HARRIS (2018)	2000 Q1– 2017 Q2	0.81–0.84	1.25–1.57	0.31 (y) / -0.15 (u)	0.41–0.46 (expectations)	Linear (Taylor rule with expectations & unemp.)
BOLD & HARRIS (2018)	2000 Q1– 2017 Q2	0.83	1.32 (expectations)	-0.15 (unemp.)	—	Modified rule (expectations & labour slack)
SCHALING & MOREMA (2022)	2000 Q1– 2021 Q4	0.84–0.85	1.8–2.0	0.3–0.5	—	Calibrated optimal flexible rule
PHIRI (2023))	1994– 2020	0.79	1.71 ( $\pi^+$ ) / 0.83 ( $\pi^-$ )	0.41 ( $y^+$ ) / 0.07 ( $y^-$ )	—	NARDL asymmetric rule

## Synthesis

The descriptive narrative of the empirical literature on IT in South Africa has been coherent. IT has provided the SARB with the tools to deliver credible communication and accountability which has resulted in lowering average inflation and improved the transparency of the institution. As such, the

post IT era is linked with overall lower inflation volatility, a flattening of the Phillips curve and noticeably lower exchange rate pass-through rates. However, the analytical part of the empirical literature appeared less of a unified front.

Looking at the meta-analysis in this section, the overall picture that emerges from it is that of significant heterogeneity in the findings as they are not uniform. Indeed, the results are vastly model, methodology and sample period dependent, which raises the researcher bias question. Additionally, structural constraints including low potential growth, high inequality and the recurrence of supply shocks remain a significant impediment to the effectiveness of monetary policy in achieving macroeconomic stability. This has often supported the criticism that monetary policy outcomes should be measured in terms of real economy and social welfare metrics. IT has undoubtedly been a necessary condition for a sustained macroeconomic stability; however, this condition does not appear sufficient. Given such an environment, we discuss the SARB's communication as a tool to guide and anchor inflation expectations to achieve central bank credibility.

#### 4 Inflation expectations, communication and central bank credibility

Anchoring inflation expectations is critical if IT is to be an effective tool. This is because inflation expectations drive actual inflation. The degree to which inflation expectations translate into actual inflation depends on the parameter  $\gamma$  in equation (2), which drives how forward- or backward-looking agents are on aggregate. A higher  $\gamma$  indicates for forward-looking agents. To anchor or manage these inflation expectations, central banks need to have a clear communication strategy and credibility.

$$\pi_t = E_t \pi_{t+1} + \kappa y_t + \eta_t \quad (1)$$

$$E_t \pi_{t+1} = \gamma \widehat{E}_t \pi_{t+1} + (1 - \gamma) \pi_{t+1}; 0 < \gamma < 1 \quad (2)$$

The SARB's MPC communication includes the monetary policy speech on policy instrument change, publications of the MPC speech and the biannual monetary policy review (MPR) bulletin. The MPC speeches are followed by engagement with the media through Q&A sessions whereas the MPR provides an overview of the monetary policy stance. The publication of the MPR includes an event that allows engagement with participants. This allows the media, professional forecasters, and financial markets participants the opportunity to seek clarity on some MPC decisions and the current understanding of the economy. But these are mainly accessible to professional forecasters and financial markets and much less to the general public, especially households and small firms. However, the SARB seems to understand and attend to communication to households by engaging with them through their monetary policy forum (MPF). This is part of the SARB's outreach programme and is held twice a year, across all the provinces. Its aim is to help stakeholders - such as government, the business sector (banking sector, insurance sector and private businesses), organised labour, business formations (associations and chambers of commerce), civil and community organisations, academic institutions, and members of the public who have a keen interest in South Africa's economic development - develop a better understanding of the mandate and functions of the SARB.<sup>5</sup> While the effectiveness of these public engagements in anchoring or managing inflation expectations remains

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<sup>5</sup> See the SARB's website.

unclear, the concerted effort of this “layered communication strategy” leaves a favourable impression of the SARB.<sup>6</sup>

Coibion et al. (2020) find that households and firms are inattentive to inflation and monetary policy conditions in developed countries, attributing this to a low-inflation environment in these countries because of “successful” monetary policy. This is called “rational inattention”. In contrast, the authors find that in developing countries, where inflation tends to be higher, households and firms do pay attention to inflation and monetary policy conditions. Unlike professional forecasters and financial markets, who are often assumed to be rational in forming expectations, households base their inflation expectations on their observation of petrol and food prices - the most volatile items of the consumer price index basket. And the heterogeneity of their food basket results in their inflation expectations not being anchored. Indeed, the South African literature on inflation expectations does indicate that economic agents are heterogeneous in setting their inflation expectations.<sup>7</sup> Using data from 2000Q3 to 2013Q1, essentially capturing the first 12 years of IT in South Africa, Kabundi et al. (2015) show that trade unions and firms, referred to as price setters, have higher inflation expectations and are also backward-looking, meaning that they adjust their expectations slowly. Table 4 shows the Granger-causality results for the aggregate and its subcomponents.

**Table 4: Granger causality test**

	F- statistic	p-value
<b>Trade unions</b>		
$\pi_t^e$ does not Granger cause $\pi_t$	0.98	0.38
$\pi_t$ does not Granger cause $\pi_t^e$	14.21	0.00
<b>Financial analysts</b>		
$\pi_t^e$ does not Granger cause $\pi_t$	1.14	0.32
$\pi_t$ does not Granger cause $\pi_t^e$	0.84	0.43
<b>Business sector</b>		
$\pi_t^e$ does not Granger cause $\pi_t$	1.91	0.15
$\pi_t$ does not Granger cause $\pi_t^e$	9.53	0.00
<b>Aggregate</b>		
$\pi_t^e$ does not Granger cause $\pi_t$	2.45	0.09
$\pi_t$ does not Granger cause $\pi_t^e$	11.27	0.00

*Notes: Granger causality between two-year ahead inflation expectations and actual CPI inflation.  
Source: SARB and authors’ calculation*

Similar to earlier results by Kabundi et al. (2015) and Reid (2015), who use a shorter series, the results in Table 4 confirm the backward-looking behaviour of price setters. The opposite is found for financial analysts. These results are similar to findings in the US by Coibion et al. (2020), which show that between the early 2000s and 2018, one-year inflation expectations of households are higher than those of financial analysts and professional forecasters by 1.5 percentage points. For the 2018 period,

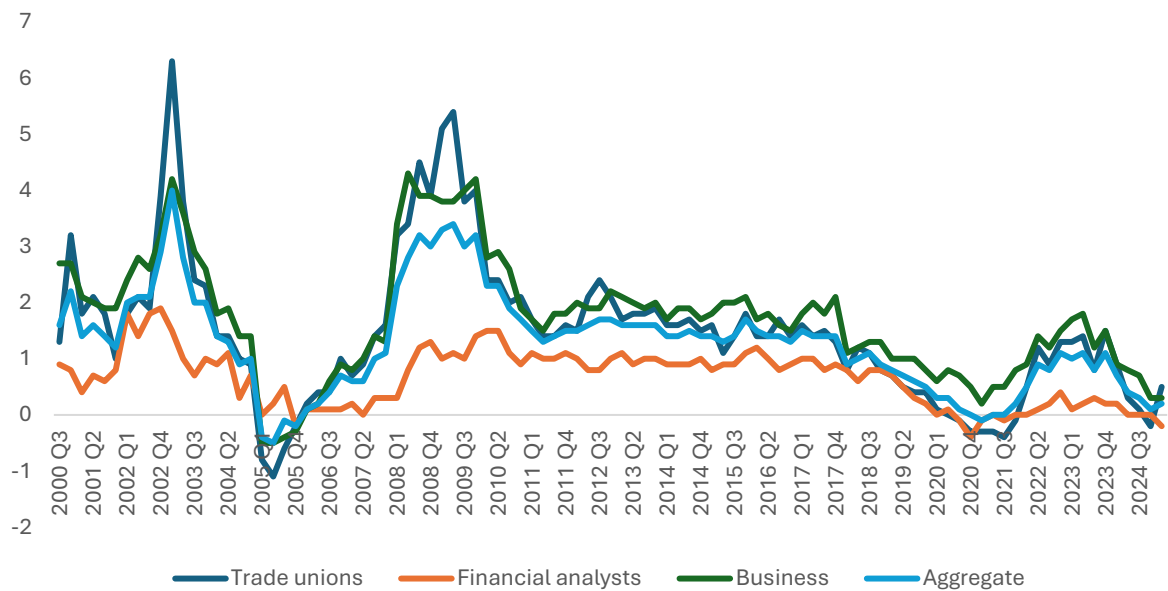
<sup>6</sup> A layered communication strategy is one where households/firms and professional forecasters/financial markets are treated differently, Coibin et al. (2020).

<sup>7</sup> See Kabundi, Schaling and Some (2015) and Reid (2015).

the only datapoint available for firms, the same paper finds that firms' expectations are the highest of other economic agents.

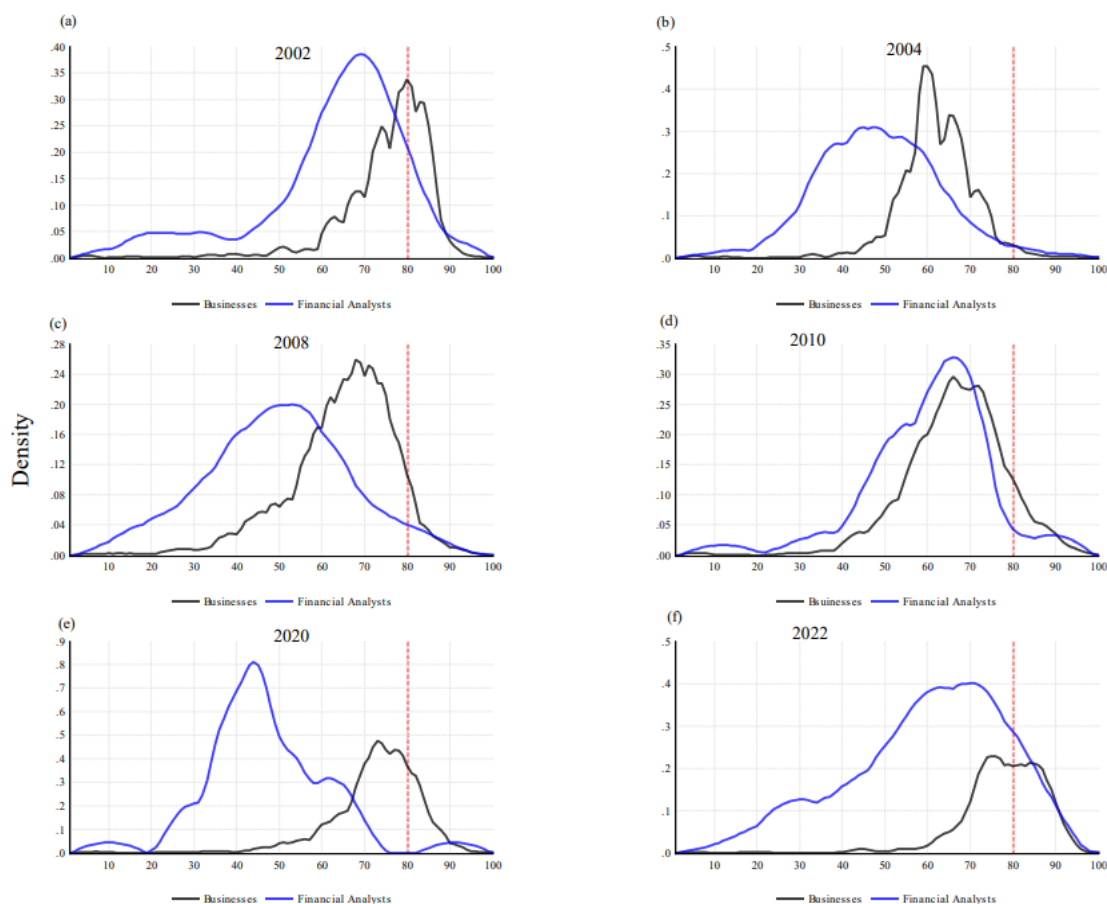
Another interesting finding by Kabundi et al. (2015) is that while inflation expectations for financial analysts seem to be anchored, they were anchored at the upper bound of the inflation band. According to the authors, this highlighted the uncertainty of a wide target band instead of a target point. Since this study, the SARB preferred anchoring inflation expectations to 4.5 percent, the midpoint of the 3-6 percent band from mid-2017 (Pirozhkova and Viegi, 2023). Figure 6 shows the deviation of inflation expectations from the midpoint. We can see that between 2016 and 2020, inflation expectations of all agents were converging to this “de-facto” midpoint target. In fact, Pirozhkova and Viegi (2023) analyse the macroeconomic dynamics of the shift to the mid-point using counterfactual analysis. They find that actual prices and inflation expectations were lower than their implied paths had the SARB continued with the 3-6 percent target band. The authors argue these results are supportive of the expectation channel of the SARB’s communication and its credibility.

**Figure 6: Inflation expectations: deviation from the 4.5% midpoint**



Source: SARB and authors' calculation.

Figure 7: Distribution of inflation



Source: Reid and Siklos (2025).

Reid and Siklos (2025) show how inflation expectations of firms and analysts can be affected by major economic shocks. Figure 7 shows the distribution of one-year ahead inflation expectations for firms and financial analysts for selected years. Distributions for other years are benchmarked to the peak value of 2002 for firms, captured at 7.61 percent and indicated by the vertical line. If inflation expectations for other years increase (decrease), relative to the peak of 2002, then the vertical line will be to the left (right) of the peak of the distribution. We see from Figure 7 that despite the SARB being able to move expectations towards the 4.5 percent midpoint before the Covid-19 pandemic, these easily shifted upwards in 2022. While the deviation of inflation expectations for analysts was less than half a percentage point from target during this inflation surge, inflation expectations of the price-setters, deviated by almost two percentage point at its peak, as shown in Figure 6. However, it is worth noting that unlike in the other spikes of 2002 and the 2008 global financial crisis, the increase in inflation expectations was smaller, giving credence to the SARB's credibility.

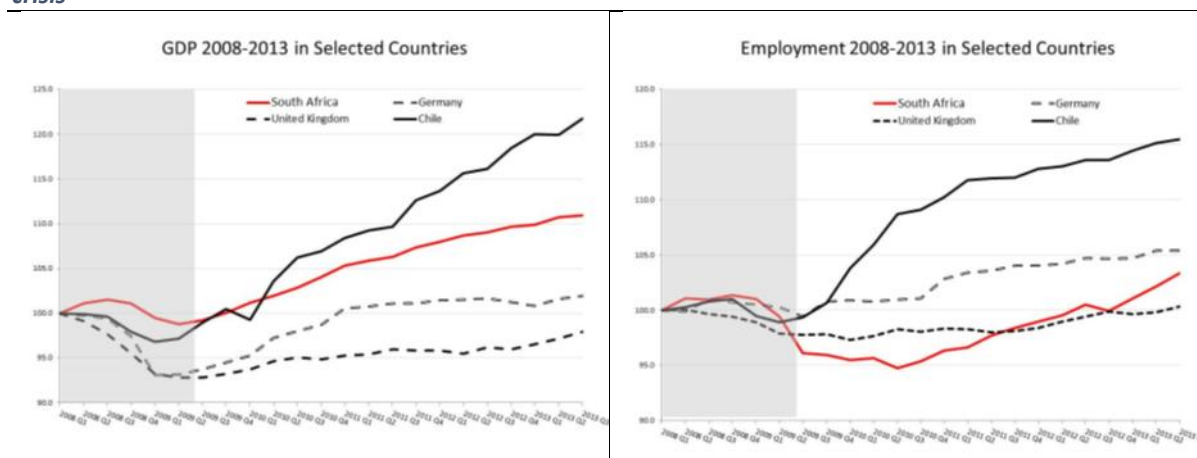
In addition, while the SARB has made strides in enhancing policy transparency, its communication could also be improved by publishing the minutes of the meetings of the MPC and engagement by senior SARB officials with National Treasury, Honohan and Orphanides (2022). Despite these gains, deeply rooted challenges have rendered the conduct of monetary policy challenging in South Africa which has often opened the door to socioeconomic criticism and populist calls for the nationalisation of the SARB. The institution has successfully navigated these challenges while ensuring transparency and credibility. We discuss these issues in the next section.

## 5 Structural weaknesses and socioeconomic critiques of the framework

What appears abundantly clear throughout this paper so far is that the SARB has been conducting monetary policy since the dawn of democracy as managing risks and establishing its status as guarantor of ‘credibility of last resort’ – a term coined by Viegi (2025) in his assessment of monetary policy in South Africa since 1994. The institution has had to face the challenges of the resurgence of structural challenges, socio and political pressures since the implementation of the IT framework. Because of the nature of the economy itself, the pursuit of stabilising inflation at the expense of alternative targets such as growth and employment among others, has generated some criticism. To assess the validity -or lack thereof - of some of the criticisms, it is important to revisit some of the key structural weaknesses of the South African economy and how relevant they are in an efficient conduct of monetary policy. We begin with the labour market which is perhaps the clearest personification of these deeply rooted issues.

The 2008 global financial crisis was highly disruptive. The implementation of IT in February 2000 was supported by a period of strong economic performance driven by high global demand and a commodity boom. Even then, the unemployment rate did not fall below the 15 percent mark. Significant issues were therefore well buried and the response of the South African economy to the 2008 global financial crisis helped unearth them. Dadam and Viegi (2015) document this response deemed peculiar in Figure 8.

*Figure 8: Comparative responses of GDP growth and employment performance following the 2008 financial crisis*



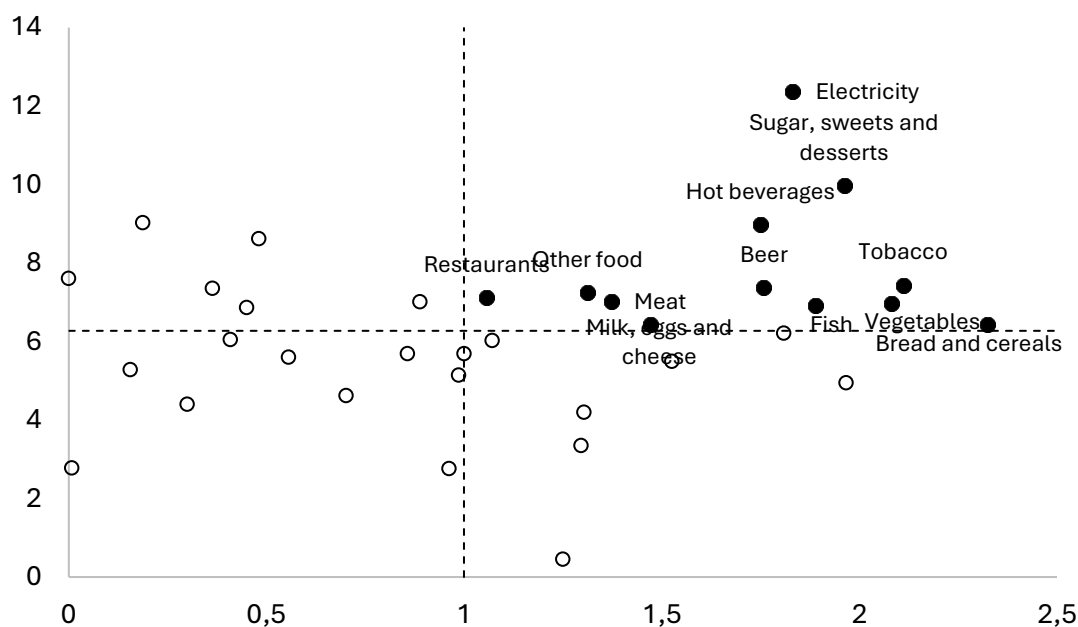
Source: Dadam and Viegi (2015)

South Africa’s GDP response following the shock is comparatively better than its peers, however this response masks a dramatic occurrence in the labour market. The economy rapidly shed about a million jobs that were not fully recovered despite accommodative policy actions. The response was therefore abrupt and highly persistent. This has supported the hypothesis of hysteresis that Dadam and Viegi (2024) found when looking at the unemployment series. This behaviour evidently puts pressure on the transmission of monetary policy, and the central bank found itself facing a significant sacrifice ratio. In particular, pursuing inflation stabilisation especially when using contractionary monetary policy, comes with the undesired increase in unemployment which, as it has been established, is structurally high in South Africa. On the contrary, an expansionary monetary policy may lead to

rampant inflationary pressures with potentially insignificant reductions in unemployment when the variable is particularly stubborn. Limited demand-side leverage often subdues the impact of an expansionary monetary policy on job creation and growth. This is dramatic in South Africa in the sense that maintaining sustained labour income represents a vital path to lifting affected households from poverty and therefore help close the inequality gap in South Africa.

Since the end of the apartheid regime, little progress has been made in terms of inequality and poverty. South Africa is currently one of the most unequal societies in the world. Naturally, the issue of the distributional effects of monetary policy has fuelled the debate. This is however not particular to South Africa. What is relevant in the country is the discussions around the acceptable level of inflation that can benefit the poorer faction of the population. The relevance of the question can find some support in the work of Dadam et al. (2019). The authors investigate the effects of inflation on the CPI baskets of South Africans and identified items in the expenditure where poor households' welfare have been impacted because of high inflation.

**Figure 9: Poor households' exposure to high inflation expenditure categories**



Source: Dadam et al. (2019)

The vertical axis of the figure denotes the inflation rate while the horizontal axis is the ratio of the weight of each expenditure category in the CPI<sup>8</sup> of the poorest 40 percent of households to that of the richest 60 percent of households during the post 2008 global financial crisis when structural challenges resurfaced. The horizontal dashed line represents average inflation while the dashed vertical line splits categories in the CPI baskets where poor households are under-exposed (left hand side) and the categories where they are over-exposed (right hand side) to increases in the price of the items in the CPI basket. The figure shows clearly that most of the items in the CPI baskets that have experienced significant inflationary pressures are products and services that are of necessity to poor households and take a significant amount of their income expenditure.

<sup>8</sup> The weight of expenditure categories in the CPI denotes the relative importance of goods and services which is measured by their shares in the total consumption of households.

The negative impact of high inflation on the welfare of the vast majority of the population is therefore evident from this analysis and is bound to impact the transmission of monetary policy. Although it is important to note that the relationship between monetary policy and inequality is complex, macroeconomic instability can impact inequality through high inflation which is found to disproportionately deplete poor households' income as evident from Dadam et al. (2019). Another channel is through recessions where unemployment tends to rise and consequently impact poorer households more. Some studies have documented channels through which easing monetary policy can impact the distribution of wealth and income. This multifaceted aspect of monetary policy conduct can be summarised through the following points.

The first one revolves around the widening of the inequality gap following monetary policy easing. A recent example is the economic effects of the Covid-19 pandemic and the accommodative monetary policy that ensued. The BIS Annual Economic Report of 2021 finds that although such policies that include interest cutting and asset purchases help offset the negative impact of the crisis, they also somewhat increased the gap between rich and poor. For instance, the boost witnessed in equity markets from the pandemic lows was partly attributed to central bank actions. This mainly benefited the rich. On the flip side, an accommodative monetary policy helps keep businesses afloat which allows them to retain the workforce and therefore keeping the unemployment rate low during crises. Furthermore, low interest rates facilitate small firms' access to liquidity through credit channels which in turn allows them to hire more workers and in turn boost economic activity as they grow.

It is important to highlight that these effects are country specific and as emphasised several times in this paper, the case of South Africa is a peculiar one. This peculiarity has often driven calls for monetary policy to do more to address the inequality issue or to add an additional objective to the central bank agenda. The answer to these calls has been debated in the literature and the consensus remains clear: adding one more objective may undermine the efficacy of monetary policy. Targeting inequality reduction may conflict with the objective of price and output stability. Therefore, central banks should prioritise clear communication about the distributional effects of monetary policy decision – be it negative or positive. Clarifications in terms of the impact of monetary policy actions on welfare and labour market prospects are essential to build trust in the institution and consolidate market expectations. Carney (2016)<sup>9</sup> and Lane (2019)<sup>10</sup> have found evidence of central banks following that trend.

It is therefore evident that using monetary policy as a tool to mitigate the negative effects of inequality leads to mixed economic results at best. Thus, this responsibility falls on government actions through fiscal policy, that is best known to embark on structural reforms to address deeply rooted issues. Additionally, a coordination between monetary and fiscal policy during crises has proven effective in dampening the negative effects. In particular, combining monetary policy with supportive fiscal policy and structural reforms results in improving macroeconomic stability and distributional outcomes. The challenge in this scenario is the temptation of fiscal dominance that may deter central bank credibility.

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<sup>9</sup> Speech by Mark Carney, Governor of the Bank of England and Chairman of the Financial Stability Board, at the Bank of England, London, 30 June 2016.

<sup>10</sup> Speech by Philip R. Lane, Member of the Executive Board of the ECB, Public Lecture for the Centre for Finance and the Department of Economics at University College London

Fiscal dominance in South Africa is well documented as previously discussed and has been at times a challenge for the conduct of IT by the SARB. This is perhaps best personified in the events of ‘Nenegate’ when the central bank actions led to a significant reduction in the country’s risk premium but at the expense of a stagnation period that followed. This was despite the macro policies embarking on an expansionary stance. An important feature of this stagnation is that it emphasises the role of the central bank as the guarantor of long-term macroeconomic stability of last resort and the constant battle to keep this status amid rising public debts and fiscal sustainability concerns. This is discussed in further detail in Loate et al. (2021) who identify the fiscal balance as a more immediate risk to South Africa’s macroeconomic stability and the conduct of monetary policy. The other main challenges are the external environment and the low potential growth of the economy. Furthermore, Loate and Viegi (2024) explore this ‘power game’ in their investigation of the interaction between monetary and fiscal policy during the period 2012 and 2019 to answer the question which of the two macro policy actions bear responsibility for the stagnation witnessed in South Africa following the 2008 financial crisis.

The aforementioned fiscal dominance challenge mirror the rigid dynamics of the relationship between the SARB and trade unions’ objectives when it comes to inflation expectations as discussed in Demertzis and Viegi (2009). The implications of the mismatch between the objectives of these agents are reflected in the anchoring of inflation expectations which have been consistently close to the upper bound when the central bank repeatedly communicated its desired target to be the midpoint of 4.5 percent. Clashes are therefore inevitable between a central bank committed to stabilising inflation and workers and trade unions that are less averse to inflationary pressures during wage negotiations. Demertzis and Viegi (2009) find that in such a policy game, for a successful anchoring of inflation expectations and to foster central bank credibility in an often uncertain environment, it is imperative for the central bank to be the leader in the policy space. Pursuing a well-anchored inflation expectations objective requires clear communication, transparency and consistent policy action amid rising uncertainties and pressures from political actors.

## **6 The road ahead: enter the new target era**

In October 2025, the finance minister announced the lowering of the inflation target from the 3-6 percent band to the 3 percent target with a 1 percentage point tolerance band. Before the announcement, arguments had been put forward for and against the change in the target. The SARB’s argument is that the current 3-6 percent inflation band is too wide and lowering it to the proposed 3 percent headline inflation will lead to increased export competitiveness with trading partners; improve investment through lower cost of private borrowing; lower the borrowing cost for government; and improve economic growth over the long-term (Loewald et al. (2025)). On the other hand, the challenges for lowering the inflation target are potential risk to the central bank’s credibility, the risk of deflation or ZLB, and the negative effect on economic growth and government debt. We unpack these arguments and counterarguments of a lower target next. We narrow the discussion to the overall impact on the economy; the ZLB; and conclude with the effect on government debt.

### **Lowering the target will be harmful to the economy**

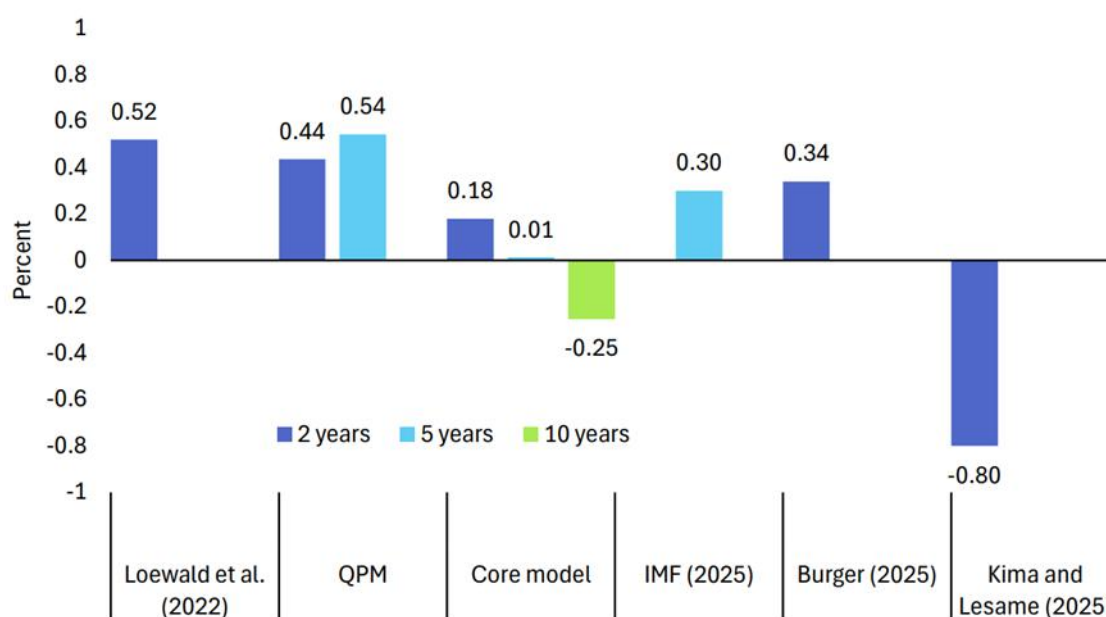
This argument is based on the premise that monetary policy has contributed to the low economic growth, high unemployment, and inequality. There is empirical evidence that suggests otherwise. We analyse these arguments from three perspectives: the output loss associated with reducing inflation, the monetary policy stance during IT, and the Phillips curve.

Having changed its inflation target numerous times, New Zealand provides a case study, as discussed in Lewis and McDermott (2016). According to the authors, the effect of lowering the inflation target depends on inflation expectations. The results by Lewis and McDermott (2016) show a textbook response of a change in inflation target. When inflation expectations are adaptive, changes in the target will have short-run effects on the economy whereas with rational expectations, there are no short-run effects resulting in a “painless disinflation”.

The IMF (2025) paper conducts a similar exercise to Lewis and McDermott (2016) for South Africa. The results show that the estimated five-year cumulative sacrifice ratio associated with lowering the target are high under the scenario of backward-looking expectations (at 1.2), low for fully forward-looking expectations (at 0.2) and moderate for hybrid inflation expectations (at 0.6). Loewald et al. (2022) use a small SVAR model and estimate the sacrifice ratio at different horizons for the 1991 to 2019 period. They find that only the estimate of 0.5 for the first year is significant. This estimate in the first year is close to the sacrifice ratio estimate of 0.4 by the IMF (2025) under the hybrid inflation expectations scenario. Similarly, the estimate by Loewald et al. (2022) at the five-year horizon, though insignificant, is 0.8, which is also close to the 0.6 by IMF (2025) for hybrid inflation expectations. Gereziher and Nuru (2024) also employ a small SVAR model for the 1991 to 2019 period and estimate a sacrifice ratio of 0.2 in the first quarter which subsequently approaches zero as the quarters increase. However, given the insignificance of the cumulative response of output to the demand shock, the sacrifice ratio estimates are also insignificant.

Using a SVAR model for the 2000-2014 period, Kima and Lesame (2025) show that a one percentage point reduction in inflation target leads to a statistically insignificant decline in output in the near-term (and thus an insignificant sacrifice ratio) and a significant increase in the short-term. Pirozhkova and Viegi (2023) use a reduced-form VAR model to investigate the interrelationship between variables when the inflation target is changed from the 3-6 percent target band to the 4.5 percent midpoint in 2017. Similar to Kima and Lesame (2025), their results suggest a painless disinflation process. They find that the shift to the mid-point did not change the dynamics for real GDP. The actual path for real GDP remains the same as the conditional forecast if the SARB continued with the target range. Figure 10 from Loewald et al. (2025) summarises the sacrifice ratios. The main finding from the empirical literature is that the output loss depends on the economic agents’ inflation expectations, the central bank’s credibility and other determinants of the sacrifice ratio discussed in Loewald et al. (2022).

Figure 10: Cost of disinflation: sacrifice ratios



Source: Burger (2025), Kima and Lesame (2025), IMF (2025) and SARB

Source: Loewald et al. (2025)

The next question is what are the channels through which the disinflation shock operates? A common thread from the above-mentioned literature on SA is that a lower inflation target reduces inflation and inflation expectations, and increases asset prices, credit to the private sector and the components of GDP. Where there is a negative effect on the components of GDP in the first few years, these are short-lived. The persistence of the effect of the disinflation shock varies across the papers, reflecting different empirical models used.

Various papers explore different transmission channels of the shock. For example, Pirozhkova and Viegi (2023) attribute the reduction in inflation and inflation expectations to the expectations channel of monetary policy communication and credibility. And this lower expected inflation risk and uncertainty is associated with higher expected real rate of return on assets and lower borrowing costs, reflected in higher private sector credit and asset prices. Economic theory suggests that this increase in economic agents' financial wealth would trigger a consumption and private investment boom (Alesina and Ardagna (2010)), which is observed in the above-mentioned South Africa literature. Kima and Lesame (2025) attribute the increase in private sector credit to the credit and sovereign risk premium channels.

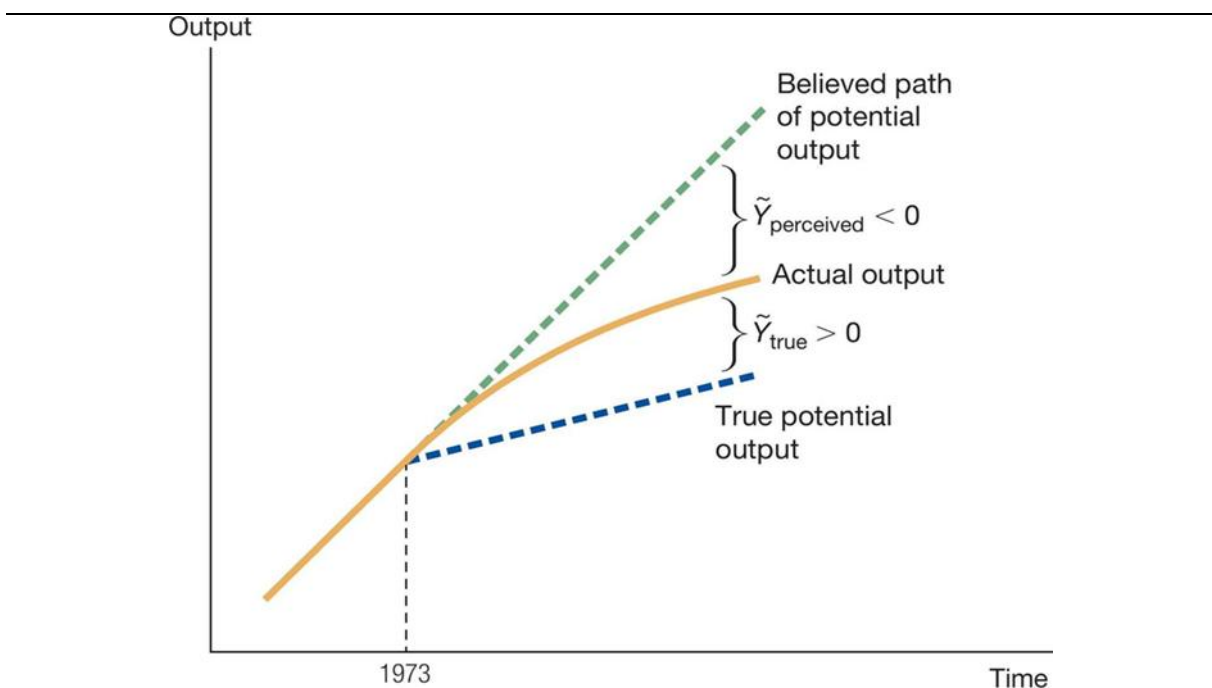
The results from the SARB's core model in Loewald et al. (2025) show that imports and exports increase, with exports increasing after two years. In addition, the increase in imports is more than the increase in exports, implying a decrease in the trade balance. Kima and Lesame (2025) show that the effect of the change in the trade balance is not significant. The authors attribute this insignificant effect to a credible monetary policy which reduces the exchange rate pass-through to inflation and thus weakening the exchange rate channel.

Next, we look at the monetary policy stance during IT. The Taylor rule is used to estimate the monetary policy stance. Several papers have found that the overestimation of real-time estimates of the output gap by the SARB has made monetary policy accommodative, at least up until 2017. The source of this

overestimation is the miscalculation of potential output ex-ante. Honohan and Orphanides (2022) use the inflation, output and real interest rate gaps to show the monetary policy stance of the SARB. The authors compare two estimates of the Taylor rule using real-time estimates of the output gap, as used by the SARB during policy-making time and 2021 estimates of the output gap, for the 2010 to 2020 period. Two insights from the exercise. Firstly, the ex-ante real interest rate is always lower than the ex-post one for the whole period. Secondly, the ex-ante real interest rate gap becomes negative around 2011 and remains so until 2017. This policy stance indicates that the ex-ante real interest rate was lower than the r-star. Earlier research by Kuhn et al. (2019) also show that up until 2017, real interest rate was below the r-star for most of the period between 2000 and 2017. A similar exercise is also conducted by Hausmann et al. (2022) and shows that the real-time estimate of the SARB’s output gap was lower than the post estimate (see Figure 32 from the paper). The consequence of this is that ex-post monetary policy becomes procyclical (Loate et al. (2021)).

This is illustrated in Figure 11, a classic textbook example of mistaking a productivity slowdown, which leads to a reduction in potential output, for a recession. This mistake is like the experience of the Federal Reserve Bank in the 1970s discussed in Orphanides (2002). However, unlike in the US, where this policy mistake contributed to the “Great Inflation”, there was no overheating of the economy in South Africa, due to local factors.

**Figure 11: Mistaking a productivity shock**



Source: Jones (6e)

The argument that monetary policy alone will have negative consequences to growth overestimates the power of IT while underestimating the role of fiscal policy. The overestimation of the output gap was also a fiscal policy mistake, leading to higher spending. Two main problems with the countercyclical fiscal policy response to the 2008 global financial crisis, as pointed out in Hausmann et al. (2022): it was permanent and not transitory; and it was inefficient, driven by an increase in non-productive spending such as wages. According to Alesina and Ardagna (2010), the permanency and composition of government spending have two implications. Firstly, the permanency of government

spending can induce a negative wealth effect in the presence of “hand-to-mouth” households. If households expect permanent fiscal adjustment in the future, and thus lower future disposable income, this can induce a reduction in consumption. The higher the share of the “hand-to-mouth” households, the larger the negative effect on aggregate demand. Secondly, their paper finds that fiscal stimulus based on wage and subsidies increases, which was the case in South Africa, has a contractionary effect on economic growth compared to tax cuts, which are found to be expansionary. Using a macro-econometric model for South Africa, and accounting for structural supply constraints, Akanbi (2013) finds that tax-based fiscal policy is more effective than government-based fiscal policy when there are structural constraints in the economy. Kemp (2020) use multiple identification strategies and finds that the effect of tax changes, measured by multipliers, is larger than that of government spending multipliers, though smaller than unity. The paper also finds that government investment multipliers are higher than government spending.<sup>11</sup>

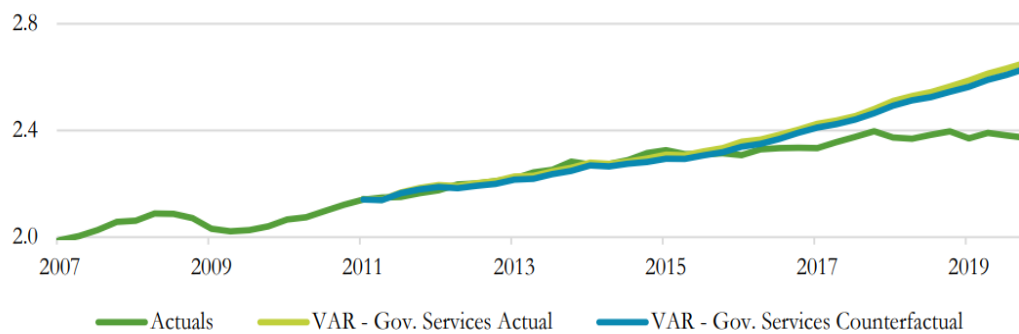
Lastly, we look at the argument using the Phillips curve. Monetary policy can control inflation if it is able to have an effect on the output gap, a relationship captured by the Phillips curve. As already discussed in section 2, there is empirical evidence of the weakness in this relationship. The following graphs (see Figures 12 and 13) show counterfactual exercises from Hausmann et al. (2022) and Loate and Viegi (2025). Both papers use a reduced form VAR model for the periods 1990-2019 and 2000-2019, respectively. The actual GDP is indicated as the solid line in Loate and Viegi (2025). In the first paper, the authors want to see if additional government spending would have correlated with higher growth, whereas in the second paper, the authors look at both monetary and fiscal policy. While the results from both papers do not infer causality, they both show that based on the interrelationships between the variables in the economy, growth outcomes based on actual fiscal and monetary policy should have been better than what we have observed. Whilst these findings do not exonerate both policies from the economic outcomes, they indicate that there are other factors that contributed significantly to the economic growth decline. According to Hausmann et al. (2022), monetary policy cannot be blamed for the current stagnation because the decline in credit growth did not coincide with the SARB’s tightening cycle. The authors also show that electricity shortage accounts for 40 percent of the decline in economic growth. In fact, insufficient energy supply is a double-edged problem, creating a stagflation effect on the economy. In addition to lowering production capacity, it contributes to higher prices in at least two ways. Firstly, by increasing the cost of doing business as businesses have to invest in alternative energy sources. Secondly, above-inflation energy price increases have contributed to higher administrative prices. Burger (2025) shows that energy shortage has a statistically significant inflationary effect.

The key take-way from this literature is that in the presence of binding structural constraints, the argument that lowering the target will constrain economic growth does not hold if monetary policy is not the main source of the lack of such growth and both fiscal and monetary policy become ineffective in stimulating demand.

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<sup>11</sup> Nuru (2020) does not find any significant effect of tax changes on output, using a SVAR model.

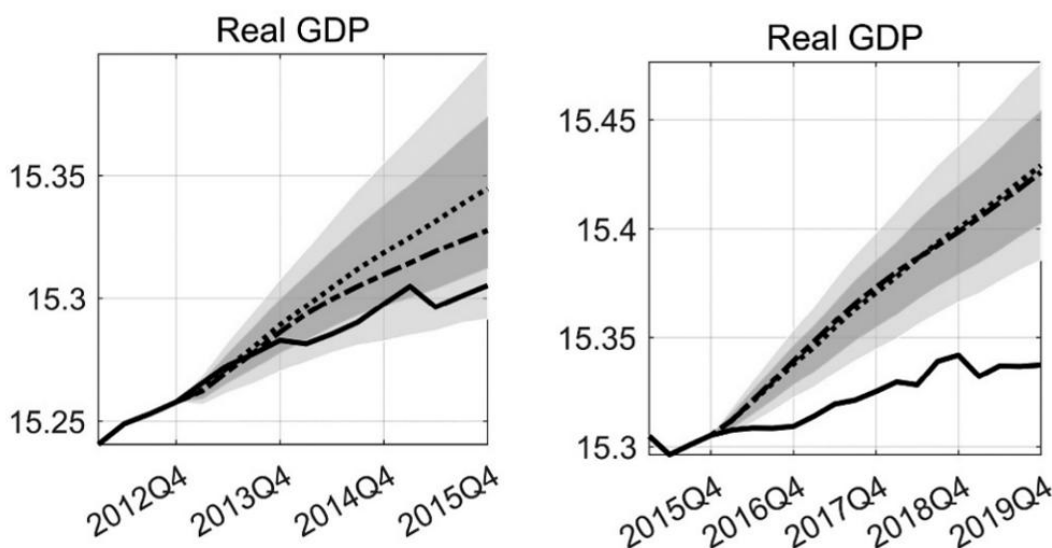
Figure 12



Note: a VAR model was estimated for quarter-on-quarter growth rates of the economy's ten sectors for the 1990-2019 period. An in-sample forecast for 2011–19 period was estimated using additive residuals (with 200 repetitions). The first scenario 'Gov. Services Actual' assumed exogenous growth of the government services sector, using the latter's actual values in the VAR forecast. The second scenario 'Gov. Services Counterfactual' added an additional 0.2 p.p. to quarter-on-quarter actual growth rates in each quarter for the 2011–19 period, and estimated the VAR taking the gov. services path as exogenous.

Source: Hausmann et al. (2022).

Figure 13



Notes: The solid line shows the actual data, and the dotted line (...) is the median of the conditional forecast with 90% in light shade and 68% in dark shade coverage intervals. The dashed line (- -) shows the median of the unconditional forecast.  
Source: Loate and Viegi (2025).

## The ZLB

Another risk of a lower target is the possibility of hitting the ZLB. Lowering the inflation target will result in a downward shift of both inflation and nominal interest rate over time. A target close to zero reduces the policy space for lowering interest rates during adverse shocks such as the 2008 global financial crisis and the Covid-19 pandemic, putting the country into the realm of unconventional

monetary policy tools, such as QE, to stimulate growth. While normally this is considered more of a problem for developed countries than emerging countries, as the latter tend to have higher levels of inflation and therefore higher interest rates, it remains a possibility worth expanding on.

According to Lewis and McDermott (2016), inflation expectation formation affects the risk of being stuck at the ZLB for more than a year in New Zealand following a change in the target, with the risk being higher under adaptive inflation expectations than under rational expectations. They find that the probability for a non-negative target is zero under rational expectations and non-zero under adaptive expectations. Thus, according to the authors, the benefits of increasing the inflation target above 2 percent are very small. However, economic agents are far from being rational and the experience of developed countries during the 2008 global financial crisis and the Covid-19 pandemic have shown us that the possibility of being stuck at the ZLB is not zero, even for New Zealand.<sup>12</sup> Swanson (2021) puts forward a different argument against the Fed needing to worry about raising the inflation target to above 2 percent. The author argues that since forward guidance and large-scale asset purchases (LSAPs) are effective substitutes for conventional monetary policy, “the zero lower bound should be much less of a concern for policymakers than if these alternative monetary policy instruments were not available”. In the context of South Africa, Honohan and Orphanides (2022) argue that since the country has neutral real interest rate of about 2 percent (compared with about zero for several advanced economies), there is policy space to avoid hitting the ZLB with an inflation target of 3 percent per year. Loewald et al. (2025) also argue that the 3 percent target is high enough to avoid the ZLB.

### **The government debt debate**

The critics of the lower target argue that it will increase *real* government debt. In addition, Willcox (2025) argues that lowering the inflation target whilst government is also implementing a spending-based fiscal consolidation would lead to deeper economic woes. The increase in real debt will require more government spending cuts, further depressing aggregate demand. On the other hand, proponents argue that over time, a lower inflation target will lower the cost of borrowing for government. We explore these arguments by looking at the components of borrowing costs and how inflation erodes the tax base.<sup>13</sup>

The cost of borrowing from the government consists of two parts (Soobyah and Steenkamp (2020)). Namely, expectations of future short-term rates and the term premium. The first part is driven by expectations of economic conditions with a steeper term structure indicating expected high economic growth. The second part is driven by credit risk and inflation risk premium. Empirical literature points to the substantial contribution of government debt to either the term structure or the yield spreads. Fedderke (2021) finds that the increase in government debt from 25% to 60% increased the yield spread by 280 basis points, a contribution of 77% to the overall 363 basis points increase in the spread.

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<sup>12</sup> In response to the Covid-19 pandemic, the Reserve Bank of NZ reduced its policy rate to 0.25% and used unconventional monetary policy tools to stimulate economic growth, Kengmana (2021).

<sup>13</sup> In addition, the focus on reducing long-term rates to spur investment overshadows the benefits of lower short-term rates for both short and long-term borrowing by the private sector. Lower monetary policy rate during Covid-19 lowered debt-service costs for households and increased the demand for residential mortgage loans, as interest rate on private-sector loans are mainly indexed to short-term rates, Fowkes (2022).

Soobyah and Steenkamp (2020) estimate the term premium and future short-term rates embedded in the long-term rates. Using these estimates, they find that a positive shock to the term structure has a contractionary effect on economic activity whereas for the short-term rate expectations, the effects are positive on impact and contractionary in the medium term. Results by Christensen and Steenkamp (2025) confirm the contribution of the term premium, specifically the government credit risk premium, to higher government borrowing costs.

High inflation not only increase the term premium but also erodes the tax base for government and leads to higher debt. From the demand side, high inflation lowers aggregate demand resulting in lower economic growth and thus lower tax revenue. The tax base can also be eroded through high cost of borrowing. High inflation will lead to high term premium, and thus high cost of borrowing. Loate and Vieggi (2025) show that the relationship between government debt and economic growth and risk premium is non-linear. The authors show that there is a negative relationship between government debt and economic growth and a positive relationship between government debt and the risk premium, when debt-to-GDP is over 40%.

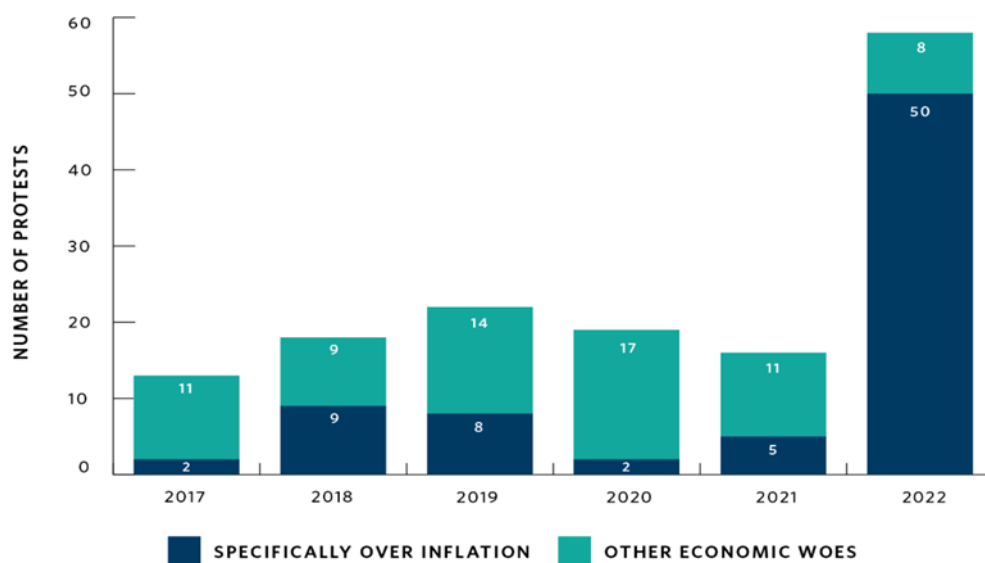
The empirical evidence on lowering the inflation target in South Africa is that it will increase government debt-to-GDP ratio in the first two years but reduce government borrowing cost on impact (Kima and Lesame, 2025 and Loewald et al., 2025). In contrast, the IMF (2025) paper finds that government borrowing costs increase in the first year before declining, regardless of inflation expectations assumptions. However, Kima and Lesame (2025) find that the reduction in borrowing cost is short-lived, casting doubt on the long-term benefit of lower borrowing costs. This is in contrast with IMF (2025) and Loewald et al. (2025) who find medium to long-term effects, respectively. The reduction in inflation risk lowers the country risk premium (Pirozhkova and Vieggi, 2023, Kima and Lesame, 2025 and Loewald et al., 2025). In fact, the simulation by the IMF (2025) shows that if the inflation target change lowers the country risk premium, the sacrifice ratios for the fully-forward and hybrid inflation expectation scenarios change from 0.2 and 0.6 to 0.1 and 0.3, respectively.

Research on the effect of fiscal-monetary policy coordination in South Africa on inflation expectations is scarce. David et al. (2025) argue that fiscal policy is important in anchoring inflation expectations and should be part of a “credible disinflationary process”. They show that fiscal consolidation reduces medium to long-term inflation expectations in emerging countries, which includes South Africa, while the effect on short-term inflation expectations is muted. The research by IMF (2025) shows that fiscal consolidation and inflation target reduction reinforce each other in the opposite direction argued by Willcox (2025). Fiscal consolidation helps reduce the risk premium further, leading to a larger reduction in it than if the inflation target change is implemented alone. This amplifies the effects of the target change, resulting in lower sacrifice ratios across all three inflation formation agents. Therefore, while fiscal consolidation increases the output loss, as argued by Willcox (2025), the scarce available empirical evidence indicates that this effect is short-lived.

On the other hand, Borio and Disyatat (2014) argue that lower interest rate can encourage more borrowing in the long term and lead governments into a “debt trap”. Using the G7 countries as an example, the authors show that the downward trend of real monetary policy and long-term interest rates coincide with the increase in their *nominal* government debt. However, government borrowing costs are too high in South Africa to even consider this as an issue.

In summary, there is consensus in the above-mentioned emerging literature of lowering the target that there is an output loss in the near to medium terms and benefits in the long-term. However, the benefits of lowering the inflation target will be limited by structural factors, high administered prices, and unsustainable government borrowing amidst a sluggish economy. These places upward pressure on the cost of doing business and direct costs to consumers. Without addressing these limitations, the central bank will then have to keep interest rate artificially higher to achieve the new lower target, making the transition much more painful than it should be. Thus, if the new target is to be achieved, a coordinated effort is required from the fiscal and monetary policy makers and the government. High inflation is not only economically unsustainable, but it is also socially not sustainable. Protests in various parts of the world during 2022 due to high cost of living (See Figure 14) provide a stark reminder that people are not oblivious to inflation.

**Figure 14: Protests due to inflation and economic woes**



Source: Carothers and Feldman (2022).

## 7 Conclusion

The literature on South Africa’s experience with inflation targeting paints a nuanced picture. On one hand, IT has delivered on its core objective of stabilising inflation, reducing its volatility, and anchoring expectations, thereby enhancing SARB’s credibility as a modern, independent central bank. Empirical studies consistently show that the framework has mitigated inflation persistence, reduced exchange rate pass-through to consumer prices, and provided a coherent rule-based guide to monetary policy, even in the face of profound domestic and global shocks. On these grounds, IT can be regarded as a qualified success in the South African context.

On the other hand, the framework’s limitations become apparent when viewed against the backdrop of the country’s structural challenges. High unemployment, fiscal imbalances, and entrenched inequality have constrained the capacity of monetary policy to support broader developmental goals. Critics argue that IT prioritises price stability at the expense of growth and employment, yet much of the evidence suggests these outcomes are driven less by monetary policy design than by the persistence of structural bottlenecks and weak fiscal discipline. The literature also underscores the

recurrent tension between monetary and fiscal authorities, as well as the need for coherent policy coordination to maximise the effectiveness of IT.

The current debate over lowering the inflation target highlights the extent to which IT in South Africa is still evolving. Proponents argue that a lower target could reinforce credibility and reduce borrowing costs, while critics caution against the risks of output losses and credibility erosion. The evidence suggests that the success of such a recalibration will depend on the anchoring of expectations, the degree of fiscal support, and the ability to address structural constraints. Ultimately, the South African case illustrates both the resilience and fragility of IT in an emerging market setting: it is a framework that has provided stability and credibility, but its long-term effectiveness hinges on complementary reforms and the resolution of deep-seated structural weaknesses.

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