Economic Research Southern Africa

Fiscal r-star and macroeconomic coordination in South Africa

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1. Introduction

South Africa's fiscal and monetary authorities now operate in a more difficult environment than they did a decade ago. Debt has risen, growth has disappointed, and sovereign risk premia have remained elevated. At the same time, inflation has fallen and the policy debate has shifted toward whether lower inflation can support growth. Our research shows that these developments are tightly connected.

This brief is based on the ERSA working paper and a forthcoming South African Journal of Economics article, "*Monetary-fiscal coordination in South Africa: Aligning the stars.*"

The paper introduces a new policy concept for South Africa: the fiscal-neutral real interest rate, or fiscal r-star. This is the real interest rate consistent with keeping the debt-to-GDP ratio stable for a given primary balance, growth rate, and debt stock. We compare this with the usual monetary r-star, the real interest rate consistent with inflation at target and output at potential.

Three findings stand out.

1. Monetary r-star has generally been above fiscal r-star, implying that the interest rate required for price stability has been higher than the interest rate consistent with debt stabilisation.
2. Market borrowing costs have also been above fiscal r-star, which means fiscal conditions have been too weak to stabilise debt without either stronger adjustment or lower risk premia.
3. The risk premium on South African borrowing is central to this wedge. It weakens monetary transmission and raises the odds of fiscal dominance if fiscal policy does not regain credibility.

The main policy conclusion is not that the South African Reserve Bank should carry the burden by reacting aggressively to fiscal variables. The model suggests that the larger and more durable gains come from a credible fiscal anchor that lowers sovereign risk, stabilises debt expectations, and allows monetary policy to focus on price stability with fewer trade-offs.

2. Why this matters now

South Africa's macroeconomic policy problem is no longer well described by thinking about inflation, interest rates, and debt in separate boxes. When debt is high and risk premia are elevated, monetary policy and fiscal policy become interdependent.

If the central bank keeps real rates at the level required to stabilise inflation, debt service costs can rise further and crowd out other spending. If monetary policy instead accommodates fiscal stress too readily, inflation control and policy credibility weaken. That is the terrain on which debates about lower inflation, debt sustainability, and macroeconomic coordination now take place.

This is why fiscal r-star is useful. It gives policymakers a direct way to think about the affordability of debt. If actual borrowing costs are persistently above the debt-stabilising rate, the state can only stabilise debt through some mix of stronger primary balances, faster growth, lower risk premia, or monetary accommodation. The last of these is the least desirable as a durable strategy.

3. What the paper does

We embed fiscal r-star in an estimated two-agent New Keynesian DSGE model for South Africa. The model allows us to compare:

- the monetary-neutral rate, linked to inflation and output stabilisation;
- the fiscal-neutral rate, linked to debt stabilisation; and
- the actual and risk-adjusted market rates faced by the economy and the government.

This lets us trace a monetary-fiscal gap over time. In the paper, that gap is defined as the difference between the risk-adjusted market rate and fiscal r-star. A positive and persistent gap means that the borrowing cost relevant for government debt dynamics remains above the rate consistent with debt stability.

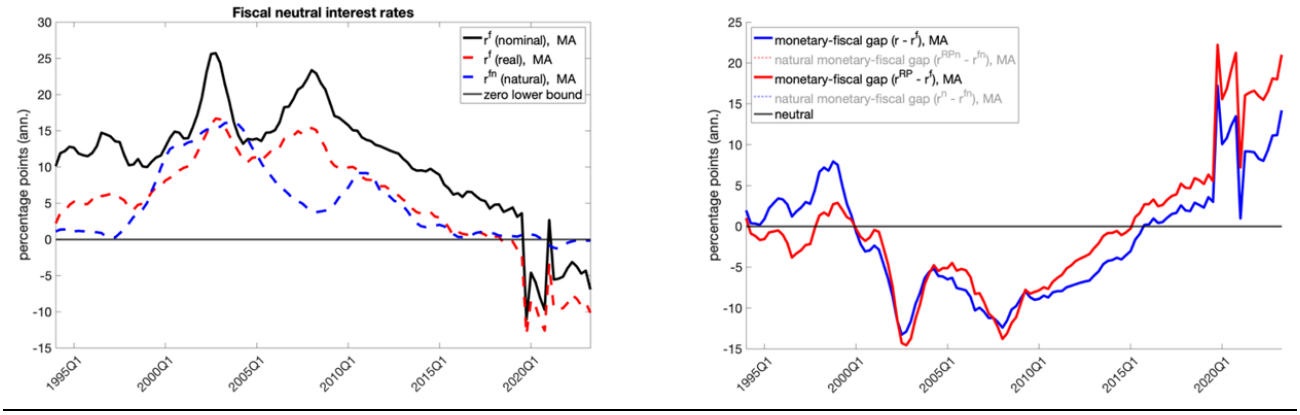
The model also allows us to ask whether monetary policy has historically responded to fiscal conditions, and whether stronger rule-based coordination would improve outcomes.

4. Main findings

South Africa faces a persistent monetary-fiscal misalignment

The paper finds that monetary r-star has tended to exceed fiscal r-star. This matters because it means the real rate required to deliver price stability is often higher than the real rate consistent with debt sustainability. In that setting, even well-intentioned monetary policy can tighten financing conditions for the fiscus (Figure 1).

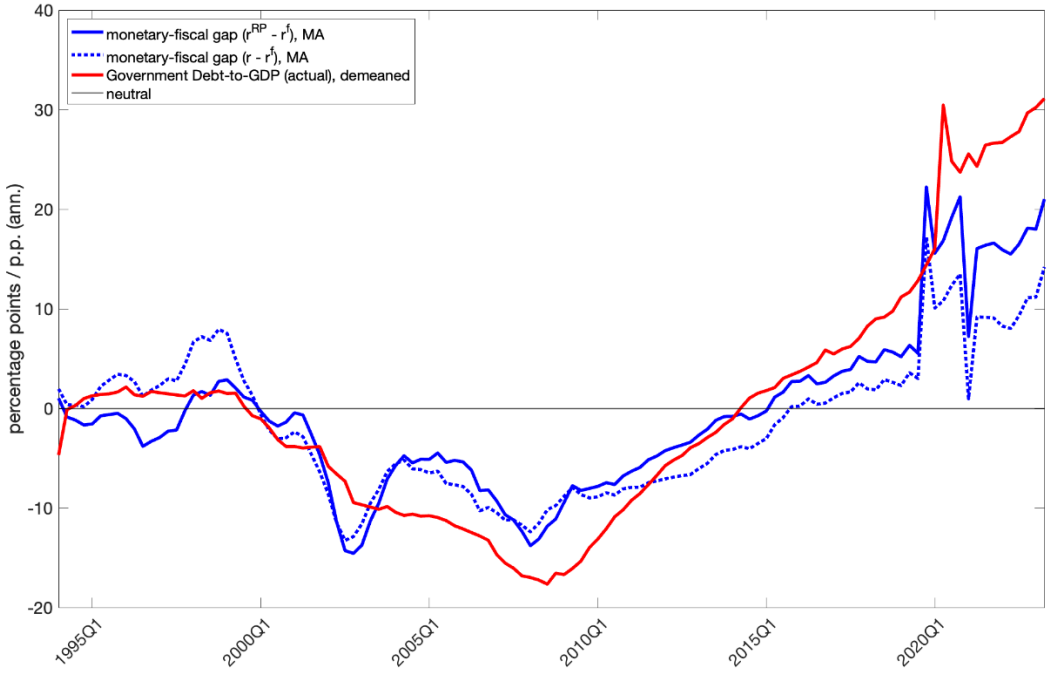
Figure 1: Fiscal-neutral interest rate and monetary–fiscal gap



Left panel: Model-implied fiscal-neutral versus natural (monetary) real interest rates. Right panel: Estimated monetary–fiscal gap: $r_t - r_t^{f*}$. *Note:* MA=5-quarter moving average.

The results also show that market rates have remained above fiscal r-star for long periods. This indicates that actual borrowing costs have been inconsistent with a stable debt path under prevailing fiscal settings. In practical terms, this shows up as higher debt-service costs, reduced budget flexibility, and greater pressure on non-interest expenditure (Figure 2).

Figure 2: Monetary-fiscal gap and government debt-to-GDP ratio

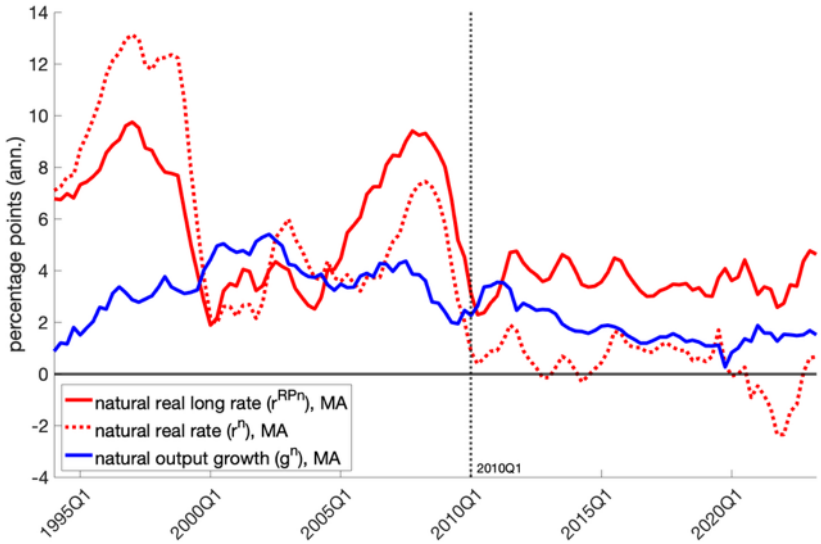


Note: the monetary-fiscal gap opened up in 2015 shortly after debt-to-GDP moved above its sample period average of ~ 40%.

The risk premium is doing much of the damage

One of the most important findings is that sovereign risk is not a side issue. The spread between the risk-adjusted rate and the observed real rate remains elevated for much of the post-crisis period, especially from around 2010 onward. This implies that South Africa's debt dynamics are not being driven only by the policy rate or by growth weakness. They are also being driven by the premium investors require to hold South African debt (Figure 3).

Figure 3: Risk-adjusted versus observed real interest rates ($r^{RP} > r > g$)



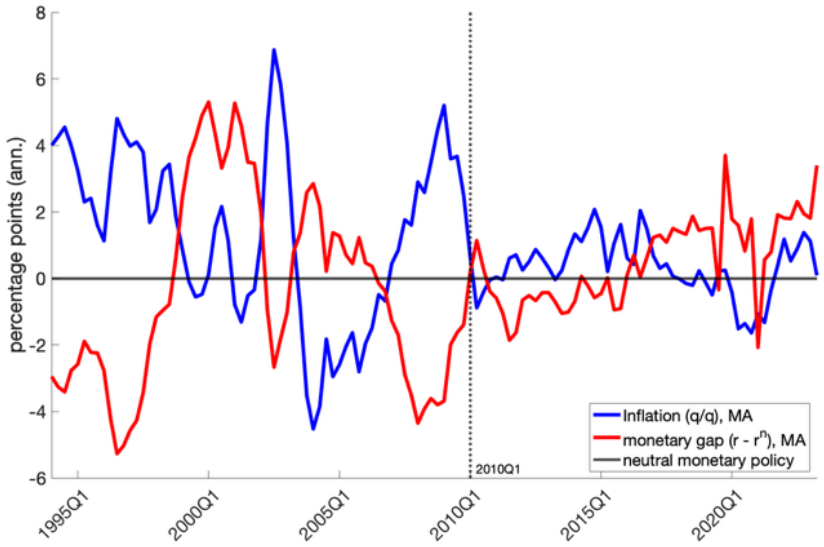
Note: MA=5-quarter moving average

This result sharpens the policy message. If the problem is partly a risk-premium problem, then simply debating the level of the repo rate misses the deeper issue. The state must improve the credibility of the fiscal path if it wants lower effective borrowing costs on a sustained basis.

Monetary policy transmission appears weaker when fiscal stress rises

The paper also finds that monetary policy appears less effective when fiscal pressures are elevated. The empirical correlation between the monetary policy gap and inflation deviations weakens from roughly -0.78 before 2010 to about -0.33 after 2010. That does not mean interest rates stop mattering. It does mean that when fiscal stress and sovereign risk are high, interest-rate changes do not pass through as cleanly to inflation outcomes (Figure 4).

Figure 4: Monetary policy gap versus inflation deviation: evidence of constrained transmission.



Note: MA=5-quarter moving average

This is consistent with a weak form of fiscal dominance. Monetary policy is not fully dominated by fiscal needs, but it becomes more constrained because fiscal conditions blunt its transmission and raise the macroeconomic costs of pursuing price stability.

A better fiscal rule matters more than asking the central bank to do more

The model estimates show that the South African Reserve Bank has likely internalised fiscal conditions to some degree already. An augmented Taylor rule that includes the monetary-fiscal gap improves statistical fit. But the policy simulations also show that stronger direct monetary responses to fiscal conditions yield only limited additional gains, and can come with greater interest-rate volatility.

By contrast, the broad direction of the welfare results is more supportive of a credible fiscal anchor. When fiscal policy is on a better debt-stabilising path, monetary policy benefits indirectly through lower risk premia and fewer conflicts between debt sustainability and inflation control. The conclusion is that the fiscus, not the central bank, must do most of the work in narrowing the gap.

5. Policy implications for South Africa

The policy message is best understood as a sequence.

First, fiscal policy needs a credible anchor that markets believe. The point is not merely to announce a rule, but to create a framework that convinces investors that debt will stabilise over time. A credible anchor lowers uncertainty about future financing needs and should reduce the sovereign risk premium.

Second, the purpose of a fiscal anchor is not austerity for its own sake. It is to restore macroeconomic room for manoeuvre. Lower risk premia reduce debt-service pressures, limit crowding out, and improve the environment in which monetary policy operates.

Third, monetary policy should remain focused on price stability rather than being redesigned around fiscal accommodation. The paper does not support shifting the burden of debt sustainability onto the SARB. Overreacting to fiscal conditions inside the monetary rule risks creating instability and confusing the central bank's mandate.

Fourth, better coordination should be understood as credible rule-based interaction, not as ad hoc bargaining between institutions. Treasury should provide a believable debt-stabilisation path; the SARB should continue to anchor inflation expectations; and both institutions should internalise the spillovers created by risk premia and debt-service dynamics.

5.1 What a credible fiscal anchor should achieve

The paper does not prescribe a single detailed institutional design, but it makes clear what any successful anchor must accomplish.

- It must place debt on a stable medium-term trajectory.
- It must improve confidence that primary balances will adjust when debt pressures intensify.
- It must reduce the sovereign risk premium rather than relying on inflation surprises or financial repression.
- It must allow monetary policy to pursue price stability without facing persistent fiscal spillovers.

In this sense, the benefit of a fiscal anchor is not only mechanical debt stabilisation. It is also a credibility device that improves the entire macroeconomic policy mix.

5.2 A caution on false solutions

The analysis also points to solutions that are less attractive than they might appear.

One is expecting monetary policy alone to offset fiscal weakness. That may buy time, but it does not solve the underlying wedge between debt affordability and price stability.

Another is allowing the economy to drift into forms of fiscal dominance or quasi-fiscal financial repression. These regimes may temporarily reduce the pressure on debt servicing, but they do so by distorting the monetary framework and weakening long-run credibility. The paper treats these outcomes as warning cases, not preferred policy paths.

6. Conclusion

South Africa's macroeconomic challenge is increasingly a coordination problem. The interest rate needed for inflation control and the interest rate needed for debt stability have diverged, and the gap has been widened

by persistent sovereign risk premia. That creates a setting in which monetary policy faces harder trade-offs and fiscal policy has less room to absorb shocks.

The central policy implication is therefore straightforward: South Africa needs a credible fiscal anchor. That is the most effective way to reduce the risk premium, narrow the monetary-fiscal gap, protect the inflation-targeting framework, and restore policy space for growth-supportive macroeconomic management.