



Munich Personal RePEc Archive

Gaps in the South African Inflation Targeting Debate

Horn, Aidan J. and Martin, Lisa and Pretorius, Jan H. and
Steenkamp, Daan

Codera Analytics

18 March 2025

Online at <https://mpra.ub.uni-muenchen.de/124010/>
MPRA Paper No. 124010, posted 19 Mar 2025 10:18 UTC

Gaps in the South African Inflation Targeting Debate

Aidan J. Horn, Lisa Martin, Jan H. Pretorius, and Daan Steenkamp

Codera Analytics

March 2025

Abstract

This paper presents a primer on assessing South Africa's optimal inflation target and the implications of the economy's structural characteristics for the conduct of monetary policy. The paper assesses what would need to be done to lower the inflation target without imposing a disproportionate cost on the economy. The main finding is that there needs to be supportive fiscal policy aimed at reducing South Africa's debt burden and government policies that reduce inflation pressures. This will, in turn, require a social compact between government, the central bank, state owned enterprises, relevant regulators, and labour unions to galvanise support for structural reforms that reduce government-related inflation and align public sector wage demands to productivity growth. Such a compact is unlikely without clear articulation of the benefits of a lower target and what is required to counterbalance the short-term costs of reducing inflation.

Corresponding author is Daan Steenkamp (daan@codera.co.za). We thank Patrick Kelly and Andrew Rankhumise of Statistics South Africa for the provision of data, Riaan Grobler for comments, and Jacques Quass de Vos, Oliver Guest, Johan Hanekom, and Hendri van Zyl for contributions to earlier versions of some of the analysis presented in this paper.

Contents

1	Introduction	1
2	What should the inflation target be?	1
3	Which inflation measure should be targeted?	3
3.1	Which goods and services prices drive inflation dynamics?	3
3.2	Bias in CPI Measurement	9
3.3	Changes in relative prices over time	10
3.4	Seasonality in prices	10
3.5	CPI dispersion in SA and implications for monetary policy	11
3.6	Underlying drivers of trend inflation in SA	18
3.7	What has been behind deviations from the target?	21
4	How anchored are inflation expectations?	21
4.1	How anchored are inflation expectations around the world?	23
4.2	Implications of backward-looking inflation expectations	25
5	How should the transition to a lower target be managed?	27
6	What are the implications of a target review for central bank communication?	29
6.1	Monetary policy guidance during transition to a new target	31
7	Conclusion	34
	References	36

1 Introduction

The South African Reserve Bank (SARB) and National Treasury have expressed interest in lowering South Africa's inflation target.¹ Yet there is surprisingly little South African research available to inform discussions into how to improve the framework. What should that target be and when should it be lowered? Google "optimal inflation target SA" and there are hardly any recent academic papers on these important questions.

This paper presents a primer on assessing South Africa's optimal inflation target and the implications of the economy's structural characteristics for the conduct of monetary policy. To help advance the debate about South Africa's inflation target, this paper discusses five unresolved questions around South Africa's inflation targeting framework:

1. What should the inflation target be?
2. Which inflation measure should be targeted?
3. How anchored are inflation expectations?
4. How should the transition to a lower target be managed?
5. What are the implications of a target review for central bank communication?

2 What should the inflation target be?

The lack of academic research for South Africa makes it hard to assess what an 'optimal' inflation target might be. Theory suggests that since inflation distorts relative prices, maintaining a low inflation rate is likely to minimise resource misallocations caused by these distortions.

This is ultimately reflected in economic growth. Yet there is a perception among some commentators that higher economic growth could be achieved if higher inflation is tolerated. An IMF paper by Khan and Abdelhak (2001) is often cited in support of such a contention. Khan and Abdelhak (2001) suggest that the relationship between inflation and growth is positive at lower inflation rates, but growth slows in advanced economies above inflation of between 1 to 3%, and above 7 to 11% for developing economies. Figure 1 shows, however, that the relationship between inflation and economic growth in South Africa has been negative at all levels of inflation.² Over the long term, higher inflation tends to be associated with a higher growth drag from inflation distortions. This also implies that economic growth cannot be sustainably boosted by tolerating a higher rate of inflation.

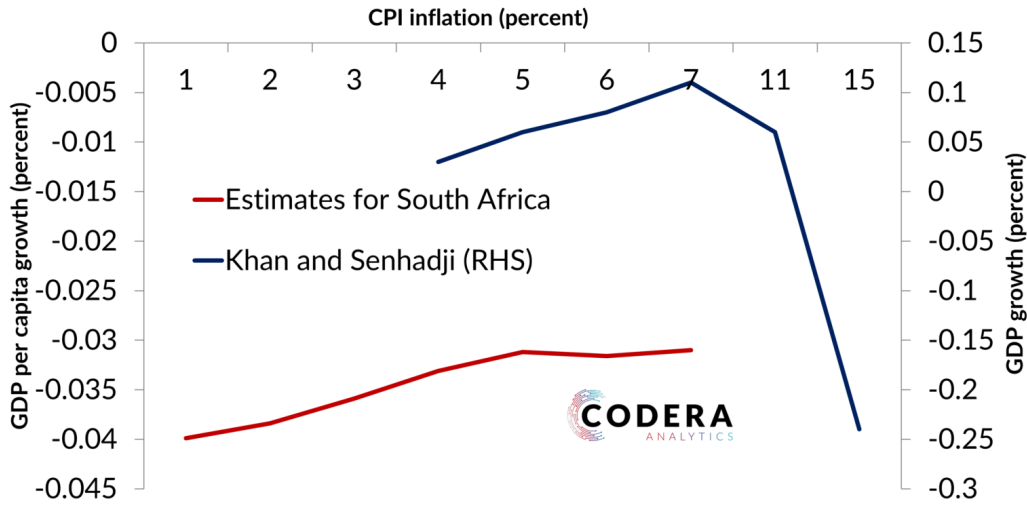
Theory and international evidence supports this argument. Anthony Diercks' 'Reader's Guide to Optimal Monetary Policy' (Diercks 2019) shows that most academic studies suggest that the inflation rate that minimises welfare losses from inflation is near zero. But the literature provides little guidance on the optimal level of the inflation target for an emerging market economy like South Africa.

South Africa's inflation target of 3 to 6%, with a preference for medium-term inflation near the midpoint of 4.5%, is quite high compared to advanced economies and leading emerging market countries. South Africa's high inflation is one reason why the exchange rate has tended to depreciate over time (see Figure 2). Had South Africa's inflation been lower, the relative price of South African goods compared with foreign goods would have fallen more, which would have boosted the economy's competitiveness.

¹See [Kganyago Lecture](#) and [Treasury Macroeconomic Policy Review](#).

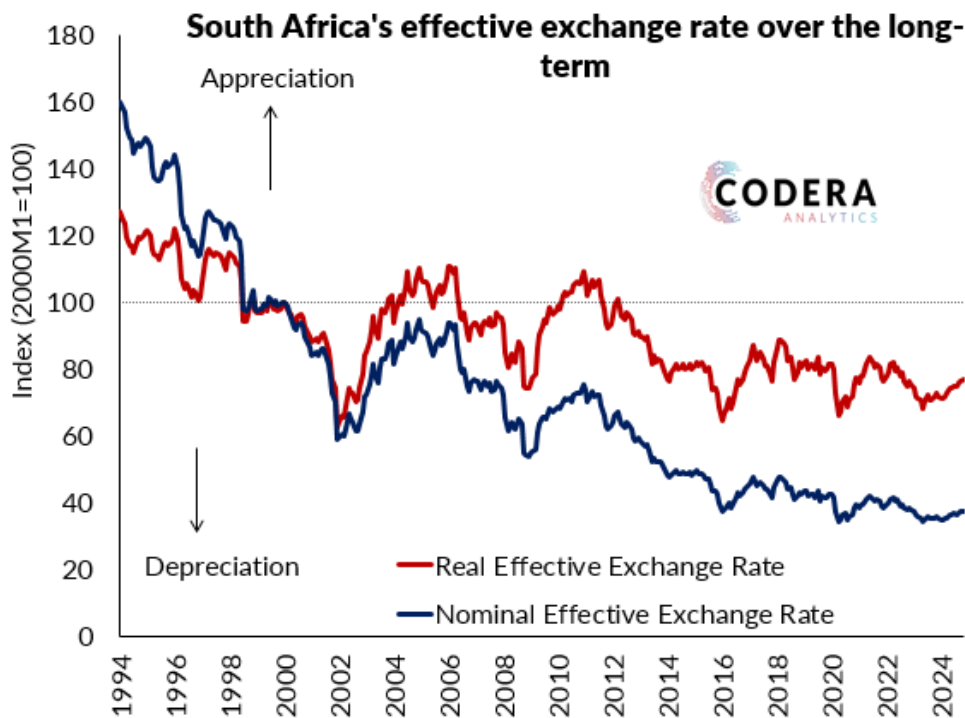
²See more detail on [Codera's blog](#).

Figure 1:
Impact of inflation on growth from Khan and Sedhadji panel model for developing countries vs estimation for South Africa



Note: South African estimates by replicating approach of Khan, M. S. and A. S. Senhadji (2001). 'Threshold effects in the relationship between inflation and growth'. IMF Staff Papers 48(1), using South African data for the period 1960Q1-2022Q2 (2020Q2 and 2020Q3 excluded).

Figure 2:



Source: BIS and Codera Analytics. Real (CPI-based), Broad Indices. These are the weighted value of a country's currency relative to an index or basket of other major currencies, deflated by inflation differences across countries.

This results in a deterioration in international competitiveness, contributing to making South Africa increasingly a high cost, low productivity economy (Rapapali and Steenkamp 2019). A lower inflation differential with South Africa's trading partners would reduce pressure on the currency, support the competitiveness of South Africa's exporters and the buying power of the currency. As we will argue, lowering the inflation target alone would not be sufficient to address this. Sustainably addressing the decline in South Africa's cost competitiveness challenges would require structural reforms to address the economic and political factors that have contributed to the long term increase in relative prices in South Africa.

If a lower inflation target might be desirable in general, how much lower should the inflation target for South Africa be and under what conditions should it be changed? This paper raises four other unresolved questions around South Africa's inflation targeting framework to inform debate around this question.

3 Which inflation measure should be targeted?

There are several considerations that matter for how the inflation target should be defined. These relate to selecting a price index that is relevant to the experience of firms and households; the types of shocks the economy is exposed to (such the susceptibility to imported inflation and the prevalence of supply-side shocks, including the exchange rate and weather); and how much flexibility should be afforded to the central bank in achieving the target (such as the target horizon and choice between a range and a point target). We start by assessing the dynamics of different consumer price components and their implications for the inflation target and monetary policy.

3.1 Which goods and services prices drive inflation dynamics?

Inflation represents the combined impact of price changes across various goods and services, weighted by their importance in household spending based on period expenditure surveys. Examining relative price changes and inflation by component provides meaningful insights into South Africa's inflation patterns and the factors driving these fluctuations over time.

We start by looking at cumulative inflation in different Consumer Price Index (CPI) components. CPI statistics are published at various levels of aggregation. Many analysts focus on a 2-digit level, where there are 12 expenditure categories, including, for example food and non-alcoholic beverages (NAB). 5-Digit CPI includes consumer price indices at category grouping such as 'fruit', 'beer' or 'fuel'. 8-Digit CPI includes CPI at category grouping such as a 'loaf of white bread'. The Figure 3 plots selected 2-Digit CPI series, showing that some categories of consumer prices have risen substantially since 2008. Food prices for example, are almost 200% higher than they were in January 2008. Education costs, which are largely domestically determined, have risen by even more.

Figure 4 plots CPI division inflation rates and weights at 2-digit level. Food and beverages and housing and utilities are the CPI divisions that have high weights in the index and have experienced average inflation well above the 4.5% target. The volatility in the food category reflects the influence of global food prices, domestic weather conditions, and the exchange rate, whilst the high average rate in housing reflects high administered price increases in electricity and water tariffs.

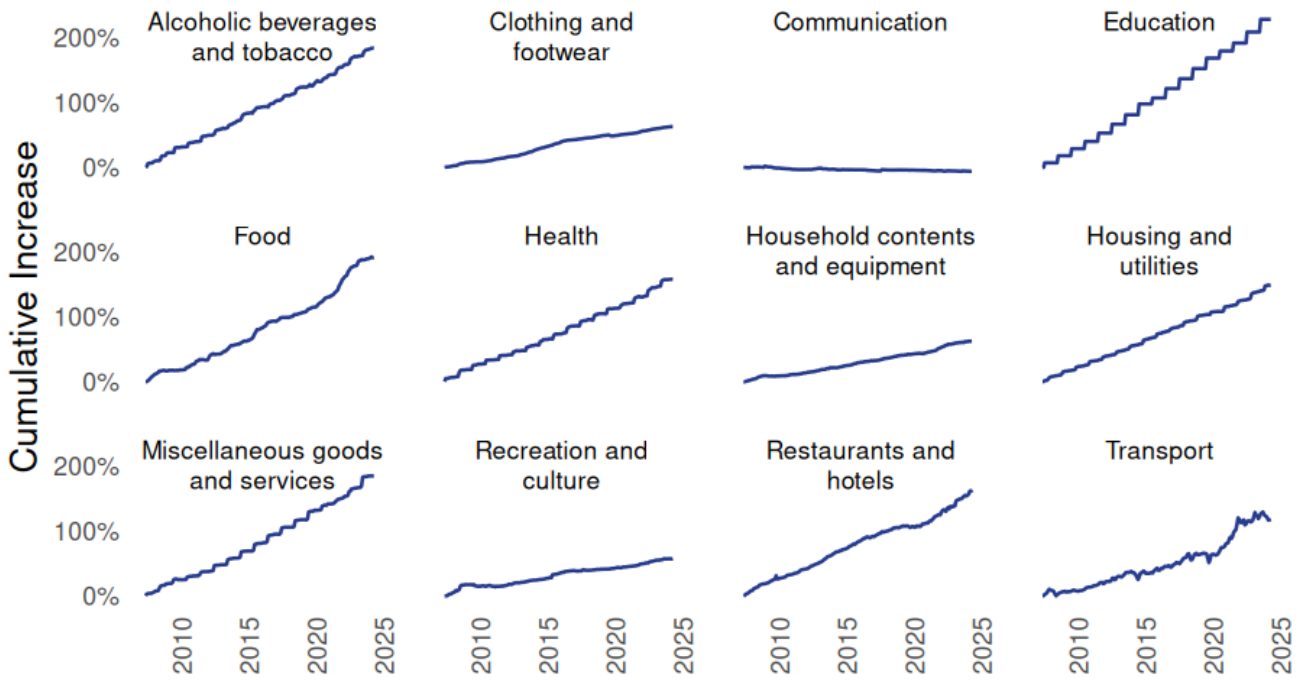
Administered prices, which include prices set by government agencies or regulators (such as electricity tariffs, water charges, fuel prices and public transport fares), have played a key role in deviations in South Africa's inflation from the inflation target. Electricity and water have been among the consumer price categories that have experienced the largest increases in prices, while used vehicles and telecommunication equipment have become more affordable over time on a quality-adjusted basis. Inflation in electricity and other fuels, water and other services and fuel categories have growth at well above the mid-point of the inflation target, averaging 11.9%, 7.9% and 7.3% respectively since 2009. Food price inflation averaged 6.5%, owner-occupied housing 3.8%, and tenant rent 4% since 2009. If one excludes volatile fuel prices, administered prices have been systematically above the mid-point of the inflation target (Figure 5). Core inflation, which excludes food and fuel categories, has consequently been more stable than headline inflation, though still higher than the mid-point of the inflation target (at 4.9% compared to 5.3% for

Figure 3:

CPI categories in South Africa: Cumulative Inflation



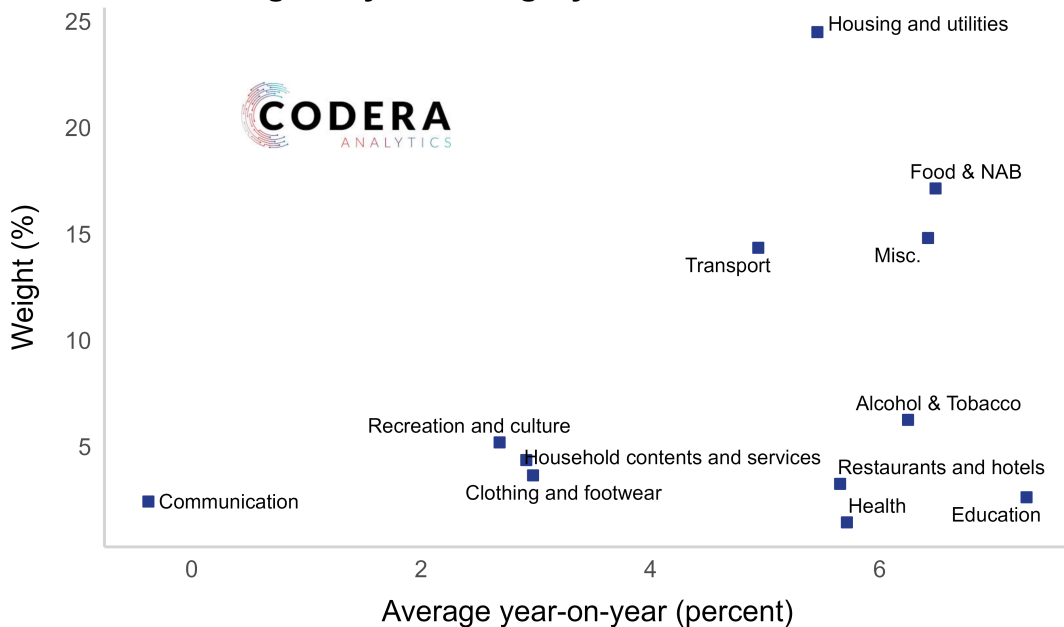
Food prices have risen 191% and education costs have risen 228% between Jan 2008 and Dec 2024



Source: StatsSA, EconData

Figure 4:

Inflation and weights by CPI category for South Africa since 2009



Source: Statistics SA, EconData.

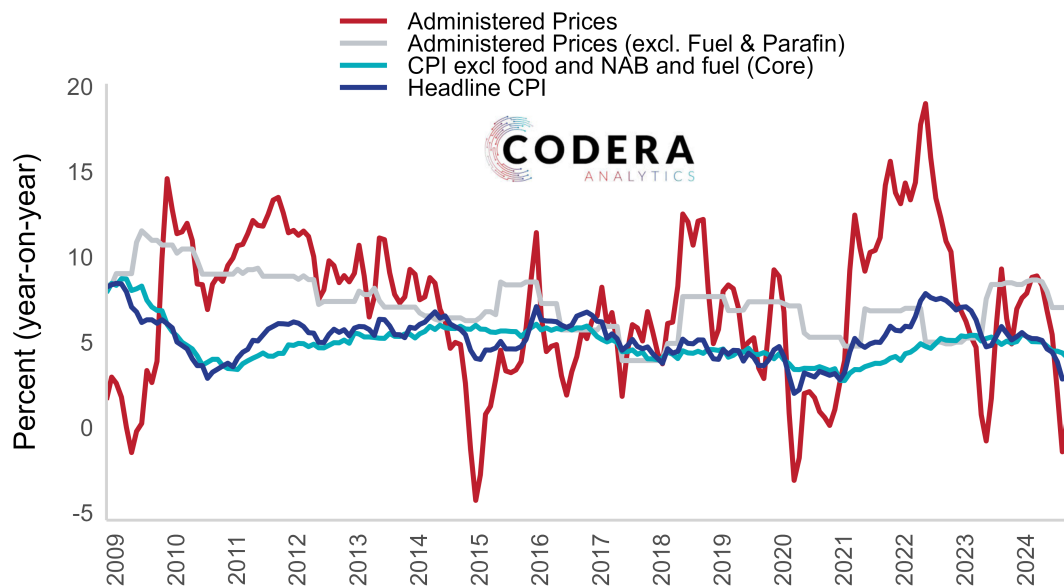
Note: Calculations done at the 2-digit (division) level, 2019 basket weights used.

headline since 2009). Overall administered prices have averaged 7.1% since 2009, compared to 7.3% if one excludes fuel and paraffin.

Another way to represent relative price changes at component level is to look at how price categories have

Figure 5:

Headline vs Core vs Administered Price Inflation in South Africa

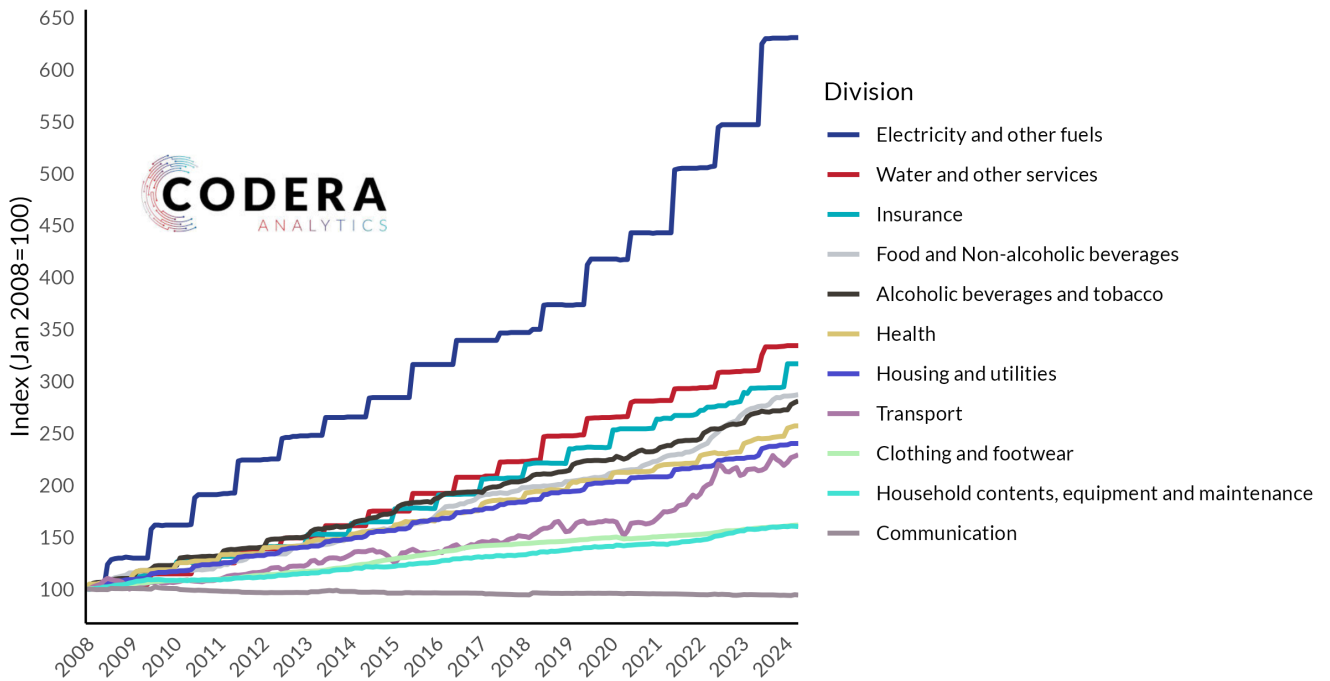


Source: Statistics SA, EconData.

evolved over time relative to others. Figure 6 shows that electricity and other fuels prices, for example, are now over five times higher than in January 2008, compared to around 200% for water and other services, 191% for food and non-alcoholic beverages, and about 63% for clothing. Eskom's aggregate standard tariffs have increased at almost 15% per year since 2010, compared to average CPI inflation of closer to 5.3% over this period. Eskom's current tariff plans imply that average electricity prices will have increased by 5.5 times its 2010 level by 2024/25, compared to expected consumer prices around 2.1 times its 2010 level by 2024/25, indicating a substantial shift in relative prices in the economy.

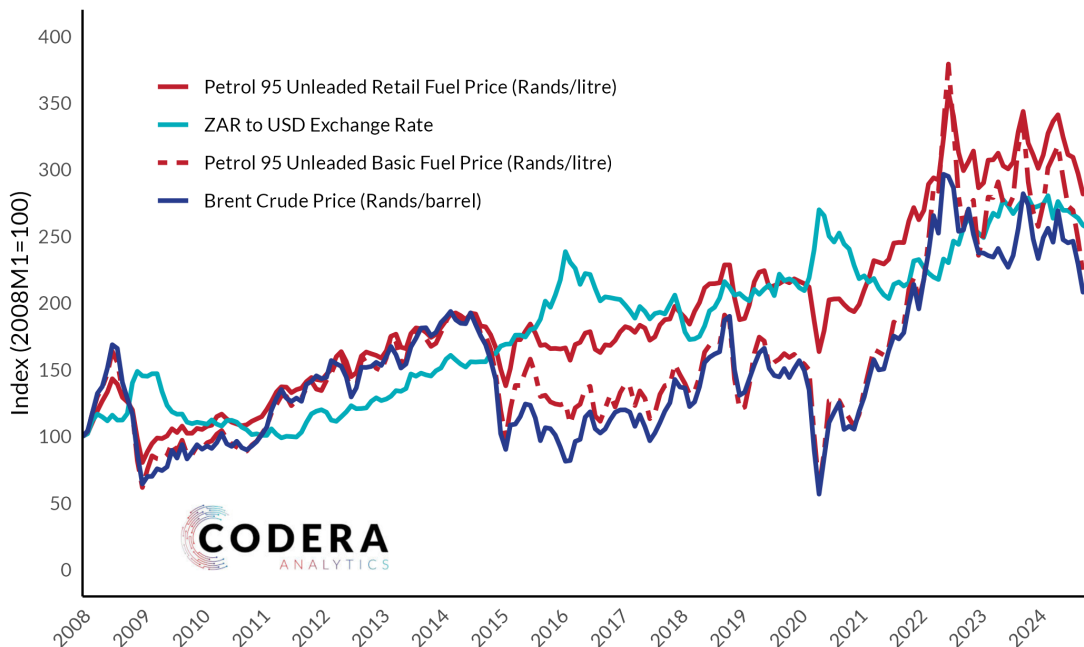
One might argue that fuel prices, given their dramatic volatility, should be excluded from the inflation measure targeted by the central bank. But it is not just the volatility in the global determinants of domestic prices that has mattered for inflation pressure. Persistent exchange rate depreciation has played a key role in the continuous rise in domestic currency fuel prices. Though less volatile, government-determined components of the retail price, such as the road accident fund levy have, have also been a faster growing component of retail pump prices, up by over 500% since 2008. The implication is that domestically determined components are an important component of the basic fuel price – sometimes representing over 50% of the retail petrol price. As will be discussed later, the variability of price categories that form a large part of households' and firms' expenditures affects the appropriate width of the inflation target band. Figures 7 and 8 show that there is a meaningful wedge between the retail petrol price, for example, and the globally determined portion of its price, reflecting the much larger cumulative increase in domestic taxes (the road accident fund levy), transport costs and margins.

Figure 6:
Selected CPI Price Series Over Time



Source: Stats SA, EconData, Codera Analytics

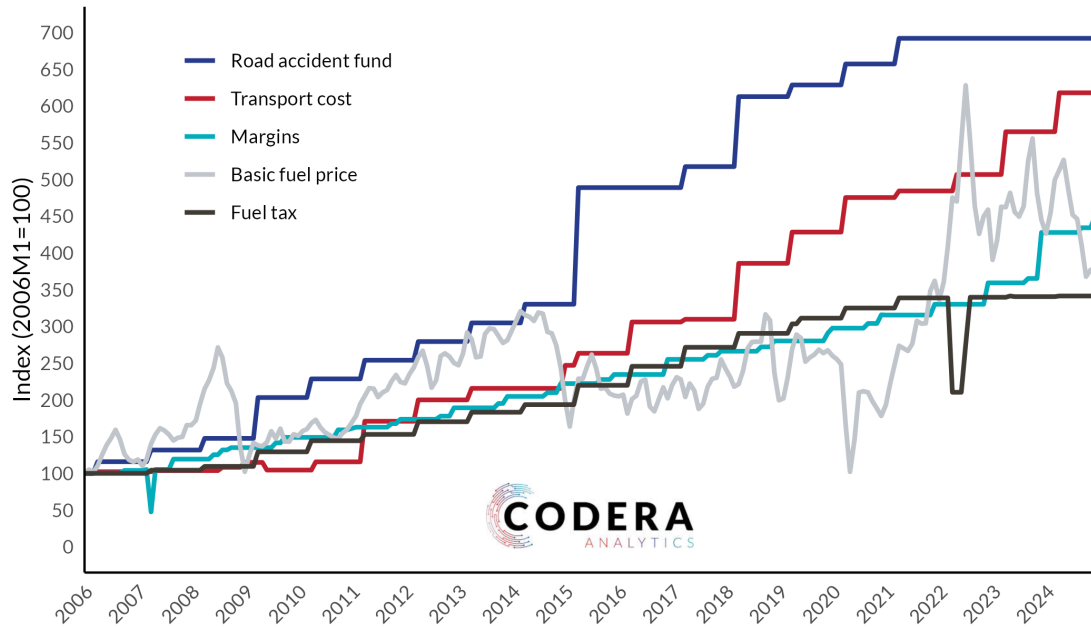
Figure 7:
Basic fuel price, retail fuel price, global oil price,
and exchange rate (South Africa)



Source: Department of Mineral Resources and Energy, EconData, Codera Analytics.

Domestically determined prices have driven inflation pressures across price categories. Figures 9 to 11 compare the weighted contributions of different components of the consumer basket at different levels of disaggregation. At a 2-digit level, the largest contributors have been housing and utilities, and food and

Figure 8:
Growth in components of petrol price in South Africa
(95 Octane unleaded)



Source: Department of Mineral Resources and Energy, EconData, Codera Analytics.
Margins include retail and wholesale.

NAB, to the average headline inflation since 2009 of around 5.3%. At 5-digit level, administrative prices is the largest combined component at 1.2 percentage points (electricity and other fuels at 0.45, fuel at 0.35, water and other services at 0.25), food at 1 percentage point, followed by housing at approximately 0.65 percentage points (owner-occupied housing at 0.5 plus tenant rent at 0.15). Lastly at the 8-digit level, the weighted contribution of health insurance is the largest single component, followed by electricity, owner occupied housing, and then petrol and diesel. Categories such as cigarettes and car prices, whose prices are affected by global prices, but which incorporate significant domestic taxes, also feature in the top ten contributors to headline inflation.

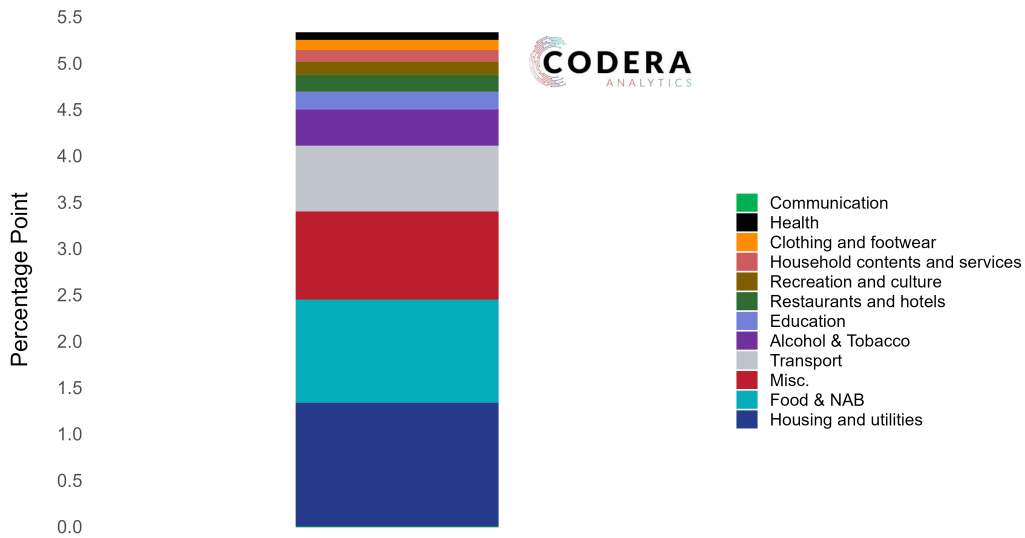
Government-related prices are clearly very important to inflation determination in South Africa. A key challenge the central bank faces if the target is to be lowered is that government-related inflation has consistently grown at well above the upper bound of the inflation target. The central bank cannot directly affect prices in such categories, so keeping interest rates high in response to such pressures is likely to impose costs on parts of the economy where prices are more flexible. The central bank could, of course, target a measure of inflation that excludes such components. But direct government-related categories (fuels, electricity, water, administrative prices and public transport) make up over 30% of the total CPI basket, so this would reduce the representativeness of such a measure against the underlying economic reality for consumers and firms.

There are also many domestic, private sector CPI components whose price inflation historically exceeded the inflation target. Many of these goods and services are produced in heavily concentrated industries. Statistics South Africa (Stats SA) estimates show that food, forestry and manufacturing sub-sectors are particularly concentrated.³ Concentrated industries tend to create challenges for the central bank as pricing might be less responsive to monetary policy (see Greenwood-Nimmo, van Jaarsveld and Steenkamp 2024, who provide some evidence in the context of bank interest rate settings in South Africa). Since the competitive structures of sectors affect monetary policy transmission, the central bank must consider

³See more detail in [this blog post](#) or [this blog post](#).

Figure 9:

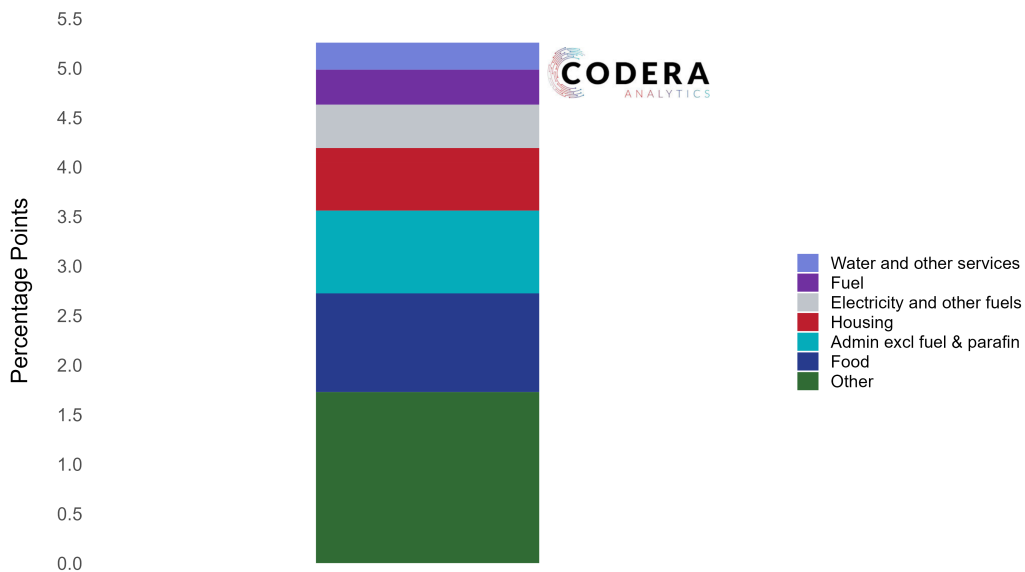
Weighted Contributions to Average Year-on-Year Inflation in South Africa since 2009



Source: Statistics SA, EconData.
 Note: Headline inflation. Calculations done at 2-digit (division) level, 2019 weights.

Figure 10:

Weighted Contributions to Average Year-on-Year Inflation in South Africa since 2009

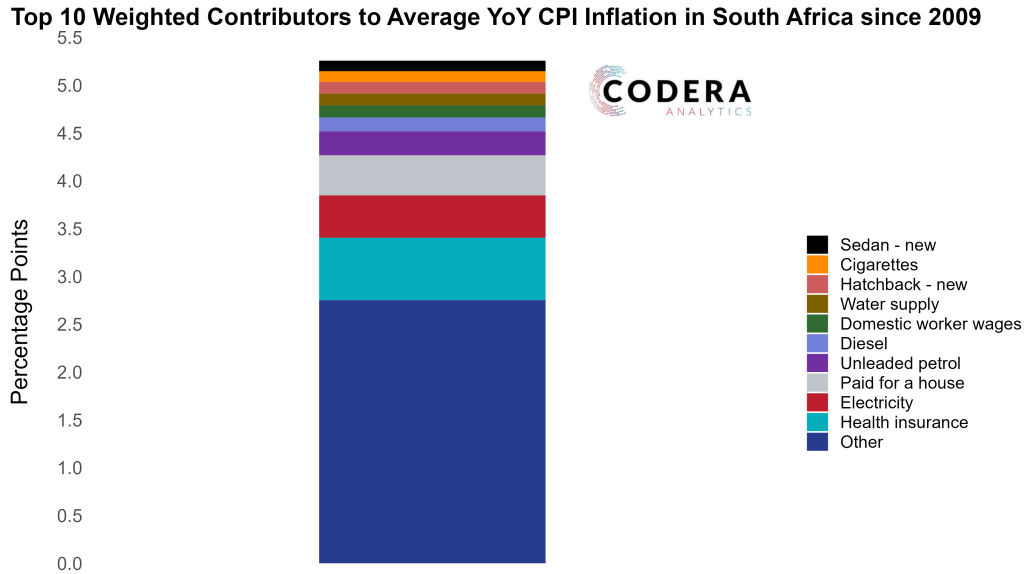


Source: Statistics SA, EconData.
 Note: Headline inflation. Calculations done at the 5-digit (subclass) level, 2019 weights used.

changes in industry structure and pricing behaviour in its analysis.

The sections that follow discuss the implications of the statistical dynamics of CPI components for the measurement of the optimal inflation target and conduct of monetary policy.

Figure 11:



3.2 Bias in CPI Measurement

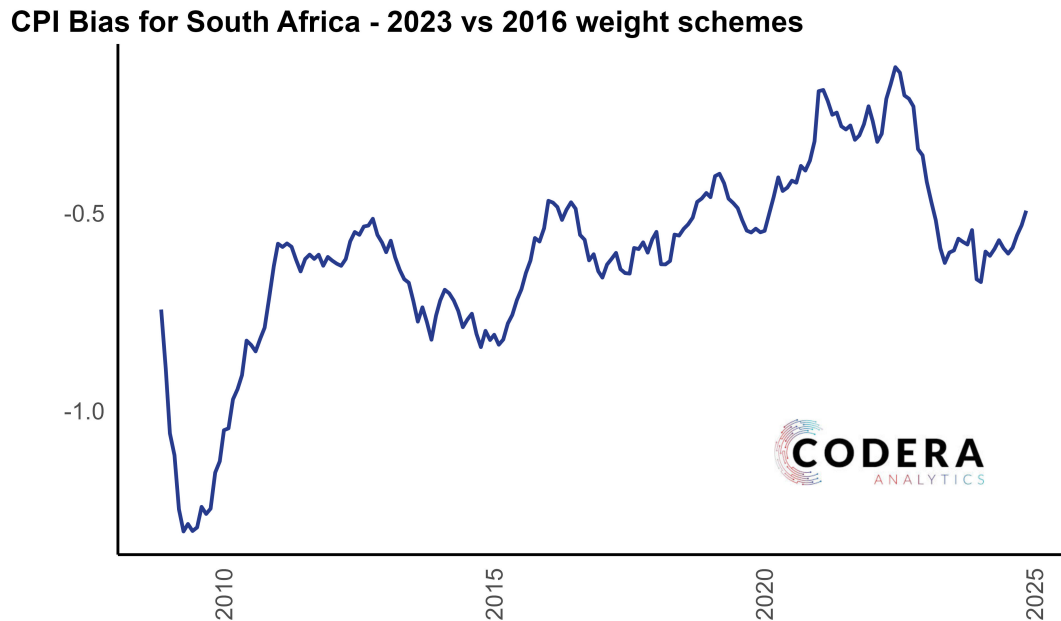
Any potential bias in CPI measurement would have implications for the optimal inflation target for an inflation-targeting central bank as it can affect the credibility of the central bank by creating a divergence between the experience of households and firms and official statistics.

The expenditure weights used in the CPI may not accurately reflect current consumption patterns, as the current CPI weights are not regularly updated. The use of fixed expenditure weights in CPI, may for example, result in understatement of inflation during periods of relative price changes encourage substitution towards cheaper products.⁴

To estimate possible bias in the measurement of CPI, Figure 12 calculates headline inflation from underlying 8-digit categories using the 2016 CPI weights and 2023 CPI weights. The most recent CPI weights were measured in 2023 but only applied in CPI measurement from 2025 onwards. We estimate that CPI has been lower by an average of 0.5 percentage points since 2009 if measured using the most recent CPI weights. A lower CPI estimate from updated weights suggests that inflation may be overstated at specific points of time when using outdated spending patterns, and newer weights provide a more accurate reflection of actual price changes experienced by consumers. On the other hand, this means that inflation has tended to be higher in real-time than subsequently measured when weights are re-estimated.

⁴During the COVID-19 pandemic, CPI inflation, which tracks price changes for a fixed basket of consumer goods and services including imports, was substantially below the GDP deflator, which measures inflation for all domestically produced goods and services in a given year. See more detail in [this Codera post](#) for a comparison of GDP- and CPI-based inflation. With respect to non-tradable inflation, Rapapali and Steenkamp (2019) suggest that between 2003 and 2017, value-added based consumer prices rose several percentage points faster than CPI-based measure in South Africa, suggesting that domestically driven inflation pressures may be higher than consumer price measures imply.

Figure 12:



Source: Statistics SA, Econdata.

Note: Rebasing of index values prior to calculation of YoY rates done relative to 2008-01-01 value. Calculations done at the 8-digit product level.

3.3 Changes in relative prices over time

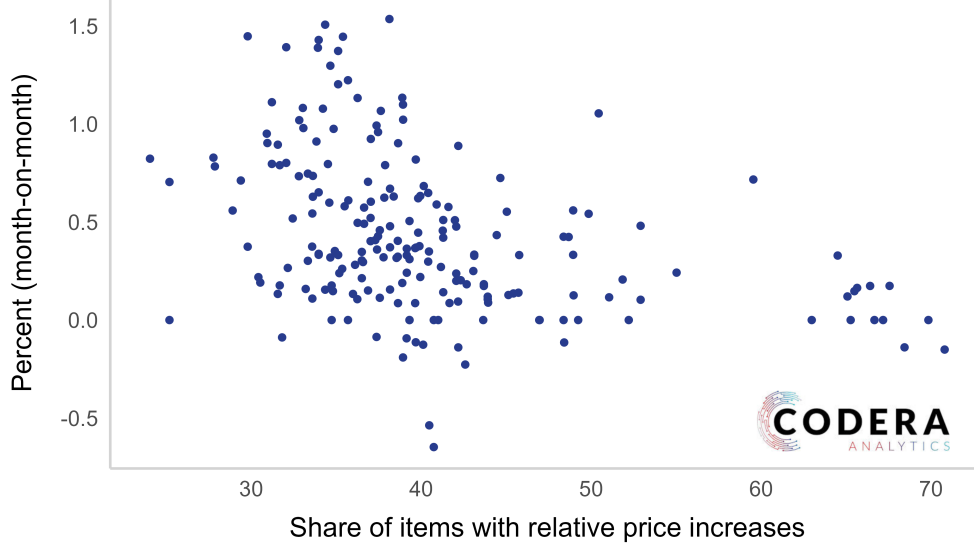
The distribution of relative price changes matters for the optimal inflation target, as it affects the tradeoffs the central bank faces in stabilising inflation and output. The distribution of relative price changes in South Africa has a longer right tail, where a small number of items tend to experience very high price increases. This means that mean inflation is pulled up by a high average inflation in a small subset of categories. Figure 13 plots the month inflation rate against the monthly share of 8-digit consumer price categories experiencing relative price increases (increases larger than the average for that month). When the share of relative price increases is low, the inflation rate tends to be high (and vice versa). In major advanced economies such as the United States (US) this relationship is tighter, though the relationship is also downward sloping (Ruge-Murcia and Wolman 2024). This indicates greater inflation instability and more asymmetry in inflation components in South Africa than in advanced economies such as the US. An important reason for this is that there is greater heterogeneity in the volatility of shocks to supply or demand that affect different price categories in South Africa, given the role of categories such as administered prices and commodities in determining prices. The central bank has greater flexibility in managing supply-side shocks if the inflation target is specified as a range around a midpoint target.

3.4 Seasonality in prices

South African consumer price index (CPI) inflation is not seasonally adjusted. While CPI does not show seasonality when inflation is expressed in year-on-year terms, there is seasonality in the month-on-month dynamics of the headline index (Figure 14). The reason is that there are many components where prices are set annually in a specific quarter (such as insurance and education which tend to have price resets for the following year in quarter one) and have had historically experienced inflation above the mid-point of the inflation target. This has implications for forecasting CPI and South Africa's optimal inflation target or conduct by the central bank. Either a slightly higher target would be needed to accommodate predictable

Figure 13:

Inflation vs Relative Price Increases in South Africa since 2008



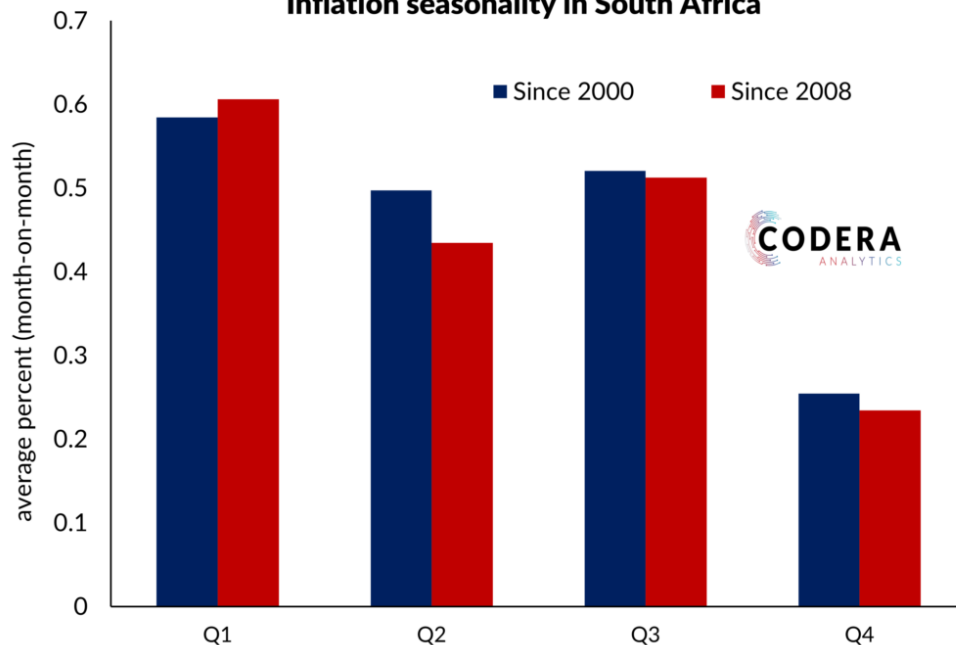
Source: Statistics SA, EconData.

Note: Month-on-month headline inflation. Calculations of share of items increasing done at the 8-digit (product) level.

quarter one spikes without triggering unnecessary monetary tightening or the central bank should focus on inflation metrics that have been purged of such seasonal patterns when making policy decisions (such as year-on-year inflation rates, as the SARB does).

Figure 14:

Inflation seasonality in South Africa



Source: Statistics South Africa, EconData, Codera Analytics. Note that these are based on seasonally adjusted figures and that there are no obvious differences in year-on-year rates.

3.5 CPI dispersion in SA and implications for monetary policy

Understanding the distribution of price changes across categories in the CPI is crucial for an inflation-targeting central bank because it provides insights into the nature, drivers, and persistence of inflation.

Price setting behaviour also has implications for the optimal inflation target and the optimal approach to inflation targeting.

In an environment with high inflation dispersion, an inflation targeting central bank should focus on controlling the trend growth rate of underlying inflation. This prevents the central bank from over-reacting to temporary fluctuations in inflation from volatility in some sub-components of the inflation basket.

Figure 15:

Distribution of CPI 5-digit Components

% year-on-year, measured monthly, January 2009 to December 2024

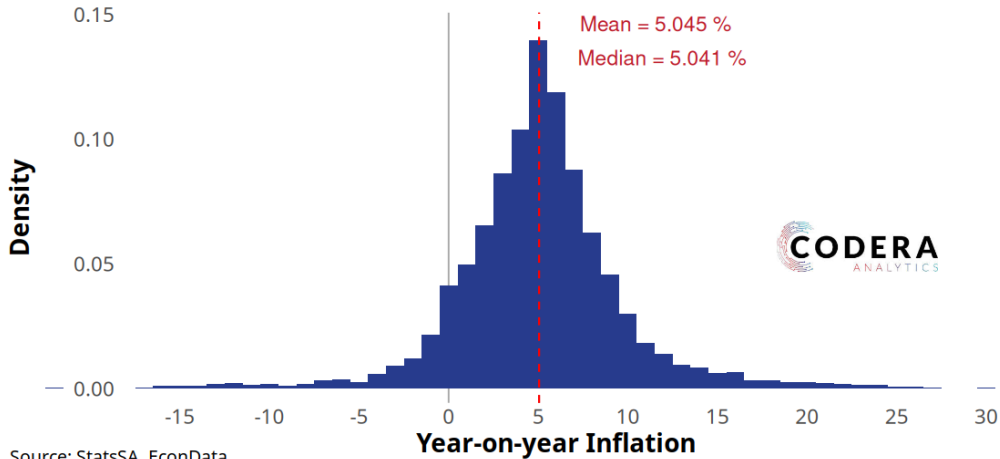
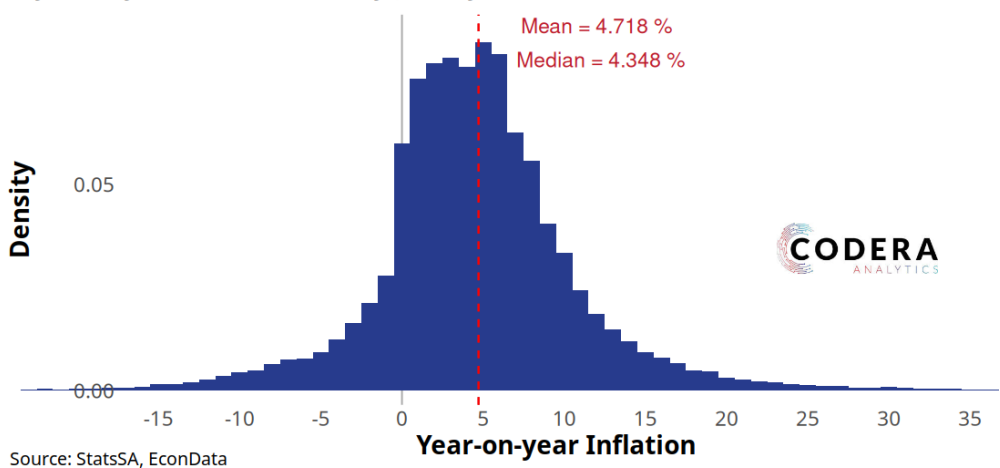


Figure 16:

Distribution of CPI 8-digit Components

% year-on-year, measured monthly, January 2009 to December 2024

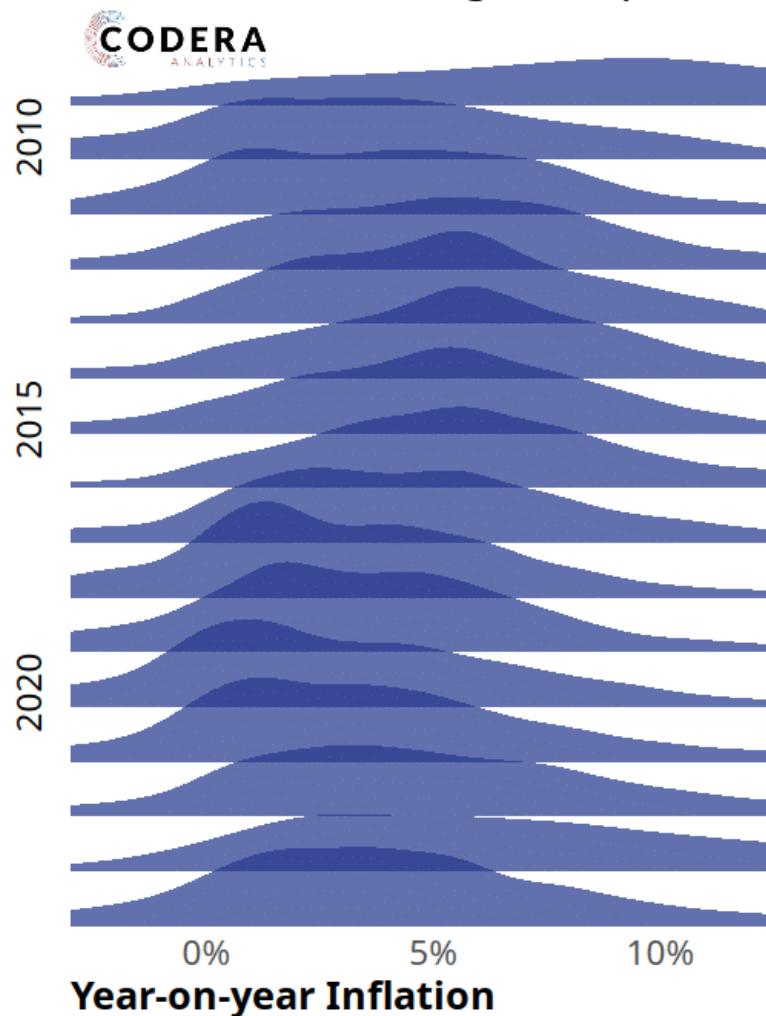


Figures 15 to 18 provide evidence of a high degree of dispersion across price categories that comprise the consumer price basket in South Africa. The first two figures show that, since 2008, a large proportion of inflation outcomes for the detailed components that comprise the consumer price basket have been outside the SARB's 3% to 6% inflation target band, whether considered at a 5-digit or an 8-digit level. Both the mean and median outcome across very detailed specific components comprising the inflation basket have been above 5% since 2009, at the 5-digit level. There is asymmetry in South Africa's inflation distribution that implies that the mean and the median of inflation outcomes will not be the same. A striking feature of the two distributions is the differences in their respective means and medians, demonstrating differences in the distributions at different levels of aggregation.

When one looks at class and product level, there has also been high dispersion, particularly for several categories that are highly dependent on tradable products such as petrol (such as transportation), administered

prices such as electricity, and some food sub-categories (Figure 18). Figure 17 shows that the dispersion is also time-varying.

Figure 17:
Distribution of CPI 8-digit Components

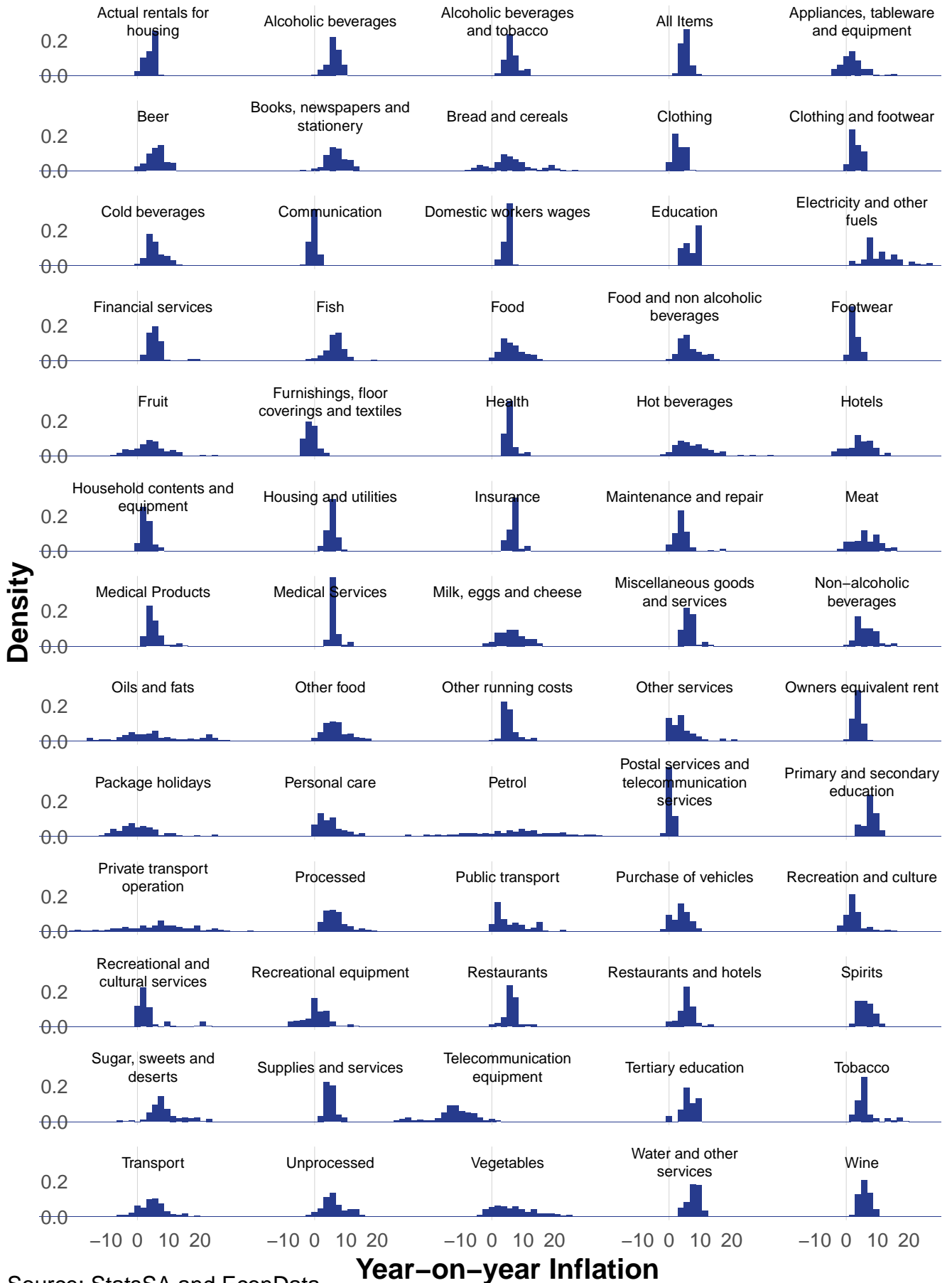


How regularly prices change provides insights into menu costs that lead to firms changing prices less frequently, although they are also affected by how consumer prices are surveyed and aggregated. We observe an upward trend in the frequency of 8-digit category (396 items) price changes in South Africa. Figure 19 shows that the average fraction of categories in consumer prices that change every month was 85%. Since 2009, price increases occurred with an average monthly frequency of 56% (Figure 20), while price decreases have occurred at a frequency of around 29% (Figure 21). This indicates a significant degree of asymmetry in price setting, with price increases occurring more frequently than price decreases. It is worth pointing out that these price change frequencies are more than four times higher than those reported by Ruch, Rankin and Du Plessis (2016) at individual product and retailer level. This is not surprising given the high degree of aggregation even at 8-digit level (the highest level of publicly available data). But it demonstrates that policymakers need to look at product and retailer level data to be in a position to assess inflation dispersion and price setting behaviour. The likely explanation for the asymmetry in inflation outcomes, in line with Ruch, Rankin and Du Plessis (2016), is that demand and supply shocks drive CPI increases, as opposed to South Africa having purely indexed price increases for most price categories.

Figure 18:

Distribution of Individual CPI 5-digit Components

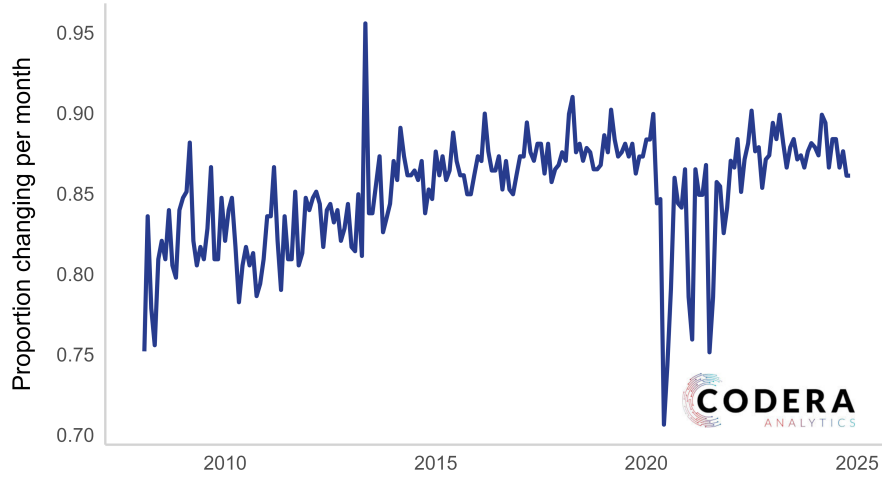
%, year-on-year, measured monthly, January 2009 to December 2024



Source: StatsSA and EconData

Figure 19:

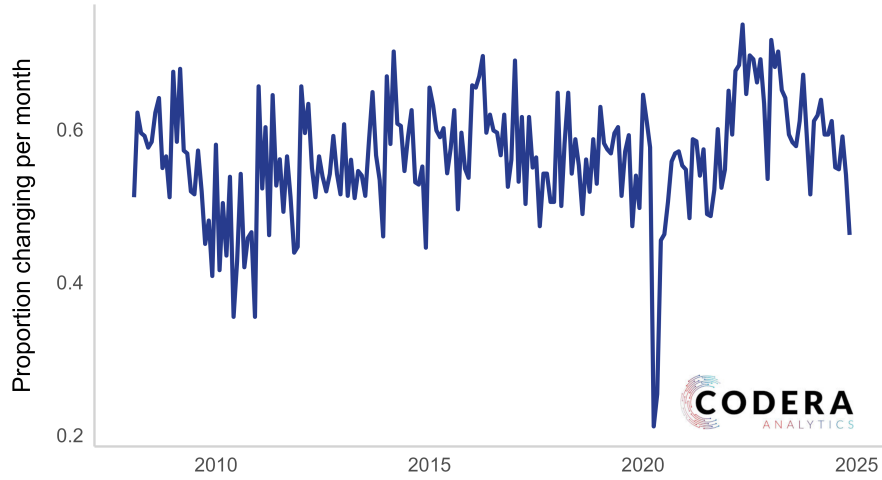
Frequency of price changes in South Africa since 2008



Source: Statistics SA, EconData.
Note: Month-on-month inflation. Calculations done at the 8-digit (product) level.

Figure 20:

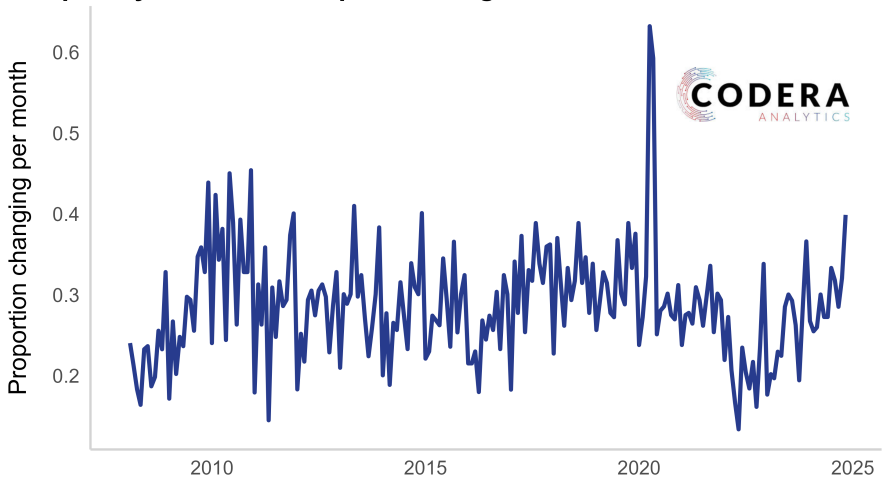
Frequency of upward price changes in South Africa since 2008



Source: Statistics SA, EconData.
Note: Month-on-month inflation. Calculations done at the 8-digit (product) level.

Figure 21:

Frequency of downward price changes in South Africa since 2008



Source: Statistics SA, EconData.
Note: Month-on-month inflation. Calculations done at the 8-digit (product) level.

For monetary policy, this means the central bank has to understand the economic drivers of inflation pressures and price setting decisions to make appropriate policy decisions. Best practice among leading central banks facing such inflation dynamics is to explain the economic drivers of dispersion in inflation and the central bank's approach to addressing such dispersion. The thinking is that such transparency helps to anchor inflation expectations and maintain the credibility of the central bank as an inflation targeter. What the South African debate is missing is structural analysis of the drivers of inflation dynamics, ongoing monitoring of price setting behaviour, and analysis of the implications for the optimal inflation target.

This also has implications for the optimal measure of inflation the central bank should monitor. Differences in the flexibility of prices in different categories is one reason why countries have positive inflation targets, as some prices are downwardly rigid. High dispersion across the components of the central bank's inflation measure implies a lot of uncertainty around inflation outcomes, which implies greater distortions in relative prices and potential misallocation of resources. While a lower target would reduce such distortions, monetary policy settings based on measures of overall or even core inflation may still result in a policy stance that is too strict or loose with respect to price pressures in certain sectors.

As we have shown, a small number of inflation components have experienced some very large price increases. This is one reason why the SARB monitors exclusion measures such as core inflation that strip out volatile components such as food and fuel. However, the exclusion-based core inflation measure the SARB tends to focus its analysis on may not be the best measure to use to inform monetary policy decisions as it does not deal with the fact that there are many other domestically determined components that sit in the tails of the inflation distribution and deviate persistently from the inflation target.

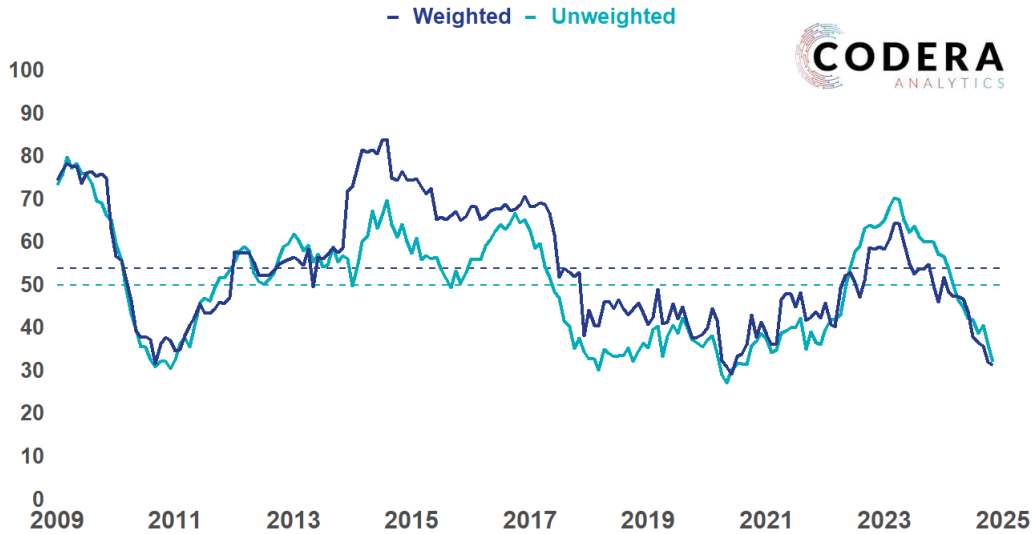
Asymmetry in price setting contributes to persistent inflationary pressures, which may weaken the transmission of monetary policy. The central bank should ideally monitor price setting behaviour to calibrate how strongly to react to shocks that could create persistent inflation deviations from the target and could unanchor inflation expectations. The appropriate inflation target may therefore need to account for sectoral inflation pressure. This raises the question of which sectors to represent in measures of underlying inflation. Developing indicators of tradable and non-tradable prices along the lines of the measures in Rapapali and Steenkamp (2019) would enhance the central bank's understanding of what these sectoral dynamics imply for the appropriate setting of monetary policy.

The share of CPI 8-digit items growing above the mid-point inflation target of 4.5% are nearing post 2009 lows, both when considering the number of detailed CPI components at 8-digit level or the weighted composition in the index of such items. The decline from the early 2023 peak represents a notable shift in the inflation landscape, indicating that price pressures may be easing across a wider range of goods and services. Figure 22 shows that the decline has been broad-based, since the profile of the unweighted and weighted individual components of the consumer basket are similar.

There is still uncertainty around how sustained the recent decline in inflation will prove to be given the uncertainty around how to best measure inflation pressure and dispersion. In the Figure 23, Codera's 'CPI-common' measure, meant to capture co-movement of inflation components, suggests that there has been more broad-based inflation pressure since 2019 than implied by the Statistics SA core measure of underlying inflation. SARB's recently published alternative measures of underlying inflation ('supercore' and 'PCCI') are meant to capture demand-driven inflation—and one has been higher than core; the other lower.

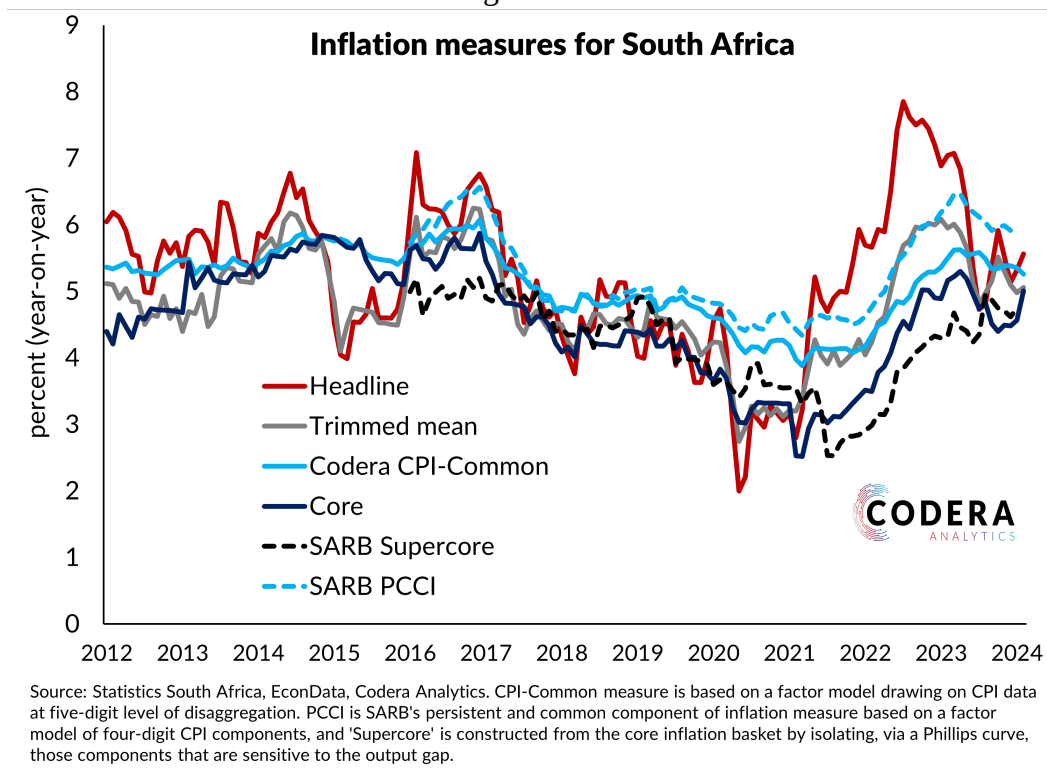
Judging whether these measures are useful from a monetary policy perspective requires showing whether they are useful for forecasting and whether they help economists understand what economic factors are driving inflation pressures. Figure 24 compares the out-of-sample predictive accuracy of different core measures, defined as the difference between their 12-month-ahead forecasts of headline inflation, less the

Figure 22:
Diffusion index for South African CPI inflation
 Share of price categories rising above 4.5 percent



Source: Statistics South Africa, EconData (Codera Analytics).
 Note: Headline CPI, 8-digit COICOP level, Dashed lines represent the mean diffusion index values for the period.

Figure 23:

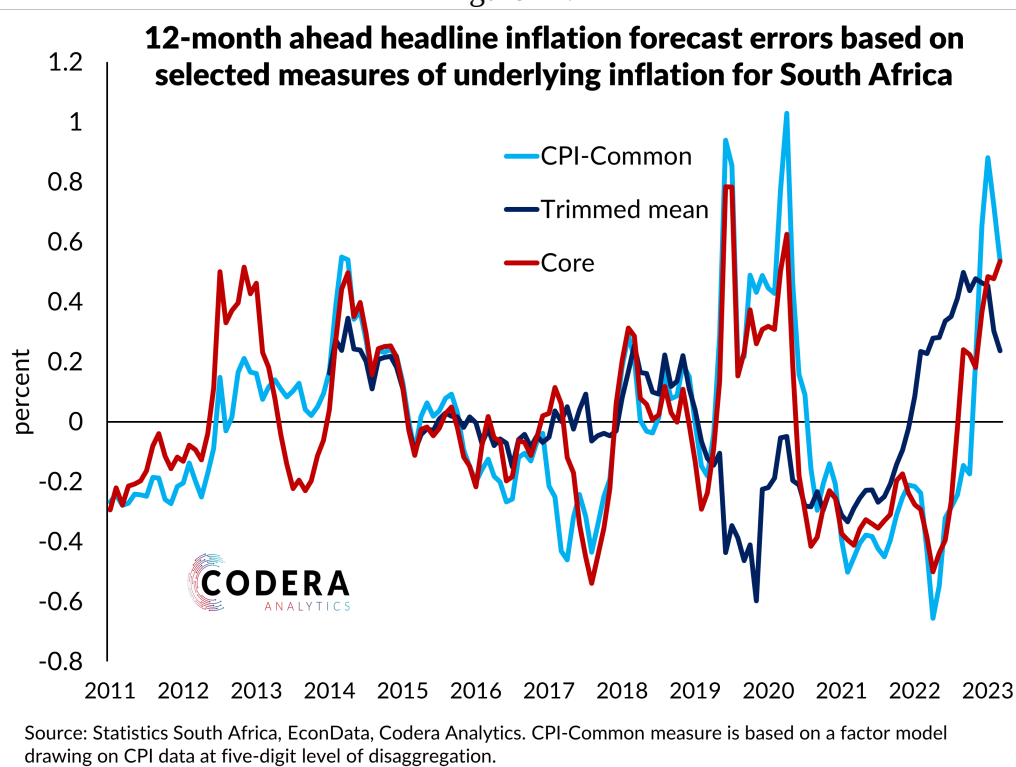


Source: Statistics South Africa, EconData, Codera Analytics. CPI-Common measure is based on a factor model drawing on CPI data at five-digit level of disaggregation. PCCI is SARB's persistent and common component of inflation measure based on a factor model of four-digit CPI components, and 'Supercore' is constructed from the core inflation basket by isolating, via a Phillips curve, those components that are sensitive to the output gap.

year-on-year rate in headline inflation that was observed for a given month. Although CPI-common has been slightly more accurate at predicting headline inflation than core, all of these measures have historically been poor guides to persistent changes in inflation in South Africa. For example, all three measures completely failed to predict the post-pandemic inflation spike. Over the full sample considered since 2008, the trimmed mean measure has the lowest absolute mean forecast error. These results suggest that market analysts and policymakers should be careful about making statements about the implications of core in-

flation outturns for headline inflation in South Africa. This also suggests that new measures of underlying inflation and models of the drivers of underlying inflation in South Africa are needed.⁵

Figure 24:



If these core inflation measures are not good predictors of inflation, then what are policymakers to do? One option is to expand the number of measures considered when assessing underlying inflation, particularly incorporating measures that have an economic interpretation. It would, for example, be useful to assess how alternative measures, such as measures of cyclically sensitive prices (as in Botha, Kuhn and Steenkamp 2020), might perform. An alternative way to assess what the structural rate of inflation might be is to estimate trend inflation.

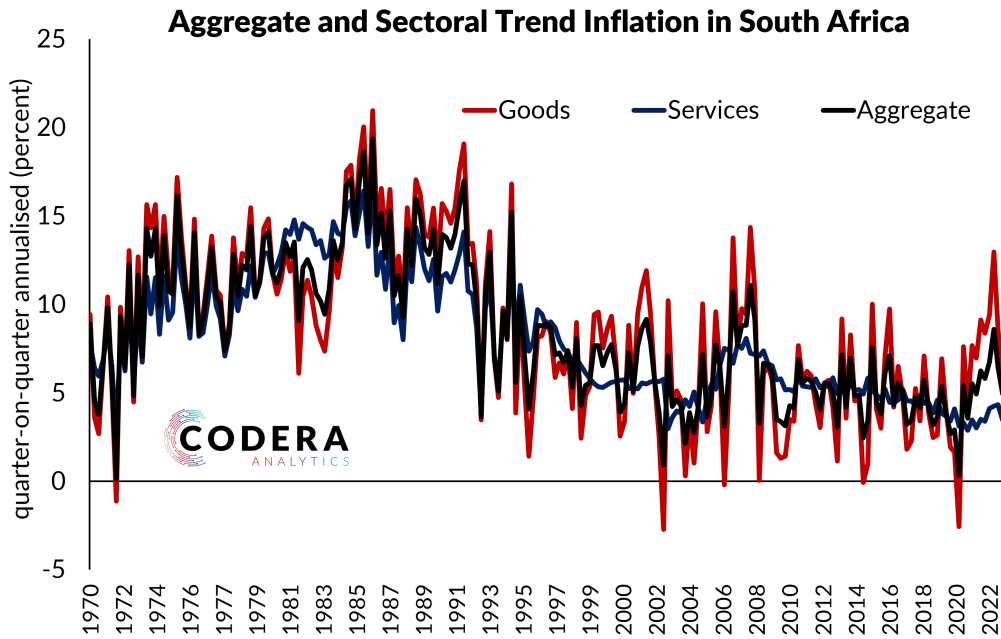
3.6 Underlying drivers of trend inflation in SA

In this sub-section, we analyse persistent components of consumer inflation by estimating trend inflation for South Africa. Using the approach of Eo, Uzeda and Wong (2023) to assess the contribution of goods and services to changes in underlying inflation in South Africa, Figures 25 to 27 show that there has been a widening gap between trend inflation in goods and services components. The estimated trend measure removes transitory noise from each inflation series to obtain a measure of ‘underlying’ inflation. These estimates suggest that underlying inflation picked up to above the inflation target after the COVID-19 pandemic. Though it has fallen back slightly from its mid-2022 highs at the end of our sample, aggregate trend inflation was still estimated to be above the midpoint of the inflation target.

Like the US estimates from Eo et al. (2023), the trend level of goods inflation fell meaningfully during the 1990s, in part a reflection of the impact of East Asian manufacturing production and increased globalisation. The trend estimates obtained for South African consumer prices are much more volatile compared to the US private consumption expenditure deflators used by Eo et al. (2023), particularly for goods inflation.

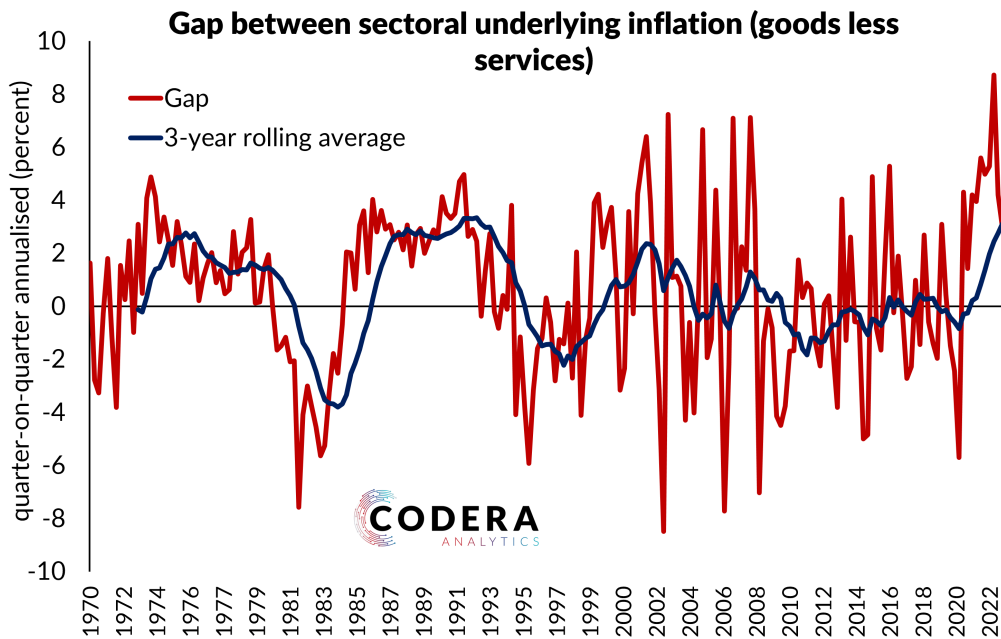
⁵A forthcoming paper by van Zyl (2024) constructs underlying inflation tweaking SARB’s supercore and PCCI methodologies and applying these to 8-digit CPI components and finds that the PCCI approach produces the most accurate short- and long-term projections.

Figure 25:



Source: Statistics South Africa, EconData, Codera Analytics. Estimated using the approach of Yunjong Eo & Luis Uzeda & Benjamin Wong, 2023. "Understanding Trend Inflation Through the Lens of the Goods and Services Sectors," Journal of Applied Econometrics.

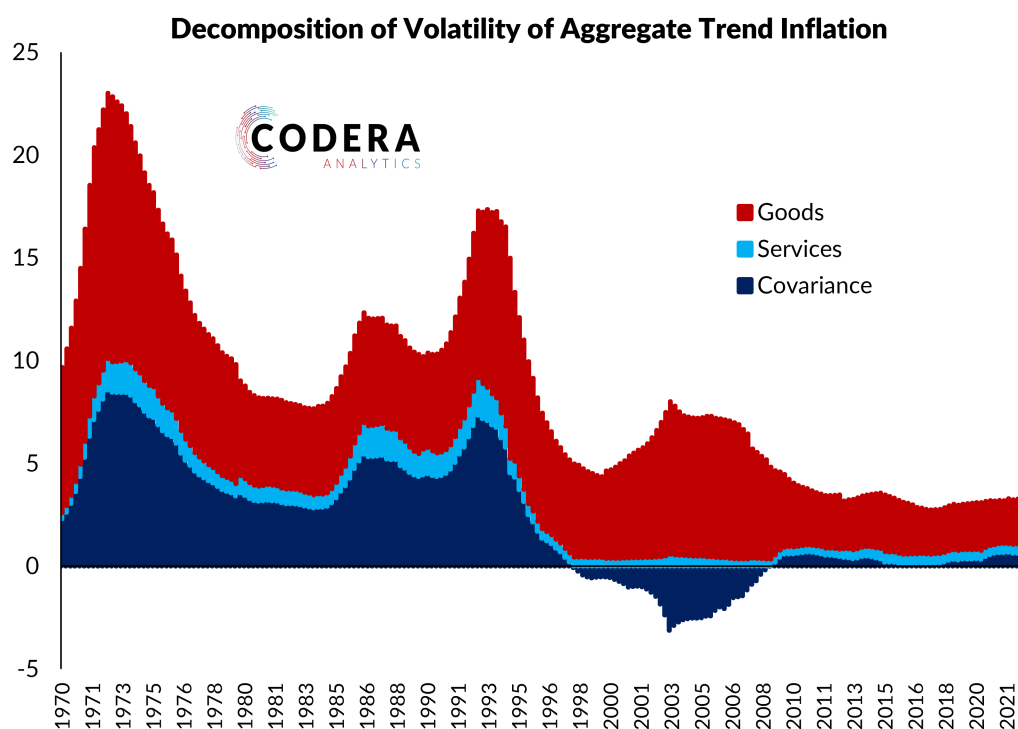
Figure 26:



Source: Statistics South Africa, EconData, Codera Analytics. Estimated using the approach of Yunjong Eo & Luis Uzeda & Benjamin Wong, 2023. "Understanding Trend Inflation Through the Lens of the Goods and Services Sectors," Journal of Applied Econometrics.

The dynamics of inflation in South Africa has also changed less than in the US, where services inflation declined less than goods inflation and the weight of services in aggregate prices has risen more. As a result, the overall picture is the reverse of what has been observed in the US recently, with the model suggesting that goods inflation has driven the volatility of aggregate trend inflation in South Africa since the global financial crisis. Even though inflation volatility has declined dramatically, it remains at levels currently that are comparable to what advanced economies experienced in the 1990s. Lastly, inflation is also much

Figure 27:



Source: Statistics South Africa, EconData, Codera Analytics. Estimated using the approach of Yunjong Eo & Luis Uzeda & Benjamin Wong, 2023. "Understanding Trend Inflation Through the Lens of the Goods and Services Sectors," *Journal of Applied Econometrics*. Trend inflation is in units of annualized quarter-on-quarter inflation.

more persistent than the estimates for the US from Eo et al. (2023) suggest, particularly services inflation.⁶

Whereas the gap between trends in goods and services inflation estimated by Eo et al. (2023) to be negative for the US, it has been positive on average in South Africa's case and has widened by more than in the US. A growing gap likely has implications for South Africa's optimal inflation rate (or appropriate inflation target) since inflation dispersion affects welfare (Wolman 2011).

The academic literature suggests that an inflation targeter facing sectoral heterogeneity in inflation rates and/or inflation persistence should put more weight on controlling inflation in the sector with the greatest distortions or the least flexible prices. This normally would be categories of goods and services whose prices are domestically-determined and not affected by intermediate import prices (e.g. non-tradable inflation). Measures of non-tradable inflation are not currently available for South Africa but would be an important complement to existing measures of underlying inflation. As we have shown, in a South African context, a large proportion of South Africa's high structural inflation owes to high administered price and government-related inflation. Since the central bank cannot directly affect prices in such categories, reacting to first-round price pressures in such inflexible price categories risks creating worse inflation volatility/price dispersion.

To understand the implications of relative price shocks such as the ones we have been observing for the appropriate setting of monetary policy, a measure of underlying inflation should be used in models to guide policy. This is indeed the case in the Quarterly Projection Model (QPM) forecasting model used by SARB, which allows for the headline CPI to be explicitly decomposed into its non-core and core sub-components.

⁶The goods and services CPI series using StatsSA data were backdated using official historical weights of each component. Estimates at a quarterly and monthly frequency were broadly similar but we chose to keep to a quarterly frequency for comparability to the original paper. It is also important to point out that the goods and services categories used may not necessarily be good proxies of tradable and non-tradable inflation since both categories will include intermediate inputs from the other sector and the share of tradable components will vary over time.

Since underlying inflation is an unobservable concept, it needs to be estimated and the policy implications of using different measures of underlying inflation continuously evaluated. The estimates presented here, along with alternative core estimates presented, show divergence over recent years. Which measure is best to use to inform monetary policy is partly an empirical question, requiring assessment, for example, of how well a given measure forecasts trend inflation as we have illustrated. Another option is to use structural models to interpret the drivers of underlying inflation.

3.7 What has been behind deviations from the target?

A key analytical question with regards to inflation through the cycle is what economic factors have been responsible for keeping inflation above the mid-point target and when such pressures will begin to dissipate. Leading central banks use their policy models to interpret business cycle drivers and assess the implications for the stance of policy. SARB's policy model allows one to assess how economic shocks (demand, supply, monetary policy stance etc.) contribute to deviations in inflation from the target. What is missing in a South African context is an application of the SARB's policy model to assess the appropriateness of its historical policy stance and its implicit economic narrative.

Given the absence of such analysis, economists can only judge the credibility of SARB's inflation forecasts by looking at SARB's consumer price component projections. Recent SARB policy reviews show that its inflation forecast errors during the post-pandemic inflation spike reflected optimistic food price and core goods forecasts, while its modelling shows that supply shocks were the most important contributor to its under-prediction of inflation in 2022/23 (SARB 2023 and 2024). The implication is that SARB, like other major central banks, under-estimated the pandemic's supply consequences in the wake of the COVID-19 economic lockdowns. The advantage of performing economic driver assessment of underlying inflation (over SARB's preferred approach of analysing individual consumer price components) is that it enables assessment of what the drivers of trend inflation have been and helps to inform the debate around the appropriate inflation target level. Key to clear communication is not simply publishing forecasts, but clarity around the judgements of policymakers that underlie their projections and policy decisions.⁷

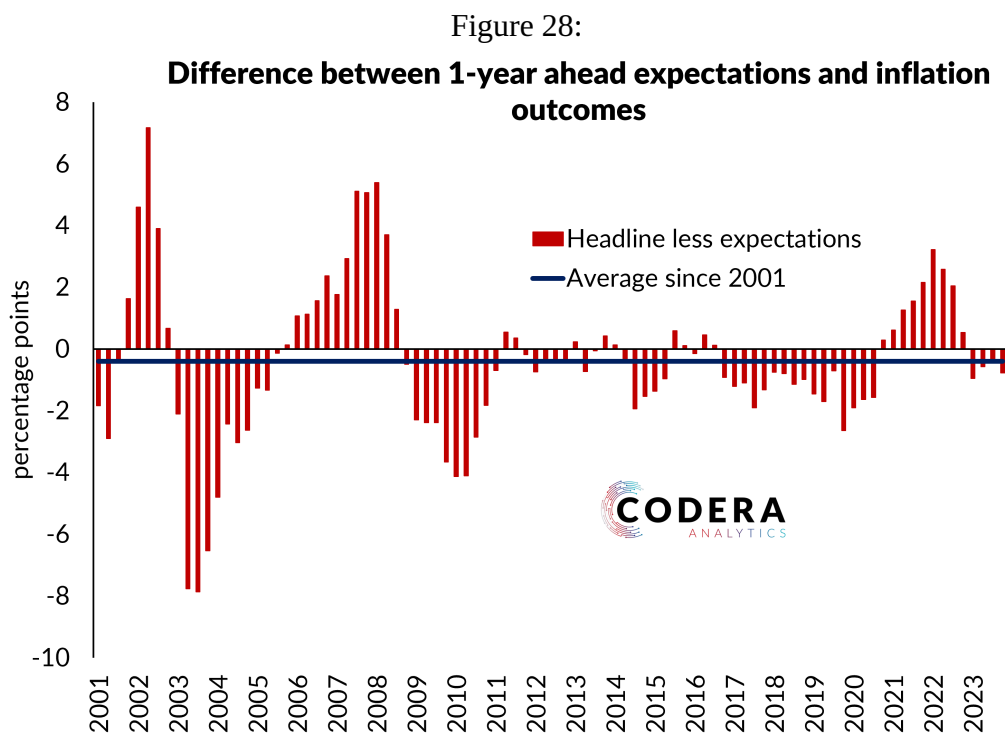
The COVID economic lockdowns and ongoing electricity constraints have likely affected macroeconomic relationships and trends in South Africa. This implies substantial uncertainty around estimates of potential growth, neutral interest rates, South Africa's equilibrium exchange rate (and the extent of exchange rate pass-through) or monetary policy transmission, all of which have important implications for assessments of the appropriate inflation target and stance of policy. Assessments of the conduct of monetary policy and appropriate inflation target must consider how the structure of the economy has changed over time. As discussed earlier, another implication of heterogeneity in inflation outcomes across consumer categories is that it can affect price setting and inflation expectations. The next section assesses how anchored inflation expectations are and what can be done to improve the effectiveness of monetary policy.

4 How anchored are inflation expectations?

A major driver of inflation is people's expectations of inflation. Inflation expectations affect wage demands and firm pricing decisions. If expectations are for inflation to remain high, the central bank would have to keep interest rates high to hammer inflation expectations lower. High interest rates weigh on economic activity and so imply a real cost to the economy.

⁷Likewise, Honohan and Orphanides (2022) argue in their assessment of SARB's policy framework and conduct that "SARB communication should highlight the role of non-model-based judgement in policy choice".

Inflation expectations affect economic outcomes by influencing the decisions of individuals, firms, and policymakers. Central banks monitor inflation expectations as a proxy for future inflationary pressures. But how useful are inflation expectation measures? To measure this, we can compare one-year ahead surveyed inflation expectations to actual inflation outcomes one year later. The figure below shows inflation expectations shifted back one year against actual inflation each month. Since 2002, one-year inflation expectations have, on average, been 0.6 percentage points higher than inflation outcomes one year later. During mid-2022, inflation was more than 3.5 percentage points higher than surveyed expectations had suggested they would be. Another interesting thing to notice from Figure 28 is that inflation expectations are partly backward-looking: as actual inflation rises, individuals' and firms' expectations of future inflation begin to rise. Between 2017 and 2022, inflation expectations, however, remained well above actual inflation, and then between 2022 and 2023, it took inflation expectations time to rise in response to higher-than-expected inflation outcomes.⁸

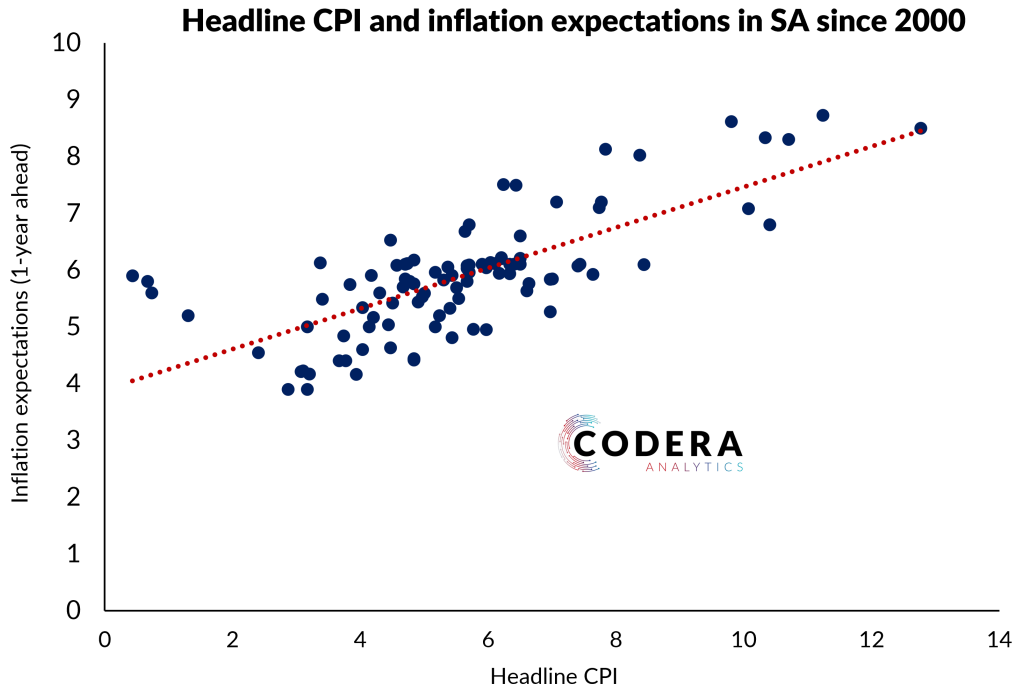


Source: Statistics South Africa, BER, EconData. Headline is quarterly average (year-on-year).

How can inflation expectations be relatively un-anchored even though they have been converging on the inflation target recently? It is also useful to compare changes in inflation expectations against the difference between actual inflation and the target as a simple way to assess how anchored expectations are (Figures 29 to 31). A positive trend line, as we observe, suggests that as inflation moves away from the target, expectations also shift, indicating less firmly anchored inflation expectations. The post-2017 period has a notably steeper slope of the line than for the 2000-2017 period. If one instead compares the level of expectations and inflation, or their differences to the inflation target, then one would obtain a higher correlation. This suggests that inflation expectations are backward-looking in South Africa.

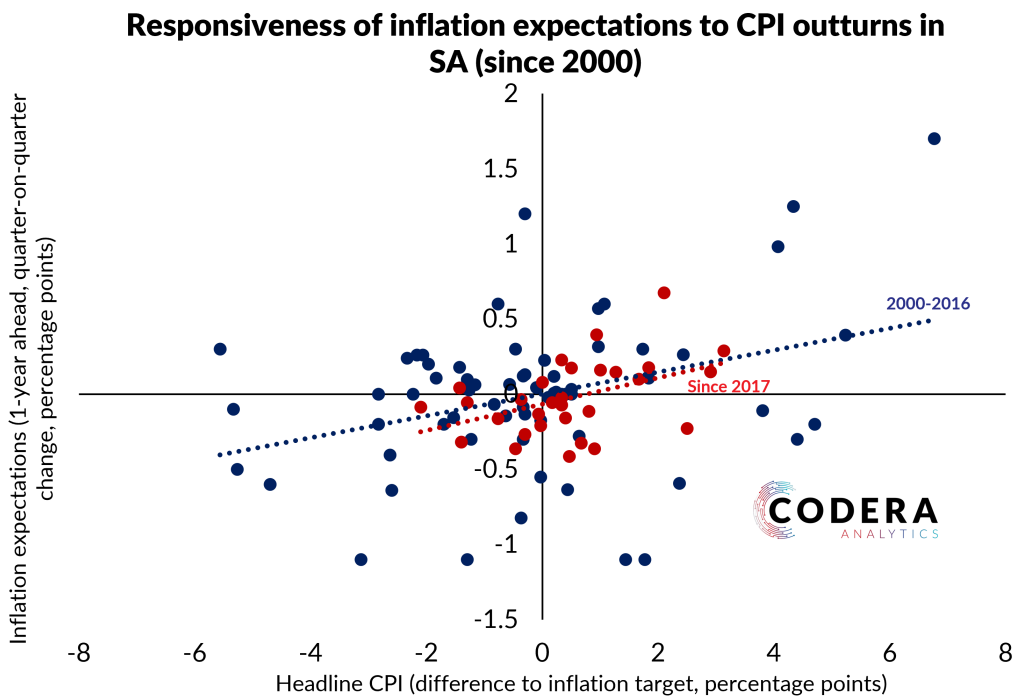
⁸Although market-based indicators of inflation expectation are available, in South Africa, like in other emerging markets, there are frictions that affect the trading and liquidity of inflation-indexed debt in secondary markets. This means that breakeven rates are, unfortunately, noisy measures of expected inflation, containing both an inflation risk premium and differential liquidity premia. There are also open questions around the representativeness of the inflation survey measures presented here, or potential bias in responses. Amaral et al. (2024), show for example, that the survey response rates has been declined dramatically - from around 1600 businesses in 2011 to around 400 in 2023.

Figure 29:



Source: Statistics South Africa, BER, EconData. Headline is quarterly average (year-on-year).

Figure 30:

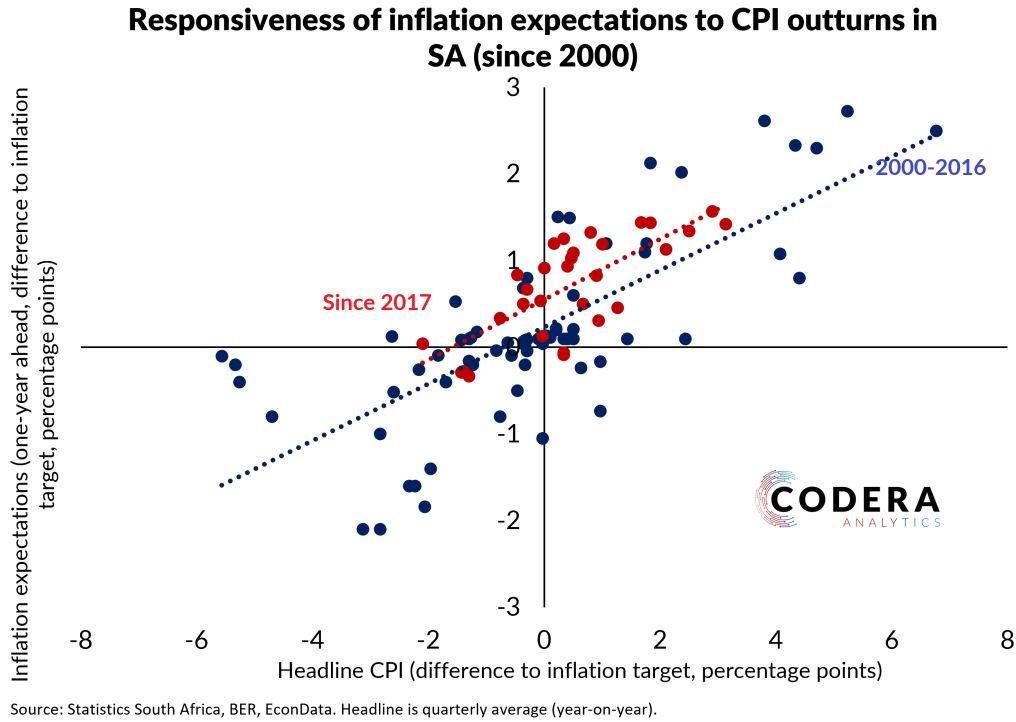


Source: Statistics South Africa, BER, EconData. Headline is quarterly average (year-on-year).

4.1 How anchored are inflation expectations around the world?

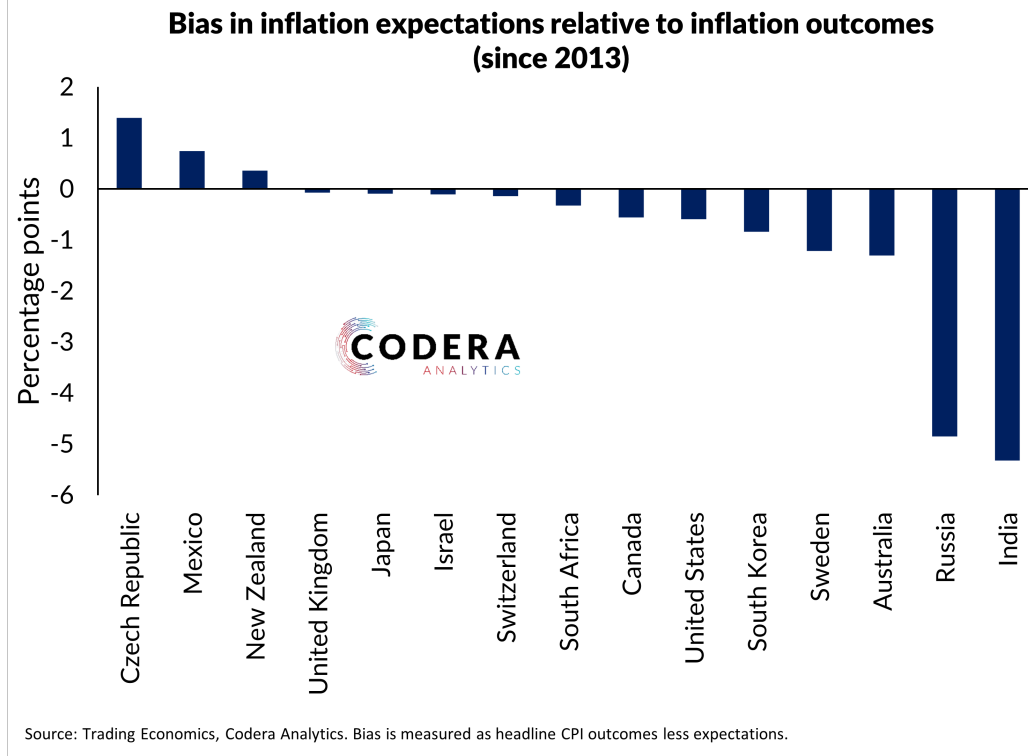
In South Africa, one-year ahead inflation expectations have tended to be above actual inflation. How does historical bias in inflation expectations in South Africa compare to other countries? Figure 32 presents a summary for countries that have long data samples. In the Czech Republic, Mexico and New Zealand, inflation expectations have often been below inflation outcomes, while they have tended to be much higher

Figure 31:



than inflation outcomes in India and Russia. Wedges between inflation expectations and inflation outcomes have also been higher in Australia, Sweden, South Korea, the US, and Canada than in South Africa.⁹

Figure 32:

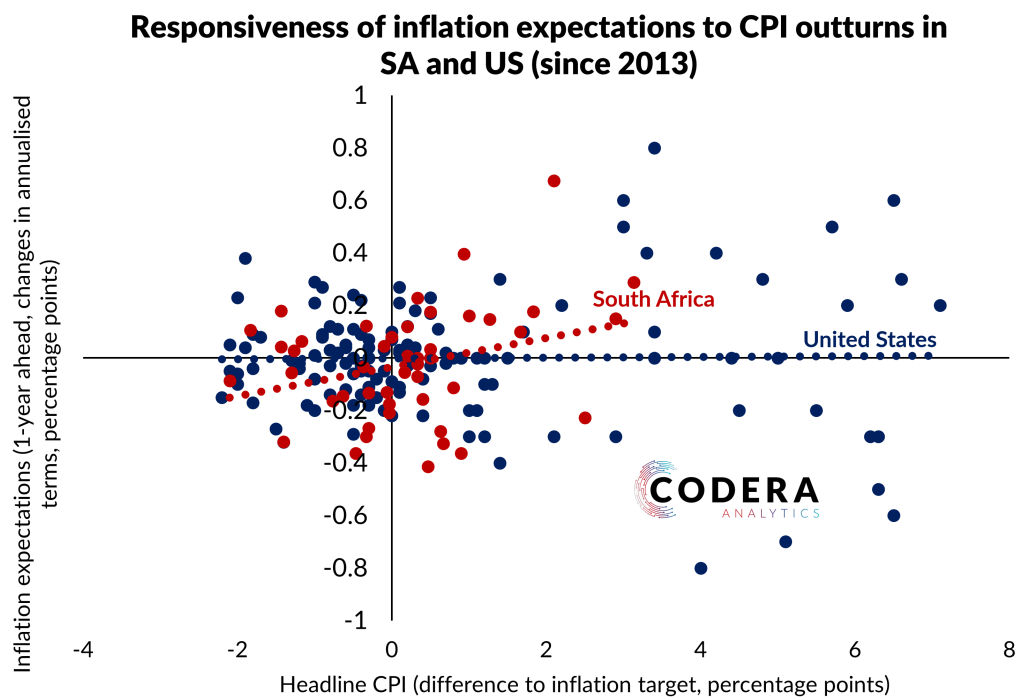


Another way to assess how anchored inflation expectations are is to look at how inflation expectations

⁹Note that Canada and Japan’s comparisons starts in 2015 and Russia’s in 2014. See [Codera’s blog](#) for how the results change when using a longer time span for countries that have longer data samples.

react to deviations in inflation from the inflation target. Figure 33 shows that inflation expectations in South Africa react more strongly to inflation deviations from the target than in the US, suggestive of less well-anchored expectations. A positive trend line suggests that as inflation moves away from the target, expectations also shift, indicating less firmly anchored inflation expectations. Figure 33 also reveals varying degrees of inflation outcome dispersion. The US' inflation target, at 2%, is much lower than South Africa's and there have been larger divergences in inflation outcomes from the target in the US. Even though there have been smaller divergences between headline inflation and the inflation target since 2013, there is still, as shown earlier, a high degree of dispersion across price categories that comprise the consumer price basket in South Africa. US inflation expectations have also tended to be above actual inflation, although the difference has been 0.6% since 2013 (compared to 0.35% in South Africa).

Figure 33:



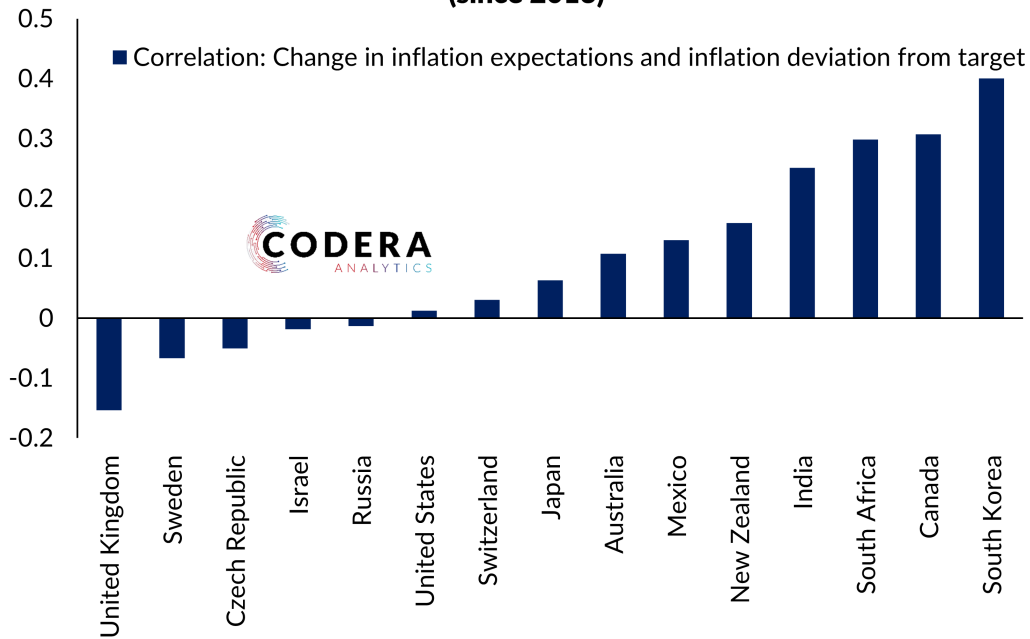
Returning to cross-country comparisons, inflation expectations in South Africa, Canada and South Korea have reacted more strongly to inflation deviations from the central bank's inflation target than in other countries, suggestive of less well-anchored expectations. Figure 34 presents a summary of the correlations between changes in inflation expectations and difference between actual inflation and the target as a simple way to assess how anchored expectations are.

4.2 Implications of backward-looking inflation expectations

The preceding sub-sections suggested that inflation expectations are partly backward-looking in South Africa: as actual inflation rises (falls), individuals and firms tend to raise (lower) their expectations of future inflation. We also observe this in wage outcomes. Pre-pandemic, despite the decline in overall inflation, inflation expectations, remained well above actual inflation. Public wages, in particular, grew much faster than the inflation target (Figure 35). Since mid-2021, public wage growth has slowed, while private sector wages have been growing faster the mid-point of the inflation target. The disconnect between wages and cyclical inflation contribute to cost-push inflation, even when demand pressures are not present. Despite

Figure 34:

**Responsiveness of inflation expectations to inflation
(since 2013)**

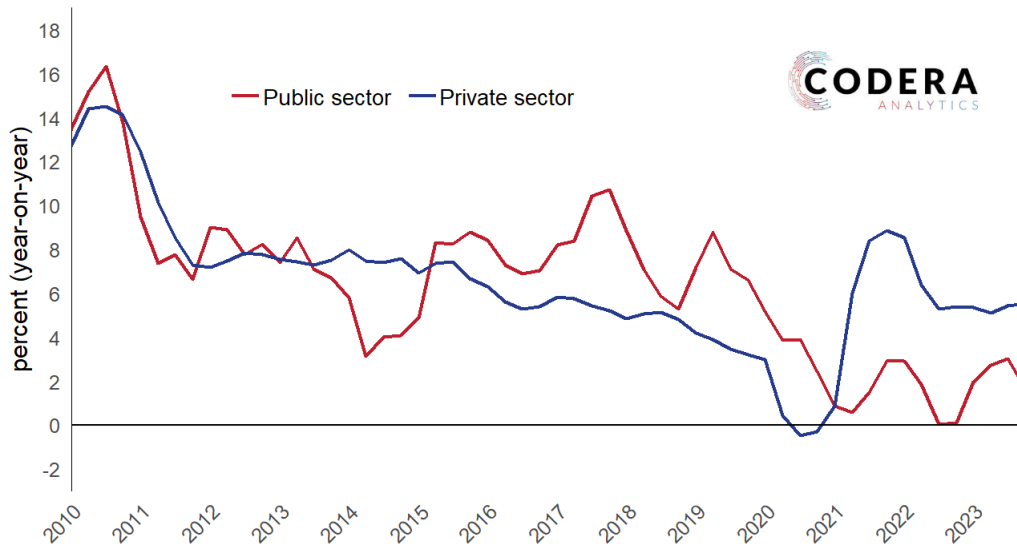


Source: Trading Economics, Codera Analytics.

their recent decline, this suggests that inflation expectations in South Africa are not yet as well anchored as in major advanced economies. Reducing inflation expectations further would therefore require an extended period of inflation below the current target, unless anchoring strengthens.

Figure 35:

**Growth in average nominal wages in South Africa:
Public vs Private sector**



Source: SARB, Econdata.
Four-quarter moving averages of year-on-year rates.

5 How should the transition to a lower target be managed?

Another important set of unanswered questions in the inflation target discussion in South Africa relate to what level of inflation might be achievable without higher interest rates and when to begin transitioning to a lower target to ensure as low a cost to the economy as possible. One might argue, for example, that SARB missed an ideal opportunity in the lead-up to the COVID-19 pandemic to lower the target given that favourable supply shocks were responsible for containing inflation at the time. As discussed in earlier sections, whether the current headline inflation undershoot represents an opportunity to cut the target depends on one's assessment of the structural inflation rate in the economy, and type of supply and demand shocks the economy is exposed to. Whether now is a good time to lower South Africa's inflation target also depends on whether the economic costs of doing so are worth bearing. These costs are likely to be time varying, and there is a lot of uncertainty around how large they might be. Lowering the target would likely signal a slightly tighter policy stance over the medium term, requiring a larger decline in inflation expectations to lower nominal long term interest rates. In general, the best time to reduce the inflation target would be when trend inflation has fallen. The analysis presented earlier suggests that core inflation measures overstate how much trend inflation has declined in South Africa, and that inflation expectations are stickier than assumed by SARB.

In a recent speech, the SARB Governor suggested that disinflation costs in South Africa have generally been low on account of SARB's credibility and quality of communication.¹⁰ Such a view is built on the idea that the 'Phillips curve' is relatively flat in South Africa and inflation expectations are well anchored. Central banks estimate the relationship between economic slack and inflation ('the Phillips curve') to assess the trade-off between reducing inflation and potential loss of employment and output. Estimates from the IMF suggest that the slope of the Phillips curve has steepened in South Africa post-pandemic, with a decrease in economic slack being associated with a larger increase in inflation, for example (Figure 36). The IMF estimates are consistent with our assessment of the implications of capacity pressure for inflation and interest rates in this pre-pandemic paper and our analysis that suggests that inflation expectations are less well anchored in South Africa than in other countries.¹¹ It also implies that the costs of shifting to a lower inflation target might be higher than implied in the Governor's speech.¹²

The short-term costs of lowering the inflation target might be worth bearing if they are less than the long term benefits of a lower target. If SARB could successfully lower expected inflation, it would be expected to contribute to lowering long-term nominal interest rates to the extent that inflation risk premia fall. Figure 37 suggests that term premia, which are a composite of liquidity, credit and inflation risk premia, are an important contributor to South Africa's high long term borrowing costs.¹³ Although lowering the inflation target would be expected to help bring down long term interest rates via lower inflation risk premia, a worsening of government finances could move rates in the other direction.¹⁴

¹⁰See [Kganyago Lecture](#).

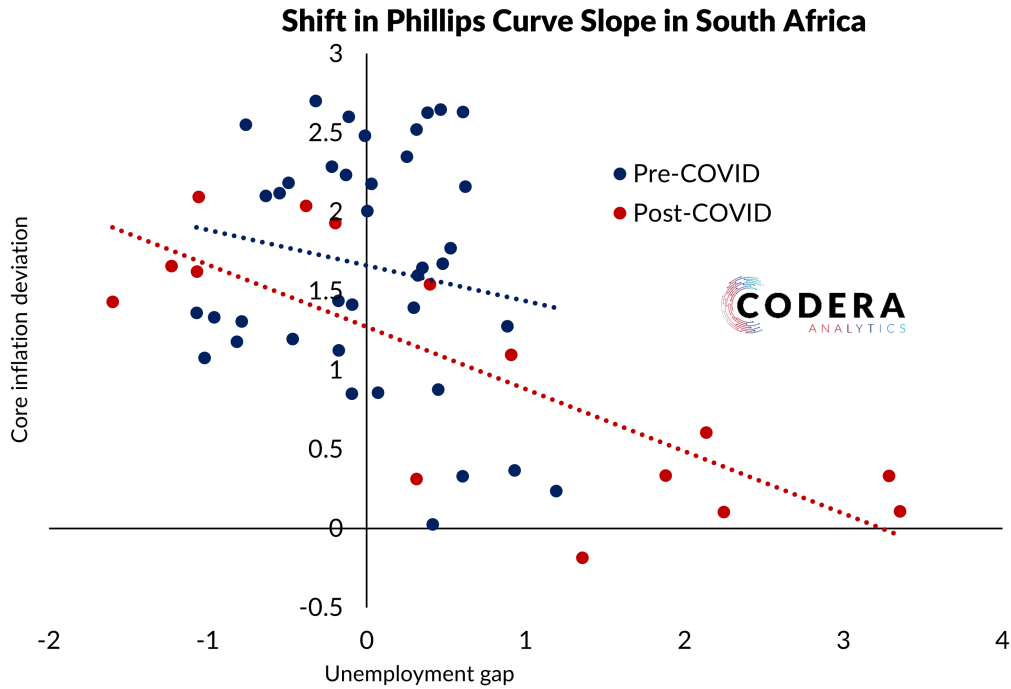
¹¹See [this Codera blog post](#) for more.

¹²This is also consistent with finding from Botha, Kuhn and Steenkamp (2020) and du Rand, Hollander and van Lill (2023) that provide empirical evidence showing that the Phillips curve has not flattened in South Africa. Recent SARB estimates from early 2024 suggest reducing the inflation target to 3% would be associated with a short-term reduction in growth by 0.3 percentage points, but would eventually be offset by higher long term growth should inflation expectations and inflation adjust downwards relatively quickly (SARB 2024).

¹³A related consideration for the feasibility of lowering the inflation target is how the government's fiscal stance is affecting the outlook for growth and inflation. IMF analysis suggests that the government's fiscal stance has remained stimulatory at the margin, despite attempts at consolidation (see [this Codera blog post](#)).

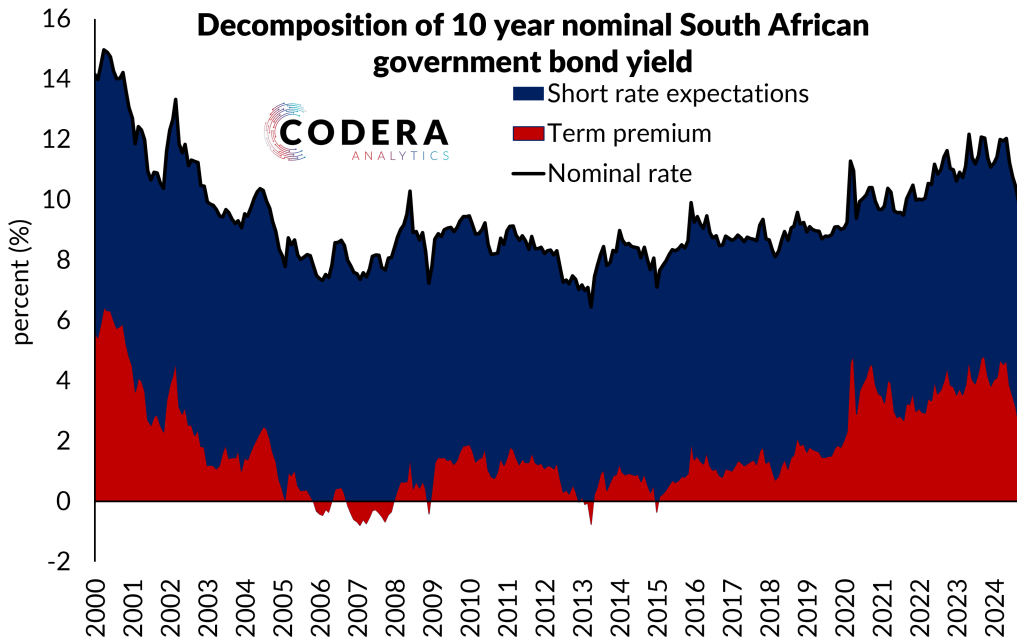
¹⁴Christensen and Steenkamp (2025) provide estimates of government credit risk premia and suggest that they contributed to higher sovereign borrowing costs.

Figure 36:



Source: IMF WEO October 2024

Figure 37:



Note: Our approach for estimating the other term premia is described in Erasmus, R., Steenkamp, D. 2022. Term Premium Estimation for South Africa. *Journal of Applied Economic Sciences*, Volume XVII, 4(78): 347 – 350. The term premium is the difference between the nominal 10-year sovereign bond yield and average expected short rates over that horizon and captures sovereign bond market liquidity risk, sovereign credit risk and inflation uncertainty.

The preceding sections argued that an implication of essential goods and services like food or electricity driving high inflation dispersion is that monetary policy aimed at reducing inflation in interest rate-sensitive parts of the economy will tend to stifle economic growth in areas that are not experiencing above target inflation. Lowering the inflation target without addressing such problems could impose large costs on the economy. Given that several government-related inflation components have pushed up headline inflation over the past decade, achieving a lower target would necessitate coordination with the government to

address the high inflation driven by administered prices in South Africa.¹⁵

This is not to say that South African policymakers should not be considering lowering the inflation target. But the structure of the economy, the measurement of the target, the stance of fiscal policy and the commitment of government to a lower target affect the economic costs of lowering the target and the ideal timing of a policy change. If a target change is being considered, a thorough review of the issues laid out in this paper, as well as development of an operational framework for a transition to a different target, will need to be communicated.

6 What are the implications of a target review for central bank communication?

The Governor announced at the January 2025 Monetary Policy Committee (MPC) media conference that SARB will host an inflation targeting conference in March this year. This section discusses the implications of a target review for central bank conduct and communication and stresses the importance of improved policy analysis and communication of the MPC's collective judgements and policy preferences. If underlying inflation pressure is higher than implied by measures of core inflation targeted by SARB, it raises the probability that the central bank would struggle to achieve a lower inflation target without higher interest rates. This would hurt the credibility of SARB, given its assertion that a lower target would be achievable at little economic cost. Likewise, an absence of supportive fiscal policy could undermine the extent to which a more ambitious target reduces borrowing costs in the economy, while a lack of buy-in from government would raise the adjustment cost for private sector firms. Political coordination, including a social compact between government (including municipalities), the central bank, state owned enterprises, relevant regulators and labour unions, would help to support the credibility of any central bank programme to permanently lower trend inflation. Such a compact is unlikely without clear articulation of the benefits of a lower target and what is required to counterbalance the short-term costs of reducing inflation.

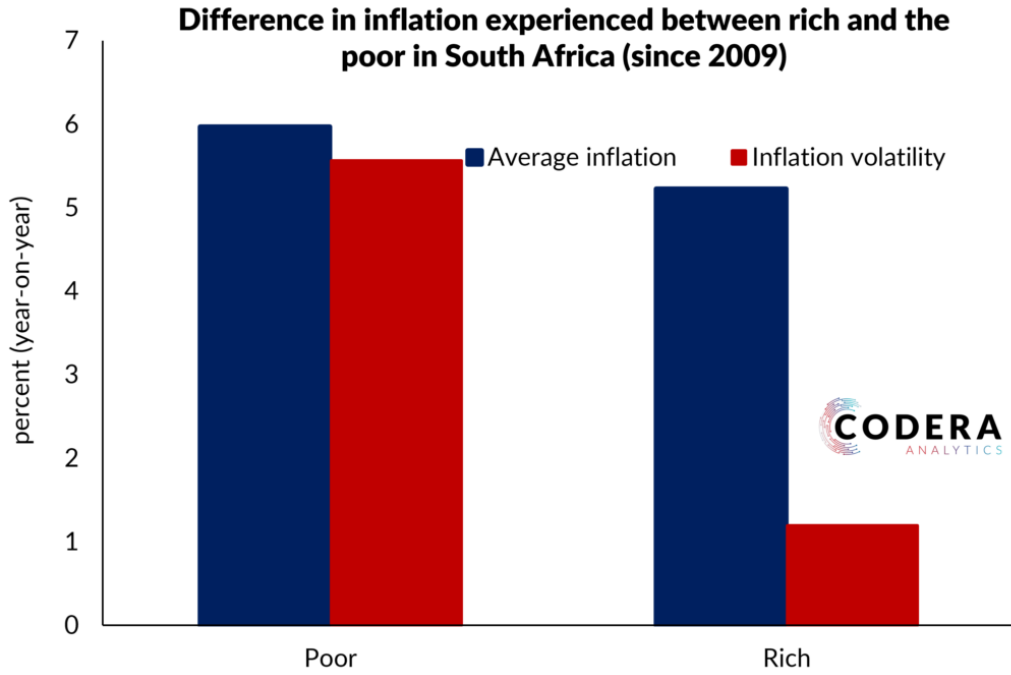
Another important consideration for the appropriate inflation target and the measure used to define it is its relationship to the experiences of firms and households. This affects how well the inflation target serves as an anchor for expectations, the central bank's credibility and therefore how well the central bank can stabilise inflation. The preceding sections suggested that inflation expectations in South Africa are not yet as well anchored as in major advanced economies. This section considers the relationship between the inflation target and the inflation experience of different groups and what aspects of the central bank's policy communication could be enhanced to support its credibility as an inflation targeter.

Low-income individuals (decile 1) have typically experienced higher inflation than the wealthiest group in South Africa (decile 10, Figure 38). Since the pandemic, low-income individuals have typically experienced higher inflation—about 2 percentage points more than the wealthiest group. But the poor experience much more inflation volatility - almost 5 times more than the rich. This is because food is the major contributor to the inflation experienced by South Africa's poorest, while rich people consume a more diverse set of goods and services, with housing and utilities playing a larger role in driving their inflation outcomes, on average (Figures 39 and 40).¹⁶ This makes the credibility of the central bank highly dependent how it communicates its tolerance for such deviations and how clear its explanations are.

¹⁵This argument is also consistent with that of Honohan and Orphanides (2022), who argue that shifting the inflation target down to 3 per cent would “require the fiscal authority to play its part, notably to avoid persistent high increases in administered prices.”

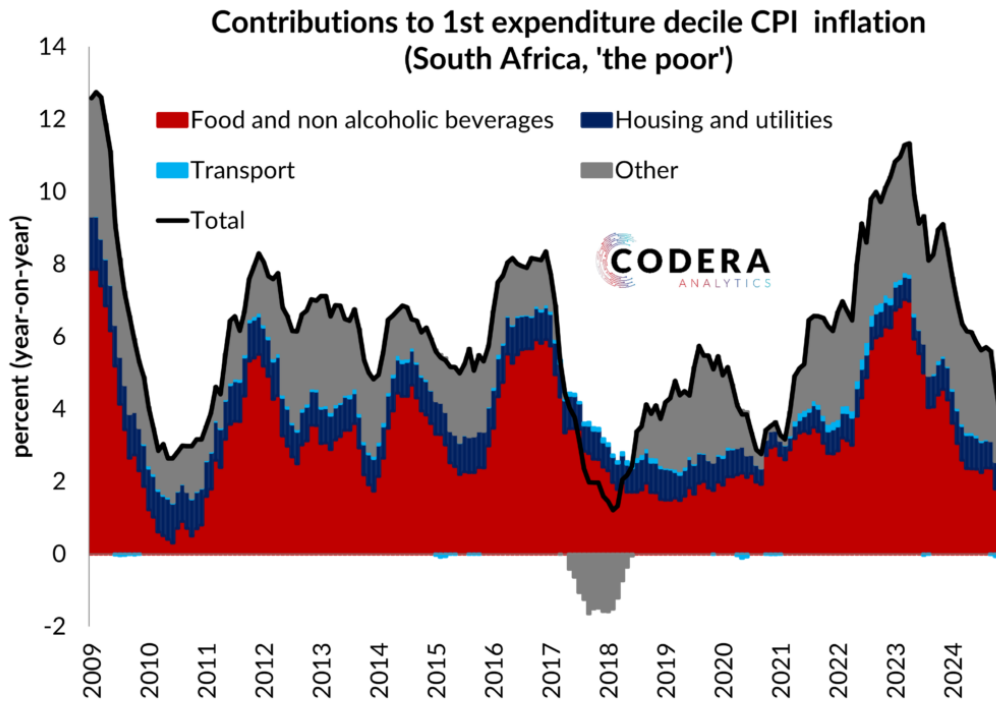
¹⁶As mentioned earlier, inflation is measured imprecisely for different groups and the existing CPI weights may misrepresent the actual inflation experienced by South African firms and households. We will update this analysis once updated weights and new CPI indices are released later this month.

Figure 38:



Source: Stats SA, EconData, Codera Analytics. Expenditure decile 10 is the richest 10% of households and decile 1 the poorest 10% of households.

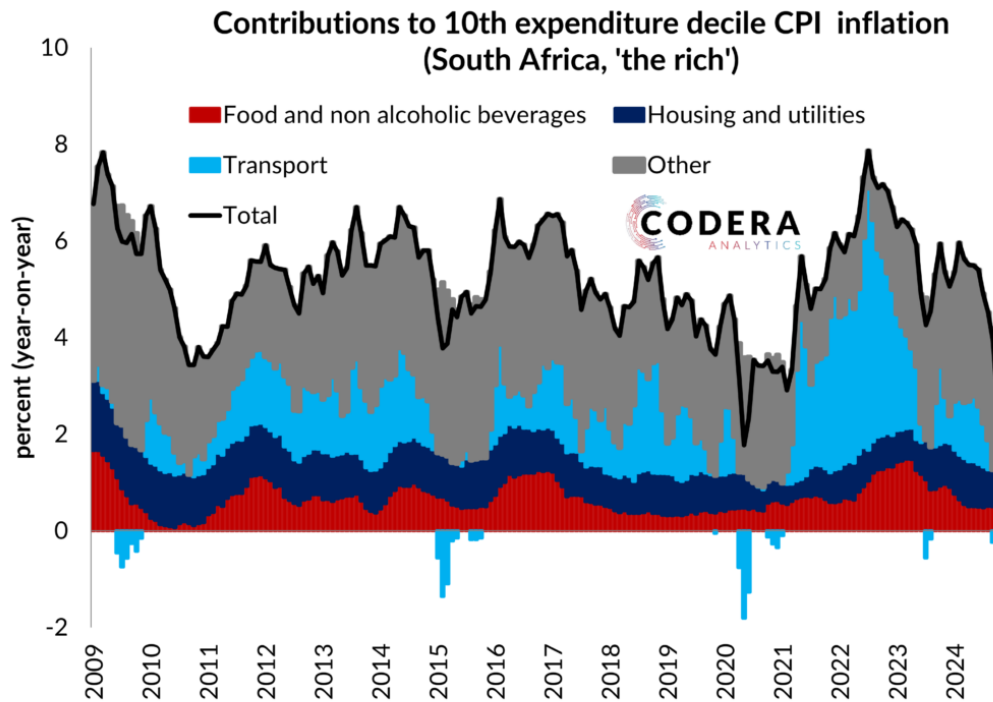
Figure 39:



Source: Stats SA, EconData, Codera Analytics. Expenditure decile 1 the poorest 10% of households.

Given the divergence of inflation experience across South African society, the central bank must demonstrate that it can explain differences between the inflation target and the experiences of specific groups. As discussed earlier, this involves assessment and communication of the structural and cyclical drivers of inflation, both in aggregate and for specific price components and participants in the economy, to ensure appropriate policy settings and management of expectations. As we argued earlier, a way to enhance policy transparency would be for the central bank to communicate the economic narrative underlying actual monetary policy decisions through the lens of its main forecasting model to ensure consistency of its pol-

Figure 40:



icy communication. Given the importance of supply-side factors for inflation in South Africa, key to the central bank's communication strategy would also be a demonstration of its understanding of the structural factors that work against its disinflation efforts and explaining how policy must address inertial price and wage settings. Measures of underlying inflation pressures are also a useful communication device for demonstrating the central bank's understanding of inflation dynamics.

6.1 Monetary policy guidance during transition to a new target

Best practice among inflation targeting central banks is for the MPC to clearly articulate its interpretation of the bank's inflation target, lay out its plans to ensure achievement of the target over the medium term, and explain how the bank is likely to react to specific shocks if they do occur. If this target is to be revised, the rationale behind a target change will need to be clearly and publicly articulated. To build trust with households and price-setters, evidence of long-term benefits that make it worth bearing any short-term costs should be presented. Complementary policies that support the central bank's disinflation efforts should also be outlined. Such policies could include structural reforms that reduce government-related inflation, promote the responsiveness of inflation to monetary policy and public commitments to the new target by organs of the state and labour unions.

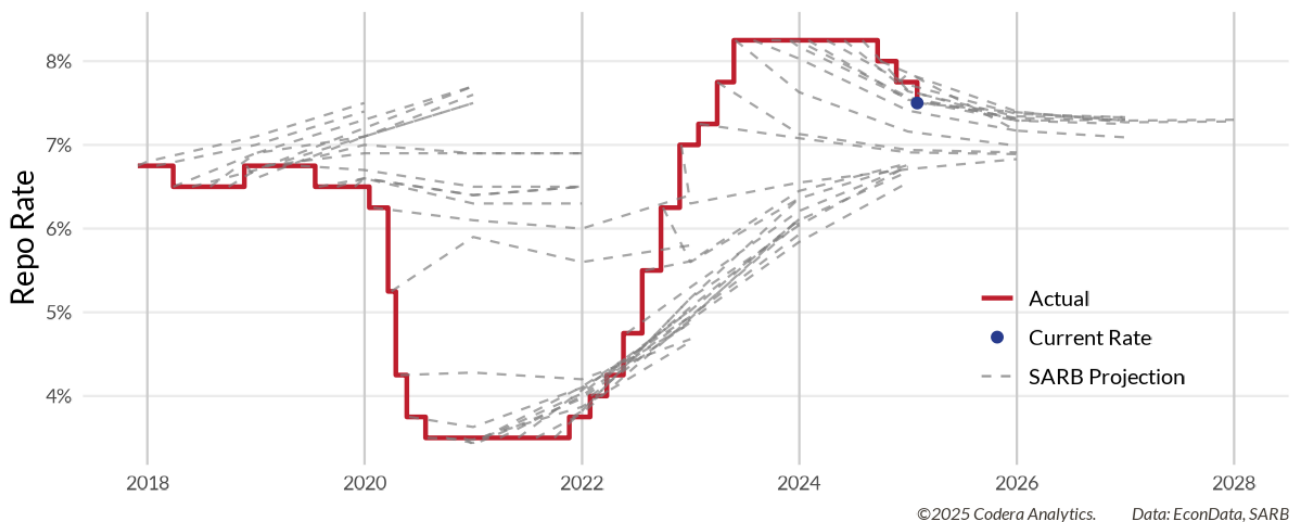
A target change would also present an opportunity for the central bank to improve how it communicates its policy preferences. The SARB stands out for publishing projections that are not necessarily in line with MPC decisions. This means that forecasts are conditioned on a different policy path than has been implemented and increases the risk that their other projections will be inaccurate. The bigger danger with doing so is that it undermines the role of central bank projections as guide for the stance of monetary policy, which could lead to asset mispricing and unnecessary market volatility. When words and deeds do not align, it undermines the MPC's credibility.¹⁷

Figure 41 shows that there have been times when SARB policy decisions have diverged from their published policy rate forecasts that accompany a monetary policy decision. The divergence between policy actions and projections were particularly large during late 2022 and 2023. The COVID-19 pandemic period should be set aside given the unpredictability of the occurrence of the pandemic. However, in the aftermath of the pandemic, the SARB continued to interpret the pandemic as predominantly a demand shock, underestimating the risk of supply-related inflation pressures in its wake. This meant that the post-pandemic spike in inflation caught SARB by surprise, as they have been slow to revise their judgements about the underlying trends in the economy, for a long time holding on to a view that inflation pressures would be transitory despite growing evidence to the contrary.

Figure 41:

Actual policy rate vs historical published projections

Projections depicted as dashed lines and actual policy rate as the solid line.
SARB only publishes end-of-year policy rate projections.



In a complex, uncertain world forecast errors and incorrect assumptions are inevitable. Whether forecast errors do damage to an institution's credibility depends on whether policymakers demonstrate that they understand the factors behind these errors and incorporate what they have learned in their judgements about the risks to the outlook. This means that transparency around monetary policy deliberations and clear communication are crucial to ensuring the market can assess whether the central bank's judgements are reasonable and that it is credibly committing to its policy target.

A few technical tweaks in how the MPC communicates its decisions would go a long way to improving the public's understanding of its policy stance. Being more transparent about the information used to make decisions, its underlying assumptions, and the process by which decisions are reached allows external

¹⁷The implication of publishing forecasts that are not based on the actual decisions made by the MPC is that it creates uncertainty around the reaction function of the SARB (i.e. how the Bank will react to specific economic shocks) and makes it difficult for market participants to anticipate how interest rates might change over time (Soobyah and Steenkamp 2020).

parties to interrogate whether SARB's decisions are credible and its modelling and forecasting practices fit for purpose. The SARB should also consider either publishing forecasts consistent with their policy stance or labelling their forecasts as independent 'staff projections' to be more consistent with best practice.¹⁸

Better co-ordination with government will also be important for enhancing the central bank's transparency about its policy target and policy decisions. A recent IMF (2024) assessment of the transparency SARB's frameworks provides suggestions for how to improve policy communication with respect to the inflation target. The report noted that "the process for setting the target is opaque and not well understood by external stakeholders. This lack of transparency has created uncertainty around the respective roles of the National Treasury and the SARB in reviewing and setting the inflation target and the interpretation of the target range". The report notes that "more clarity is advised with respect to the review of the SARB's monetary policy framework and the setting of the inflation target by the National Treasury in consultation with the SARB". The report also proposed that the SARB should "systemically conduct transparent post-mortems of its monetary policy framework and its implementation."

¹⁸The easiest would be to label the projections it publishes as 'staff projections' (as the US Federal Reserve's Federal Open Market Committee) does. This would make it clear that the forecasts are not based on the views of MPC members. It would also help if the MPC formally explained how the members' views about the outlook differ from what has been assumed in the QPM. A more challenging alternative would be to align QPM projections with assumptions representing the consensus of the MPC members, as is done by the Bank of England. Economists tend to disagree, so it can be hard to achieve consensus or characterise the diversity of views around how the economy works and how policymakers should respond. The Bank of England achieves this because it has a well-defined decision-making process and sophisticated forecasting technology that makes it easy to update forecasts and incorporate MPC assumptions, as well as a culture that promotes constructive debate and consensus-building.

7 Conclusion

The Reserve Bank Governor is proposing to lower the inflation target in South Africa. Yet there is little research that provides guidance on the optimal level of inflation in South Africa. The optimal target would be the level of inflation that is considered to be consistent with price stability, while providing sufficient flexibility for the SARB to respond to inflationary and deflationary shocks without creating undue economic volatility. South Africa's inflation target is higher than many other emerging market economies, so there is an argument to be made for transitioning to a lower target. But there are many unanswered questions about the definition of the target that would be optimal given South Africa's economic context.

High structural inflation has weakened the competitiveness of South Africa's exporters and the buying power of the currency. This has contributed to South Africa becoming a high cost, low productivity economy. A lower inflation target would help in this respect but there is a raft of structural and political factors that have contributed to the decline in South Africa's cost competitiveness and long-term increase in relative prices in South Africa.

A particular challenge the SARB faces is that several government-related inflation components have consistently grown at well above the upper bound of the current inflation target. The SARB cannot directly affect prices in such categories, so keeping interest rates high in response to such pressures imposes costs on parts of the economy where prices are more flexible. Achieving structurally lower inflation will require a sustained reduction in these government-driven cost pressures.

In a recent speech, the SARB Governor suggested that disinflation costs in South Africa have generally been low. Our estimates, which are consistent with recent estimates from the IMF, suggests that the costs of shifting to a lower inflation target might be higher than implied the Governor. If the costs of disinflating are high and the SARB were to struggle to achieve a lower inflation target, it would hurt the reputation of SARB. Worse still, an absence of supportive fiscal policy could undermine the extent to which a more ambitious target reduces borrowing costs in the economy. Lowering the target without buy-in from government would raise the adjustment cost for private sector firms and erode the SARB's hard-won credibility.

If the inflation target is to be revised, the rationale behind a target change will need to be clearly and publicly articulated. To build trust with households and price-setters, evidence of long-term benefits that make it worth bearing any short-term costs should be presented. Complementary policies that support the SARB's disinflation efforts should also be outlined. Such policies could include structural reforms that reduce government-related inflation, promote the responsiveness of inflation to monetary policy and public commitments to the new target by organs of the state and labour unions.

Another gap in the debate about the inflation target is how it should be measured. There are several considerations that matter for how the inflation target should be defined. These relate, for example, to selecting a price index that is relevant to the experience of firms and households or the types of shocks the economy is exposed to. In South Africa's case, inflation is very sensitive to imported inflation and supply-side shocks, including the exchange rate and weather. Another important question is how much flexibility should be afforded to the central bank in achieving the target (such as the target horizon and choice between a range and a point target). There is very little academic or policy research that address these issues in a South African context.

The measures presently used by policymakers to assess inflation dynamics do not sufficiently describe the nature of structural inflation in South Africa. There are biases and uncertainties in the statistics monitored by the central bank that affect judgements around underlying inflation pressure. These impact assessments of the appropriateness of policy settings, given the importance of supply shocks in the determination of inflation in South Africa. This also creates a communication challenge for the SARB, given differences in the inflation experienced by different households and firms.

Even though inflation has recently fallen towards the bottom end of the SARB's target range, measures of trend inflation have been stubbornly above the midpoint of the inflation target and that there is a high degree of inflation dispersion across price categories. Our estimates of underlying inflation pressure also suggests that there has been more broad-based inflation pressure since the pandemic than implied by the 'core' measure that excludes some volatile components such as food and fuel prices that the SARB focuses on in its Monetary Policy Statements. To be able to judge the rate of structural inflation and when an opportune time would be for a reduction in the inflation target, the SARB needs new measures of underlying inflation. To understand the impact its policies will have on the economy, the SARB must use frameworks for interpreting the economic drivers of underlying inflation pressures on an ongoing basis to support its policy credibility.

Despite expectations near the mid-point of the current target, monetary policy will need to stay tighter than otherwise to lower inflation expectations further and anchor inflation to a lower level over the medium term. The duration of a more restrictive policy stance would depend on whether households and businesses believe the SARB is fully committed to bringing inflation down to the lower target and keeping it there. Achieving this without raising interest rates beyond current projections would require a strong government commitment to tackling the root causes of structural inflation. This would need to include determined efforts to improve efficiencies in electricity production, addressing high administered price inflation, and a commitment to tying increases in public wages to productivity growth. Political coordination, including a social compact among the government, SARB, state-owned enterprises, relevant regulators, and labour unions, would bolster the credibility of any central bank programme to reduce trend inflation permanently. Such a compact is unlikely without clear articulation of the benefits of a lower target and what is required to counterbalance the short-term costs of reducing inflation.

References

- Amaral, A., Kruger, M. and M. Reid (2024). "Looking to the price setters what can we learn from firm level inflation expectations data," Occasional Bulletin of Economic Notes 11057, South African Reserve Bank.
- Botha, B., Kuhn, L. and D. Steenkamp (2020). "Is the Phillips curve framework still useful for understanding inflation dynamics in South Africa," Working Paper WP/20/07, South African Reserve Bank.
- Botha, B. and D. Steenkamp (2024). "Reserve Bank could do much more to increase transparency", Business Day, 02 July 2024.
- Christensen, J. and D. Steenkamp (2025). "Joint Estimation of Liquidity and Credit Risk Premia in Bond Prices with an Application", Working Paper WP/25/01, South African Reserve Bank.
- Diercks, A.M. (2019). "The Reader's Guide to Optimal Monetary Policy". Available at SSRN: <https://ssrn.com/abstract=2989237>
- du Rand, G., H. Hollander and D. van Lill (2023). "A deep learning approach to estimation of the Phillips curve in South Africa," WIDER Working Paper Series WP-2023-79, World Institute for Development Economic Research (UNU-WIDER).
- Eo, Y., L. Uzeda and B. Wong (2023). "Understanding trend inflation through the lens of the goods and services sectors," Journal of Applied Econometrics, John Wiley & Sons, Ltd., vol. 38(5), pages 751-766, August.
- Erasmus, R. and D. Steenkamp (2022). "Term Premium Estimation for South Africa", Journal of Applied Economic Sciences, Volume XVII, Winter, 4(78): 347 – 350.
- Greenwood-Nimmo, M., D Steenkamp, and R. van Jaarsveld (2024). "A bank-level analysis of interest rate pass-through in South Africa", Journal of Macroeconomics, Volume 82.
- Honohan, P. and A. Orphanides (2022). "Monetary policy in South Africa, 2007–21", WIDER Working Paper No. 2022/29, UNU-WIDER, March 2022.
- International Monetary Fund (2024). "South Africa: Central Bank Transparency Code Review". IMF Country Report No. 24/320. December.
- Khan, M and Abdelhak S.M. (2001). "Threshold Effects in the Relationship Between Inflation and Growth", IMF Staff Papers, 48, issue 1, number 1.
- Rapapali, M and D. Steenkamp (2019). "Is There a Relationship between Productivity and Relative Prices in South Africa?" Journal of Development Perspectives, vol. 3, no. 1-2, 2019, pp. 164–190.
- Ruch, F., N. Rankin and S. du Plessis (2016). "Decomposing inflation using micropricelevel data South Africa's pricing dynamics," Working Papers 7353, South African Reserve Bank.
- Soobyah L. and D. Steenkamp (2020). "Occasional Bulletin of Economic Notes 2001 A measure of South African sovereign risk premium June 2020," Occasional Bulletin of Economic Notes 10009, South African Reserve Bank.
- South African Reserve Bank (2023). "Monetary Policy Review", April.
- South African Reserve Bank (2024). "Monetary Policy Review", October.
- Steenkamp D. (2018). "Productivity estimates for South Africa from CES production functions," Working Papers 8937, South African Reserve Bank.
- Steenkamp D. (2024a). "More monetary policy guidance, please", Business Day, 25 March 2024.
- Steenkamp D. (2024b). "Perhaps it's time for Reserve Bank to review its modelling and forecasting", Business Day, 29 May 2024.
- Steenkamp D. (2024c). "Low trend inflation best time to cut target", Business Day, 29 July 2024.
- Steenkamp D. (2024d). "Not behind the curve, but rates may not fall as much as hoped", Business Day, 10 October 2024.
- Steenkamp D. (2024e). "The SARB's schizophrenic policy guidance", Currency news, 4 February 2025.
- Wolman, A.L. (2011). "The Optimal Rate of Inflation with Trending Relative Prices", Journal of Money, Credit and Banking, 43: 355-384.
- Ruge-Murcia, F.J. and A.L. Wolman (2024). "A Model-Based Perspective on Inflation and the Distribution of Relative Price Changes", Richmond Fed Economic Brief, Federal Reserve Bank of Richmond, vol. 24(30), September.
- van Zyl, H. (2024). "Supercore vs. PCCI: Evaluating the predictive performance of novel underlying inflation measures in SA". Forthcoming.