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Cross-border M&A vs. greenfield FDI: Economic integration and its welfare impact

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Abstract

This paper examines the impacts of regional economic integration on the FDI entry mode of multinational firm and the welfare implications focusing on two entry modes, greenfield investment and cross-border M&A. Based on a oligopoly model where each representative firm competing in Cournot fashion, we demonstrate that the preferential trade arrangement increases the multinational firms' incentives to shift its entry mode from greenfield investment to cross-border M&A. Moreover, greenfield investment is a welfare dominant FDI entry mode for the host country while cross-border M&A might be preferred by multinational firms when the strategic effects of M&A are considered in addition to the asymmetric technology transfer effects of two entry modes. Finally, it is shown that there exists a unique equilibrium policy intervention to induce the choice of greenfield investment when the multinational firm's marginal cost is lower than the critical value.

JEL classification: F13; F12; F11

Keywords: Cross-border M&A; Greenfield direct investment; Regional economic integration; Welfare implications of FDI entry modes

1. Introduction

After the liquidity crisis of Asian region in late 1990s, foreign capital inflows have been considered as a new engine for the sustainable economic growth. Especially, one of the major reasons for South Korea and other small economies in Asian region to boost up the efforts to arrange preferential trade arrangements is the expectation that FTA arrangement will increase

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Table 1
The impacts of FDI on capital formation of aggregated Korean Industry[a].

Types of FDI	Elasticity on total fixed capital formation	Contribution to the increase of total fixed capital formation (billion US dollars)
Greenfield investment	0.11	8.72
Cross-border M&A	−0.04	−3.19

[a] Kim and Park (2008). Data analysis for this table is based on time-series data between 1999 and 2006.

FDI inflows into the integrated region. However, the majority of capital inflows into Korea after the liquidity crisis took the form of cross-border M&A rather than the greenfield investment. For example, in the second quarter of 2006, the share of the cross-border M&A in total FDI inflows into Korea reached 67%, and the growth rate of the cross-border M&A reached 500.6% while greenfield investment decreased by 29.6%.[1]

However, quite a few cases of cross-border M&As by the western private equity funds in South Korea have been criticized as speculative funds seeking only the arbitrage profits with no value-adding contribution such as the technology transfer or new investment for technological innovation. One recent anecdotal example is the case of a Korean car producer, Ssangyong motors, which was merged by a Chinese car producer, Shanghai Motors in 2004. In mid 2006, the labor union of Ssangyong Motors went into a serious strike criticizing that the Chinese investor has made little investment after the merge, and just tries to take out the technologies developed by Ssangyong motors to China. The labor union became suspicious about the Chinese investor's strategy that the company might close the production line of the merged firm after they take all available technologies from it.[2]

As shown in the example, FDI inflows have different impacts on the host countries depending on the types of FDI such as greenfield FDI or cross-border M&A. According to a traditional view on the welfare impacts of each different types of FDI, greenfield FDI is expected to increase the capital formation and productivity of host countries, while cross-border M&A is expected not to increase host country's capital formation or productivity, but to transfer host country's income to foreign countries. This traditional view on the role of the cross-border M&A is consistent with the recent Korean attitude towards the western private equity funds that merged many Korean firms suffering from liquidity mismatches. In addition, there are increasing concerns against the cross-border M&A not only from industrial nationalism, but also from welfare consideration focusing on the technology transfer effects and the resulted cost reduction effects due to FDI inflows.

Recent data on the contribution of greenfield investment and cross-border M&A in South Korea shows that greenfield investment contributed to the increase of total fixed capital formation by the amount of 8.72 billion dollars, while cross-border M&A actually contributed to the decrease of the capital formation by 3.19 billion dollars (Table 1).[3]

Moreover, the correlation coefficient between the two modes of FDI and capital formation and job creation in Korea turns out to be consistent with the traditional beliefs about the asymmetric

[1] MOCIE, *Statistics on FDI Inflows into Korea Statistics on FDI Inflows into Korea*, 2006.
[2] Refer to '*Korea Times*' (August 28, 2006) for the detailed description about the case.
[3] Refer Kim and Park (2008) for more detailed description and data about recent FDI entry modes and capital formation and employment development in South Korea.