South Africa's 3% inflation target

The South African Reserve Bank believes we must take advantage of the current lower levels of inflation and has announced that it will now interpret its mandate as targeting 3%. This has been met with mixed responses. Sandy McGregor provides some context on the origins of inflation targeting and explains why a lower target has many positive benefits.

The origins of inflation targeting

Public policy evolves in response to past experience. A significant cause of the rampant inflation that plagued the 1970s was a long period during which interest rates were too low. After inflation was crushed in developed economies by high interest rates in the early 1980s, some argued that rates were too high and had an unnecessarily adverse impact on economic growth. Inflation targeting is predicated on the idea that between these extremes, there is an interest rate that allows for an optimal combination of price stability and economic growth. This is now known as the neutral rate. A consensus has developed that the objective of monetary policy should be to use interest rates to direct the economy towards that optimal combination.

In 1990, New Zealand became the first country to adopt an inflation target as the primary objective of monetary policy. The concept gradually gained traction, and with the adoption of a 2% target by the US Federal Reserve Board in 2012, it became mainstream central bank practice. It is noteworthy that many of the countries that were among the first to follow New Zealand's example had previously had a bad inflationary experience. This includes South Africa, which adopted a 3% to 6% target range in 2000.

The contribution of Milton Friedman

Milton Friedman ranks with Adam Smith and John Maynard Keynes as an economist who profoundly changed the way people understand how the economy works. He argued that monetary policy has a profound impact on macroeconomic outcomes. He cited the Great Depression of the 1930s as an example of the consequences of excessively restrictive monetary policy. He also said that inflation is and always will be a monetary phenomenon, caused by central banks allowing an excessive expansion of the money supply. As prices soared out of control in the 1970s, Friedman's ideas gained the status of an accepted paradigm explaining inflation. It was a simple step to argue that if inflation is a monetary phenomenon, central banks should be given the responsibility of controlling it. Friedman's ideas evolved into today's widespread inflation-targeting policies.

The monetary tool used to control inflation is an interest rate appropriately higher than the inflation rate. Inflation is a manifestation of economic inefficiencies. Real rates promote the efficient use of capital, which reduces inflationary pressures.

Since the widespread adoption of inflation targeting, inflation is no longer an economic problem. Central banks responded to the post-pandemic surge in prices with significantly increased interest rates. While inflation in developed economies remains higher than before the pandemic, it has now returned to levels which do not threaten macroeconomic stability. Of course there will always be countries like Argentina, Venezuela, Zimbabwe and Turkey where crazy monetary and fiscal policies combine to create hyperinflation, but these are the exceptions.

However, central banks have been too ready to claim credit for this success. While an appropriate monetary policy is a necessary condition for price stability, it is not the only one. Equally important has been the impact of productivity. While Friedman's ideas about money are important, his greatest impact was made as one of the most articulate proponents of the market economy, which naturally promotes economic efficiency. Despite his statement to the contrary, inflation is not simply a monetary phenomenon. Since 1980, the global economy has been transformed by increased productivity arising from growing trade between nations and advances in technology. This has reduced the cost of goods and services, promoting an environment of price stability. It is the combination of prudent monetary policy and improving productivity that has tamed inflation.

Inflation targeting in South Africa

An inflation target range of 3% to 6% was set in 2000 by the then Minister of Finance Trevor Manuel. It was a wide range which addressed the political realities of the time. The responsibility for implementing this target lay with the South African Reserve Bank (SARB). For the next 14 years, the SARB targeted the 6% upper band of the target range.

In the first decade after inflation targeting commenced, inflation averaged 6.2% but was very volatile, reaching a peak of 13.7% in August 2008. It was only during Gill Marcus's term as SARB governor between 2009 and 2014 that inflation settled down at about 6%. When Lesetja Kganyago became governor in 2014, he interpreted the SARB's mandate as requiring that the target should be 4.5%, the midpoint of the range. This was achieved in 2019 when inflation averaged 4.2%. In common with other central banks, during the pandemic the SARB slashed interest rates, taking the repo rate down to 3.5%. Then in response to the post-pandemic inflation shock, which took South African inflation to 7.6%, the repo rate was gradually increased, reaching 8.25% in June 2023. Inflation again started to decline, and in November 2024 was only 2.8%. It has remained close to 3% ever since, as shown in Graph 1 (see page 2).

The SARB has taken advantage of this welcome development to announce that it will now interpret its mandate as targeting 3%, the bottom of the prescribed range. It said we must seize the opportunity presented by the decline in inflation. This was welcomed by the bond market where bond yields have declined but concerns about the decision have been expressed elsewhere.

Graph 1: South Africa's interest and inflation rates over time

Source: Iress (accessed: 12 August 2025)
Note: Inflation for July 2025 is an estimate. CPI inflation has been calculated based on the most recent rebased values from Stats SA, reflecting the data as at 30 June 2025.

The benefits of low inflation

Inflation is a stealth tax which disproportionately burdens the poor. Those with wealth can protect themselves against its harmful consequences because they have assets whose value appreciates with inflation, but those without assets have no similar protection. Margaret Thatcher used to say that there was a moral imperative that governments eliminate inflation.

While theoretically current interest rates impact future inflation, usually it is inflation that leads interest rates. The widespread claim that monetary policy is data dependent is an admission of this truth. As inflation falls, so does the appropriate real rate. In South Africa, inflation at 4.5% requires a real rate of about 2.5%, giving a nominal rate of 7%, which happens to be the current repo rate. As inflation declines, the real rate required to promote price stability also declines. With inflation at 3%, it will be about 2%, which implies the nominal rate should be 5%, 2% lower than when the target was 4.5%. There will be many beneficiaries of permanently lower rates: A 2% cut in mortgage rates would constitute a windfall of about R30bn annually to those whose homes are mortgaged. The affordability of house purchases would improve. Lower rates could resurrect the moribund property market outside the Western Cape. The government has already benefited from lower bond yields. Business would be incentivised to borrow more for investment. Lower interest rates would promote stronger economic growth.

The critics of a lower inflation target

Within financial markets, sceptics question whether current levels of inflation can persist. The SARB's models project that in the last quarter of 2025, inflation will accelerate to an annualised rate of 3.9% and the July print was 3.5%. The problem may be that the sudden advent of 3% inflation has taken many, including the SARB, by surprise.

The counter-argument is that experience elsewhere is that once inflation declines to a substantially lower level it tends to stay there because the decline is the outcome of improving efficiencies, many of which will be permanent. Also, South Africa has an open economy, which is significantly influenced by what happens elsewhere. China is exporting deflation to the rest of the world. The Organization of the Petroleum Exporting Countries (OPEC) has concluded that it lacks the power to sustain high oil prices by curtailing production, and its interests are best served by producing more oil at lower prices. South Africa's current account is reasonably balanced, which promotes rand stability. A stable currency creates an environment supportive of low inflation.

Another group of critics argues that a 3% target will force the SARB to keep interest rates artificially high, which will damage the economy. However, given that inflation is already at 3%, draconian changes to the path of interest rates are unnecessary. As stated above, inflation is the outcome of a diverse mix of economic processes of which monetary policy is only one. The South African economy is changing in ways which promote greater price stability. Rates have already been calibrated to achieve the 4.5% target. A lower target does not require higher rates. It provides the opportunity for lower rates.

An opportunity we should not miss

The SARB is correct in saying that we are presented with an opportunity we should not miss. The journey to 3% inflation could be volatile. However, if inflation stabilises at about 3% the entire structure of interest rates can reprice lower. South Africa is trapped in economic stagnation. The positive economic benefits arising from lower rates would contribute to getting the economy going again.

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