SARB's inflation target: 4%, not 3% or 4,5%

The South African Reserve Bank's (SARB) inflation target is currently under review by the National Treasury (NT) as part of a broader macroeconomic policy review for the country. The SARB indicated it would prefer an explicit point target for inflation rather than the current inflation band of 3-6%. It also indicated it favours a lower-point target than the current mid-point of 4,5%, with a 3% or 4% target mentioned as the preferred level.

We have conducted our own review of the inflation target. While South Africa's current target band is high compared to peers, we believe a point target of 4% is more suitable than a 3% target given domestic price dynamics. A 4% target rather than a 3% one would also minimise risks to credibility and a potentially high sacrifice ratio the SARB faces.

Within this context, we provide an analytical framework to analyse the yield curve adjustment under a lower inflation target. We think of the potential move in the yield curve in three stages. The SARB's credibility in reaching the target would determine how long it takes to shift from the first stage to the last stage.

As far as a timeline is concerned for the broader macroeconomic policy review underway by the NT, the MTBPS indicated that a "…draft review document, due at the end of March 2022, will form the basis for workshops, public discussions and additional research. A final review is expected to be published in 2023".

External comparison, internal dynamics and a read-through to bonds

In analysing the SARB's inflation target, we start by comparing South Africa's current inflation target to that of other countries. We then look at South Africa's internal inflation dynamics to better understand what an achievable target may be. Third, we analyse South Africa's sacrifice ratio – the trade-off between temporary lower growth and permanently lower inflation – to assess the impact should SARB be forced to hike interest rates to achieve a lower inflation target. Lastly, we provide a framework for analysing the impact of a lower inflation target on the yield curve.

An international comparison of inflation targets

When comparing South Africa's current inflation target with that of other inflation-targeting central banks, it becomes clear that the country's inflation target band of 3-6% and mid-point of 4,5% are at the high end of existing targets. Exhibit 1 lists the major developed-market (DM) economies and emerging-market (EM) or developing economies that have central banks with inflation target mandates. Our list may not be exhaustive, but it does capture all the major DM and EM central bank inflation targets.

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EM economies have an average inflation target of 3,9%

Globally, DM economies have, in general, settled for a 2% target. Although there are exceptions, EM economies have opted for inflation targets generally anywhere from 3% to 5%. The average inflation target for DMs is 2,1% and for EMs, this is 3,9%. South Africa's inflation target, when compared to EM peers', is at the higher end of the spectrum. This is the case when we compare the mid-point of the target band to that of peers. If the SARB would allow inflation expectations to drift towards 6%, which is the higher end of the target band, only Ghana in our list would have a higher inflation target than South Africa.

The average inflation target for DMs is 2,1% and for EMs, this is 3,9%. South Africa's inflation target, when compared to EM peers', is at the higher end of the spectrum

Many countries review targets and it is not uncommon for targets to shift

A few EM economies have opted to shift their targets lower in recent years as global inflation and inflation volatility have declined. South Africa appears to be a laggard when it comes to reviewing its monetary policy target. For example, Brazil is in the process of lowering its inflation target from the current 3,75% in 2021, to 3,5% in 2022, 3,25% in 2023 and 3% in 2024. Romania started with an inflation target of 7,5% in 2005 and decreased it incrementally over several years to the current 2,5% that has been in place since 2012. Indonesia, too, has been guiding its inflation target lower, decreasing it from 3,5% in 2019, to 3% in 2020 and 2021.

A few EM economies have opted to shift their targets lower in recent years as global inflation and inflation volatility have declined. South Africa appears to be a laggard when it comes to reviewing its monetary policy target

Exhibit 1: Central Bank inflation targets

Country	Inflation target	Mid-point
New Zealand	Between 1% and 3%	2.0
Canada	Between 1% and 3%	2.0
UK	Point target of 2%	2.0
Sweden	Point target of 2%	2.0
Czech Republic	Point target of 2%	2.0
Israel	Between 1% and 3%	2.0
Thailand	Between 1% and 3%	2.0
South Korea	Point target of 2%	2.0
Norway	Point target of 2%	2.0
Peru	Point target of 2% with a tolerance band of +/- 1%	2.0
Japan	Point target of 2%	2.0
ECB	Point target of 2%	2.0
Australia	Between 2% and 3%	2.5
Poland	Point target of 2.5% with a tolerance band of +/- 1%	2.5
Iceland	Point target of 2.5% with a tolerance band of +/- 1.5%	2.5
Romania	Point target of 2.5% with a tolerance band of +/- 1%	2.5
Chile	Point target of 3% with a tolerance band of +/- 1%	3.0
Colombia	Point target of 3% with a tolerance band of +/- 1%	3.0
Hungary	Point target of 3% with a tolerance band of +/- 1%	3.0
Mexico	Point target of 3% with a tolerance band of +/- 1%	3.0
Philippines	Between 2% and 4%	3.0
Indonesia	Point target of 3% with a tolerance band of +/- 1%	3.0
Albania	Point target of 3%	3.0
Georgia	Point target of 3%	3.0
Brazil	Point target of 3.75% (3.5% in 2022, 3.25% in 2023 and 3% in 2024)	3.75
Guatemala	Point target of4% with a tolerance band of +/- 1%	4.0
Armenia	Point target of 4% with a tolerance band of +/- 1.5%	4.0
Paraguay	Point target of 4%	4.0
Dominican Republic	Point target of 4% with a tolerance band of +/- 1.5%	4.0
India	Between 2% and 6%	4.0
Kazakhstan	Below but close to 4%	4.0
Russia	Point target of 4%	4.0
South Africa	Between 3% and 6%	4.5
Turkey	Point target of 5% with a tolerance band of +/- 2%	5.0
Uruguay	Between 3% and 7%	5.0
Uganda	Point target of 5%	5.0
Moldova	Point target of 5% with a tolerance band of +/- 1.5%	5.0
Serbia	Point target of 3% with a tolerance band of +/- 1.5%	6.0
Ghana	Point target of 8% with a tolerance band of +/- 2%	8.5
Average inflation target	All countries under consideration	3.3
	Developed market economies	2.1
	Emerging market economies	3.9

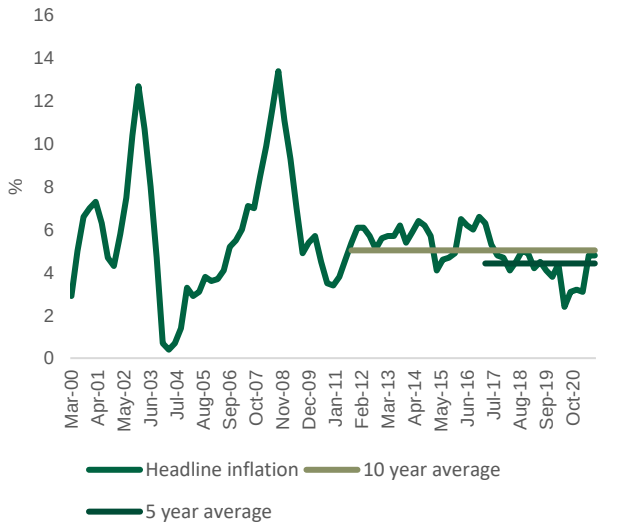
Source: Nedbank CIB Markets Research, various central banks, IMF

The internal dynamics of South Africa's inflation

If South Africa's inflation target is high compared to EM peers, is it possible to set a lower target? For this, we analyse the internal dynamics of South Africa's inflation.

Since the inception of inflation-targeting in 2000, South Africa's headline inflation has steadily declined over time, both in level and volatility (Exhibit 2). Headline inflation has averaged 5,05% in the past 10 years and 4,5% in the past 5 years. At the same time, surveyed inflation expectations have been less volatile than headline inflation and, more importantly, declined towards the mid-point of the target rate of 4,5% in 2020 (Exhibit 3).

Exhibit 2: Headline CPI vs the 10-year and 5-year average



Source: Nedbank CIB Markets Research, StatsSA, BER

Exhibit 3: Headline CPI vs surveyed inflation expectations

Source: Nedbank CIB Markets Research, StatsSA, BER

Less than 20% of the CPI index has averaged below 3% in the past

One way to measure how easy it would be to push inflation to, say, an inflation target of 3% would be to look at how many sub-indices have managed to average 3% and lower over an extended period. The greater that percentage, the greater the chance that a 3% target is achievable without having to raise interest rates unnecessarily high.

To do this, we present the 10-year, 5-year and 3-year averages of the main sub-indices of the headline CPI index. We also show the average of the sub-indices since 2017. We look at the average since 2017 because that is the year when SARB started using the QPM more actively in its policy decision making and also started targeting the mid-point of the target band (ie 4,5%) more explicitly. We rank the sub-indices from low to high according to average inflation since the inception of the QPM. Of the 11 sub-components,

- Five sub-indices averaged below 3%. However, these subcomponents make up a weight of only 19,06% in the CPI basket
- A further five sub-indices averaged between 4% and 5%, making up a weight of 63,36% in the CPI basket
- The remaining two indices averaged above 6%. These two indices have a weight of 17,58% in the CPI basket

Exhibit 4: Headline CPI and its 11 main sub-indices

Sub-index group	Weight	10-year average	5-year average	3-year average	Average since 2017 (QPM)
Sub-indices that averaged below 3% since 2017 (weight in basket: 19,06%)					
Communication	2.63	- 0.26	- 0.18	0.05	- 0.18
Recreation and culture	5.16	2.26	1.80	1.19	1.45
Clothing and footwear	3.83	3.20	2.12	1.45	1.89
Household contents and equipment	4.35	2.74	2.49	2.34	2.38
Restaurants and hotels	3.09	4.86	3.17	2.15	2.91
Sub-indices that averaged above 3% and below 5% since 2017 (weight in basket: 63,36%)					
CPI headline		5.05	4.46	3.97	4.31
Housing and utilities	24.62	5.23	4.47	4.07	4.40
Transport	14.28	4.49	4.52	3.97	4.48
Alcoholic beverages and tobacco	5.82	5.75	4.59	4.52	4.54
Food and non-alcoholic beverages	17.24	6.23	5.32	4.46	4.88
Health	1.4	5.18	4.99	4.42	4.97
Sub-indices that averaged above 6% since 2017 (weight in basket: 17,58%)					
Miscellaneous goods and services	15.05	6.34	6.11	5.54	6.01
Education	2.53	7.35	6.19	6.10	6.30

Source: StatsSA, Nedbank CIB Markets Research

Administered prices remain high and sticky

We also present the analytical components of the CPI index and break down the indices according to the same time periods as in Exhibit 4.

The analytical breakdown of the CPI basket suggests that only CPI for durable and semi-durable goods managed to average below 3% since the inception of the QPM. This is not unique to South Africa; globally, durable and semi-durable goods have experienced declining inflation in recent years.

Our breakdown further suggests that administered prices remain a problem, with CPI excluding administered prices averaging 4% in recent years and CPI for administered prices averaging 5,93%. In fact, the analytical series with the highest average CPI is all regulated or administered prices. The stickiness of administered prices is clear from the CPI for administered prices excluding fuel and paraffin (both fuel and paraffin can be volatile), but the rest of the administered prices have consistently averaged above 6%.

CPI excluding administered prices has averaged 4% in recent years, while CPI for administered prices has averaged 5,93%

Exhibit 5: Analytical series for South Africa's CPI

Group	Weight in basket	10-year average	5-year average	3-year average	Average since inception of the QPM
Analytical indices that averaged below 3% since 2017					
CPI for semi-durable goods	5.68	2.76	2.00	1.46	1.75
CPI for durable goods	7.81	2.34	2.78	2.78	2.48
Analytical indices that averaged above 3% and below 5% since 2017					
CPI excluding administered prices	83.83	4.79	4.19	3.64	4.00
CPI excluding food and NAB and fuel	74.43	4.80	4.23	3.90	4.12
CPI excluding fuel and energy	91.67	4.89	4.30	3.78	4.13
CPI for all goods	48.7	4.86	4.37	3.93	4.16
CPI excluding energy	96.25	4.91	4.35	3.76	4.20
CPI excluding food and NAB	82.76	4.82	4.29	3.87	4.20
CPI excluding fuel	95.42	5.03	4.42	3.99	4.26
CPI excluding housing	75.38	4.98	4.45	3.93	4.28
CPI for services	51.3	5.23	4.57	4.02	4.49
CPI excluding owners' equivalent rent	86.68	5.21	4.66	4.23	4.52
CPI for non-durable goods	35.21	6.00	5.20	4.67	5.02
CPI for regulated prices	11.76	6.34	5.78	5.55	5.87
CPI for administered prices	16.17	6.45	5.84	5.68	5.93
Analytical indices that averaged above 6% since 2017					
CPI administered prices excluding fuel and paraffin	11.54	6.72	6.02	6.56	6.04
CPI for administered prices that are not regulated	4.41	7.03	6.11	6.18	6.19

Source: StatsSA, Nedbank CIB Markets Research

Cutting administered prices is not straightforward

With the country facing a combination of an infrastructure deficit and high debt levels at both the government and SOE levels, clamping down on administered prices may not be the optimal response, or even possible.

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Administered prices are often tied to goods and services delivered by the government and SOEs, and the rollout of infrastructure to deliver these goods and services may depend on higher prices or tariffs (eg water and electricity). Administered prices are also often tied to taxes and levies (such as the fuel levy), and lower prices may result in greater fiscal deficits. Administered prices are unlikely to be responsive to moral suasion that aims to push inflation expectations lower. Nor will administered prices necessarily be responsive to higher interest rates.

Lastly, we argue that in many instances, it would be possible to reduce administered prices via more efficient implementation of policies; this would most likely be a multi-year approach and outside the control of monetary policy. When, or if, this is achieved, any inflation target could be re-evaluated and adjusted accordingly.

If South Africa targets 3% inflation and administered prices are at 6%, the effective target for the rest of the CPI basket is 2,4%

To put the current level of administered prices in perspective relative to the rest of the basket, SARB moving to a 3% inflation point target and administered prices remaining at 6% (ie similar to levels seen over the past five years) imply that the rest of the CPI basket, which constitutes 83,83% of the CPI index, would need to average 2,4% to achieve an inflation point target of 3% (Exhibit 6). This would be well below levels seen in other EM countries and as pointed out in Exhibit 4, only 19% of the CPI basket has managed to average below 3% for an extended period in the past.

SARB moving to a 3% inflation target and administered prices remaining at 6% imply that the rest of the CPI basket, which constitutes 83,83% of the CPI index, would need to average 2,4% to achieve an inflation point target of 3%

Should expectations fail to adjust for the rest of the CPI basket to 2,4%, it may necessitate monetary policy that is substantially tighter than what would otherwise be the case. Put differently, we are not convinced moral suasion would be able to push inflation expectations low enough. As a result, higher interest rates than what would otherwise be the case may be necessary to achieve this. In this instance, the sacrifice ratio would be quite high, in our view.

Unless administered prices come down, an inflation target of 4%, instead of 3%, seems more achievable

In our view, a more achievable alternative to a 3% inflation point target is a 4% target. This 4% target could be a permanent one or an interim measure until such time conditions (such as administered prices) favour an even-lower-point target.

In our view, a more achievable alternative to a 3% inflation point target is a 4% target

To put this in perspective, given the weight of administered prices of 16,17% in the CPI basket, if CPI for administered prices remains sticky at 6%, the rest of the CPI basket would need to average 3,6% to hit a 4%-point target for headline inflation.

A 4% target rather than a 3% one would have two advantages, in our view: first, it allows for inflation expectations for the CPI basket excluding administered prices to adjust to a level well below 4%. This is also at a level where a large part of the adjustment in inflation expectations could happen through moral suasion rather than tighter monetary policy. Second, an interim 4%-point target could provide some time and incentive for the government to implement a strategy that will make the adjustment of administered prices easier on infrastructure rollout and the fiscus.

Exhibit 6: What administered prices at 6% implies for the rest of the basket under 3% and 4% inflation targets

	Weight	3% target	4% target
CPI for administered prices	16.17	6.0%	6.0%
CPI excluding administered prices needed to reach point target	83.83	2.4%	3.6%
Headline CPI	100.00	3.0%	4.0%

Source: Nedbank CIB Markets Research, StatsSA

One must be cognisant of the sacrifice ratio

When an inflation target is shifted lower, one must consider the sacrifice ratio. There is a short-term trade-off between inflation and growth – the so-called sacrifice ratio – where growth may be sacrificed in the short term to obtain permanently lower inflation. The size of the sacrifice ratio depends on several factors, particularly the following:

- the current level of inflation relative to the target,
- the current level of inflation expectations relative to the target and
- the credibility of the central bank.

The closer inflation and, in particular, inflation expectations are to the inflation target, the smaller the sacrifice ratio tends to be

The closer inflation and, in particular, inflation expectations are to the inflation target, the smaller the sacrifice ratio tends to be. Furthermore, if a central bank is very credible, it may be able to influence inflation expectations lower by merely signalling its intent to do so, without any actual tightening. In such a scenario, the sacrifice ratio would be small.

Naturally, the SARB's preference would be to push inflation expectations lower via moral suasion rather than raising interest rates. But if the SARB gets a formal inflation point target at, say, 3%, it may be forced to raise rates higher than what would otherwise be the case if moral suasion does not push inflation expectations to the target. In this case, the economy is likely to sacrifice growth.

Our estimate of the size and shape of the sacrifice ratio

If moral suasion does not push inflation expectations lower and a central bank must push inflation lower, it must raise interest rates where the trade-off between inflation and growth comes into play. In analysing this inflation/growth trade-off, we estimate the increase in the repo rate that would be needed to anchor our inflation forecast at a lower level over the next three years. At the same time, we estimate the potential impact of such a hike in the repo rate on inflation expectations and growth. This enables us to calculate the size and shape of the sacrifice ratio.

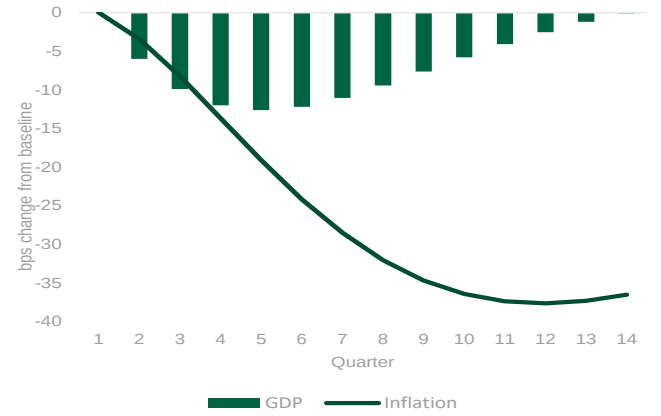
Naturally, the SARB's preference would be to push inflation expectations lower via moral suasion rather than raising interest rates. But if the SARB gets a formal inflation point target at, say, 3%, it may be forced to raise rates higher than what would otherwise be the case

Inflation: Our estimates indicate that a 50 bps hike in the repo rate would result in an inflation rate that is 35 bps lower over 12 quarters (Exhibit 7). Given that the current inflation rate is expected to average around 4,5% in the next two years, this would imply that if a new point target is set at 4%, an additional 70 bps of hikes would be necessary, over and above what is already needed to keep inflation at 4,5%, while an additional 215 bps of hikes would be necessary if the point target is set at 3%.

Real GDP: Our simulation suggests that the impact of a 50 bps hike in the repo rate is transitory, with the largest impact in year 2. The cumulative growth forgone in year 1 is 30 bps; in year 2, it is 45 bps; and in year 3, it is 20 bps. The rate hike impulse on growth remains in the economy for three years, during which cumulative growth of just under 100 bps is forgone.

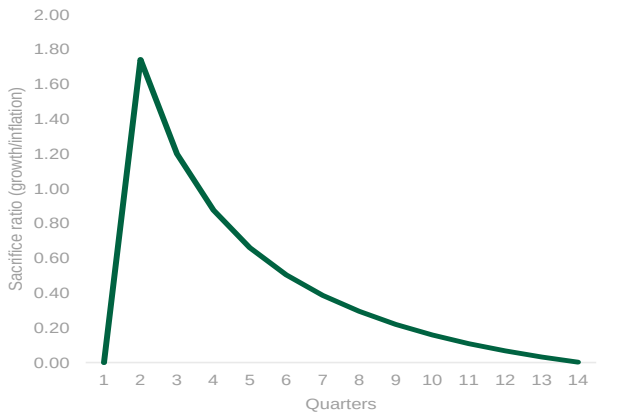
The sacrifice ratio: Our analysis suggests, as expected, that the impact of a hike on GDP growth is transitory, while the impact on inflation is more permanent. This shows up in the shape of our estimate of South Africa's sacrifice ratio (Exhibit 8). The sacrifice ratio hits a high of 1,80 two quarters after the rate hike. At this point, the sacrifice is the largest. Specifically, the ratio implies that at two quarters after the hike, South Africa sacrifices 1,8 bps of growth for every 1 bps of lower inflation. After four quarters, the sacrifice ratio drops to below 1, indicating that the impact on inflation is greater than the impact on growth. The impulse remains in the economy for 12 quarters.

Exhibit 7: Impact of a 50 bps rise in the repo rate



Source: Nedbank CIB Markets Research

Exhibit 8: The shape of South Africa's sacrifice ratio



Source: Nedbank CIB Markets Research

The sacrifice to push inflation lower via interest rate hikes:

- If the repo rate is hiked by an additional 70 bps to push inflation from 4,5% to 4%, over a three-year period, South Africa may forgo a cumulative 140 bps of growth
- If the repo rate is hiked by an additional 215 bps to push inflation to 3%, over a three-year period, South Africa may forgo 430 bps of growth

Other risks from an inflation target that is set too low

There are three additional risks from setting an inflation target too low: fiscal slippage, a loss of credibility and less policy flexibility

In our view, there are three additional risks from setting an inflation target too low (apart from the risk of having to sacrifice growth to push inflation, and inflation expectations, lower via interest rate hikes if moral suasion does not work).

The first risk lies with the fiscus. As nominal GDP growth adjusts lower because of lower inflation, so will tax revenue. However, government expenditure would also need to be adjusted lower, in line with lower inflation. It is well known that the government has struggled to rein in expenditure, and this is likely to remain a challenge. This creates a real risk that government deficits will overshoot expectations, ultimately putting more pressure on monetary policy as fiscal pressures build.

Second, and closely related to the first, is the risk that if the SARB struggles to meet a too-low inflation target, it may end up losing some credibility over time. This could happen because of wider government deficits mentioned under the first risk and resultant sticky administered prices, or greater fiscal pressures and a weaker exchange rate and higher import prices or simply because of fiscal dominance and a belief that government debt will ultimately result in a higher, not lower, inflation target.

Lastly, and a lesser risk at this point but still worth highlighting, is that a lower inflation target (that is met) implies a lower nominal repo rate. If the target is set too low, it means there is less room for the SARB to respond to a sharp economic downturn via cutting the repo rate aggressively. This also raises the risk that the SARB may need to resort to other avenues to support the economy in a sharp downturn, such as buying government bonds. This is not an issue, in our view, because the SARB and other central banks have done this before. But it could set a dangerous precedent if this is accompanied by a fiscal position that is already severely strained.

A lower target and its impact on yields

We think of the potential move in the yield curve in three stages

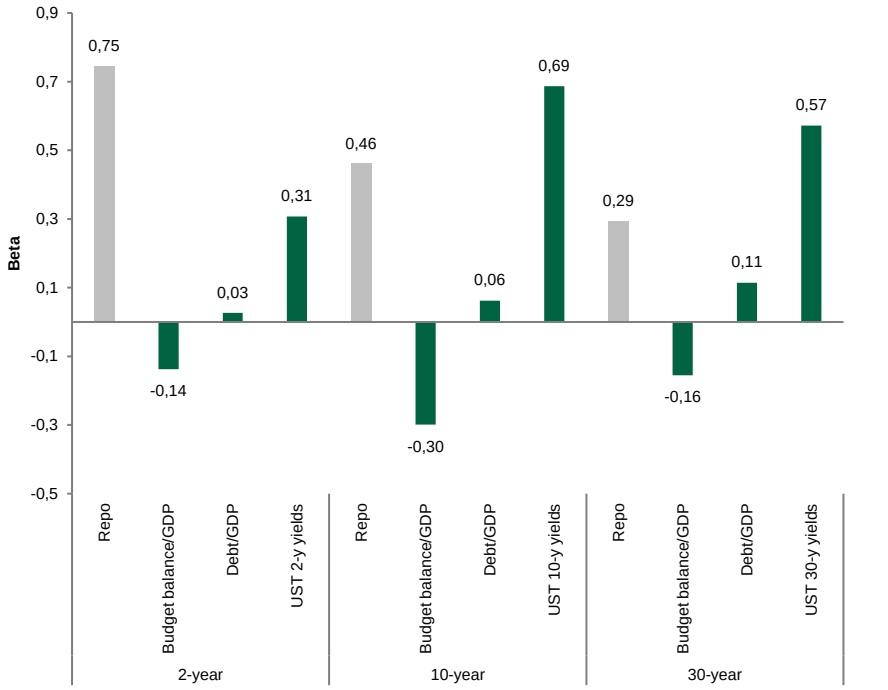
We think of the potential move in the yield curve in three stages. The first stage is where the SARB raises interest rates to push inflation towards the lower inflation target. The second stage is where inflation and inflation expectations start declining towards the target. The third stage is where inflation expectations are anchored at the lower inflation target and the front end of the curve can move in anticipation of a lower repo rate.

The SARB's credibility would determine how long it takes to shift from stage 1 to stage 3

The SARB's credibility would determine how long it takes to shift from stage 1 to stage 3. If the SARB is very credible and manages to shift inflation expectations lower through moral suasion, it is possible to bypass stage 1 and stage 2 and move straight to stage 3.

To analyse what these three stages look like, we estimate a system of equations for three points on the nominal yield curve: the 2-year yield, the 10-year yield and the 30-year yield. We specify the yields as a function of the repo rate, the budget deficit, the debt-to-GDP level and the US bond yield of equal maturity – this captures the dynamics between domestic monetary policy, domestic fiscal policy and US bond yields and their impact on local yields. We show the betas in Exhibit 9, where the betas represent the basis point (bps) shift in the yields due to a 1% move in each variable. In line with expectations, the repo rate has a large impact on shorter-maturity yields; this fade as we move further up the curve.

Exhibit 9: A factor analysis of the impact of monetary and fiscal policy on the yield curve



Source: Nedbank CIB Markets Research

Next, we use the results in Exhibit 7, which shows how inflation reacts to a rise in the repo rate, and the betas in Exhibit 9 to calculate the impact on the yield curve if the SARB starts raising interest rates to push inflation lower.

As indicated before, Exhibit 7 suggests that under an inflation target of 4%, the SARB would need to raise the repo rate by an additional 70 bps over and above what is already forecast. For an inflation target of 3%, the SARB would need to raise the repo rate by an additional 215 bps. The impact of this on the shape of the yield curve, during each stage, is shown in Exhibit 10 below.

Exhibit 10: The impact of 3% and 4% inflation targets on the shape of the yield curve

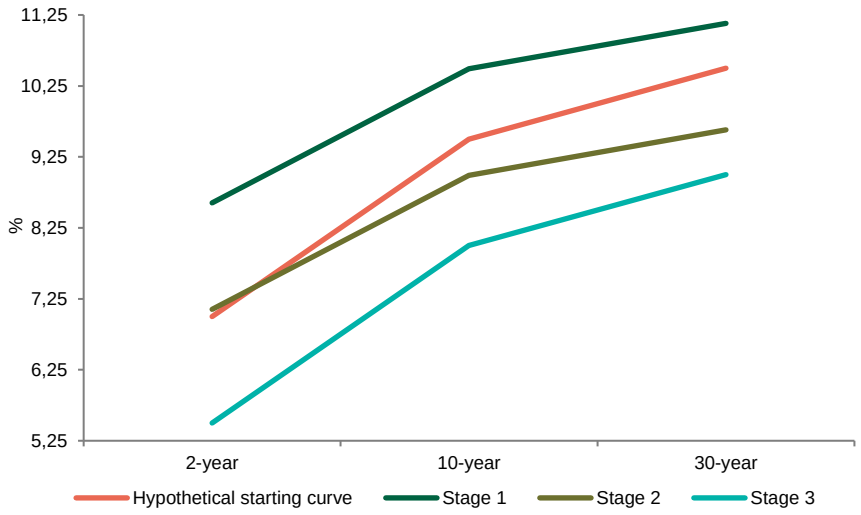
			Stage 1	Stage 2	Stage 3
	Temporary hikes necessary to push inflation expectations from 4,5% to target (from Exhibit 7)	Maturity	Rise in yield due to temporary hike in repo rate	Net effect on yield with higher repo and lower inflation	Net effect on the yield curve with permanent lower inflation
Inflation target at 4.0%	70 bps	2-year	0.52	0.0 (0.52 – 0.50)	-0.5
		10-year	0.32	-0.2 (0.32 – 0.50)	-0.5
		30-year	0.21	-0.3 (0.21 – 0.50)	-0.5
Inflation target at 3.0%	215 bps	2-year	1.60	0.1 (1.60 – 1.50)	-1.5
		10-year	0.99	-0.5 (0.99 – 1.50)	-1.5
		30-year	0.63	-0.9 (0.63 – 1.50)	-1.5

Source: Nedbank CIB Markets Research

Stage 1 results in an initial bear curve flattening of the yield curve as the SARB raises rates, followed by stage 2 with a bull curve flattening as inflation starts to decline but front end rates remain high. Finally, stage 3 sees a sharp bull curve steepening.

Exhibit 11 graphically presents the three stages for an inflation target of 3% where the SARB needs to raise rates by an additional 215 bps. Our starting point is a hypothetical curve of 7% for the 2-year yield, 9,5% for the 10-year yield and 10,5% for the 30-year yield.

Exhibit 11: Movement in the yield curve as inflation expectations adjust to a lower inflation target



Source: Nedbank CIB Markets Research

What about breakeven inflation and the real yield curve?

In theory, one would expect breakeven inflation to move lower by the same amount as the nominal curve and the real yield curve to remain largely unchanged. However, if the market believes there is going to be fiscal slippage because of lower nominal GDP growth, the wider budget deficit and higher debt/GDP ratio would put upward pressure on real yields, as our estimation in Exhibit 9 suggests. This greater real risk is likely to result in a steeper ILB curve and offset some of the gains in nominal yields due to a lower inflation target. This could leave breakeven inflation and nominal bond yields at longer-dated maturities higher than what would be suggested by the lower inflation target. This, in our view, is a real possibility.

If the market believes there is going to be fiscal slippage because of lower nominal GDP growth, the wider budget deficit and higher debt/GDP ratio would put upward pressure on real yields

A 4% target seems possible; a 3% target seems restrictive

Adjusting a central bank's inflation target is not uncommon, and South Africa's current target does appear to be at the high end of peer economies. However, internal inflation dynamics, driven largely by administered prices that remain sticky around 6%, suggest a 3% inflation target may be too restrictive. As Exhibit 7 shows, a 3% inflation target would result in 83,83% of the CPI basket having to average 2,4% to hit a 3% target. However, we do believe a 4% target may be a good compromise, which could also be achieved through fewer interest rate hikes and more moral suasion. This would also minimise the sacrifice ratio for South Africa and reduce the probability of fiscal slippage.

We do believe a 4% target may be a good compromise, which could also be achieved through fewer interest rate hikes and more moral suasion

We would also argue that an inflation target of 4% can always be adjusted lower in the future. As pointed out earlier, this is common practice. However, if a 3% target is set and the SARB fails to achieve this because of too-high administered prices, and the inflation target needs to be adjusted higher again, say from 3% to 4%, this could harm the SARB's credibility.

We would also argue that an inflation target of 4% can always be adjusted lower in the future.

A lower inflation target is likely to result in an initial bear curve flattening of the nominal yield curve as the market expects a more hawkish SARB. This is likely to be followed by a bull curve flattening as inflation starts to decline. Finally, once inflation expectations are anchored at the target, we could see a sharp bull curve steepening as front-end rates decline. The more credible and realistic the new point target, the quicker we would move from bull curve flattening to bull curve steepening.....