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Fire-Sale Foreign Direct Investment and Liquidity Crises

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Abstract

In placing capital market imperfections at the center of emerging market crises, the theoretical literature has associated a liquidity crisis with low foreign investment and the exit of investors from the crisis economy. However, a liquidity crisis is equally consistent with an inflow of foreign capital in the form of mergers and acquisitions (M&A). To support this hypothesis, we use a firm-level data set to show that foreign acquisitions *increased* by 91% in East Asia between 1996 and 1998, while intranational merger activity declined. Firm liquidity plays a significant and sizable role in explaining both the increase in foreign acquisitions and the decline in the price of acquisitions during the crisis. This contrasts with the role of liquidity in noncrisis years and in noncrisis economies in the region. This effect is also most prominent in the tradable sector. Quantitatively, the observed decline in liquidity can explain 25% of the increase in foreign acquisition activity in the tradable sectors. The nature of M&A activity supports liquidity-based explanations of the East Asian crisis and provides an explanation for the puzzling stability of FDI inflows during the crises.

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