Positive Feedback Loops: The Inflation Shift Reshaping South Africa's Growth and Fiscal Outlook

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This year provided a seminal moment for South African fixed income investors. On the 12th of November 2025, the National Treasury announced a change to the country's inflation rate target. The target has been lowered from 3%-6%, a band that has been set in place since the inception of inflation targeting in 2000, to a singular target of 3% that incorporates a 1% tolerance band. The topic, that had remained largely academic over the years, rapidly gained traction due to growing pressure and action from an opportunistic South African Reserve Bank (SARB). After contested debate, technical work committees and public and political consultations, the National Treasury formally adopted a new inflation rate target to which the SARB is now mandated to carry out.

This article will aim to provide a brief overview of the history of inflation rate targeting in South Africa, as well as describe why the current economic environment presents an opportunity for an inflation target recalibration. The positive effects and challenges of this recalibration will be outlined, with a closing note on how the team at Northstar perceives the medium-term horizon in the local fixed income space and our positioning thereof.

The previous inflation target was a band of 3%-6% and was first implemented in March 2000. This band was expected to decline and narrow to 3%-5% in 2001 and then to be adjusted lower again to 2%-4% in 2004. The aim of this methodology was to ensure that inflation expectations could be reliably guided and anchored lower. However, the Dot-com bubble and financial crisis that followed into 2002 resulted in elevated local inflation. This setback placed a low probability of the SARB being able to achieve the near-term inflation targets. In 2004, the minister of Finance, along with the Governor of the Reserve Bank, announced that the inflation target would remain 3%-6% and that the planned step down to a 3%-5% target would fall away "until further notice".

It was not until 2017 when the inflation target was finally revisited. Since the Global Financial Crisis, South Africa had been experiencing sticky CPI levels that trended upward and settled around the high-end of the target band. Inflation hovering at around the 6% mark was beginning to become entrenched in the expectations of future inflation, held by businesses, trade unions, analysts and wider economic agents. The risk that interest rates would have to move decidedly higher was growing and the SARB was in danger of losing confidence and credibility over its monetary policy. Therefore, in late 2017, the Monetary Policy Committee (MPC) announced a preference for targeting 4.5%, the midpoint of their then mandated 3%-6% band. Over the following two years, the Reserve Bank made notable progress. Inflation fell to an average of 4.0% between 2018 and 2019, well below the 5.4% average experienced from 2010-2017. Furthermore, and importantly, inflation expectations were gradually guided lower towards the midpoint of the target band.

Fast-forward to the July 2025 MPC meeting, where the governor announced that the SARB would prefer inflation to settle at 3%. The MPC then formally and independently decided to aim for the bottom of their mandated 3%-6% inflation target range. Governor Lesetja Kganyago stressed that with actual inflation now close to 3%, an opportunity to "achieve permanently lower inflation at minimal cost" had presented itself. Furthermore, the growing prospect of a lower inflation target had given strong support to the rand, driven the yield curve lower and caused a slight moderation of inflation expectations. The SARB was eager to build on and sustain this progress in order to minimise any market uncertainty over their long-term objectives of monetary policy. MPC members reasoned that the current opportunity to consolidate low inflation would set the stage for lower interest rates that would ultimately benefit the country through various factors. The SARB published a working paper, providing evidence for their reasoning and arguments.

The first positive of a lower inflation target speaks to competitiveness and increased investment. South Africa's efforts to grow non-traditional exports will be fruitless if the price levels within the country are rising faster than those of our competitive trading peers. Higher relative inflation in comparison to trading partners necessitates a higher cost of capital which in turn deters investment. A move from the midpoint target of 4.5% down to 3%, brings South Africa more in line with its emerging market peers. The primary benefits that accrue as the result of a sustained decline in price levels are: less economic uncertainty which subsequently increases productive investment and reduces the loss of competitiveness over time. Low and stable inflation encourages fixed investment, while also allowing for interest rates to decline over time. This creates an advantageous environment as investment returns and savings become more predictable. Thus, it can be observed that clear and relative price signals lead to less uncertainty, more investment and higher competition. This combination is supportive of economic growth and job creation.

Another major positive of lowering the inflation target is that, through a sustained feedback loop, substantial gains and headspace are created within the fiscal framework. Throughout the past decade, various risks have led to considerable fiscal decay and slippage. The National Treasury has valiantly attempted to instil a credible agenda of fiscal consolidation. However, debt-to-GDP has yet to peak and debt servicing costs remain historically elevated. Assistance is needed and lower inflation can be critical for achieving improved fiscal outcomes. This occurs in two ways:

Firstly, lower inflation leads to stronger economic growth which raises tax revenues. This creates fiscal headroom for the sovereign to better meet its interest and expenditure costs, therefore easing future funding requirements. This results in a compression of the country's default premium bestowed on it by the market.

Secondly, lower and stable inflation causes inflation differentials to narrow. Investors view this dynamic positively and begin to price lower, the inflation premiums embedded within the nominal yield curve. The compression of these premiums causes yields to rally lower. The critical outcome of this mechanism is a notably lower yield curve, across which the sovereign can issue its debt. Therefore, debt service costs move lower and this translates into important fiscal gains.

The aforementioned dynamics kickstart a strong and reinforcing feedback loop. As debt service costs decline and interest payment burdens diminish, the sovereign's fiscal framework becomes more credible and investors begin to discount additional risk premia across the yield curve. This results in a continued lowering of borrowing rates and a further improvement in fiscal balances. Declining debt costs and funding requirements, coupled with growing revenues, as a result of the economic growth stemming from low and stable prices, further improves the overall credibility and sustainability of the sovereign's fiscal position.

Contra arguments against a lower inflation target all stem from a concern of the sacrifice ratio. It is posited that in order to drive inflation lower, interest rates need to remain restrictive for longer or even be raised. Higher interest rates suffocate households' propensity to consume and this dents GDP growth. However, the SARB has argued that the faster the disinflation adjustment, the lower the resultant economic cost is. Credibility of monetary policy determines how fast inflation expectations are able to adjust. Therefore, a highly credible commitment to dis-inflate quickly, tied with a clear forward looking objective, should result in a negligible real economic impact and lower output losses. Evidence has showed that the SARB's credibility and communication channels have been steadily improving. As a result, forward looking inflation expectations have been reactive to the Reserve Bank's forecasts. Therefore, with current CPI already below 4%, the SARB believes that it has the requisite tools to successfully lower the inflation profile with a reduced sacrifice ratio.

Nevertheless, two material rigidities operate within the current South African inflation complex. These are administrative prices and public sector wages. Thus, government's alignment with the SARB's desired inflation target was pivotal, not just on a constitutionality or formality basis, but in terms of the ability to provide meaningful action in relieving these two inflation rigidities. Directed political capacity and will is needed to adjust administrative prices lower and successfully negotiate longer term wage deal increases that do not jeopardize the goal of a low and stable inflation profile.

The change of the inflation target mandate is a decisive event for South Africa. It marks an inflection point after many years of economic and fiscal malaise. In Q1 of 2025, the Northstar BCI Income Fund increased its duration exposure, taking its allocation to fixed rate South African Government Bonds to above 30%. Performance benefited strongly from this position, as the inflation target narrative gained traction and nominal yields fell in response. With the yield curve rallying materially lower and valuations beginning to strongly compress, we took profits and trimmed down the duration exposure in the fund, allocating towards asset classes which portrayed clearer opportunities on a relative value basis. This robust and consistent process has been implemented throughout the fund's more than 10-year history, leading to successful outcomes for clients. This framework and philosophy will continue unabated.

Looking forward, the team will closely monitor progress on the key factors that are needed to sustain the positive feedback loop. These are namely: evidence of downward adjustments to inflation expectations, successful implementation of policy reforms that result in tangible growth outputs, concerted efforts to resolve administrative price pressures and a resolute commitment to contain public sector wage growth. We hold a cautiously optimistic view on the medium-term prospects but stand ready to react flexibly should any downside or upside risks begin to manifest.

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