Overreaction and Diagnostic Expectations in Macroeconomics

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We present the case for the centrality of overreaction in expectations for addressing important challenges in finance and macroeconomics. First, non-rational expectations by market participants can be measured and modeled in ways that address some of the key challenges posed by the rational expectations revolution, most importantly the idea that economic agents are forward-looking. Second, belief overreaction can account for many long-standing empirical puzzles in macro and finance, which emphasize the extreme volatility and boom-bust dynamics of key time series, such as stock prices, credit, and investment. Third, overreaction relies on psychology and is disciplined by survey data on expectations. This suggests that relaxing the assumption of rational expectations is a promising strategy, helps theory and evidence go together, and offers a unified view of a great deal of data.