On the Effects of Economic Integration on Greenfield Investments and Cross-border Mergers and Acquisitions Location Pattern

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Abstract

This paper investigates the linkages between economic integration and horizontal Foreign Direct Investment (FDI) location. In a three-country partial equilibrium model with differentiated Cournot and Bertrand competition, we incorporate the two main FDI modes: Greenfield Investment (G.I.) and cross-border Merger and Acquisition (M&A). We also allow regionally-based firms to invest outside the regional area. Economic integration characterized by internal and external transaction costs may affect entry modes (G.I. vs. M&A) and its location (intra - extra regional flows). Our findings suggest the existence of complex linkages between economic integration and FDI location pattern depending simultaneously on set-up fixed costs, the competitive mode of market interaction and the product differentiation. However, the role of cross-border M&A as well as the importance of FDI outflows from the regional area is highlighted.

- JEL Classification: F15, F23, L10, L13, G34
- Key words: FDI, integration, location, entry mode, mergers and acquisitions

I. Introduction

In recent years, a wave of regional integration agreements has surged. This wave has reshaped multinational companies strategies as several empirical studies have
confirmed it\(^1\). Theoretical works usually emphasize two opposite consequences of economic integration on horizontal foreign direct investments (FDI). If FDI is motivated by tariff-jumping arguments, regional integration is expected to decrease FDI flows and to encourage cheaper exports. Conversely, a reduction in barriers to trade should increase FDI if the major motive for internationalization is the exploitation of intangible assets (Blomström and Kokko, 1997). Many authors\(^2\) have more precisely examined the linkages between regional FDI inflows and economic integration. Norman and Motta (1993, 1996) or Neary (2002) have particularly enriched economic analysis by examining the FDI pattern in a three-country model framework. Indeed, firms could react differently to the formation of a regional area according to whether they are located within (insiders) or outside this trade area (outsiders). Norman and Motta (1996) emphasize the impact of changes in market accessibility and external barriers to trade on outsider and insider FDI in a Cournot setting with identical production costs among competitors. In a previous work (1993), they suppose asymmetric production cost but restrict their analysis to the FDI strategy of the outsider firm. Neary (2002) also focuses on the FDI strategy of the outsider firm putting forward tariff-jumping and export platform motives.

However, to our knowledge, the incidence of economic integration on FDI outflows from the regional area has been not studied although FDI substitution effects within and outside the region may appear because of financial or organizational constraints (Blomström and Kokko, 1997). Consider for instance the case of the NAFTA (North America Free trade agreement) signed by the USA, the Canada and Mexico in 1992, and really implemented in 1994. During the corresponding period 1990-1997, a significant increase in the ratio U.S. extra-regional FDI (to other OECD countries) over U.S. intra-regional FDI (to Mexico and Canada) is observed. This ratio\(^3\) goes from 2.4 in 1990 to 3.7 in 1997. It remains to understand to what extent this regional integration agreement could have contributed to this evolution.

In addition, almost all these papers in international economics traditionally

\(^1\)See for instance Dunning (1997) for the European community.

\(^2\)Smith (1987) or e.g. Horstmann and Markusen (1992) study the impact of economic openness on market structure.

\(^3\)Source: OECD (Authors calculation).