The Impact of Irrational Behavior on Decision-Making in Personal Finance

The Role of Emotion Attachment in Installment Debt

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Abstract. Emotions play a significant role in debt-driven consumption made by individuals leading them into irrational behavior that can result in substantial financial issues if not appropriately controlled. There exists a correlation between emotional attachment towards product/service purchases via loans & irrational spending practices among most people struggling with debt burdens because, over time, they feel the need to keep up with the emotional bond they have created. This can lead to a cycle of debt where consumers use additional credit, loans, or borrowing to sustain their current lifestyle choices. In this paper, we discussed several methods that help consumers avoid these negative consequences. People need to take proactive measures such as educating themselves on personal finance management and creating realistic budgets based on their income levels while considering long-term sustainability factors rather than temporary satisfaction only. By doing so, they can manage their emotional attachments effectively without compromising future financial stability while avoiding common pitfalls associated with overspending through credit purchases or other forms of loan repayment plans due to misleading information through marketing campaigns or peer pressure influences.

Keywords: Emotion; Emotion Attachment; Installment Debt; Irrational behavior

1 Introduction

Frequent irrational behavior in financial decision-making refers to the tendency of individuals to make choices decisions that are not in their best interest. Instead, their decisions are influenced by psychological factors, such as cognitive biases and emotional responses. Understanding this concept is crucial because it can lead to unfavorable financial outcomes, including missed opportunities, excessive debt, and inadequate savings. This behavior is driven by various economic concepts, such as long-term trends and speculative trading, resulting in the contraction of unnecessary spending and chasing after luxury goods, among other things[1]. Factors that influence consumer irrationality include negative emotions like fear and anxiety, coupled with cognitive biases that

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inform decision-making processes. These behaviors have detrimental effects on both individual households and the broader economy.

The COVID-19 pandemic has caused prolonged uncertainty and placed immense pressure on millions worldwide. Coupled with unprecedented interventions from authorities, this macroenvironment has given rise to various potential triggers for irrational behavior among ordinary consumers.

2 Market Backdrop of the COVID-19 Pandemic and Its impact on consumer spending

2.1 Macroeconomics trends

The emergence of the COVID-19 pandemic has had profound and detrimental effects on the global macroeconomic environment, leading to significant impacts on consumer spending patterns and capacity. One of the most severe consequences of the pandemic has been the disruption in the supply chain and availability of day-to-day goods. The implementation of pandemic-related regulations, such as lockdowns, brought logistical systems to a halt, making it difficult for consumers to access even basic necessities. The restrictions directly affected the demand and supply dynamics, with consumer demand surging while the supply chains faced disruptions, resulting in an economic crisis [2].

Furthermore, the overall industrial activity was severely impacted, leading to a decline in goods manufacturing. Developing markets experienced a decline in GDP by 6.7 percent, while developed economies saw a decrease of 2.4 percent. The emergence of the disease also exacerbated income inequality and affected income levels in both advanced and developing nations. Governmental restrictions, such as office closures, resulted in millions of people losing their jobs. This had a negative impact on consumer spending as lower income levels limited individuals' purchasing power. For example, developed nations experienced a 4.6 percent reduction in employment [2].

2.2 Authority response

Authorities worldwide immediately delved into a response action to tackle the negative impact COVID-19 had on the global macroeconomic environment and consumer spending, and other related factors. The International Monetary Fund (IMF) played an imperative role. For instance, the institution aided member countries with emergency financing by doubling the extent of access to Rapid Credit Facilities and Rapid Financing Instruments, thus, helping about 80 member nations to soothe the macroeconomic failures [3]. The IMF has also aided member countries with debt payments via a program called CCRT (Catastrophe Containment Relief Trust). Moreover, IMF has also emerged with the aid of managing liquidity for countries in order to curb their financial backdrop that impacted consumer spending. This has been done by establishing SSL (Short term liquidity line).

2.3 Labor market

The emergence of COVID-19 had a significant impact on the labor market. Governmental restrictions, such as lockdowns, brought economic activity, including industrial and service sectors, to a halt, leading to widespread job losses. The unemployment rate reached unprecedented levels during the pandemic, reflecting the severity of the labor market shortage [4]. Businesses were forced to close, and economic activity slowed down, further exacerbating the challenges faced by the labor market. The chart below (figure 1) illustrates the increasing unemployment rate during the COVID-19 pandemic [5].

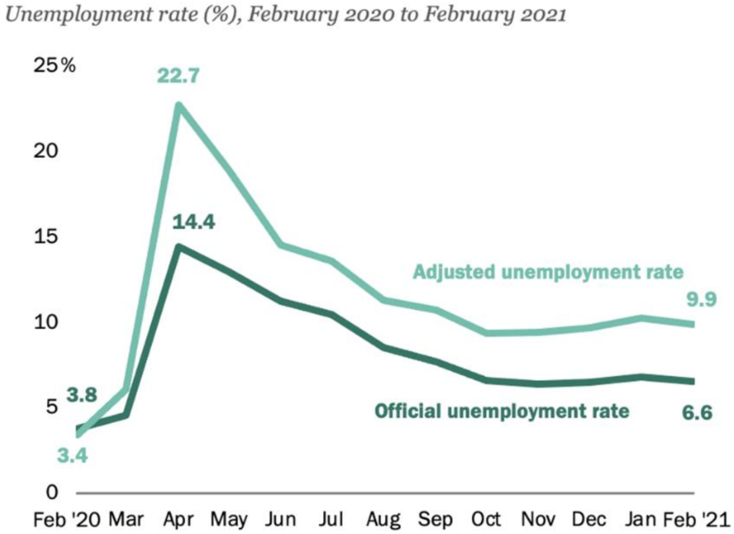


Fig. 1. U.S. unemployment rate from Feburary 2020 to Feburary 2021.

Source: Pew Research Center analysis of 2019, 2020 and 2021 Current Population Survey monthly files (IPUMS)

3 Frequent irrational behavior in making financial decisions

There are several frequently observed irrational behavior that might have a significant impact on decision-making in personal finance.

3.1 Emotion Attachment

Emotion attachment refers to the feelings evoked by consumer purchases concerning the perceived value rendered by these products or services. It can be seen from both positive (pride) and negative (shame) perspectives but is commonly observed towards luxury items that serve no practical purpose other than ego satisfaction. In most cases where customers take out installment loans, for example, car loans or mortgages, they form a deep emotional attachment with them since the loan helps them realize long-term goals for housing and transportation needs; thus providing meaning beyond just satisfying short-term desires like impulse shopping does.

However, the emotional attachment to installment debt can be significantly impacted by persistent illogical behavior when making financial decisions. Consistently making irrational financial decisions might make people feel more emotionally attached to the debt they have accrued. Making unwise financial decisions, such as overspending or taking on needless debt, can increase emotional attachment to material items or experiences, which becomes a vicious cycle. Each impulsive acquisition of these things or increase in debt just increases our emotional satisfaction. This reinforcement makes the emotional connection stronger and can make it more challenging to let go of debt in the future.

Higher levels of financial stress and anxiety are frequently brought on by frequent illogical behavior in financial decision-making. People could become financially precarious, unable to pay their debts off, and too concerned about their financial condition. As people become emotionally concerned about finding remedies to ease their suffering, this tension deepens their attachment to the debt even more. Emotional attachment to installment debt can cause illogical behavior to become more irrational as a result of increased emotional connection. This cycle can continue indefinitely. People who seek emotional solace through hasty spending or excessive borrowing continue the cycle and reinforce their emotional ties to debt.

3.2 Availability Heuristic

The availability heuristic is a mental shortcut used when people make judgments based on information that readily comes to mind. In other words, we tend to overestimate the likelihood of events or situations that we have experienced recently or vividly recall from memory. Availability heuristic refers to the extent of importance one is inclined to place on something merely because of readily available information. It is a form of a biased cognitive process that takes place where an individual makes decisions based on whatever information is quickly available [6]. Thus, the availability heuristic can explain why irrational behaviors in making financial choices exist. For instance, during the COVID-19 pandemic, people would buy bulks of products regardless of what they were priced at in installments in fear of running short later. Availability heuristic played a role in this regard, pertaining to the irrational bulk purchase based on information such as supply chain disruptions that would later cause their unavailability.

3.3 Framing

Framing is yet another aspect of behavioral economics that tends to impact the irrational financing or purchase decisions of consumers. In framing, the way a decision point is portrayed is altered in order to influence the decision-making. In other words, the frame of reference is adjusted such that perception might change. Consumers' financing habits are also impacted by the fear of loss factor. This involves the fact that customers are mysteriously attracted to products that are lesser in number and would exhibit irrational purchase behavior in installment regardless of the product's use and value simply because they fear that the product will soon run out. This concept is called loss aversion; for instance, losing USD 100 has a more intense psychological effect than gaining USD 100. In other words, losing feels almost twice as harmful to customers as winning does [7].

3.4 The Collective Effect with Other Factors

Emotional attachment can also be used as a psychological coping method. People may feel momentary emotional relief or pleasure when they engage in illogical behavior, such as overspending. People often choose immediate gratification over long-term benefits when making financial decisions. For example, an individual might opt to buy a new pair of shoes in installments through credit card instead of investing that money in a retirement fund. This behavior can result from the belief that choosing something that brings instant happiness will outweigh future benefits. Another factor impacting consumer behavior economics and their financing decisions is monetary or social (cause) reward, which has a different impact. The monetary reward is what the name suggests, a monetary or money-related reward and includes coupons, discounts, and hold value in terms of what economic advantage they provide. Social (or cause) rewards, on the other hand, include verbal praise, certificates of appreciation, and friendly gestures and hold importance in reference to reinforcement they provide linked to the probability of the same behavior reoccurring in the future [8].

This comfort offers a momentary respite from underlying emotional problems or stressors, strengthening the emotional bond with the behavior and the debt it generates. Decision-making is hampered by frequent illogical behavior, making it difficult for people to make wise financial decisions. Emotional attachment can impair rational thought and skew judgment, making it challenging to assess the long-term effects of financial decisions. The cycle of impulsive spending, debt accumulation, and emotional attachment to that debt can be sustained by this impairment. Frequent irrational behavior in financial decisions has an effect that is not just on the individual. Relationships with family members, friends, or partners who may be impacted financially by these choices might become strained. The emotional environment surrounding the debt might become more complicated due to the emotional link to the debt, which can cause guilt, humiliation, or hatred.

4 Typical Irrational Consumer Spending behavior during uncertainty

Consumers' irrational spending habits can significantly impact the emotional attachment to installment debt during uncertain times. Economic uncertainties like recessions, job uncertainty, or financial crises can cause emotional reactions that result in irrational and impulsive expenditure. Here is how this conduct may affect the emotional connection to installment debt: People may become more stressed, anxious, and afraid about their financial future during uncertain times. Some people use consumer purchasing as a type of emotional distraction or release in an effort to deal with these emotions. The act of buying things gives people a fleeting sense of pleasure and power, temporarily easing their mental distress. This behavior, meanwhile, has the potential to become people emotionally attached to their purchasing habits and debt accumulation.

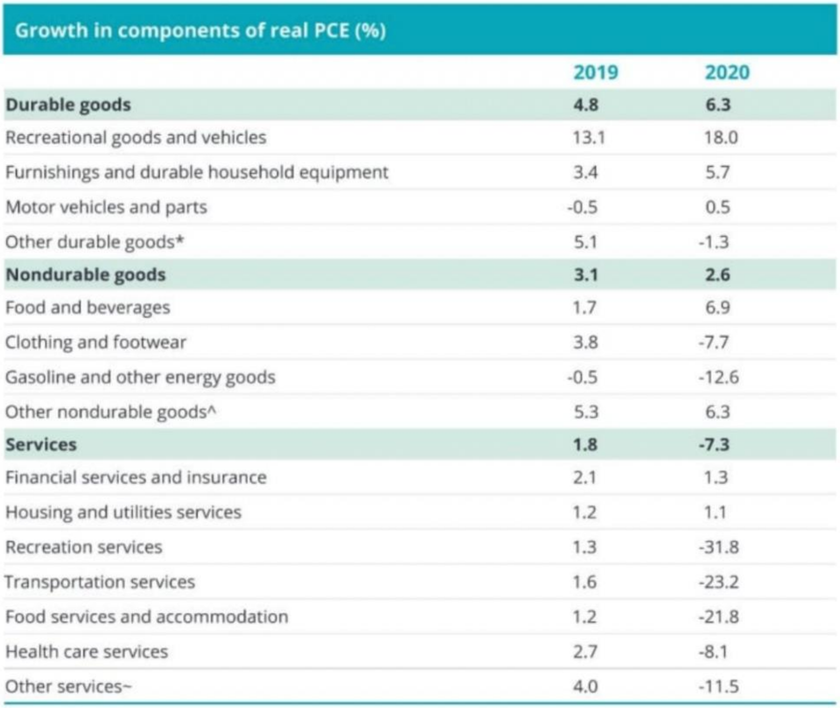
During uncertain times such as economic recessions or global pandemics like COVID-19, consumers tend to adjust their spending habits [9]. They become more cautious with their spending and focus on essential goods and services. However, some consumers may adopt impulsive buying behaviors as a coping mechanism for stressors related to uncertainty. Besides this, past experiences also affect current financial decisions. For instance, if a consumer went through an economic downturn that affected them personally previously might exhibit conservative financial behaviors even when currently experiencing prosperity.

Anxiety can lead to a need for both an escape from reality and rapid gratification. Impulsive spending is a behavior that people sometimes participate in to escape from their troubles or to get a quick high. The emotional attachment results from the temporary emotional comfort that spending brings, which creates a vicious cycle of seeking emotional gratification through consumption and building up debt. Businesses frequently take advantage of uncertainty by incorporating emotional appeals into their marketing plans. They may use anxiety, scarcity, or a sense of urgency to persuade customers to buy things they don't need. These marketing strategies encourage emotional attachment by convincing customers to purchase goods or services in installments which they can pay later to allay their emotional worries or feel secure.

The ability to make reasonable financial judgments might be impaired by uncertainty. Emotional decision-making overrides rational judgment. Emotions like fear or worry can trump reason and cause impulsive and irrational spending decisions. People prioritize emotional relief and short-term satisfaction over long-term financial security and debt management, which leads to the development of an emotional attachment to installment debt [10].

Unwise consumer purchasing during times of uncertainty can lead to heavy debt loads. People may feel regret, guilt, or humiliation as the effects of impulsive purchases become clear. The emotional attachment grows stronger as people experience emotional stress as a result of their mounting debt, which can result in a vicious cycle of unfavorable feelings and additional illogical expenditure. During uncertain times, individuals may become more susceptible to predatory lending practices, including high-interest loans on credit offers. People may be more vulnerable to these predatory financial products if they have an emotional connection to the need for security or stability. Being caught in a cycle of high-interest payments and financial stress might make people feel more emotionally attached to their debt.

When faced with a time of crisis, or an uncertain situation, consumers tend to be more cautious and deliberate significantly about their purchase habits. They pull back from spending on unnecessary or luxury items perceiving that the necessities purchased would come in handy. For example, shoppers during the outbreak of the COVID-19 pandemic, an uncertain time, surged their purchase of essential items such as food, toilet paper, and medical supplies. Thus, contracting unnecessary spending, especially considering that COVID-19 had immense economic impacts, like a halt in income. The following chart (figure 2) explains how badly consumer spending was hit for unnecessary spending [11].



Growth in components of real PCE (%)

	2019	2020
Durable goods	**4.8**	**6.3**
Recreational goods and vehicles	13.1	18.0
Furnishings and durable household equipment	3.4	5.7
Motor vehicles and parts	-0.5	0.5
Other durable goods*	5.1	-1.3
Nondurable goods	**3.1**	**2.6**
Food and beverages	1.7	6.9
Clothing and footwear	3.8	-7.7
Gasoline and other energy goods	-0.5	-12.6
Other nondurable goods^	5.3	6.3
Services	**1.8**	**-7.3**
Financial services and insurance	2.1	1.3
Housing and utilities services	1.2	1.1
Recreation services	1.3	-31.8
Transportation services	1.6	-23.2
Food services and accommodation	1.2	-21.8
Health care services	2.7	-8.1
Other services~	4.0	-11.5

Fig. 2. PCE on recreational goods and vehicles surged in 2020 even as recreation services fell sharply.

Source: United States Department of Commerce (sourced through Haver Analytics); Deloitte Services LP economic analysis.

5 Case Study: Affirm

There is an established business model which takes advantage of this irrational behavior among consumers and is helping several successful companies make significant profits. Here we take Affirm as an example and will conduct a deep dive into its business.

Affirm is a company that facilitates consumer payments. Their business model revolves around income from consumers and merchants and is primarily based on the buy-now-pay-later factor as well as a point-of-sale loan. Their target market consists of Generation Z and Millennials, who struggle with having ample wealth, credit card payments, and lower income levels. Thus, Affirm leverages this aspect to make money. The first and foremost income stream Affirm leverages is the interest the company earns by providing customer loans. The loans can lead up to USD 2,500 in four installments [11] and the company uses an algorithm to analyze the customers based on their credit history and relationship with the company before providing loan approval. The second way of making money is processing fees for merchants. Merchants pay a transaction cost which proves to be an income for Affirm.

Compared to the traditional financial services such as banks, Affirm's value proposition is the convenience of payments provided to the market segment. Moreover, Affirm provides complete transparency to their loans, does not hide any additional charges, and provides APR (annual percentage rates), unlike competitors in the field. The loan terms are based on an artificially intelligent algorithm that considers several factors in order to lay out loan terms customized to every user of Affirm.

The company is based on having a network of merchant partners, including many brands such as Adidas, Walmart, and Peloton, and has maintained relationships with a total of 400,000 such merchant partners [12]. When a consumer browses these websites, the close integration of Affirm as a payment option significantly lowers the friction in such actions. Thus, the business model can trigger irrational shopping behavior in terms of "chasing luxury brands," where a consumer may purchase a luxury item from a renowned luxury brand like Adidas merely because Affirm facilitates the purchase by providing POS loans. This shopping behavior is irrational because the customer may not have made the purchase in-store, where they would have to pay the full amount at the time of purchase.

6 Conclusion

To conclude, consumers tend to exhibit irrational spending behaviors, especially during times of crisis or uncertainty. The irrationality in buying and purchase habits can be explained by several heuristics that impact the consumers' cognitive and emotional capacity, which plays a critical role in determining their decision. This includes the availability heuristic, framing reference, fear of loss, social versus reward perception, and several others that ultimately contributes to how they display their purchase behavior in times of uncertainty. Irrationality in such times can be related to the most since the world recently suffered from the outbreak of COVID-19, that not only affected the macroeconomic environment but also played a major role in altered shopping/purchase behavior of consumers around the globe. Thus, it is imperative to understand the science of making personal finance decisions in the face of uncertainty so that consumers can learn to exhibit and regulate their emotions and cognitions in case a crisis ever hits again. And based on the above findings, the following advices would be offered.

For individuals, it is important to set out their long-term and short-term financial goals. This could be catered to by writing down what financial plans a person has. Short-term goals would normally include immediate purchases, whereas long-term goals may include investments, education. Once that has been figured out, the rest of the financial planning would be based on the set goals in order to keep a better track of expenses and cash flows. It is recommended that personal finance decision-making must be based on a budget. For instance, an individual should conduct a financial analysis by reviewing their bank statements, debt dues, income streams, and investment returns. Based on this, a budget must be established, especially during uncertain times when income levels tend to plummet. Then, by sticking to the budget, personal finance decisions are easy to conduct without running the risk of facing financial insecurity.

It is also important to remember that consulting with financial experts and analysts can also help an individual plan their financial decision-making. Financial planners have ample knowledge and share what risks are associated with particular spending and whether it is coherent with the current personal financial situation [13]. To overcome cognitive biases, one strategy would be to seek expert opinions from seasoned investors who have been successful within the field at stake. In addition, individuals can implement strategies such as diversification and rebalancing their portfolios regularly across investment types, including varying geographical sectors, to minimize risk exposure. Another approach would be for individuals to work hard at improving their financial literacy by reading critically about various investments and understanding different principles related to them.

To mitigate against negative effects caused due to typical irrational consumer behavior during uncertain times, it's recommended that policymakers promote transparency among financial institutions to limit speculation tendencies. Additionally, individuals can take steps to manage negative emotions and cognitive biases by applying mindfulness practices like deep breathing or meditation. Finally, households can implement budgetary plans based on necessities prioritized over non-essentials.

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