

# Financial Stability and Financial Regulation under Diagnostic Expectations

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## Abstract :

This paper studies the implications of “diagnostic” expectations—an empirically relevant form of non-rational extrapolation in expectation formation (Bordalo, Gennaioli and Shleifer (2018))—for financial stability and the appropriate conduct of financial regulation. We find that interactions between diagnostic expectations and financial frictions intensify instability in financial markets relative to the rational expectations benchmark. We also find that diagnostic expectations command tighter financial regulation, regardless of the degree of diagnostic expectations of the regulator.