Research on the Influence Mechanism of the Agency Problem on Financial Stability from the Perspective of Economics and Sociology

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Abstract: The competence of the national economy depends on the reliability of the financial system, which is an inevitable mechanism utilized in developed market economies. This provides the reasoning, however, that agency problems in the financial system, because of information asymmetries and conflicts of interest, are the root of most financial crises. This paper aims to find out how the delegation problem arises and what financial stability loss in a market economy is from the viewpoint of economics and sociology. This article on inter-relations, influencing components, and the basis of economic agents' delegation debt to the system's stability is analyzed. Additionally, this article provides for the influence of the agency problems and the financial system stability, including the reasons and implications, as well as how we improve the efficiency and strength of the financial system and optimize corporate governance simultaneously. This research paper integrates economic and sociological schools of thought to examine the agency dilemma in the financial system and the implications of this problem for financial stability. Since the study explains how agency problems affect decision-making, it aims to make the economic system more effective and sustainable.

Keywords: Financial system, Agency problem, Socio-economics, Market stability

1. Introduction

In a sophisticated economy, the financial system is a mandatory controlling tool, which has the essential function of smoothing the transition process of money and efficiently managing the overall limited social resources. But at the same time, it also brings a common agency problem, which is that as a trustee (such as a company manager or financial intermediary), its interests are difficult to align with the interests of the entrusted responsible party (shareholders or investors) [1]. The emergence of this problem will affect the stability and efficiency of the entire fiscal system.

In the aftermath of the 2008 global financial crisis, substantial advancements have been made in recent research on agency problems and their impact on financial stability. Although most current research focuses on strengthening regulatory structures and reward mechanisms, to truly address institutional issues, they still need to be incorporated. This requires considering social factors, social norms, cultural values, and political systems as essential factors that significantly impact subject behavior, decision-making processes, and even the stability of the economic system as a whole.

This paper aims to bridge this gap by examining agency problems and their implications for financial stability from economic and sociological perspectives, thereby providing a more comprehensive understanding of a broader socioeconomic context. Sorting out existing theories and cases from the perspectives of sociology and economics has specific reference significance for research on agency problems, financial stability, and macroeconomic backgrounds.

2. Agency Problem-Economic Analysis

2.1. Definition and Type of Agency Problem

The problem of delegation, which exists in most financial and market economic systems of today, is a multidisciplinary issue that incorporates both sociology and economics. "Conflict of interest" is the term that demonstrates the dilemma when the principal transfers the decision-making authority to the principal who seeks to achieve the maximum profit. Agency issues may occur due to information asymmetry, target variation, and risk preferences of different organizations [1].

This problem in the financial system has become even more aggravated due to the intricacy of corporate governance and the expansion of present-day companies. Institutional investors, capital efficiency, and market regulation systems will have an impact on a company's business practices. As companies struggle with delegation-related issues, the most common is the "moral hazard" and "reverse selection." In the case of incomplete information, the players with the advantage of the asymmetric information are ready to sacrifice their objectives to maximize the profit, referred to as the "moral hazard." [2]. Under circumstances where a consumer cannot give a credible evaluation, reverse selection occurs, the phenomenon of "bad coins chasing out good coins"[3].

2.2. Agency Problems-Causes

The information asymmetry in the economy and the theory of agency, which is not consistent, has brought about principal-agent issues. Information economics focuses on the role of information in market economies, and it explains why informational asymmetry among agents increases agency problems [4]. Information economics explores the competition within enterprises according to market norms. This leads to one side's winning an informational advantage over the other. In a market economy, it is challenging for principals to fully comprehend agents' details, abilities, effort levels, and risk tolerances [3]. The client finds it challenging to properly govern it due to this mismatch, which exacerbates the agency problem.

According to the principal-agent theory, agency issues in a market economy result from principals and agents having competing objectives. Typically, principals assume that agents will act in their best interests. Still, because agents are also rational economic actors, they might use their ability to make decisions to further their interests at odds with those of principals. The knowledge asymmetry and risk preference gap between the principal and the agent make it challenging for the principal to create a successful incentive system, as demonstrated by Bernhold and Wiesweg's analysis [5].

3. A Socio-Economic Analysis of Agency Problems and Their Impact on Financial Stability

3.1. An Economic Investigation of Financial System Stability under Agency Problems

From an economic perspective, the financial system's stability is related to the efficient allocation of resources and the smooth market operation. However, distortions introduced by agency problems can undermine this stability. Firstly, driven by individual benefits, delegation issues can lead to unreasonable resource allocation within the enterprise, resulting in a decrease in enterprise efficiency and a shortage of resources in core industries. As a result, the "moral hazard" and "adverse selection" among agents will exacerbate the occurrence of "market failure," leading to a decrease in operational efficiency, resource scarcity, and adverse effects on sustainable social development [3].

Second, the efficacy of the securities market is determined by appropriate investing behavior and adequate information disclosure.

Delegation-related asymmetric information increases transaction costs and friction, affecting the pricing signal, the transparency and fairness of the market, and, ultimately, the market's overall operating efficiency [3]. These extremely clever intermediaries often engage in speculative activities that undermine investor confidence, tamper with asset integrity, and perhaps endanger financial stability. The long-term effects of institutional issues on economic growth can also be seen in the stifling of innovation, the hindrance of technical advancement, and the excessive or insufficient investment that weakens the economy's momentum and aggravates fiscal instability. These effects are made worse by the financial system's interconnection, which raises the possibility that they might spread to other organizations and endanger the system's stability.

From an economic perspective, measuring the stability of a country's financial system is essential. These include measurements for investor confidence, such as credit spreads and stock market volatility; indications of financial fragility, such as leverage and capital adequacy; and market integrity metrics, such as the frequency of insider trading and market manipulation.

In summary, agency problems threaten the financial system's economic stability and investor trust, necessitating efficient regulation, openness, and incentives to maintain its resilience, thereby enhancing investor trust and market integrity.

3.2. The Social Attribute and Role Conflict of Agency Problem in the Financial Market

According to sociology, the health of the fiscal system is a measure of the economy and the effectiveness of a social organization. Maintaining a power structure, adhering to social norms, respecting cultural values, trust between various organizations, and adequate money and resource allocation in the financial market contribute to its stability. If the financial system is disrupted or tampered with, the entire system might face dire repercussions.

Sociologists believe that agents affected by agency problems in financial markets have "role conflicts" between society and brokers, including moral dilemmas and conflicts of interest with principals, and are affected by social norms, cultural values, and interpersonal relationships [6-7]. The deep cause of the agency problem can be regarded as a "role conflict" and "trust crisis," which not only damages the interests of the principal but also destroys the social norms and the trust relationship within the financial sector[6-7].

Second, trusting relationships are essential for stabilizing the social structure and the financial system.

Social network structure influences agency problems to a great extent. The formal and informal relationships among market participants significantly impact the information, resources, trust, and cooperation flows. When agency problems occur, market participants may lose faith and trust in each other, eventually leading to market panic and loss of confidence [8]. The lack of confidence could lead to a danger to financial system stability through market disruptions and drying up of liquidity.

The agency's problems can also affect financial stability by the way social standards are being undermined. Market participants obey Social norms as codes of behavior and ethics, which are crucial in keeping the market and order stable. When agents deviate from social norms, they threaten their interests, which can spill over to the other market participants, eventually leading to market disruption and chaos.

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Evaluating the system of finance's stability would mean comparing it to social norms that consider several issues. First, market trusteeship must be assessed. Secondly, I would like you to consider how social norms are obeyed.

Third, it must evaluate the degree to which market order is upheld. Finally, there should be a careful examination of the functioning of financial markets. An adverse change in these dimensions can indicate that the financial system's stability is at risk.

To sum up, from a sociological point of view, agency problems have significant implications for the financial system's stability. Therefore, economic indicators should be considered when assessing the financial system's stability, and changes in these social factors should be monitored.

4. Correlation Analysis between Agency Problem and Financial System Stability

Building upon the aforementioned economic analysis and sociological review, it is crucial to investigate the impact of agency problems on financial system stability through a comprehensive case study. The subsequent case study will examine two specific examples, shedding light on the intricate relationship between agency problems and financial system stability, facilitating a more profound and nuanced understanding.

4.1. Agency Problem and Regulatory Failure in the Enron Bankruptcy Case

The bankruptcy of Enron is a good example, demonstrating how complex the relationship between institutional issues and fiscal stability is. This case illustrates how delegation problems affect market efficiency and distort resource allocation at the economic level. The best example is the improper association between corporate management authorities and external auditors with regulatory oversight [9]. There needs to be a better connection and management oversight between Enron and external auditors, which would allow it to use sophisticated accounting methods and undisclosed transactions to conceal its financial situation.

This case underscores the importance of financial stability in maintaining social and economic order. Economic growth is supported, capital flows are facilitated, and stable financial institutions foster trust. Enron's fraudulent activities could have eroded market trust, triggered investor panic, and caused a shock to the financial system, potentially impacting social order and public confidence.

Furthermore, regulatory failures exacerbate agency problems. Regulators play a pivotal role in upholding market integrity while safeguarding investor interests. However, in the context of the Enron case, regulatory inadequacies allowed these agency problems to persist and escalate, encouraging managerial misconduct and weakening market discipline effectiveness by undermining rules—thus posing hidden risks for future financial crises [9].

To sum up, agency problems exist within financial institutions/customers and pervasively within companies and between companies/external auditors or regulators. It shows that the existence of agency problems and the failure of supervision will lead to the financial market's local instability, damage the market's efficiency and resource allocation, and more likely to destroy the market trust and social and economic order.

4.2. Agency Issues and Socio-Economic Implications of the Nordic Banking Crisis

The Nordic banking crisis of the early 1990s serves as a prime illustration of how agency problems are intricately intertwined with socioeconomic factors. In the late 1980s, before the crisis, the banking systems in Nordic countries witnessed a significant credit expansion, particularly within the high-risk real estate market. Throughout this process, agency problems became prominent and were manifested through excessive risk-taking by bank management and inadequate supervision by regulators [10].

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From an economic perspective, agency issues in the banking sector led to poor long-term planning and excessive risk-taking in loan granting. This, combined with regulators' incompetence and management's excessive real estate investment, exposed the banking system to economic fluctuations, resulting in high defaults, bad debts, and credit crunches, ultimately leading to financial instability [11]. This instability affected economic expansion, job prospects, social welfare programs, and public confidence in financial institutions. Bank collapses and credit crunches may result from these issues.

From a sociological perspective, instability erodes society's trust, is critical to a stable financial system, and threatens economic advancement and social welfare. Public mistrust of financial institutions contributes to economic decline along with social instability. This demonstrates the close relationship between financial stability and socio-economic order, suggesting that instability in the financial system can swiftly extend to all areas of society.

The example of the Nordic banking crisis brings to light the intricate relationships between agency issues and socioeconomic factors that impact the overall stability of the financial system. It also bolsters the research's assertion that the financial system is unstable inside and outside its domain and across different social networks.

4.3. Correlation Analysis

In the two-dimensional perspective of economics and sociology, the interaction between delegation problems and financial stability manifests as a dual structure. Through the above case analysis, this article draws the following important conclusions:

Firstly, from an economic perspective, delegation issues can impact resource allocation, affecting market information transmission. Enron Company's management deceived investors by manipulating accounting information, affecting stock market fairness and regular pricing. Improper trading methods could have helped market efficiency. The banking crisis in Northern Europe caused an excessive burden on bank managers and a lack of supervision, leading to unnecessary credit inflation and a financial storm.

Secondly, in the sociological sense, to maintain the regular operation of society, it is necessary to ensure the stability of finance. The stability of the financial market is crucial for maintaining the regular operation of society, as it affects economic development, employment, social welfare, and public trust in the financial system. Enron's fraudulent behavior led to the bankruptcies of several Nordic banks, causing investor fear and chaos. The outflow of funds caused turmoil and social instability, leading to a loss of confidence in the public sector and worsening the current recession.

Therefore, this project will analyze the bidirectional mechanism between delegation problems and financial stability: delegation problems interfere with resource allocation and market signals in the real economy, leading to interference in the operation of financial markets, weakening credit, causing fear, and causing harm to financial markets.

This dual effect mechanism highlights the need to handle the issues of this organization well and maintain financial stability. To solve this problem comprehensively, it is necessary to adopt a comprehensive policy approach. Firstly, enhancing the independence and authority of banks is crucial in ensuring comprehensive monitoring and effectively avoiding agency issues. Secondly, improve the transparency and fairness of the financial market and strengthen the training and protection of investors. At the same time, further exploration of the fundamental causes and mechanisms of institutional issues can provide a theoretical basis for further developing more targeted and efficient risk prevention and control strategies. Only in this way can it better maintain the stability of our country's fiscal system and ensure that it plays a positive role in promoting our country's economic growth.

5. Conclusion

From the perspectives of economics and sociology, this paper comprehensively discusses how the delegation problem affects the financial system's stability under market economy conditions. The research results indicate that information asymmetry, inconsistent interests, and moral hazard among market entities lead to internal delegation issues within enterprises. The above problems seriously affect the effectiveness and stability of China's financial system. Secondly, economic, social, and political factors such as social and cultural norms and political systems impact fiscal stability. The above factors and delegation issues exert power on the entire financial market. The collapse of Enron and the Nordic banking industry indicates a close connection between agency issues and the financial system's stability. Establishing an effective system to address the issues above will help enhance the resilience and effectiveness of China's financial market.

This paper also points out that to ensure the financial system's stability, it is necessary to handle the delegation relationship properly. However, there are still things that could be improved in this study. Firstly, in terms of the mechanism by which the delegation problem affects economic stability, this study has yet to consider various possible economic variables, such as the system and culture of the enterprise. Future research will expand to a deeper exploration of influencing factors, enabling us to understand them comprehensively. Secondly, this paper only adopts two methods: literature research and case study, and the analysis method needs to be diversified more. By exploring these facets, future studies can add to a more thorough knowledge of agency difficulties and their effects on the financial system.

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