

The Psychology of Decision-Making: How Emotions Influence Financial Choices

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Abstract

Financial decisions are often assumed to be based on rational thinking and logical calculation. However, behavioral economics and psychology reveal that human emotion plays a crucial role in shaping financial judgment and market behavior. This paper explores how emotions—such as fear, anxiety, and overconfidence—affect individual and collective financial decision-making. Drawing on key theories in behavioral economics, including Prospect Theory and the concept of bounded rationality, this study analyzes the psychological factors that drive risk-taking, saving behavior, and investment choices. The paper also reviews the impact of emotional reactions during market fluctuations, demonstrating how panic selling or euphoric buying can amplify volatility. Moreover, it discusses how understanding emotional bias can lead to more effective financial education and policymaking. By integrating economic models with psychological insight, this study highlights the need for a balanced approach to decision-making that acknowledges both logic and emotion as essential components of human behavior in financial contexts.

Keywords

behavioral economics, decision-making, emotional bias, financial psychology, risk perception

1. Introduction

In traditional economics, people are often described as rational thinkers who make careful choices to achieve the best outcomes. However, real-world studies show that this assumption rarely holds true. Many investors react too strongly to market news, shoppers buy unnecessary items, and individuals fail to save money even when they understand its importance. According to Kahneman and Tversky these irrational patterns reflect that emotions and cognitive biases play a major role in financial decision-making [1].

Behavioral economics was developed to explain such psychological influences. It combines insights from psychology and economics to understand why people often make choices that deviate from logic. Barber and Odean observed that emotional factors like fear and overconfidence cause investors to trade excessively and earn lower returns [2]. Similarly, Almansour emphasized that emotional reactions such as anxiety or excitement directly affect individuals' perception of financial risk. These findings suggest that emotions systematically shape financial judgment rather than serving as random noise [3].

Understanding emotional factors in financial behavior is essential in modern society. Today, individuals face a wide range of complex financial choices, such as investing in the stock market or managing long-term savings. During financial crises, fear often leads to panic selling, while in times of market optimism, excitement and overconfidence lead to excessive investment. Annapurna et al. [4] found that emotional intelligence can reduce the negative impact of behavioral biases, helping investors make more stable decisions. Moreover, Herathmenike [5] provided evidence from a large meta-analysis that emotional biases consistently predict financial outcomes across cultures and markets. Therefore, emotions influence not only individual decisions but also the stability of entire markets.

This paper examines how emotions shape financial decisions through the lens of behavioral economics. It discusses the major emotional biases that influence decision-making, analyzes how they affect both individuals and markets, and explores strategies to reduce their negative effects. Effective decision-making requires a balance between logical reasoning and emotional awareness to ensure better financial outcomes. In recent years, the growing influence of social media and emotional consumption has made this balance even more important in daily life.

2. Literature Review

Behavioral economics has become one of the most important fields in understanding how emotions influence financial decisions. Early research by Kahneman and Tversky introduced Prospect Theory, which explains that people value gains and losses differently [1]. They found that individuals tend to avoid losses more strongly than they seek gains, a pattern known as loss aversion. This idea challenged the classical economic belief that people always act rationally and aim to maximize utility. Their study laid the foundation for later research connecting emotions with risk perception and investment behavior.

In addition, Shille argued that market bubbles and crashes are often driven by emotional narratives rather than pure economic fundamentals [6]. He showed that collective emotions—such as optimism, fear, or herd behavior—can spread among investors and create self-reinforcing market trends. Lo supported this view in his Adaptive Market Hypothesis, suggesting that emotions evolve as part of investors' learning processes [7]. Together, these studies demonstrate that emotions are not random mistakes but part of a broader psychological mechanism shaping economic activity.

More recent studies have deepened this understanding. Barber and Odean provided evidence that overconfidence leads investors to trade too often, resulting in poor returns and higher risk exposure [2]. Similarly, Almansour examined how financial anxiety affects decision-making and found that emotional stress reduces the ability to process information rationally [3]. Annapurna et al also highlighted the role of emotional intelligence, arguing that individuals with stronger emotional awareness are better at controlling behavioral biases, such as overconfidence or herd behavior [4]. These findings suggest that improving emotional regulation may lead to more stable and informed investment strategies.

Furthermore, a large-scale meta-analysis by Herathmenike reviewed more than 60 studies on investor psychology and confirmed that emotional bias is a universal factor influencing financial behavior across different markets [5]. The study pointed out that while culture and market structure can slightly modify emotional patterns, core biases such as fear, regret, and overconfidence are consistent worldwide. This indicates that emotional finance is not limited to one culture but is a general human phenomenon.

In summary, the existing literature consistently shows that emotions have a major influence on how people perceive risks, evaluate outcomes, and make financial decisions. Classical theories emphasize rational thinking, while behavioral approaches highlight emotional and psychological factors. The combination of these perspectives helps explain both individual and collective patterns in modern financial behavior, forming the basis for this paper's further analysis in the next sections. While most previous studies focused on investment and market behavior, recent consumer trends show that emotional decision-making also extends into lifestyle spending and online social behavior. This shift highlights the continuing evolution of behavioral economics in the digital age.

3. Emotional and Behavioral Aspects of Financial Decisions

Financial decisions are not only guided by logic but also shaped by emotions and psychological biases. When people make choices about spending, saving, or investing, they often rely on feelings rather than careful analysis. Kahneman and Tversky identified several key emotional patterns that lead to predictable errors, including loss aversion, regret, and risk-seeking after losses [1]. These emotions affect how people judge financial outcomes and how they respond to uncertainty. For example, investors may hold losing stocks too long because they fear realizing a loss, or they may sell winning stocks too early to protect a small gain.

One of the most common emotional biases is overconfidence. Overconfident investors believe they can predict the market better than others, leading them to trade more often and take unnecessary risks. Barber and Odean found that this behavior often results in lower long-term returns, since frequent trading increases costs and reduces overall performance [2]. Similarly, Annapurna et al. observed that emotional intelligence can help limit the effects of overconfidence by making individuals more aware of their own mental shortcuts [4]. This shows that self-awareness and emotional control are critical to better decision-making.

Another key factor is financial anxiety. When people experience stress about money, their ability to make rational choices declines. They may avoid necessary investments or make impulsive spending decisions to relieve emotional tension. Almansour explained that financial anxiety is linked to negative emotions such as fear and shame, which reduce an individual's confidence in managing finances [3]. In times of economic uncertainty, these feelings can spread through society, leading to collective behaviors like panic selling or sudden saving frenzies.

Group emotions also play a major role in markets. Shiller noted that social narratives and shared excitement can drive collective optimism or pessimism, producing asset bubbles or financial crises [6]. When people see others profiting, they tend to follow the crowd—a behavior known as the herd effect. This emotional contagion can create strong market swings even without major economic changes. Herathmenike confirmed that herd behavior is one of the most universal emotional biases found in global markets [5].

In addition, emotional responses influence how individuals process information. When people feel confident, they focus on positive news and ignore warning signs. When they feel fearful, they overreact to small risks. Lo suggested that emotional adaptation is part of an evolutionary process that helps humans survive uncertainty but sometimes leads to irrational market behavior [7]. Therefore, emotions should not be viewed only as weaknesses; they can also provide useful signals when balanced with rational thinking.

Overall, emotional and behavioral factors explain why financial decisions often deviate from traditional economic predictions. Emotions such as fear, greed, overconfidence, and regret are powerful forces that shape both individual and market behavior. Understanding these psychological dynamics helps investors, educators, and policymakers design systems that promote stability and reduce emotional overreactions in financial markets. These emotional and behavioral patterns, once observed mainly in financial markets, are now visible in daily consumer choices and online communities, reflecting a broader cultural change.

4. Theoretical Reflection and Real-world Cases

The influence of emotions on financial decisions is no longer limited to investment or savings—it has become central to modern consumer behavior. In today's digital environment, people spend money not only to meet functional needs but also to express emotions, identity, and belonging. This emotional pattern is especially visible in China, where social platforms like Douyin (the Chinese version of TikTok) have turned consumption into an emotional ritual. Products such as Labubu figurines, Matt characters, and pet-related goods have become symbols of comfort and self-expression. These items often carry little practical use, yet they provide consumers with emotional satisfaction and psychological comfort, confirming Shiller's idea that social narratives and shared emotions can drive economic behavior [6].

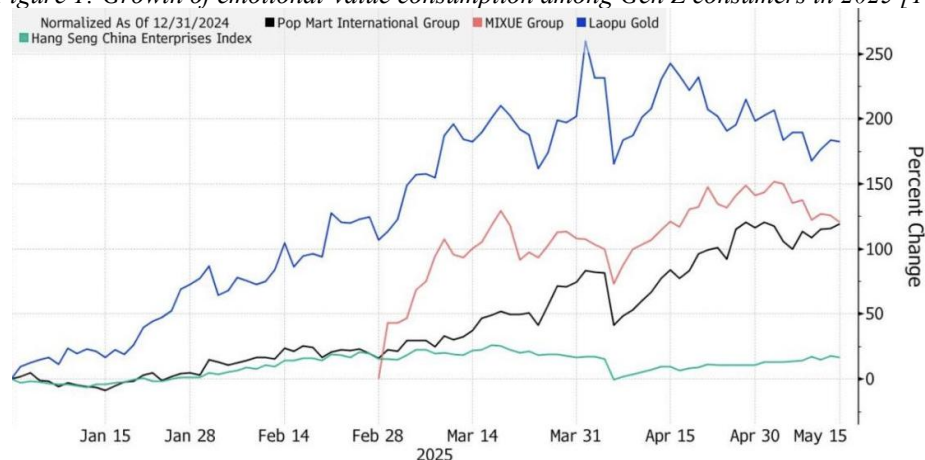
Recent consumer reports show that emotional value has become one of the most important motivations for spending in 2025. Surveys by McKinsey and Numerator reveal that even as the global economy slows and prices rise, people continue to pay for products that make them feel seen, happy, or understood [8, 9]. This phenomenon aligns with Almansour and Annapurna et al., who argue that emotions like stress, comfort, and

pride play major roles in financial choices [3, 4]. Consumers are not simply responding to market prices; they are responding to psychological triggers such as nostalgia, social belonging, or the desire for emotional stability.

On platforms like Douyin and TikTok, emotional consumption spreads rapidly through social contagion. When people watch influencers unbox collectibles or share their pets' daily lives, they feel emotionally connected to others. This sense of belonging encourages similar spending, illustrating Herathmenike's conclusion that herd behavior and emotional contagion strongly shape financial patterns [5]. In this sense, modern social media acts as both a marketing channel and a psychological amplifier, merging emotional needs with economic behavior.

In conclusion, these examples show how emotions now dominate many financial decisions in everyday life. The digital era has transformed spending into a form of emotional communication—people buy feelings rather than objects, and these feelings become a new kind of social currency. Understanding this change is essential not only for economists but also for policymakers and educators who aim to promote healthier, more mindful financial behavior in an emotionally driven world [10].

Figure 1: Growth of emotional-value consumption among Gen Z consumers in 2025 [11]



5. Conclusion

This paper has examined how emotions influence financial behavior through the lens of behavioral economics, from classic theories to modern digital practices. Through this analysis, it becomes clear that financial decision-making is not purely rational. Emotions such as fear, overconfidence, anxiety, and empathy consistently shape how individuals and groups respond to risk, uncertainty, and social influence. In the context of 2025, emotional factors play an even stronger role in financial behavior. Economic uncertainty increases emotional sensitivity, leading people to make financial choices that prioritize psychological comfort and personal meaning. Rather than simply maximizing material value, individuals increasingly seek emotional reassurance, identity affirmation, and a sense of control through their spending and financial decisions. This paper also highlights how digital environments intensify emotional influence. Social media platforms expose individuals to others' emotions, lifestyles, and financial behaviors, which can unconsciously shape their own choices. As a result, financial decision-making becomes more reactive, socially driven, and emotionally charged, creating both opportunities for connection and risks of impulsive behavior. Overall, this study emphasizes that understanding emotional influence is essential for making healthier financial decisions. Recognizing emotional bias allows individuals to reflect more carefully on their choices and encourages a balance between emotional awareness and rational thinking. In an increasingly emotion-driven economic environment, developing this balance will be crucial for building a more sustainable and mindful financial culture in the future.

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Conflicts of Interest

The authors declare no conflict of interest.

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