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Declining US Natural Interest Rate: Quantifying and Qualifying the Role of Pensions

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Abstract: We develop a life-cycle model and calibrate it to the US economy to quantify and qualify the role of the public pension system for the past and future trend of the natural interest rate, the so-called r. Between 1970 and 2015, past pension reforms mitigated the secular decline in r*, raising it by around 1%, mainly through the positive effect of a higher replacement rate. As regards the future, we simulate the demographic trends, expected between 2015 and 2060, combined with alternative pension reforms and productivity growth scenarios. An increase in the effective retirement age delivers the highest r*, and thus the best welfare results, regardless of future productivity. On the contrary, the effects of a lower replacement rate strongly depend on the future productivity scenario. Under stagnant productivity, such pension system adjustment would exacerbate the fall in r* induced by population ageing, with negative implications for welfare.

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