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Tail Risk Neglect and Selective Recall

Abstract

Selective recall from memory offers a micro-foundation for the formation of tail beliefs and the impact of personal experiences. We show in a representative survey that recalled memories exhibit recency and primacy effects, and the impact of memories on tail beliefs is shaped by similarity and interference. Belief updating in response to news is asymmetric and state-dependent, consistent with dynamic tail risk neglect as predicted by diagnostic expectations. Tail beliefs influence decisions asymmetrically in an asset allocation experiment: Households adjust only in response to higher perceived tail risks, and safe-haven assets depend on the type of tail event considered. In sum, tail beliefs are shaped by selective recall from memory, display tail risk neglect, and can impact household decisions.

(joint work with Valentin Stockerl)