



Moses Kotane Research Institute

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COMMENTARY

Proposed lowering of the inflation target by the South African Reserve Bank: The pros and cons.

Moses Kotane Research Institute
Research Services Unit
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1 Introduction

The Constitution of the Republic of South Africa gives its central bank, i.e., the South African Reserve Bank (SARB), a clear mandate to protect the value of the Rand. In turn, the Bank uses monetary policy instruments at its disposal, including interest rates, to try and keep inflation low and steady. The SARB uses the repo rate as a policy interest rate to control inflation in the economy. To achieve a steady inflation rate which supports sustainable economic growth, the Bank adheres to a monetary policy framework called inflation targeting. This is currently set as an inflation target range of between 3 and 6%. This policy is set by the National Treasury, with the SARB having independence to pursue this target in a manner they deem fit. There has been recent clamouring from sections of South African society for a reduction in this target range to a lower level, with various reasons being advanced in favour of such a move. In a recent monetary policy committee announcement by the SARB, this move seems to be gaining traction with the bank itself. This commentary looks at the pros and cons of such a move and the implications for the South African economy. However, understanding inflation targeting and how it has fared in the South African context is necessary for proper context. This commentary thus first gives an overview of this monetary policy framework, briefly dissects its performance in South Africa and then looks at the pros and cons of a lower inflation target. We end by giving our view on the way forward before a summary and conclusion.

2 Inflation Targeting: Overview

Inflation targeting is a strategy employed by central banks to keep inflation stable. To do this, the central bank sets a specific inflation rate goal. This goal can be a specific figure or a target range. South Africa's central bank, SARB, has a target range of 3-6%, while developed countries normally target specific rates, usually between 2% and 3%. Inflation targeting is premised on the idea that stable prices promote sustainable economic growth by taming inflation. The inflation targets are normally shared with the public whereby; by so doing, central banks seek to foster transparency, credibility and accountability in their actions. Through the prioritisation of inflation, central banks help manage expectations of economic agents, an action which can lower uncertainty, thus encouraging sustainable economic growth.

To reiterate, central banks have various monetary policy instruments at their disposal which they use to achieve the inflation targeting objectives. They may use interest rates (the policy rate or repo rate, as in South Africa) and can also conduct open market operations. Both these actions have the effect of managing the quantity of money supply and overall demand within the economy. One of the most important ways central banks use inflation targets is via the



adjustment of interest rates. When the actual inflation rate differs from the target, they change policy (repo) interest rates to alter spending patterns and borrowing costs, and this action ultimately impacts inflation. As an example, if inflation is deemed to be too high, the South African Reserve Bank may increase interest rates to slow down the economy, thus easing price increases. Alternatively, when inflation is too low, the central bank can lower interest rates to encourage economic growth, which can raise inflation.

3 South Africa's Inflation Targeting Regime

South Africa formally adopted an inflation targeting framework back in February 2000. The country's inflation target range is officially pegged at 3–6%, a policy that was initially set for the years 2002-3. Before this policy framework was adopted, the bank used several different frameworks, which included the exchange rate targeting regime as well as money supply targeting. The SARB claims that the inflation-targeting approach has been more successful. They cite the policy framework as having enabled better and more realistic alignment between the bank tools and its objectives. Furthermore, the bank contends that this framework has also improved transparency and accountability by giving the bank "...a clear and publicly visible objective."

A deeper dive into the experience of South Africa with inflation targeting is more revealing. The country's experience with inflation targeting before the 2008 financial crisis was not as successful. It was not successful both in terms of the proponents' self-stated goals as well as in terms of critical, final real sector goals such as higher economic growth and lower unemployment. Notably, like several other countries, the SARB's policy regime and its stance as pertaining to monetary policy changed greatly as a direct response to the financial crisis of 2008. Most central banks implemented an expansionary monetary policy then to stimulate the economy. In terms of the inflation performance, Comert and Epstein (2011) contend that "when the target band became binding, the inflation rate was within the target only in 39 out of 82 months." Noting that the most successful period in terms of inflation for SARB was between the years 2003 and 2006, the authors further argue that this was not without its costs. Heintz and Ndikumana (2010, 24) argue that "during the period in which the inflation target of the SARB was met (roughly from 2003 to the start of 2007), the index of the real effective exchange rate was recorded as higher in relation to the other quarters. This means that the real exchange rate appreciated with commensurate negative implications for export performance. Another profound observation is that during the years when the inflation rates were within the target band, commodity prices were experiencing the lowest inflation levels in many years. However, when the prices of these commodities began to increase and the rand exchange rate depreciated, the inflation rate notably exceeded the upper bound of the inflation target range,



remaining relatively high in the process. In this instance we observe that local inflation is affected by global trends in commodity prices with potentially negative consequences for other macroeconomic variables.

Many authors have contended that controlling inflation should not be the end in itself. Inflation should matter only as far as it affects the two variables economic agents care most about, which are output and its distribution. Although inflation has been largely controlled in South Africa, output growth has remained average. Unemployment, poverty and income inequality have remained stubbornly high, with the country having one of the worst records in terms of unemployment globally.

The above analysis seems to suggest that at best inflation targeting's success in South Africa has been ambiguous, with the odds heavily tilted towards a lack of success. With this context of uncertainty regarding the efficacy of the inflation targeting policy framework, the SARB has in the recent past further hinted that they now favour a shift towards an even lower inflation target regime. This brings to the fore the question of not only whether inflation targeting is desirable but also the pros and cons of having a lower inflation target. The below section looks at the latter question.

4 Pros and Cons of a Lower Inflation

A lower inflation target is advantageous when the low inflation being targeted materialises. Low inflation has several advantages. Some of the advantages of low inflation are well documented. Low inflation is critical for maintaining a stable economic environment desirable for both businesses and consumers. Citizens and companies plan their finances more effectively, thus encouraging savings and investment, since people do not fear that their money will rapidly lose value. Consumer confidence surges, and investment is encouraged. Additionally, countries that have low inflation can maintain international competitiveness. When domestic prices increase slower than in other countries, exports are kept attractive. This possibly leads to a positive balance of trade and strengthens the economy, other things being constant. Perhaps one of the most important aspects is the avoidance of deflation. The maintenance of low inflation is critical in avoiding deflation. Deflation can lead to more pronounced economic downturns and increases the real value of debt, which makes it more difficult for borrowers to repay their loans. This can lead to reduced consumer spending as citizens wait for prices to fall further. Overall low inflation helps maintain a healthy economy and creates a conducive environment for growth. In the South African context, we see that though inflation targeting on its own cannot claim the success of achieving the inflation target, it is noted that the consistent use of this



framework has helped in bringing about this result since it strengthened the SARB's mandate to focus on price stability.

On the other end, besides the pros of having a lower inflation, there are also downsides to lower inflation. As a caveat, having cited the various challenges afflicting South Africa in this commentary, it is quite clear that containing inflation must be balanced with other priorities of the country, such as sustaining growth. South Africa has seemingly not adopted this paradigm shift yet. A low inflation targeting regime is not a panacea to economic problems faced by the country. From a purely macroeconomic view, excessively low inflation presents several challenges. One such problem is that a low inflation persisting over a long period provides only a small shield against deflation. When inflation is low, it only requires a relatively small disturbance to tip the economy into deflation. The commensurate macroeconomic implications of deflation are well chronicled. A few examples can be cited. When economic agents expect falling prices, they delay their purchases as well as investments. A combination of falling output prices and nominal wages which are sticky downwards erodes the profitability of businesses while at the same time reducing the demand for labour. While weighing the above pros and cons may lead to one settling for the more popular views, our view is that context is always important. The section below advances some of the issues that need consideration in this lower inflation targeting debate.

5 Our view

In addition to the aforementioned disadvantages of low inflation, a moderate inflation rate may not be as detrimental as commonly perceived. Bruno and Easterly (1996) assert that there is increasing evidence indicating that moderate inflation rates do not have predicted adverse effects on the actual economy. They additionally demonstrate that moderate inflation is not associated with diminished growth, decreased investment, or other significant real variables. This is the type of discourse that local economists ought to engage in, given the background of exceedingly high unemployment and persistently sluggish economic growth in South Africa. The aforementioned authors observe in their empirical studies that a positive association exists between inflation and economic growth in the short term. This is supported by case studies from Latin America and specifically Brazil showing that countries were able to achieve high growth rates while having double-digit inflation rates (Beires, 2015). In fact, they observed that a positive relationship between inflation and economic growth stayed intact for inflation rates that were between 15- 30%, however turning negative when inflation exceeded these figures. The authorities in South Africa should therefore look for trade-offs and closely look at the current scenario to consider flexibility in their approach. This has happened before, where strict



rules under the inflation targeting regime took a back seat after the 2008 financial crisis while the South African Reserve Bank and Treasury focused on protecting employment as well as incomes through industry and domestic activity. Back then some authors stated, “... overall, the SARB has demonstrated considerable flexibility and pragmatism to counteract the spillover effects from the global crisis” (Heintz and Ndikumana 2010). Joseph Stiglitz, former head of the World Bank, also makes a case that for developing nations an inflation rate of 10% and over is often needed to stimulate economic growth and demand. We view this point as warranting attention in South Africa, coming from one of the more seasoned global economists. We advance the argument that there are more pressing idiosyncratic facets of the South African economy that do not warrant further high interest rates in order to achieve a lower inflation target. Besides disincentivising foreign direct investments through the high cost of capital we so desperately need, high interest rates overburden the consumer who is already struggling. Economic development needs should be balanced with social and economic justice.

6 Summary and Conclusion

The monetary authorities in South Africa seem to be fixated on achieving a lower inflation target range at 3%. Focusing on the mandate by the SARB is not a bad thing. However, in economic crisis times abnormal policy responses must be initiated. South Africa has one of the highest unemployment rates in the world as of today. This scenario requires that economic growth of at least 3 per cent be reached for a sustained period to create the much-needed employment. The country cannot base its decision solely on the analysis of trade partners. Its context is very important. A lower inflation target regime than the current target range seems inappropriate for a nation which faces a myriad of challenges, including unemployment, high inequality and structural bottlenecks that hinder growth prospects. The SARB needs to be flexible and seek to develop a wider policy to focus on a broader set of targets, which include economic growth and employment. Furthermore, there should be avoidance of signalling policy shifts by the bank in their monetary policy statements, which seem to be at odds with the national treasury. Credibility and in-sync communication between the two institutions are critical for investor confidence. The alternatives need to be given a chance and pursued with tact, noting that the convention has proven to be in most part ineffective in South Africa.



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