

Diagnostic Expectations and Macroeconomic Volatility*

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Abstract

Diagnostic expectations have emerged as an important departure from rational expectations in macroeconomics and finance. We present a first treatment of diagnostic expectations in linear macroeconomic models. To this end, we establish a strong additivity property for diagnostic expectations. The solution method and stability properties are discussed in full generality. Under some conditions, diagnostic expectations generate higher volatility than rational expectations. We show that this is true in standard New Keynesian models, as in medium-scale DSGE models; in real business cycle models output and investment are characterized by dampening, instead. Finally, we discuss how the combination of diagnosticity with imperfect information can rationalize under- and over-reaction in macroeconomics.

Keywords: Heuristics, representativeness, shocks, endogenous cycles.

JEL codes: E12, E32, E71.

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