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Stock liquidity and default risk☆

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ABSTRACT
This paper examines the impact of stock liquidity on firm bankruptcy risk. Using the Securities and Exchange Commission decimalization regulation as a shock to stock liquidity, we establish that enhanced liquidity decreases default risk. Stocks with the highest default risk experience the largest improvements. We find two mechanisms through which stock liquidity reduces firm default risk: improving stock price informational efficiency and facilitating corporate governance by blockholders. Of the two mechanisms, the informational efficiency channel has higher explanatory power than the corporate governance channel.

JEL classifications: G12; G14; G33; G34

Keywords: Stock liquidity; Bankruptcy risk; EDF; Price efficiency; Governance

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