



SOUTH AFRICAN RESERVE BANK

**Address by Lesetja Kganyago,
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Managing supply shocks: The role of monetary policy

Good morning.

It is fashionable nowadays to say we face unprecedented uncertainty. I have good news and bad news: uncertainty has declined lately – but only because things are more certainly worse.

Back in March we had a meeting of the Monetary Policy Committee (MPC) and it was a straightforward decision to leave rates unchanged because there was so much uncertainty. We saw price spikes for commodities like oil and fertiliser, but there were hopes the conflict might be short lived. Markets were moving on each new social media post. It seemed possible there could be a deal, the Strait of Hormuz would be reopened and prices would come back down again.

Those hopes have now faded.

Not only has the strait stayed closed, with only a few ships getting through,¹ there has also been enough infrastructure damage and depletion of stocks that we must now accept that prices for Gulf products like oil will not be back at February levels any time soon.

Worse, the outlook for food prices has also started to deteriorate because of fertiliser shortages and because there is so much diesel in supply chains. I have heard South African farmers say that, at these prices, it is not worth planting next season. And that is before we start to discuss another food price risk: El Niño, which could bring drought next year to various parts of the country,

In this context, at our MPC meeting last week, we decided to raise rates from 6.75% to 7%.

In my years as a central banker, I have learned again and again the difficulty of communicating about supply shocks.

Critics never tire of objecting that monetary policy can do nothing about droughts or higher oil prices, so it is a mistake to respond. Meanwhile, introductory economics classes often teach monetary policy as an exercise in demand management, with the central bank raising rates when growth is strong and cutting when it is weak.²

Neither of these simple claims reflects the actual workings of monetary policy, especially in small, open economies like South Africa.

I thought in 2022 we might be making progress, because various emerging markets saw trouble coming and raised rates, while some advanced economies argued instead that you must look through shocks. In the end, 'Team Transitory' lost: do-nothing

¹ The proportion of ships transiting the strait, as a share of pre-conflict traffic, has been around 8–10% lately. See J Saul, '[COSCO products tanker leaving Strait of Hormuz, oil traffic still limited](#)', Reuters, 27 May 2026.

² See, for instance, M Greene, '[Central banks need to learn lessons about supply shocks](#)', *Financial Times*, 9 October 2025: "Generations of economists – myself included – were taught to think about changes in economic activity primarily in terms of demand. But supply can prove every bit as consequential for output and inflation, as we recently experienced in the face of a pandemic and a war in Europe."

strategies were abandoned and most central banks tightened policy. Emerging markets got credit for responding timeously.³

It seemed like a teachable moment: yes, you can't do much about initial shocks with interest rates but it does not follow that you should do nothing. Inflation can be persistently higher after a shock has passed, if people start believing higher inflation is normal. The central bank's job is to stop this.⁴

It is an elegant playbook, and I hope more people will engage with it. For the time being, we communicate as best we can. And, of course, we work hard to execute effectively.

Whatever the difficulties of communication, South Africans detest inflation – and the mandate to keep inflation low and stable sits with us at the central bank. Even if stakeholders are not following monetary policy decisions closely and absorbing our communications, good outcomes speak for themselves. A trusted institution delivers results, not just speeches. So, we need to do more than talk about the playbook; we need to execute it effectively.

The challenge is, while it makes sense in theory to distinguish second-round effects of supply shocks from first-round effects, in practice it is a difficult exercise.

One problem is that you cannot wait for clear evidence. Monetary policy operates with lags, so if you wait for complete proof of second-round effects, you are probably too late. Policy is made under conditions of uncertainty and requires judgement calls. We made one of those judgement calls last week, raising rates on indications that second-round effects are arriving, given large and overlapping shocks, affecting both food and fuel.

³ W B English, K Forbes and Á Ubide, [Monetary Policy Responses to the Post-Pandemic Inflation](#), London: Centre for Economic Policy Research (CEPR), 2024.

⁴ N Bandera, L Barnes, M Chavaz, S Tenreyro and L von dem Berge, '[Monetary policy in the face of supply shocks: the role of inflation expectations](#)', ECB Forum on Central Banking, 2023.

The second problem is distinguishing first-round from second-round effects. Even in our most recent MPC meeting, we had a lively debate about where exactly to draw the line. We can agree that a shock to global oil prices raises the price of petrol and diesel, and that is a first-round effect. But, when that petrol goes in a taxi and the taxi fare rises, is that also a first-round effect? If the diesel goes in a delivery truck and the price of groceries then goes up because groceries have to be delivered to shops, is that still a first-round effect? What if employees use petrol to get to work and demand higher wages to offset their higher transport costs?

The standard language is that second-round effects are visible in wages and inflation expectations moving.⁵ These are helpful indicators but still a little vague.

It is probably more helpful to ask, what is the relative price adjustment and where is the general price level moving?⁶

If there is a supply shock, then the quantity of the affected item changes and the economy must adjust to that. In a market system, that process works through price incentives. There is less oil available, so fuel prices rise and then firms and households make new decisions. For example, they give up on a family road trip. They carpool to work, even though you get home later. In this way, supply and demand find an equilibrium. It does not matter what monetary system you use – gold or the dollar or the rand – some products must get more expensive relative to other products to deal with a sudden change in supply. The price change is how the economy adapts.

But now let us imagine that a bit of inflation in specific items turns into broad-based inflation. This is no longer a price signal to avoid some items and buy others instead. It is a general upshift in the price level, and the rational response is for everyone to raise wage demands, and prices, to keep up.⁷ In this way, the inflation process becomes self-perpetuating.

⁵ C Baba and J Lee, '[Second-Round Effects of Oil Price Shocks – Implications for Europe's Inflation Outlook](#)', IMF Working Paper No. 2022/173, 2022.

⁶ C Borio, P Disyatat, D Xia, Egon Zakrajšek, '[Monetary policy, relative prices and inflation control: flexibility born out of success](#)', *BIS Quarterly Review*, September 2021.

⁷ R Reis and M W Watson refer to this as "pure inflation" in R Reis and M W Watson, '[Relative goods' prices, pure inflation, and the Phillips correlation](#)', *American Economic Journal: Macroeconomics* 2(3), 2010, pp 128–157.

This possibility is the reason that central bankers care so much about inflation expectations. This is a third factor in our models, separate to supply- and demand-side pressures, that affects how people set prices. Indeed, over time, it is probably the most important factor.

The unfortunate fact is everyone supports low and stable inflation, until they are asked to pay a price. It is no fun raising rates when the economy is weak. Unfortunately, if price stability is something you only prioritise when it is easy, it is not much of a commitment. If that is the best a central bank can offer, it is rational to plan for higher inflation.⁸

Historically, several central banks committed policy errors by promising price stability but then subordinating that to growth when they had a choice. This violates time consistency. Why trust such a promise?

The solution is to make promises that can be trusted. This requires clear targets, transparency and independence – the keystones of inflation targeting.

Inflation targeting was first adopted in New Zealand, followed soon after by countries like Chile and Canada. But its intellectual roots lie deeper, in the experience of the Great Inflation. This was an episode in the 1970s and early 1980s when inflation accelerated in many countries, including major advanced economies like the United States (US) and the United Kingdom.⁹ It has been described, for the US, as the greatest macroeconomic policy failure of the second half of the 20th century.¹⁰ South Africa was also hit by the Great Inflation, with inflation at double digits through most of the 1970s and throughout the 1980s.¹¹

⁸ L I Jácome, N E Magud, S Pienknagura and M Uribe, '[Inflation targeting and the legacy of high inflation](#)', IMF Working Paper No. WP/25/79, April 2025.

⁹ M D Bordo and A Orphanides, '[Introduction](#)', *The Great Inflation: The Rebirth of Modern Central Banking*, Chicago: University of Chicago Press, 2013, pp 1–22.

¹⁰ M Bryan, 'The Great Inflation 1965–1982', Federal Reserve History, 2013.

¹¹ J Rossouw and V Padayachee, '[An analysis of inflation from a central banking perspective: The South African experience since 1921](#)', University of KwaZulu-Natal, 'Working Paper No. 50', UKZN School of Development Studies Working Paper Series, 2015. pp 15.

The proximate cause of the crisis was the two oil shocks of 1973 and 1979. But the Great Inflation was only so 'great' – or more realistically, so terrible – because of the ineffective responses of central bankers. We know this because a couple of central banks tried different policy approaches and got much better results. The Germany Bundesbank and the Swiss National Bank are prime examples. In the words of one study, they “[opted] out of the Great Inflation”.¹²

This event showed that demand and inflation can go in opposite directions, contradicting the Keynesian paradigm dominant at the time and giving us the term 'stagflation'.

It also showed that the same supply shock can have different effects when interacting with different frameworks. The successful frameworks did better at managing expectations, which led to lower inflation over time. This was a breakthrough for the development of inflation targeting.¹³

Revisiting this episode also shines light on our contemporary challenges.

For a start, it contradicts the claim that inflation targeting struggles with supply shocks. I recall a certain US academic in 2008 who looked at high oil and food prices and wrote that “inflation targeting is being put to the test, and it will almost certainly fail”.¹⁴ We had a lot of countries experimenting with inflation targeting back then – the Bank for International Settlements counts 23¹⁵ – and not a single country abandoned the framework.

¹² Parenthetically, these authors celebrated the success of the Bundesbank at keeping inflation to 3.1% for the period 1960–1988. This confirms inflation outcomes around 3% as a benchmark for central bank success.

¹³ B Bernanke and I Mihov, '[What does the Bundesbank target?](#)', *European Economic Review*, Volume 41, Issue 6, June 1997, Pages 1025-1053; F S Mishkin and M T Kiley, '[The Evolution of Inflation Targeting from the 1990s to the 2020s: Developments and Challenges](#)', NBER Working Paper No. 33585, March 2025.

¹⁴ J E Stiglitz, '[The failure of inflation targeting](#)', *Project Syndicate*, 1 May 2008. See also B Kahn, '[Challenges of inflation targeting for emerging-market economies: The South African case](#)', 2009. pp.

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¹⁵ The figure cited is for 2008. See database here: https://www.bis.org/publ/qtrpdf/r_qt2503c.htm

If you make a prediction that something will almost certainly fail, and then it does not fail in even a single case, that is probably not a good prediction. Thinking back to the Great Inflation helps us understand why. Inflation targeting is not about preventing supply shocks. It cannot and should not try to prevent *relative* price adjustments. It is about managing expectations so the overall price level does not start rising out of control. Inflation targeting could better be described as a framework that evolved to deal with supply shocks.

Furthermore, the experience of the Great Inflation is relevant today, because we once again seem to be in a decade punctuated by inflation surges. In the 1970s, it was the two oil crises. In the 2020s, it was first the post-COVID, Ukraine-conflict shock. And now it is the Middle East oil shock.

Of course, we hope the current conflict will end sooner rather than later, and that it will be less disruptive than the 1979 oil shock. But hope is not a strategy. There is a danger that expectations will move up faster now because the memory of higher inflation is fresh.¹⁶ In these circumstances, the lesson of history is clear: central banks need to safeguard their credibility and keep a grip on expectations. We should have realistic plans for moving back to our targets again – not just excuses why we keep missing. This is the context for our recent decision to raise rates.

We reached a judgement that, with the size of the oil shock as well as spillovers to food prices from higher diesel and fertiliser costs, second-round effects are developing, and we should tackle them. We are projecting core inflation around 4% in the first half of next year, within the relevant horizon for monetary policy.

By changing rates, we hope to send a clear and credible signal that we will keep inflation under control.

¹⁶ “These developments suggest that price shocks are likely to feed through the economy faster than in 2021, as memories of that painful inflation episode are still fresh.” See I Schnabel, [‘The quiet erosion of central bank independence’](#), Speech by Isabel Schnabel, Member of the Executive Board of the ECB, at the Fifth Annual Charles Goodhart Lecture, London, 7 May 2026.

This is intended to keep expectations contained. We have already made good progress getting expectations down and we want to sustain that.

Our rate settings also have more mechanical effects.

The obvious one is that higher rates support the exchange rate, which gives us more favourable import prices. The exchange rate channel is an important part of monetary policy transmission.

There is also a demand-side angle. As firms embark on price changes, they will have to see if the market can stomach increases. If businesses raise prices because of higher fuel costs, then they should expect to lose customers. This is economically necessary, as explained earlier, because it aligns demand with supply.

However, if firms are raising prices because they figure demand is strong enough that they can get away with it, our job is to block that. We do this by taking away excess demand with higher rates.

The message to price setters is: if you are raising prices, then you must be willing to lose customers. We are not going to play the game where everyone puts up their prices, everyone raises their wages and, in the end, the cost falls on people who cannot avoid inflation – typically the old and the poor. There is not going to be enough demand in this economy for everyone to demand bigger price increases.

Ladies and gentlemen, to conclude, I have had a few questions recently, including at our MPC press conference, about whether we will do what was done in 2002 and abandon the lower target and revert to 3–6%. We will not be doing this. That 2002 episode was one of the greatest macroeconomic mistakes of the democratic era. Why would we repeat it?

Even with the Middle East crisis, we are in a better place now with the lower target than we were before. Our baseline is that we will have inflation of 4.4% this year, reverting to 3% by 2028. This is less inflation than we would have had under the old 4.5% objective.

We have also largely retained the gains we saw last year, such as lower borrowing costs. While longer-term bond yields moved up with the shock, the average yield at government's main bond auction is still about 150 basis points lower than it was in early 2025.¹⁷ The spread of South African borrowing costs over US borrowing costs is now at its lowest since January 2013.¹⁸ This is the context for S&P Global upgrading South Africa last year, keeping us on a positive outlook last week, and for Moody's also assigning a positive outlook recently. At a time when advanced economy borrowing costs are reaching multi-decade highs, it is reassuring that our yields are trending lower, not higher.¹⁹

Of course this is not purely a target story. There were other contributing factors, like a better fiscal outlook. However, the timing of market moves around events like our July 2025 MPC decision to aim at the bottom of the 3–6% band, makes it clear that target reform has been one of the big wins for South Africa recently. We are not going to snatch defeat from the jaws of victory.

Finally, as I hope this speech has made clear, the absolute worst message monetary policy can send following a temporary shock is that the price level will be persistently higher. Good monetary policy is all about blocking that expectation.

Let there be no doubt, the South African Reserve Bank will be getting inflation back down to 3%. I hope our history of delivering on our targets makes that promise convincing. Last week's rate hike should help too. I cannot tell you now if more will be needed, or how much. We take our decisions meeting by meeting. But the policy objective should be crystal clear. We are committed to low and stable inflation.

Thank you.

¹⁷ This refers to the vanilla bond auction held weekly on Tuesdays.

¹⁸ On sovereign risk, see also R Kima and K Lesame, '[New 3% inflation target meets its first test](#)', SA-TIED blog, 27 May 2026.

¹⁹ See R O Abad, '[Global bond yields: The kettle is whistling](#)', Franklin Templeton Insights, 2026. "Investors interested in [developed-market] countries are increasingly demanding compensation for inflation uncertainty, fiscal deterioration, heavier sovereign issuance and geopolitical risk."