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Do Markets Anticipate Capital Structure Decisions? – Feedback Effects in Equity Liquidity^{☆,☆☆}

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Abstract

We analyze the impact of expected (targeted) capital structure decisions on information asymmetries. We measure information asymmetry from equity liquidity through the use of an information asymmetry index that is based on six measures that capture trading activity, trading costs, and the price impact of order flow. Modeling the joint determination of leverage and liquidity, the data indicate that expected increases in leverage (target leverage changes) decrease the information asymmetry index. This is consistent with the signalling hypothesis of Ross (1977), and is equivalent to increases in equity liquidity.

Keywords: Capital Structure, Liquidity, Information Asymmetry, Signalling

JEL: G14, G19, G32

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