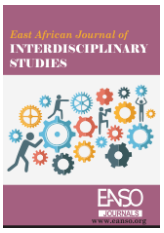

East African Journal of Interdisciplinary Studies
eajis.eanso.org
Volume 8, Issue 1, 2025
Print ISSN: 2707-529X | Online ISSN: 2707-5303
Title DOI: https://doi.org/10.37284/2707-5303

EAST AFRICAN NATURE & SCIENCE ORGANIZATION

Original Article

The Illusion of Rationality: How Behavioural Biases Affect Economic Decisions and Market Equilibrium

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Article DOI: https://doi.org/10.37284/eajis.8.1.3196

Date Published:

23 June 2025

Keywords:

Rationality (D01), Behavioural Economics (D03), Market Equilibrium (D11), Cognitive Biases (D81), Decision-making Behaviour (G41).

ABSTRACT

The assumption of rational market participants lies at the core of many economic models. However, real-world observations often reveal systematic deviations from this ideal. Economic decisions are frequently shaped by psychological patterns such as loss aversion, anchoring effects, and herd behaviour. These cognitive distortions do not occur randomly, nor do they neutralise each other in the aggregate. Instead, they tend to reinforce one another, leading to structural shifts that question the classical notion of stable market equilibrium. This paper examines how behavioural biases alter the dynamics of market processes and how their cumulative effects influence pricing, coordination, and systemic stability. Drawing on insights from behavioural economics and the epistemological critique of the Austrian School, the study challenges the assumption that markets function as efficient arenas of rational exchange. The research follows a qualitative methodology, combining a conceptual literature analysis with case-based insights from financial markets, particularly during episodes of volatility and crisis. Rather than proposing a new predictive model, the paper suggests a different lens through which to view market phenomena: one that acknowledges perception, expectation, and error as constitutive elements of economic activity. Market behaviour is presented not as the outcome of logical optimisation, but as a reflection of human subjectivity under uncertainty. The study further discusses the implications for economic policy, highlighting the limitations of both laissez-faire ideologies and technocratic intervention. It concludes that robust institutional frameworks are needed to mediate between psychological vulnerability and systemic resilience. The paper calls for a pragmatic approach to market regulation, grounded in a realistic understanding of decision-making processes. In doing so, it reframes the idea of equilibrium from a normative anchor to a contingent outcome shaped by human behaviour, cultural context, and epistemic constraints.

Article DOI: https://doi.org/10.37284/eajis.8.1.3196

APA CITATION
Oberdieck, T. & Schulte, M. (2025). The Illusion of Rationality: How Behavioural Biases Affect Economic Decisions and Market Equilibrium. *East African Journal of Interdisciplinary Studies*, *8*(1), 465-473. https://doi.org/10.37284/eajis.8.1.3196.

CHICAGO CITATION
Oberdieck, Tobias and Michelle Schulte. 2025. "The Illusion of Rationality: How Behavioural Biases Affect Economic Decisions and Market Equilibrium". *East African Journal of Interdisciplinary Studies* 8 (1), 465-473. https://doi.org/10.37284/eajis.8.1.3196.

CITATION
Oberdieck, T. & Schulte, M. (2025) "The Illusion of Rationality: How Behavioural Biases Affect Economic Decisions and Market Equilibrium", *East African Journal of Interdisciplinary Studies*, 8(1), pp. 465-473. doi: 10.37284/eajis.8.1.3196.

IEEE CITATION
T., Oberdieck & M., Schulte "The Illusion of Rationality: How Behavioural Biases Affect Economic Decisions and Market Equilibrium", *EAJIS*, vol. 8, no. 1, pp. 465-473, Jun. 2025.

MLA CITATION
Oberdieck, Tobias & Michelle Schulte. "The Illusion of Rationality: How Behavioural Biases Affect Economic Decisions and Market Equilibrium". *East African Journal of Interdisciplinary Studies*, Vol. 8, no. 1, Jun. 2025, pp. 465-473, doi:10.37284/eajis.8.1.3196.

INTRODUCTION

The notion of the rational decision-maker has long been a main element of economic theory. It underlies models, informs market concepts, and shapes academic teaching. According to this idea, individuals assess options, compare outcomes, and act with logical consistency. Yet even a brief look at real-world behaviour calls this assumption into question. Why do investors ignore evident advantages? Why do consumers cling to choices that are clearly disadvantageous? Traditional theory often struggles to provide convincing explanations. Theory often offers only weak answers to these questions.

The rational actor has long been the silent premise of economic thinking. He compares, calculates, and chooses detached from impulse, immune to confusion. Upon this abstraction, entire theories were built: from general equilibrium to market efficiency. Yet real behaviour resists such clarity. People hesitate, follow instincts, cling to illusions. Investors ignore warning signs; consumers repeat costly mistakes. Neoclassical models like the Expected Utility Theory or the Arrow–Debreu framework offer little insight here. They assume preferences are stable, choices are consistent, and information is processed without distortion. But the empirical record shows otherwise. Even the Efficient Market Hypothesis – elegant in its logic falters when panic spreads faster than prices adjust. These frameworks, though internally coherent, remain silent when confronted with contradiction. Their assumptions explain idealised coordination, not lived confusion. The elegance of traditional economic theory rests on assumptions that prove fragile in practice. Over the past decades, a growing body of research has illuminated this discrepancy. Behavioural economics does not portray individuals as calculating machines, but as human actors prone to error, simplification, and impression-driven reasoning. Phenomena such as loss aversion, anchoring effects, or framing are not outliers. They occur systematically, especially under conditions of uncertainty, complexity, or time constraints. And their consequences are not limited to the individual they shape aggregate outcomes and alter market dynamics.

This paper explores whether and in what ways cognitive distortions affect market equilibrium. The focus lies not on isolated misjudgements, but on their cumulative impact and the resulting shifts in aggregate behaviour. Can markets still be considered stable if the decisions within them are systematically unstable? What follows for economic modelling if rationality is not the norm, but the exception? To address these questions, the analysis builds a bridge between theory, empirical observation, and critical reflection. At the heart of

Article DOI: https://doi.org/10.37284/eajis.8.1.3196

this study is the hypothesis that behavioural distortions not only influence individual decisions, but also have cumulative effects that change the structure of market processes. These systemic effects call into question the classical notion of a stable market equilibrium. The analysis is therefore not aimed at a complete refutation of existing models, but at their further theoretical development. This is because economic reality proves to be resistant to simplified assumptions of rationality and calls for models that can withstand this complexity.

THEORETICAL BACKGROUND

For much of the twentieth century, economics drew a clean portrait of its central figure: the rational agent. He acts with purpose, processes information objectively, and responds predictably to incentives. From this figure, the image of market equilibrium emerged precise, harmonious, mathematically elegant. The general equilibrium theory of Arrow and Debreu gave this vision formal expression; prices coordinate, preferences align, outcomes converge. Yet beneath this clarity lies a fragility. No model of logic can fully account for fatigue, hesitation, or misperception.

Behavioural economics was the first to confront this gap head-on. It does not dismiss rationality, but questions its dominance. Beginning with Kahneman and Tversky's Prospect Theory, the field showed that choices under uncertainty systematically deviate from expected utility theory. Losses loom larger than gains; framing shapes decisions more than facts. Anchoring, availability bias, and overconfidence enter where classical theory expects consistency. These distortions are not marginal. They are patterned, recurrent, and deeply embedded in contexts of complexity and time pressure.

The critique, however, is not new. Long before behavioural economics rose to prominence, the Austrian School of Economics questioned the very possibility of objective optimisation. Mises viewed action as purposeful but unfixed by universal rules. Hayek, more radically, denied the central availability of knowledge altogether. In his view, markets function not as calculators, but as dispersed systems of trial, adaptation, and discovery. From this vantage point, the actor is never fully informed, and equilibrium if it arises is provisional, emergent, and contingent.

What unites both schools, despite their differences, is a shared doubt: that the rational agent is a useful fiction at best. Behavioural research exposes the fault lines of psychology; Austrian theory questions the epistemic premises themselves. In both frameworks, the classical equilibrium loses its certainty. If knowledge is fragmented or distorted, coordination becomes unstable. Markets do not settle they shift. They reflect perception, not perfection.

RESEARCH DESIGN AND CHOICE OF METHODS

This study does not follow the logic of linear hypothesis testing. Its goal is not to statistically verify isolated effects, but to understand the conditions under which cognitive biases become economically relevant. The research adopts a qualitative and theory-oriented approach, grounded in the principles of interpretive methodology (Mayring, 2015). The design consists of two closely linked elements: a structured literature review and an illustrative analysis of selected market dynamics.

At the centre of this inquiry is the following research question:

This study does not follow the logic of linear hypothesis testing. Its aim is not to measure isolated effects, but to understand the conditions under which cognitive biases take on economic relevance. To that end, it adopts a qualitative, theory-oriented approach grounded in the principles of interpretive social research (Mayring, 2015). The method is not deductive but reflexive: it follows meaning, not metrics. Rather than treating deviations from rationality as statistical anomalies, the study

Article DOI: https://doi.org/10.37284/eajis.8.1.3196

examines them as structurally embedded features of real-world decision-making.

At the centre of the inquiry stands the following research question:

Main Research Question:

How do cognitive biases cumulatively affect market equilibrium, and to what extent do they undermine the theoretical assumption of rational coordination in markets?

Sub-questions:

- Which cognitive biases systematically influence economic decision-making (e.g., loss aversion, disposition effect, herd behaviour)?
- How do these biases affect individual behaviour under uncertainty and time pressure?
- In what ways do individual distortions aggregate into collective market phenomena such as bubbles or misallocations?
- How do these cumulative effects destabilise classical notions of equilibrium?
- To what extent can general equilibrium theory (e.g., Arrow & Debreu; 1954) still hold under conditions of systematic irrationality?
- How does the epistemological critique of the Austrian School (e.g., Mises, Hayek) contribute to explaining these dynamics?
- What are the theoretical and policy implications for modelling and regulating markets under behavioural uncertainty?

To explore these questions, the study proceeds in two interlinked steps. First, a structured literature review integrates behavioural economics and Austrian epistemology. The goal is not to compile descriptive findings, but to reconstruct how cognitive distortions are conceptualised, and how they systematically alter market coordination. Special attention is given to how perception, expectation, and decentralised knowledge interact in non-linear ways.

Second, the study conducts a qualitative case analysis. Market dynamics are not chosen to generalise across contexts, but to serve as reflective examples. The 2008 financial crisis is examined as a paradigmatic constellation: it makes visible how biases such as overconfidence, herd behaviour, and status quo persistence interact under uncertainty. The selection follows a theory-guided logic of illustration: the case is heuristic, not representative, and aims to uncover how collective irrationality disrupts equilibrium assumptions. The analysis draws on market narratives, institutional responses, and behavioural triggers. Internal coherence is ensured through a case-oriented interpretive procedure, which examines empirical patterns in relation to the conceptual premises of the theoretical framework.

This openness of method is not incidental; it reflects the epistemological stance of the Austrian School. As Hayek (1945) argues, economic insight cannot be derived from fixed variables, but emerges situationally. In this spirit, the study avoids mechanical application of theory to data. Instead, theory and observation mirror one another. Theoretical categories guide empirical sensitivity, while empirical cases test and stretch theoretical boundaries. This interplay enables a richer understanding of how market behaviour evolves under uncertainty, fragmentation, and bounded cognition.

EMPIRICAL FINDINGS FROM BEHAVIOURAL ECONOMICS

The Financial markets are not arenas of detached calculation. They reflect human expectation, emotion, and uncertainty. Prices do not arise solely from the interaction of data and logic they also express collective sentiment. Nowhere else is the impact of cognitive distortions on economic outcomes more evident. Heuristics and biases dominate particularly where high volumes and time

Article DOI: https://doi.org/10.37284/eajis.8.1.3196

pressure collide. The notion of a consistently rational investor appears less as a factual description and more as a theoretical afterthought.

One well-documented distortion is loss aversion. Experimental research has shown that investors perceive losses as significantly more painful than equivalent gains (Kahneman & Tversky, 1979). This psychological asymmetry influences not only individual portfolios but also collective reactions in declining markets. During phases of falling prices, loss aversion often triggers panic selling and reinforces downward momentum. Such dynamics directly contradict the assumption of stable, information-based pricing mechanisms.

Another persistent pattern is the disposition effect: the tendency to sell winning assets too quickly and hold onto losing ones for too long. Odean (1998), in a large-scale study of real-life investment portfolios, empirically confirmed the prevalence of this effect over extended periods. Follow-up studies have further validated this behaviour as a widespread phenomenon (Barberis & Thaler, 2003). These findings suggest that investment decisions are often guided less by rational evaluation than by behavioural routines.

A further key phenomenon is herd behaviour, particularly in times of market uncertainty. Investors tend to imitate the actions of others, even when doing so contradicts their own available information. This form of social contagion can trigger self-reinforcing feedback loops. Bikhchandani, Hirshleifer and Welch (1992) showed how early actions by a few market participants can create informational cascades, where later actors adopt similar strategies not out of conviction, but to avoid the risk of deviating from perceived group consensus. These dynamics are difficult to reconcile with the ideal of efficient markets processing information independently and accurately.

The 2008 financial crisis offers a historical example of these distortions at work. The collapse of complex financial products was not merely the result of flawed fundamentals but of excessive optimism, herd dynamics, and institutional inertia. As Shiller (2008) argues, this crisis cannot be understood without accounting for psychological drivers such as fear, greed, and social validation. Markets no longer functioned as neutral processors of information; they acted as amplifiers of psychological turbulence.

These observations suggest that financial markets are not governed solely by rational supply and demand, but also by perception, error, and shared behavioural patterns. The distortions involved do not follow economic logic, but emerge from psychological structure. As a result, equilibrium models founded on assumptions of consistent, information-driven behaviour lose explanatory power. What may appear rational within the confines of a model can unfold as collective irrationality in actual market settings.

In parallel to these empirical findings, the Austrian School arrives at similar conclusions through an epistemological critique. Mises (1949) emphasises that purposeful action cannot be formalised, while Hayek (1945) argues that knowledge is decentralised and incomplete. Their work does not describe behaviour as erroneous, but as fundamentally uncertain. Market outcomes, in this perspective, reflect not optimality, but ongoing processes of discovery.

Recent approaches seek to integrate these lines of thought. The Subjective Dynamic Decision Model (SDEM), for instance, offers a formal structure to describe decision-making under radical uncertainty. It forgoes normative rationality assumptions and instead incorporates psychological and epistemological dimensions (Moch, 2025a). According to this view, markets cannot be fully understood through models of optimisation. They must be analysed as systems shaped by context-dependent choices, limited information, and social embeddedness.

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EFFECTS ON THE MARKET EQUILIBRIUM

In economic theory, market equilibrium is not merely a descriptive concept it is a structural assumption. It represents the idea that prices coordinate supply and demand, that resources are allocated efficiently, and that decentralised interests are harmonised through voluntary exchange. This logic assumes rational actors making consistent decisions based on full information (Arrow & Debreu, 1954). But what if rationality is systematically absent or distorted?

Behavioural economics shows that cognitive biases do not remain isolated. They accumulate and shape collective behaviour, which in turn affects market structures. Speculative bubbles and price volatility often emerge not from fundamental shifts, but from expectation dynamics. Investors influenced by overconfidence or herd behaviour may drive prices far beyond intrinsic value. When this occurs, price signals lose their coordinating function and instead become reflections of collective sentiment (Shiller, 2008).

These distortions also influence long-term capital allocation. The disposition effect, for example, leads to suboptimal investment strategies. Gains are realised too early; losses are held too long. The result is not efficient adaptation to new information, but behavioural inertia (Odean, 1998). On the supply side, capital misallocation persists; on the demand side, feedback loops distort preferences. The classical image of equilibrium, based on adaptive and balanced reactions, becomes untenable.

Informational cascades, as described by Bikhchandani et al. (1992), further destabilise the market. When individuals no longer decide independently but instead follow perceived group signals, markets become vulnerable to abrupt shifts. Minor signals can trigger disproportionate reactions, especially in periods of uncertainty. Instead of decentralised information processing, there is imitation and crowd behaviour. The foundations of equilibrium theory, independent action and reliable signalling are thus undermined.

The Austrian critique addresses the problem from a different angle. Hayek (1945) argues that market participants never possess full information. Knowledge is fragmented, contextual, and evolving. Equilibrium, in this view, requires an informational coherence that does not exist in reality. Markets are not balanced systems but adaptive coordination processes under uncertainty. What appears stable in theory is, in practice, a temporary and fragile alignment.

Taken together, these insights reveal a shared conclusion: equilibrium is not a natural end state, but an exception. It depends on decision-making conditions that are rarely met. Distorted behaviour, once aggregated, does not lead to harmony but to persistent volatility and structural fragility. This does not imply that markets fail per se, but that the idea of a self-correcting system must be reconsidered.

DISCUSSION AND CATEGORISATION

The findings presented so far raise fundamental questions both for economic theory and for policy design. If markets are not driven by rational decision-making but shaped by perception, emotion, and collective behavioural patterns, then the traditional belief in autonomous self-regulation becomes problematic. Equilibrium is not automatically achieved. It shifts, dissolves, and sometimes misleads. In this light, stability appears less as a natural market outcome and more as a function of institutional design.

A central issue lies in the role of signals. In neoclassical theory, prices are seen as efficient conveyors of scarce information. They are assumed to coordinate actors and guide resource allocation. But as empirical findings suggest, these signals are often distorted. If loss aversion leads to disproportionate reactions, or if expectations are shaped socially rather than individually, then prices lose their informational value (Shiller, 2008). This

Article DOI: https://doi.org/10.37284/eajis.8.1.3196

leads to misaligned incentives, misallocations, and false perceptions. The result is not market failure in the regulatory sense, but a failure of expectation.

This creates a paradox for economic policy. If markets tend to destabilise themselves through endogenous behavioural mechanisms, then external structures are required to ensure their functionality. Yet too much intervention can undermine the adaptive power of decentralised systems. Thaler (2015) proposes a form of libertarian paternalism, which aims not to restrict choices, but to guide them through thoughtful design. Although controversial, this approach acknowledges a central dilemma: without institutional scaffolding, markets collapse; with too much control, they lose their autonomy.

The Austrian School addresses this tension with a different kind of scepticism. For Hayek (1945), the key danger lies in interrupting the process of decentralised discovery. Markets are not to be perfected by intervention, but understood as open systems of experimentation. This perspective implies that policymaking should be cautious, adaptive, and aware of its epistemic limits. Institutions must be capable of learning, not simply enforcing.

A current example can be found in Argentina under President Javier Milei. His economic agenda explicitly draws on Austrian principles, moving away from neoclassical assumptions and embracing decentralised reform strategies. In this framework, markets are not viewed as equilibrium mechanisms, but as dynamic fields of subjective order formation (Moch, 2025b). Decisions are not the result of optimisation, but of conviction, expectation, and belief. This case highlights the role of interpretation and cultural framing in economic behaviour. Rationality, in this context, becomes not a universal standard, but a historically and socially embedded orientation.

What emerges is a field of tension that resists simple solutions. Cognitive distortions do not render markets obsolete, but they do make them vulnerable. Economic policy must learn to work with uncertainty, rather than trying to eliminate it. The concept of equilibrium retains heuristic value but loses its normative authority. Markets are not calculation machines. They are social arenas in which perception, coordination, and failure coexist. Their stability depends not on perfection, but on the capacity to absorb complexity without collapsing under it.

LIMITATIONS OF THE STUDY

This study approaches market behaviour from a psychological and theoretical perspective. It draws on conceptual integration and qualitative analysis, focusing particularly on financial markets. While this approach enables in-depth insight, it remains selective in scope. Not all behavioural distortions are analysed equally, and the diversity of market forms is not fully represented. This study approaches market behaviour from a psychological and theoretical perspective. It draws on conceptual integration and qualitative analysis, focusing particularly on financial markets. While this approach enables in-depth insight into key mechanisms of distortion, it necessarily narrows the analytical lens. The analysis concentrates on empirically robust and structurally relevant biases such as loss aversion, the disposition effect and herd behaviour. In contrast, other distortions like the sunk cost fallacy, mental accounting or the endowment effect are excluded. Their omission is not a judgement of insignificance, but a methodological decision in favour of those biases whose effects extend beyond the individual level and visibly shape market coordination.

In addition, the study does not cover the full range of market types. It focuses on financial markets due to their density of decision-making, speed of reaction and sensitivity to perception. Markets with different institutional logics, such as labour, energy or housing, may reflect other behavioural dynamics that lie outside the scope of this investigation. Accordingly, the findings offer conceptual depth rather than empirical breadth.

Article DOI: https://doi.org/10.37284/eajis.8.1.3196

The aim is therefore not to offer comprehensive coverage, but to raise awareness of systemic effects that standard models often neglect.

A further limitation concerns the generalisation of findings. The case selection such as the financial crisis of 2008 and experimental studies from behavioural economics highlights key dynamics but cannot claim universal validity. The degree to which similar distortions occur in other institutional or cultural contexts remains an open question. Markets differ not only in structure but also in interpretation. Rules, expectations, and reactions vary across settings.

Finally, the interdisciplinary approach itself involves certain conceptual frictions. Behavioural economics, Austrian action theory, and policy analysis operate with different premises and terminologies. Their integration requires interpretive effort and sometimes simplification. While this study seeks to balance those perspectives, theoretical nuances may be compressed, and some differences remain unresolved. The work does not aim to unify these traditions, but to bring them into constructive dialogue.

CONCLUSION AND OUTLOOK

The notion of the rational market actor has long served as a simplifying assumption in economic modelling. It allowed for formalised theories, facilitated simulations, and supported the development of equilibrium-based frameworks. However, the empirical and theoretical findings discussed in this study challenge this core premise. Cognitive biases systematically shape decision-making, disrupt coordination mechanisms, and undermine the expectation of stable equilibria.

Market behaviour, as revealed here, does not arise from consistent optimisation. Instead, it reflects expectation, emotion, and social framing. This reframing becomes particularly evident when insights from behavioural economics are combined with the epistemological critique of the Austrian School. From this perspective, markets no longer appear as perfectly functioning systems, but as dynamic arenas of trial and error. Equilibrium, therefore, is not an empirically observable endpoint. It is a methodological construct, useful in theory but limited in practice.

This reinterpretation has direct implications for economic policy. Regulation must acknowledge the interplay between decentralised decisions and behavioural vulnerability. Neither technocratic control nor naïve market optimism can resolve this contradiction. What is needed are institutional frameworks that support learning processes, adapt to feedback, and mitigate systemic misperceptions. In this context, robustness replaces perfection as the guiding principle of policy design.

Finally, this shift raises questions that go beyond economics. If market dynamics are driven by collective biases, responsibility for systemic failure must be re-examined. Legal and institutional frameworks will need to address outcomes that are not rooted in intentional misconduct, but in structurally embedded distortions. This affects the normative relationship between market, state, and society. Stability, from this vantage point, becomes not an inherent property of the market, but a shared and fragile achievement.

These insights do not signal the end of rationality as a theoretical category. But they suggest that rationality must be understood as context-bound and historically situated. Economic understanding requires more than abstract models. It requires a deeper awareness of the human condition that underlies all market activity.

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