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European Economic Review 48 (2004) 1211 – 1226

EUROPEAN ECONOMIC REVIEW

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Economic integration and the profitability of cross-border mergers and acquisitions

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Received 14 February 2003; accepted 29 March 2004

Abstract

The 1990s was a decade of increased economic integration. The decade also witnessed a sharp increase in cross-border mergers and acquisitions. From a theoretical perspective, the increase in international mergers in more integrated economies is rather puzzling. It is a well-established result that due to the "business stealing effect", mergers in integrated markets are not likely to be profitable. A reasonable conjecture would therefore be that closer integration of markets would reduce the attractiveness of cross-border mergers and acquisitions. The present paper demonstrates that this is not necessarily the case: Economic integration may trigger cross-border acquisitions by reducing the business stealing effect and by reducing the reservation price of the target firm. The paper thus provides explanations to the observed increase in cross-border mergers in a world of more integrated economies.

JEL classification: F15; F21; F23; L12; L13

Keywords: Economic integration; Mergers and acquisitions; Trade; Foreign direct investment

1. Introduction

Cross-border mergers and acquisitions (M&As) increased sharply during the 1990s. UNCTAD reports that the value of cross-border M&As rose from less than $100 billion in the late 1980s to $720 billion in 1999. Within Europe alone, the value of cross-border acquisitions reached $498 billion in 1999, a 75% increase from the year before.[1]

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[1] In the following, the terms M&A, merger, acquisition, and takeover will be used interchangeably. The great majority of transactions classified as cross-border M&As are in fact acquisitions, see UNCTAD (2000, Chapter IV).

0014-2921/$ - see front matter
doi:10.1016/j.euroecorev.2004.03.007

Indeed, most of the growth in international production during the 1990s has been driven by cross-border M&As, in 1999 accounting for more than 80% of foreign direct investment flows.

Together with this dramatic increase in international acquisitions, the 1990s saw a liberalization of international trade and closer regional integration. Examples of trade liberalization include the conclusion of the Uruguay round and the establishment of the single-market in the European Community. Moreover, UNCTAD (2000, p. 146) reports that in the period 1991–1999 close to one thousand regulatory changes facilitating foreign direct investment flows were made in over 100 countries.

Many observers refer to economic integration as an important reason for the expansion of international M&As. For instance, on p. 20 in the overview of the UNCTAD 2000 report, it is stated that: "Trade liberalization and regional integration efforts have added an impetus to cross-border M&As by setting the scene for more intense competition..."

From a theoretical perspective, the link between economic integration and profitability of cross-border M&As is far from trivial. It is well known from the literature that in a fully integrated market it is generally more profitable to be outside a merger than to participate in it, see Stigler (1950). Moreover, Salant et al. (1983) show that in a Cournot model with symmetric firms, a merger involving less than 80 percent of the industry will not be profitable. The reason is that the outside firms will expand their production and thereby "steal business" from the merging parties. A reasonable conjecture would therefore be that economic integration would reduce the profitability of cross-border mergers. [2]

Although cross-border acquisitions is an empirically important phenomenon, it has received relatively little attention in the literature on trade and investment and likewise in the literature on mergers. Exceptions include Kabiraj and Chaudhuri (1999), Head and Ries (1997), Barros and Cabral (1994) and Horn and Levinshon (2001), which analyse the welfare effects of mergers and derive policy implications. More recently, the positive issue of equilibrium market structure in an international context has been analysed by Horn and Persson (2001), Norbäck and Persson (2004), and Görg (2000).

The present paper is closely related to Horn and Persson (2001) who focus on international versus national mergers. In their paper, the main advantage of a cross-border merger is that it provides access to a foreign market, while a national merger reduces the competitive pressure in the domestic market. Their main result is that an increase in trade costs may increase the profitability of domestic mergers relative to cross-border mergers. The intuition is basically that when trade costs are high, a domestic merger results in very limited international competition, which is a more profitable venture than a cross-border merger resulting in tough duopoly competition in both markets. When trade costs are low, national mergers do not reduce the competitive pressure to any significant extent. The market access argument then dominates, resulting in cross-border mergers.

[2] For recent contributions to merger formation in a closed economy, see Barros (1998), Gowrisankaran (1999), Tombak (2002), Inderst and Wey (2002), and Lommerud et al. (2004). Deneckere and Davidson (1985) demonstrate that in an oligopoly with Bertrand-competition, mergers of any size are profitable.