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Debating South Africa's approach to a lower inflation target

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SOUTHERN CENTRE FOR INEQUALITY STUDIES

Introduction

This policy brief argues against lowering of the inflation target. A lower inflation target will worsen South Africa's fiscal dynamics, leading to deeper and longer fiscal austerity, which will result in lower economic growth and employment. The arguments of the South African Reserve Bank (SARB) for a lower target are cogent but ignore the impact on government debt, and hence the negative impact on the macroeconomy at large.

SARB's argument for lower inflation

In October 2024, the Governor of SARB gave a speech at the University of Stellenbosch, to lay out the case for a lower inflation target. The Governor's argument was as follows:

First, the Governor emphasised that South Africa's relatively high inflation rate is a policy choice, not an inevitable structural feature of the economy. The Governor demonstrated this by comparing South Africa to Chile. Both countries adopted inflation targeting in 2000, but Chile's lower target of 3% (versus South Africa's 3%–6% range) resulted in significantly lower price increases over time.

Second, the Governor argued that people strongly dislike inflation, drawing from recent global experience where public unhappiness with inflation was even deeper than economists expected. The Governor suggested South Africans would prefer price stability and would look back at periods of inflation over 5% as a time of "great inconvenience and difficulty".

Third, the Governor challenged the common argument that high administered prices prevent South Africa from achieving lower inflation. While acknowledging that administered price inflation is problematic, the Governor pointed out that 1) administered prices only make up 16% of the consumer price index (CPI) basket, and 2) when overall inflation was reduced to 4.5%, administered price inflation also declined while maintaining the same differential to headline inflation.

Fourth, the Governor argued against the assumption that achieving lower inflation requires sacrificing economic growth. The Governor cited economic studies showing that South Africa's move to targeting 4.5% inflation (from around 6%) had little to no economic cost in terms of gross domestic product (GDP) growth or unemployment. This success was attributed to clear communication and central bank credibility rather than forcing down inflation through recession.

Finally, the Governor argued that South Africa is out of step with its peers in having a relatively high inflation target. Lower inflation would mean permanently lower interest rates and, based on the successful transition to a 4.5% target, the Governor believed further reductions could be achieved at minimal economic cost through effective execution and clear communication. SARB has also argued that having a higher inflation rate than our trading partners will result in South African exporters becoming uncompetitive.

We are sceptical of some of the arguments about lowering the inflation target, especially regarding the costs. Our argument is that we should not lower the inflation target based on three considerations: first, that it is possible to set the inflation target too low as deflation is much more damaging than moderate inflation; second, that lowering the inflation target will result in higher levels of government debt, which will lead to lower economic growth and employment in the long term; and third, the combination of a lower inflation target and fiscal austerity will result in job losses and lower growth through the negative impact on demand.

Short-term demand

In order to get to a lower inflation target, SARB would need to have higher interest rates than if the target were to remain as is. In effect, interest rates would be higher while Treasury was implementing an extended fiscal consolidation. A recent SARB Working Paper (Loewald, Steinbach and Rakgalakane, 2025) has shown that the sacrifice ratio – the amount of GDP growth that needs to be given up to get a reduction in inflation – is low. But not zero. Even the lowest estimates show that the short-run impact of higher interest rates will be lower economic growth and less employment. South Africa will have fewer people working, contributing less tax revenue.

The dangers of setting the target too low

If the inflation target is too low, even small economic shocks could push the economy into deflation. Deflation is generally more damaging than moderate inflation because it encourages consumers to delay purchases as they expect prices to be lower in the future. It also increases the real value of debt, making it harder for borrowers to repay loans. This could trigger a dangerous deflationary spiral where falling prices lead to reduced spending and production, and lowered GDP.

Second, a low inflation target reduces the central bank's ability to respond to economic downturns. When inflation is low, nominal interest rates will also be low. This gives central banks less room to cut rates

during recessions. Once policy interest rates hit zero, central banks must rely on less effective unconventional tools.

The zero lower bound was a constraint for advanced economy central banks during the global financial crisis. During the Covid-19 crisis, many economies were constrained by policy interest rates falling to zero, notably including Chile,[1] a country SARB has mentioned as an exemplar for South Africa. Because inflation targets were set too low, central banks were unable to respond effectively to the economic crisis. These arguments apply to most economies, but are more salient in developing economies where the variance of inflation is higher, so the risk of policy reaching the lower bound is also higher.

Third, low inflation could make labour markets less flexible. Workers generally resist nominal wage cuts and, with very low inflation, real wage adjustments often require such cuts. This makes it harder for labour markets to adjust to economic shocks and could lead to higher unemployment during downturns.

Finally, lower inflation means higher real interest rates for a given nominal rate and slower erosion of existing debt in real terms. This creates greater difficulty in reducing public and private debt burdens over time.

The impact on fiscal dynamics

A lower inflation target will result in a higher real debt load. This would necessitate further austerity, resulting in weaker economic growth. The level of debt is determined by:

$$D_t \approx \frac{(1 + r_t)}{(1 + g_t)} D_{t-1} + PB_t$$

where *D* is the debt-to-GDP ratio, *r* represents the effective interest rate on government debt, *g* is the nominal GDP growth rate, and *PB* denotes the primary balance as a percentage of GDP.

The level of government debt at any point is determined by the existing stock of debt and the annual fiscal balance. When a government runs a primary deficit, it increases the debt stock, while a primary surplus helps to lower it.

[1] https://www.bis.org/publ/bppdf/bispap122_d.pdf

Interest rates influence the cost of servicing debt. Higher interest rates lead to greater debt-servicing costs, making it more challenging to stabilise or reduce debt unless the government generates sufficient primary surpluses. The burden becomes particularly heavy if the interest rate exceeds the rate of nominal GDP growth. In such cases, the debt-to-GDP ratio is likely to increase unless countered by a fiscal adjustment.

Nominal GDP growth affects the debt-to-GDP ratio by altering the denominator. Strong nominal GDP growth can reduce the relative debt burden, as the economy's overall size increases. If the economy grows faster than the interest rate on debt, the debt ratio may decline even if a modest primary deficit exists. However, if GDP growth lags behind interest rates, the debt burden relative to GDP may increase, necessitating a larger primary surplus to stabilise debt (Havemann and Hollander, 2022).[2] At higher levels of debt, such as those now seen in South Africa, the ratio of debt service costs to the rate of nominal growth plays a larger role in determining debt dynamics than the primary balance.

Inflation has two roles in debt dynamics, acting on both interest rates and growth rates. Inflation reduces the real value of nominal debt, making repayment easier if a large portion of debt is fixed in nominal terms, especially if this inflation is unexpected. This erosion of real debt value can be advantageous, particularly in managing high debt levels. However, if inflation triggers higher interest rates, either through inflation expectations or central bank policy responses, the cost of future borrowing may rise, potentially offsetting the benefits of debt erosion.

Proponents of a lower inflation target would argue that by lowering inflation, a lower inflation target would result in lower debt service costs as investors would require less compensation to lend long term to government. Reduced debt service costs would improve debt dynamics. This claim is partly accurate as long-term interest rates are a function of expected inflation. But importantly, fiscal dynamics would also influence interest rates, with higher debt levels associated with increasing rates.

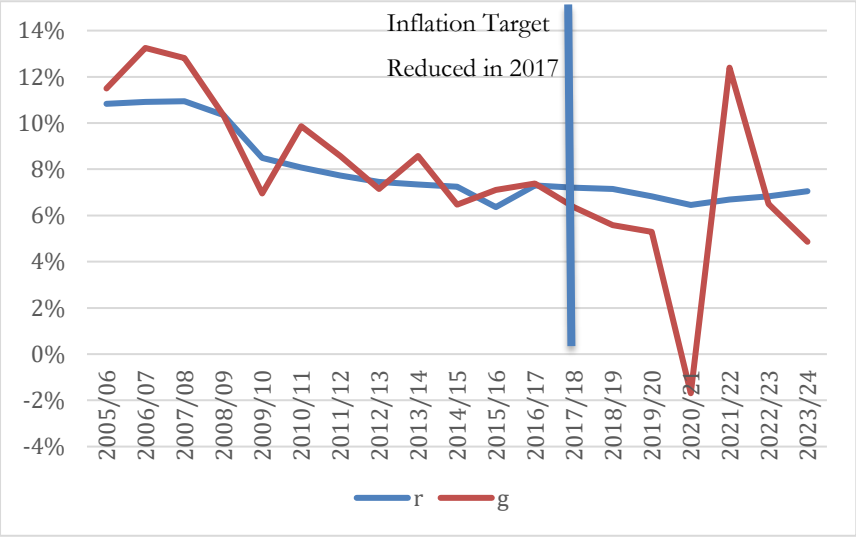
The initial result of a lower inflation target would be to reduce the growth rate of nominal GDP, even if it were assumed that there was no impact on real GDP through higher interest rates. The impact of a move from a 6% target to a 4.5% target in 2017 is that nominal GDP in South Africa was 10% lower than

[2] See Havemann and Hollander (2022) for more discussion of the dynamics or *r* and *g* and their impact on debt level. https://www.wider.unu.edu/publication/fiscal-policy-times-fiscal-stress

it would have been.[3] Because nominal GDP was 10% lower, the debt-to-GDP ratio was seven percentage points[4] higher.[5]

The key problem for fiscal dynamics is that the reduction in growth is almost immediate, but lower debt service costs will only come about with a long delay. Once government has sold a bond, the holder of the bond will receive a fixed coupon for the life of the instrument. Thus, even if interest rates fall, this will not impact the cost of current debt. Rather, reduced interest rates will only feed into reduced debt service costs, as bonds expire and are rolled over. Thus, the average maturity of debt is an important driver of fiscal dynamics. In South Africa, the average maturity of debt is 10.7 years. This means that it would take at least 10 years for reduced interest rates to feed into only half of the current debt stock. In effect, lowering the inflation target would result in a wedge driven between *r* and *g*, which would be severely detrimental to debt dynamics, and would lead to a higher debt load.

Figure 1: Evolution of debt service costs and nominal economic growth



Source: Statistics South Africa (2025) and National Treasury (2025)

The deterioration in debt dynamics will overwhelm any initial declines in debt service costs. What is likely to happen in practice is that, when investors see that inflation is likely to move lower, they will require less

[3] This is calculated by adding 1.5% to the growth rate of nominal GDP. We have assumed that there is no impact on real GDP through higher interest rates, but there probably would have been, so this is an underestimate. How long the impact would have lasted is up for debate, but higher interest rates almost certainly would have resulted in lower real economic growth.
[4] This is calculated from the lower nominal GDP value and assumes that the nominal amount of debt was the same. This is a simplifying assumption as the change in nominal GDP would affect both revenue and expenditure. We have assumed that the effect on both sides roughly cancels out.
[5] Seven percentage points is substantial. At the 2024 MTBPS, Treasury forecast that austerity would continue for another eight years and, in that time, debt to GDP would reduce from a peak of 75.5% in 2024/25 to 67.0% in 2032/33, a decline of 8.5 percentage points. Thus, the lowering of the inflation target in 2017 has resulted in a debt increase that would require nearly eight years of austerity to undo.

compensation for holding long-term debt. Interest rates are likely to decline. Over time, however, the impact of the higher debt ratio will counteract this initial movement, and interest rates will move upwards, perhaps even higher than they were initially. South Africa's experience with the initial lowering of inflation target in 2017 is congruent with this argument. As can be seen in Figure 1 above, both *r* and *g* declined, but *g* declined by more, worsening fiscal dynamics.

Thus, the result of lowering the inflation target will be to reduce *g* by 1.5 percentage points, while *r* will fall slowly, if at all, with the result that debt levels will be higher.

The negative impact of austerity

Imagine you have a large debt to a bank, a R1 million loan. You need to pay back the full amount in ten years and, in the meantime, you pay a fixed amount each month for interest. Under these conditions, should you hope that inflation increases or decreases?

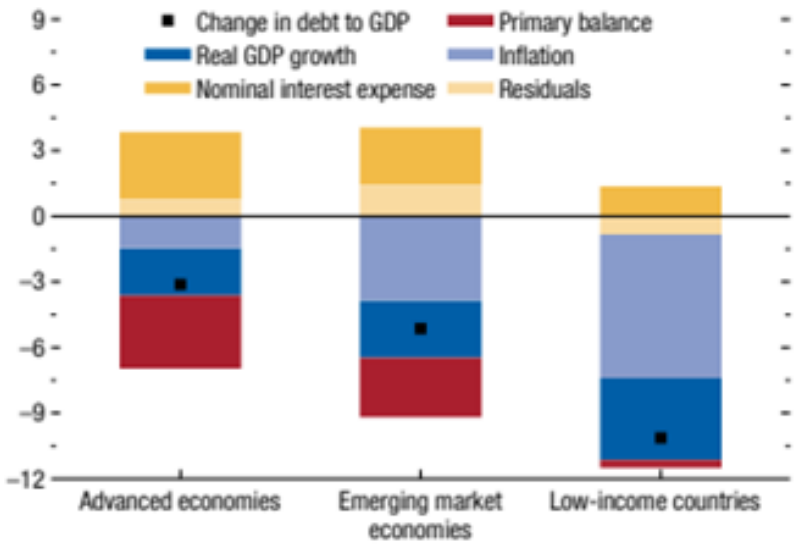
Higher inflation would mean that the purchasing power of each rand falls, so that at the end of the ten-year period, the real value of the R1 million debt is much lower. This is the exact situation that the South African government faces: it has large amounts of debt that need to be fully repaid once the term of the loan expires, and it has to make fixed payments in the interim. And the South African state has some control over the rate of inflation in the South African economy. Under these circumstances higher inflation leads to lower levels of debt, while lower inflation will increase the debt burden.

The often forgotten lesson from economic history is that inflation has helped many economies to reduce debt stocks, even in advanced economies. As Reinhart and Sbrancia (2015: 1) argue: "High public debt often produces the drama of default and restructuring. But debt is also reduced through financial repression, a tax on bondholders and savers via negative or below-market real interest rates. After World War II, capital controls and regulatory restrictions created a captive audience for government debt, limiting tax-base erosion. Financial repression is most successful in liquidating debt when *accompanied by inflation*. For the advanced economies, real interest rates were *negative* half of the time during 1945–80"(emphasis added).

This finding has been strengthened by recent work by the International Monetary Fund (IMF). The IMF World Economic Outlook (WEO) of April 2023 (IMF, 2023) contains a chapter on the relationship between fiscal austerity and debt consolidation. Austerity in this case is taken to be a decline in the primary balance and consolidation is a decline in the debt-to-GDP ratio. The finding is interesting because it notes

that austerity is only successful in half of all cases. Austerity was successful in reducing debt load in cases where global economic growth was high, domestic interest rates were low and inflation *relatively high*. As the accompanying Figure 2 shows, in successful consolidations in emerging markets, two-thirds of the reduction in debt was through economic growth and inflation, with the primary balance, austerity, playing a smaller role.

Figure 2: Contribution to change in debt-to-GDP during reduction episodes (%)



Source: IMF World Economic Outlook (2023)

The implications for South Africa's fiscal crisis are that fiscal consolidation will only be successful if inflation is slightly higher. This will result in higher nominal economic growth rates and, thus, debt will be deflated away over time. Lowering the inflation target will be a move in the opposite direction and will make South Africa's fiscal consolidation much more difficult and costly. With a lower inflation target, Treasury will have to run a wider fiscal surplus by reducing expenditure further, resulting in serious negative consequences for service delivery.

The competitiveness argument

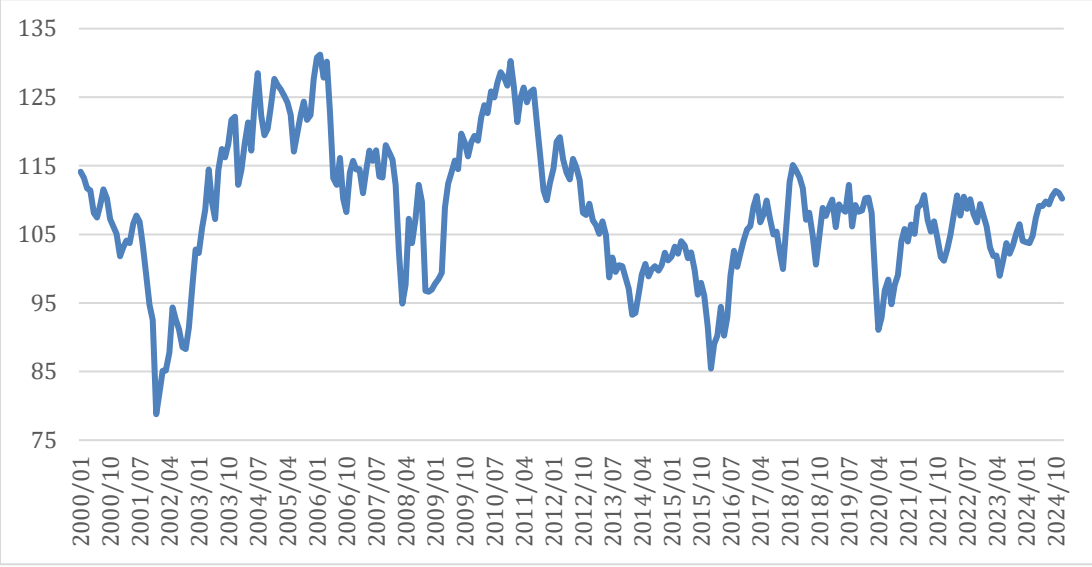
Loewald, Steinbach and Rakgalakane (2025: 2) argue that "South Africa's price level increases faster than that of its trading partners, reducing competitiveness". But this argument does not take account of purchasing power parity. Purchasing power parity is a theory that argues that differences in inflation between two economies will be reflected in movements in their exchange rate. If one country has higher inflation than the other, then their exchange rate will depreciate so that both currencies maintain similar purchasing power. For example, if inflation in South Africa is 4.5% and 2.0% in the United States, then

we would expect the rand to depreciate against the dollar by 2.5% on an annual basis. This is not an ironclad rule; other factors could lead to more or less depreciation from time to time. However, purchasing power parity is the dominant determinant of exchange rate movements over the long term. On a month-to-month basis, we might see more or less depreciation than predicted by purchasing power parity but, in the long term, we would expect differences in inflation to result in movements of exchange rates.

The SARB argument is that there is some factor that prevents the full difference in inflation rates from being passed into the exchange rate. In our example above, perhaps for some reason the rand only depreciates by 1.5% a year. This would cause significant difficulties for the South African economy. Over time, exporters' costs would rise faster than the revenue they received from selling their products in foreign markets. Producers in the South African market would face a similar problem when competing with imported products, as imported products would become progressively cheaper.

There are some concerns about this argument which should give us pause. First, if this argument is correct, then the real effective exchange rate of the rand would continually appreciate. As can be seen in the graph below (Figure 3), this is not the case. Instead, the real value of the rand has periods of appreciation and depreciation, but the long-term level is stable, not showing a depreciation or appreciation trend.

Figure 3: Real Effective Exchange Rate, 2000-2025



Source: South African Reserve Bank (2025)

Second, SARB is in effect arguing that the rand is insufficiently volatile. This is at odds with the many findings that the rand is, in fact, one of the most volatile currencies in the world. SARB has never explained what factor prevents inflation differentials from being passed into the exchange rate. In fact, it is hard to

think of anything that could cause such a fundamental misalignment of exchange rates that are traded in international markets.

And lastly, the contention that the exchange rate is continually appreciating against particular currencies can be examined empirically, asking whether relative purchasing power holds. This has been studied many times and the consensus is that relative purchasing power parity does in fact hold in South Africa and that, therefore, the full inflation differential will be passed into the exchange rate.

Mokoena et al. (2009) demonstrated PPP holds, especially when using advanced econometric techniques, such as non-linear methods. They argued that "As such, any deviation from PPP, either over- or under-appreciation of real exchange rates is temporary" (Mokoena et al., 2009: 12)

Lacerda, Fedderke and Haines (2010) found that correcting for regime shifts in inflation and monetary policy resulted in convincing econometric evidence for purchasing power parity.

Given that there is compelling evidence that purchasing power parity is valid in South Africa, there can be no impact on competitiveness because of inflation differentials.

The venue for the arguments

On a political level, the decision as to whether the inflation target should be lowered must be made by government as the representative of South Africa's citizens. SARB must implement the mandate. There was no decision by the Minister of Finance to change the implicit inflation target from less than 6% to rather target the midpoint of the range. That decision was SARB effectively setting its own mandate, which is beyond its powers. This cannot be allowed to happen again in a potential move to a 3% target. In 2010, the Minister of Finance clarified the mandate of SARB in a letter that confirmed that the inflation target was between 3% and 6%. There was no further letter to instruct SARB to target the midpoint of the range. The issue needs to be debated and this needs to take place in Parliament, with representatives of the people who make the decisions.

Conclusion – austerity and higher interest rates: A toxic brew

Our argument is that a lower inflation target will lower economic growth and will increase government debt levels. Because debt levels will be higher, government will have to increase austerity.

In the current South African context, fiscal austerity is a risk to both immediate economic recovery and long-term growth prospects. The immediate impact of austerity would be a reduction in aggregate demand at a time when the economy is already struggling with low growth rates. This contractionary effect becomes even more concerning when combined with proposals for a lower inflation target, which would effectively raise real interest rates by approximately 150 basis points.

The damage from austerity extends far beyond short-term economic contraction. Public sector cutbacks would severely undermine the foundational institutions and infrastructure necessary for sustainable economic growth.

The situation becomes particularly concerning when austerity is combined with a lower inflation target. This combination would create a self-reinforcing cycle: lower inflation increases the real value of existing debt, necessitating deeper expenditure cuts and potentially extending the duration of austerity measures. The result would be a longer period of reduced public services and investment, causing more sustained damage to economic fundamentals.

If debt levels are such a concern that a policy as severe as austerity is necessary, then government should pursue policies to reduce debt as quickly as possible. Government should prioritise minimising both the depth and duration of any necessary fiscal consolidation. Reducing the inflation target would lead to more austerity, and lower economic growth and employment.

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