American Journal of Science and Learning for Development

ISSN 2835-2157
Volume 2 | No 4 | April -2023

Behavioral Finance as a New Direction in Economic Science

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Abstract: *Numerous studies confirm and insist that in various situations a person can be influenced by all sorts of irrational factors, such as emotions, feelings, illusions, prejudices, erroneous perceptions, herd instinct, spontaneous decision, and so on. This statement is based on a relatively new financial science - behavioral finance. The reason for the emergence of this branch of economic theory was that the behavior of market participants is far from rational, therefore it does not correspond with the assumptions underlying the classical theory of political economy.*

Behavioral finance is a field of economics that studies the influence of social and emotional conditions on economic decision making by individuals or institutions and the consequences of this influence on economic processes. The global financial crisis is the motive that forces many entrepreneurs, investors and other market participants to rethink their concepts and beliefs.

The most common patterns of human behavior studied by behavioral finance include the following:

1. Crowd effect- Among the numerous examples of irrational behavior of people, one of the first to be discovered was the “crowd effect” or it is also called the “bandwagon effect”. Sociologists and psychologists scientifically confirm the specific influence that a group of people has on specific members of this group. It turns out that a person in a group tends to behave quite differently comparing person, who acts alone. The crowd has the so-called collective mind and turns the people into one single whole. This effect is extremely contagious, it is common for group members to sacrifice personal interests at the expense of public ones.

A number of studies have shown an interesting pattern. It has been proven that 35% of the people present in the group adhere to the opinion of the majority, even if they themselves do not completely agree with it. But the situation can change with the appearance of a person who loudly declares his disagreement with the collective vision of a certain problem. It is likely that these 35% begin to support the new opinion expressed [1].

Collective consciousness is explained by the fact that actions contrary to the majority cause a person to feel fear. Even obvious facts can be questioned if the general opinion is contrary to them. As a consequence, people under the influence of the crowd lose the ability to think for themselves.

It is the “crowd effect” that explains the phenomenon of the popularity of bestseller lists. After all, we often choose a particular product based on the fact that a new product has been approved by so many people.

2. The effect of erroneous perception, processing of information and formation of conclusions- With different presentation variations, we tend to perceive the same information in different ways.

And under the influence of certain factors, people can incorrectly assess the likelihood of an event occurring, as a result, false ideas and conclusions can be formed.

Research shows that it is the presentation of information that can significantly influence our choices and decisions. During the experiment, a fictitious situation was proposed in which a terrible catastrophe or an epidemic of a deadly disease struck the world. If urgent actions had not been taken, 600 people would have died. Participants were then asked to choose between two programs. The first one would save 200 people with a probability equal to 100%, and the second assumes the salvation of all 600 people, but with a rather low probability - 1/3. At the same time, most people were inclined to launch the first program. But one has only to change the wording - and everything changes radically. In the second case, a much larger number of people preferred the second program, because it was said that the first program would lead to the inevitable death of 400 people, and the second could save everyone with a probability of 1/3. The conditions of the programs have not changed at all, the situation has remained unchanged, but the wording has played a decisive role in decision-making. The reason for this phenomenon (the so-called design effect) can be called the fact that people underestimate the information given to them, take limited insufficient information, and open information as really significant in a particular case [2].

It is quite obvious that skillfully playing with the human psyche, presenting information and the situation from the right side, you can crank out the most diverse, amazing, and most importantly, profitable operations.

3. Possession effect or fear of loss- The essence of this theory is that a person in quantitative terms receives less satisfaction from the acquisition of the n-benefit compared to the frustration gained when it is lost. That is, the experiences will overtake us if we lose $100, this will not only be diametrically opposed in nature to those feelings that we will experience if we get the same $100, but will also be much stronger than the latter. Thus, a person regards things that he owns as more valuable than similar things that do not belong to him. That is why people tend to overestimate the value of what belongs to them. This fully explains the fact that entrepreneurs often inflate the value of their business, as they take into account all the efforts invested in the process of creating and developing a business.

4. The effect of overconfidence- The effect of overconfidence is significant practical importance, both in entrepreneurship and in investing. Being aware of its presence, we can avoid a lot of economic mistakes. Surveys show that about 82% of car drivers consider themselves to be quite qualified and consider themselves to be among the safest. But statistics say that this group is only 30% of the total number of motorists. The situation, similar to the one described above, takes place not only among drivers. Research shows that most people are overconfident in their qualifications, professionalism, skills, abilities, and intuition. In a survey of almost 3,000 start-up founders, more than 80% of them are absolutely sure that their company has a much better chance of success than everyone else. The groundlessness of such overly optimistic beliefs is confirmed by statistical data: 61.5% of new companies cease operations within the first 5 years, 79.6% within 10 years [1].

The presented models of behavior are only one of many effects and anomalies, which together constitute the phenomenon of irrational behavior of participants in economic markets. The impossibility of explaining this behavior in terms of classical theory increasingly leads to a search for a relationship between economics and psychology. Therefore, for successful activity in the entrepreneurial, marketing, investment and financial environment, it is no longer enough to use such orthodox models as standard approaches to the equilibrium of supply, demand and macroeconomic theories. Leading companies and specialists are adopting the psychological characteristics of irrational behavior of both individuals and entire societies. An interesting fact is that absolutely everyone is affected by these effects, regardless of the intellectual level, professional training, field of activity or work experience. Therefore, the study of psychological aspects within the framework of economic behavior can significantly increase the efficiency of activities and the success of strategies in various sectors of the economy.

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