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New 3% inflation target meets its first test

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South Africa's new 3% inflation target is navigating its first external shock in the face of the hefty fuel price hike. The evidence suggests that containing inflation can boost growth, but this dividend is conditional. What determines whether it materialises has as much to do with fiscal policy as with monetary credibility.

In November 2025, South Africa adopted a 3% inflation target, replacing the 3–6% range that had been in place for more than two decades. Inflation settled at 3% in February 2026, before a Middle East oil shock drove fuel prices sharply higher and pushed headline inflation to 4% in April, the highest reading since August 2024. As the Monetary Policy Committee meets this week (28 May), with a rate hike widely anticipated, the question is how the new framework navigates its first external shock. Using a structural econometric model with South African quarterly data, we assess what this shift can realistically deliver, and what it cannot.

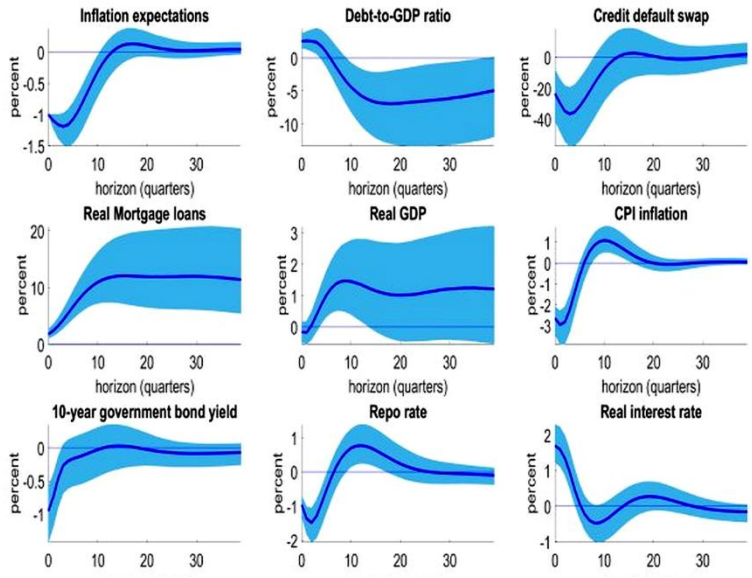
Not through the front

Most analyses of a central bank lowering its inflation target focus on the interest rate channel: inflation falls, rates follow, credit becomes cheaper, investment rises. That mechanism is present in South Africa too, but the more consequential channel reflects something specific about South Africa’s position as an emerging market carrying elevated sovereign risk.

When a central bank credibly commits to lower inflation, it reduces the perceived riskiness of government debt as inflation expectations adjust to a lower target. In South Africa, where that risk premium has historically been meaningful, credit default swap spreads (a financial market measure of how risky investors consider government debt) fall persistently over time following the target shock. On the model’s account, bank-funding costs decline, mortgage lending expands, and asset prices rise. The improvement in household balance sheets drives a sustained expansion in consumption that, on the model's projections, peaks at 2.35% above baseline after roughly seven quarters.

Overall output reaches approximately 1.2% above baseline after about two years. The short-term output cost of the adjustment, the feared output losses or recession during the transition, is not statistically significant.

Figure 1: How the sovereign debt risk premium channel responds to an inflation target shock

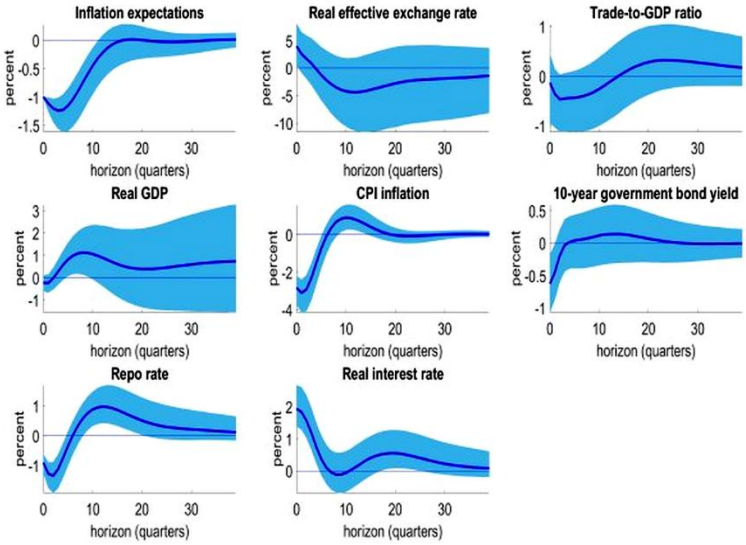


Note: Author´s own calculations. This figure displays the posterior median IRFs (solid blue lines) of the model variables to a 1% negative inflation target shock, along with the 68% credible sets (blue error bands)

This is not without historical grounding. When the Reserve Bank shifted to the 4.5% midpoint in 2017, output did not suffer, sovereign risk fell, and asset prices rose. The 3% target follows the same logic at greater ambition.

The exchange rate channel plays only a minor role in this story. Improved monetary policy credibility over the past decade has already reduced how sensitively domestic prices respond to rand movements, and the new target inherits that more resilient foundation.

Figure 2: How the exchange rate channel responds to an inflation target shock



Note: Author´s calculations. This figure displays the posterior median IRFs (solid blue lines) of the model variables to a 1% negative inflation target shock, along with the 68% credible sets (blue error bands)

The first test

South Africa is in the first year of the transition: real interest rates still elevated, investment restrained, consumption gains still building. Into this arrives an oil shock that has pushed fuel inflation above 18% and lifted the near-term projection above target, raising questions about whether the framework is already under strain.

The evidence suggests a different reading entirely. The analysis of how inflation-target changes transmit through the South African economy shows that during a transition, the policy rate and inflation tend to move together: both declining as expectations adjust downward, but also both rising when an external shock disrupts that process mid-way. The SARB Governor, Lesetja Kganyago, drew exactly this distinction in a public address at Rhodes University on 4 May, describing the well-tested playbook for supply shocks and noting that the framework entered the crisis from a broadly neutral position, with inflation precisely at the 3% target and policy moderately restrictive. The March MPC drew the same distinction: unavoidable first-round pass-through of higher energy costs can appropriately be looked through, provided second-round effects, where the initial shock triggers broader price increases and inflation expectations begin to drift, do not take hold. A firm policy stance in these circumstances is not a departure from the disinflationary path. It is, on the evidence, the mechanism through which the credibility that enables the growth dividend is preserved.

The scale of what is at stake is measurable. The inflation target shock accounts for close to 40% of short-term repo rate fluctuations and 61% of CPI inflation movements at the two-year horizon, suggesting that inflation-target dynamics are already shaping nominal conditions in a meaningful way. Allowing credibility to erode under the pressure of a supply-side shock

risks delaying the growth dividend and unwinding some of the expectations gains already achieved, raising the eventual cost of completing the transition.

What 3% cannot fix

There is a dimension of the case for the target change that the evidence does not support. The argument that lower inflation will structurally compress long-term borrowing costs is not borne out by the data. The target shock contributes only marginally to movements in the ten-year government bond yield. What drives long-term borrowing costs in South Africa is primarily the trajectory of public debt itself.

The broader pattern reinforces the point. The effects of a lower inflation target in South Africa are less persistent than in advanced economies: where equivalent effects in the United States and Japan last 40 quarters or more according to recent studies, in South Africa they resolve over roughly two to 11 quarters. The gains are real but not self-compounding. They will not substitute for fiscal consolidation. Lower inflation and fiscal discipline are complementary commitments, and the evidence does not support treating one as a proxy for the other.

Two things must move together

Two conclusions follow. First, the inflation targeting framework has been built through years of consistent policy, and its growth benefits flow entirely through channels that depend on the perceived durability of that commitment. Allowing credibility to erode under a supply-side shock would be costly to reverse. Second, a lower target cannot substitute for fiscal action: the path to structurally lower long-term borrowing costs runs through the public debt trajectory, not through price stability alone. The consumption benefits are real and already building. The modelled sovereign risk reduction appears already underway.

But these effects take some time to materialize, require the framework to keep performing, and will not insulate South Africa from the fiscal consequences of a rising debt burden. On 28 May, and in the months that follow, the question is not whether the commitment was right: the evidence suggests it was. The question is whether monetary and fiscal policy will move together to see it through.

This article draws on SA-TIED Working Paper 275, 'Macroeconomic effects of lowering South Africa's inflation target: An SVAR analysis', by Richard Kima and Keagile Lesame.