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The impact of multinational entry on domestic market structure and investment☆

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ABSTRACT

We model the impact of different modes of multinational entry on the choices of domestic firms. Focusing on the competitive effects of foreign entry for the host country we demonstrate that greenfield investment will increase competition only if it is not countered by anti-competitive reactions on the part of the domestic firms. Together with cross-border mergers and acquisitions the model, thus, provides two alternative explanations for the increase in concentration ratios in industries with mostly horizontal foreign direct investment. Moreover, foreign presence is shown to raise total investment in the local industry at the cost of crowding out domestic investment.

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1. Introduction

Worldwide foreign direct investment (FDI) has grown impressively in the past 30 years. According to the World Investment Report 2006 (UNCTAD, 2006) FDI inward stock has grown on average at 13.5% per year between 1986 and 2005. Since the late 1980s FDI has increasingly taken the form of cross-border mergers and acquisitions (M&A) rather than greenfield investment (UNCTAD, 2000). At the same time concentration ratios in industries with strong horizontal FDI activity such as automobiles, pharmaceuticals and banking have risen (UNCTAD, 1999). The impact of these multinational players is likely to be felt strongest in the markets they enter. Previous work has mainly examined this in the light of technology spillovers from the foreign to the domestic firms. However, given their size, entry by a foreign multinational enterprise constitutes first of all a major change in the market structure of the host country industry. This may induce a reaction by the domestic firms that can take the form of investment in technology, exit, or a domestic merger. The aim of this paper is to emphasise this latter aspect by examining the interaction between different modes of multinational entry and the induced moves of the domestic firms regarding changes in market structure and investment.

From the perspective of a multinational firm, the choice between a cross-border merger or acquisition and greenfield entry is ascribed to different firm characteristics (see UNCTAD, 2000, p. 145). Good organisational and managerial skills, high advertising intensity, and the prospect of a speedy market entry are more conducive to M&A. Whereas a technological advantage works in

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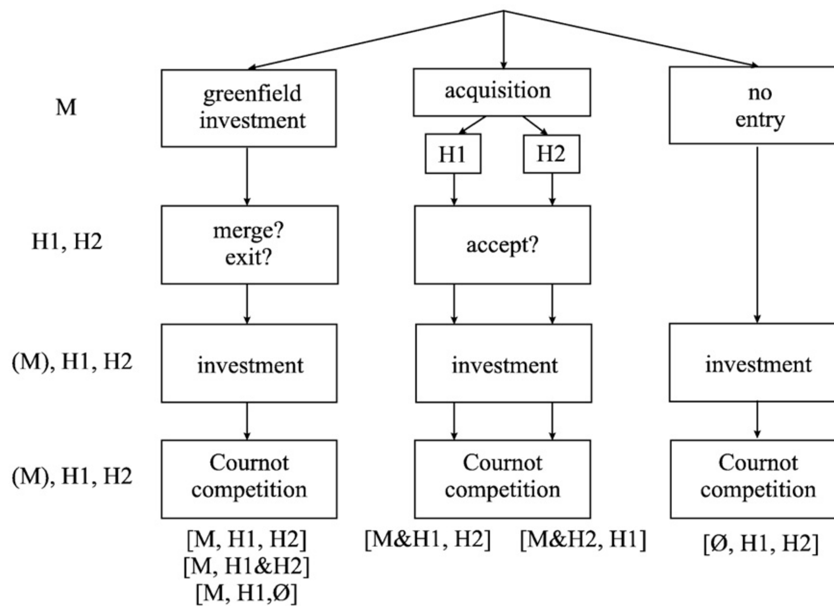

Fig. 1. Game structure.

favour of greenfield investment. Host country governments, in turn, often favour greenfield investment as it is said to increase competition by adding new production capacity to the market. M&As, in contrast, are associated with a decrease in competition or at best with no change in market structure. However, this perception disregards that firms acquired by foreign investors may initiate competition with incumbents in the host country, for example with the help of superior technological skills from parent companies. Furthermore, if inefficient target firms which otherwise may be forced to exit are acquired and restructured by foreign investors, M&As may enhance competition in the host country. By the same token, it is possible that an initial increase in competition through greenfield entry may trigger domestic firms to exit or to merge. Cases where the constraint for domestic firms to merge has been relaxed after foreign entry are difficult to find, most likely because in anticipation of the competition authorities' concerns such moves are not attempted in the first place. However, exit is shown to be a relevant strategy for domestic firms by De Backer and Sleuwaegen (2003). They find that both import competition and FDI discourage entry and stimulate exit of domestic entrepreneurs in a sample of Belgian manufacturing firms.

The theoretical literature has long treated foreign direct investment as a homogenous phenomenon, where cross-border mergers and acquisitions and greenfield investment are observationally equivalent (see Markusen (1995) for a survey). The focus of recent papers breaking with this tradition is mostly on the multinational firms' motives for choosing one mode of entry over another accounting for host country characteristics, e.g. Horn and Persson (2001), Bjorvatn (2004), Eicher and Kang (2005), Nocke and Yeaple (2007). The present paper is more in the tradition of the literature on the preemptive role of foreign direct investment that goes back to Horstmann and Markusen (1992). In the model presented here we look at i) how the MNE's mode of entry choice is affected when the firms in the host country are allowed to react; ii) how this interaction affects market structure and iii) its impact on the level of investments in the host country. To this end, we build a four-stage game where the MNE chooses between entry via acquisition of a domestic firm and greenfield investment in the first stage of the game. The domestic firms can react to this choice in the second stage. Finally, all active firms can first make an investment to reduce marginal cost before engaging in Cournot competition in the product market.

The assumption of an asymmetric duopoly as the initial market structure in the host country allows us to demonstrate that the impact of foreign entry on the host country is not independent of possible reactions by the local incumbents. In particular, we show that a concentrated market structure may result even in the case of greenfield entry when the domestic firms merge or exit the market as a consequence. In this way, the paper provides an explanation for the increase in concentration ratios in industries where horizontal FDI is prevalent that is complementary to the surge in cross-border M&A as a share of FDI. Moreover, we show that a technological advantage of the multinational firm only favours greenfield investment over an acquisition when either the domestic firms are sufficiently competitive or when they are induced to eliminate competition among themselves by merging. Looking at the incentives to make a cost-reducing investment in such a setting, we obtain a result that is in line with the empirical evidence: The presence of a more efficient foreign firm in the domestic market increases total investment in the industry. However, this comes at the cost of crowding out domestic investment when compared to a situation with domestic firms only.[1]

The remainder of the paper is structured as follows: Section 2 presents the setup. Section 3 first outlines the model in the benchmark equilibrium without foreign entry (3.1); then the game with foreign entry is analysed (3.2). Section 4 illustrates the

[1] This is in contrast to Veugelers and Vanden Houte (1990). In their study of the impact of foreign competition on the innovative efforts of a domestic firm, the less differentiated products, the less likely a negative impact of multinational presence on local innovative efforts.

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