Cross-border acquisitions in response to bilateral/regional trade liberalization

Prescott C. Ensign*

This note examines why a major change in economic policy will require a change in policy at the firm level. Specifically examined is how bilateral or regional trade and investment liberalization causes a firm to pursue international restructuring or integration of operations. Regional economic integration results in increased competition and a larger market. It also results in new opportunities and threats. In this environment, the search for competitive advantage may require a firm to make a cross-border acquisition, especially within the region. It is suggested in this note that a cross-border acquisition may be needed in order for a firm to internationalize operations; rationalize operations; maximize advantages; and minimize disadvantages. The major drivers of this response are considerations of market share and market power; linkages — both intra-firm linkages and inter-firm linkages; technology/innovation; and cost/efficiency.

Introduction

An understanding of cross-border acquisitions involves understanding trade, foreign direct investment (FDI) and the reasons why firms become transnational. Over the years, many explanations have been provided. They have had one central focus: trying to understand the behaviour of the transnational corporation (TNC). Early theoretical work focused on the market and viewed TNCs as oligopolists (Hymer, 1960; Knickerbocker,

* Research Fellow, Hautes Etudes Commerciales, Montreal, Quebec, Canada. This work has benefited from comments made by Andrew Delios, the anonymous referees of this journal and participants at the 1997 Canadian Economics Association meetings. The author appreciates the abundance of criticisms provided by Ig Horstmann, most of which remain to be resolved in empirical analyses. Support as a Fulbright Scholar from the Foundation for Educational Exchange between Canada and the United States, the Institute of International Education and the J. M. Smucker Company is gratefully acknowledged.
Succinctly put, “direct investment will not occur in industries with pure competition” (Kindleberger, 1973, p. 247). A firm entering a new market must have “some special advantage” over firms currently competing in that market. Superior coordination is one such means, “because of its knowledge [the entering firm is] able to economize through synchronizing operations” (Kindleberger, 1973, p. 247). Further, “Hymer’s theory of direct investment states that foreigners can pay more for an earning asset, such as a business, in country A than residents of country A would, not because they are content with a lower [rate of return], but because they can earn a higher [stream of income]” (Kindleberger, 1973, p. 249). More recent research includes an emphasis on assets, especially firm resources and capabilities that are created or learned. Finally, the external environment that included trade barriers has been viewed as a primary reason for FDI.

Beginning in the early 1970s, global oligopolists — in particular the entry of the Japanese Keiretsu into the United States market — began to change radically the competitive environment (Chesnais, 1993). International cross-investment gave firms the capacity to become what Kenichi Ohmae (1985, 1990) calls “global insiders”. Global oligopoly, primarily among the Triad (Japan, Europe and the United States), describes the extent to which rivals can enter (cross-invest) and operate in each other’s markets. Such global concentration has given rise to a search for corporate growth and transnational expansion. The present trend towards trade liberalization — with a change from multilateral/global efforts to bilateral/regional efforts — has resulted in increased intra- and inter-regional competition. Greater economic integration has forced firms to serve larger markets and operate in new ways.

Growth in FDI and trade has resulted in an irreversible pattern of dominance by TNCs. In fact, most firms recognize that “globalization” or international strategies may be necessary in order to compete in the present economic environment. In some industries/sectors, FDI may even be an imperative for maintaining the status quo. Explanations for cross-border acquisitions have focused on the increase in global competition, the desire for market share and market power, overcoming trade and certain investment restrictions etc. Depending on the time period and location of cross-border acquisitions, different theories were put forth to explain firm behaviour.
The focus of this note is on cross-border acquisitions during trade and investment liberalization\(^1\) — an environment of increased economic integration. It is suggested that there is a difference between the environment of multilateral/global trade liberalization and that of bilateral/regional trade liberalization. The distinction is that one may create the need to become global insiders, the other the need to become regional insiders. This note examines the response to bilateral/regional trade agreements by firms that are affected — due to the nature of their physical location — by such economic integration.

This note considers the response a firm makes to a new environment of bilateral or regional trade liberalization. A firm’s response to such a major economic policy change can range from doing nothing; increasing trade; entering an alliance; undertaking greenfield investment; or acquiring another firm. This note focuses on the last response — the acquisition of foreign assets.\(^2\) There is reason to speculate that such a response is likely; Milford B. Green (1990) finds evidence that government policy (including trade and investment regulation) plays a role in cross-border acquisitions. The specific question covered is why a cross-border acquisition is chosen in response to bilateral/regional trade liberalization. Regional economic integration results in increased competition. In the search for competitive advantage during trade liberalization, an international response, i.e. the restructuring of operations may be required. I suggest that a cross-border acquisition may be needed in order to internationalize operations; rationalize operations; maximize advantages; and minimize disadvantages. The major drivers behind a response to trade liberalization are market share/market power; linkages (intra-firm linkages and inter-firm linkages); technology/innovation; and cost/efficiency.

The premise is that acquisitions may afford opportunities not available via other entry modes. Certainly, industry rationalization is one scenario. Aside from buying up assets for efficiency and market power reasons, a firm may undertake an acquisition to gain control over downstream assets (e.g. marketing or advertising skills) or upstream assets (technology or innovation

\(^1\) In practice, trade and investment liberalization are inseparable; the two have become conjoined in “real world” economic policies. Throughout this note, the term “trade liberalization” will commonly be used to refer to trade and investment liberalization.

\(^2\) In this note, “acquisition” will be used to signify the taking of a direct controlling interest of productive assets, be they a firm or a portion thereof.
In addition to opportunities, cross-border acquisitions may also be the only means available to meet constraints satisfactorily. Costs and risks may be minimized through entry into an existing array of connections; acquisitions provide such a foray into inter- and intra-firm linkages. For example, Ignatius Horstmann and James R. Markusen (1987) find that, for a firm contemplating international expansion, firm-specific assets dictate that full control is preferred to partial control. They (1996) also find that full control is superior to other entry modes in cases in which the market is large and the variability in profits is small. Both these conditions are likely to be met in the case of a region undergoing trade liberalization.

From multilateral/global trade liberalization to bilateral/regional trade liberalization

Major progress towards multilateral/global trade liberalization is considered to have started with the General Agreement on Tariffs and Trade (GATT). Signed in 1948, it helped to address the problems associated with trade protection that had plagued the world market for a number of years. This accord initiated proactive measures to keep world markets open. It was an effort to prevent or eliminate the kind of tariff and non-tariff trade barriers that were imposed with legislation such as the Smoot-Hawley Act. In the years that followed, the GATT rounds (e.g. Kennedy, Tokyo and Uruguay) have attempted to keep multilateral trade liberalization moving forward. Over the past 50 years, significant progress has been made to reduce trade restrictions on a worldwide basis (Scherer, 1994).

More recent trade liberalization initiatives have been less multilateral and more regionally driven or have been even bilateral in scope only. They indicate a pattern of economic integration that is largely centered on the three major economic regions of the world: Asia, Europe and North America. The European Union (EU) is the result of many nations joining together in an economic union that not only provides liberalization of trade and investment but also moves its constituents closer to monetary and political integration. The European Commission’s 2000 report indicates that EU markets are continuing to integrate and that acquisitions are strong catalysts for such change. North America’s evolutionary course towards trade liberalization has also expanded regional economic integration. This effort has resulted in specific sectoral trade pacts (e.g. the Canada-United States auto pact) as well as general agreements including the Canada-United
States Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA). Within the Asian region, there have been a number of initiatives aimed at trade liberalization on a regional basis, e.g. the Association of Southeast Asian Nations (ASEAN). Regional economic integration has also been evident in the non-capitalist (communist) countries, the Caribbean, Africa and Latin America (Gibb and Michalak, 1994; Scherer, 1994). Regional economic integration even emerges as an issue within countries, e.g. Canada (Ensign, 1994a, 1994b).

The rise of such regionalism has resulted in a number of new issues. First, trade liberalization has increased the economic power of the three major regions, in essence the power of the Triad. Closer economic cooperation among nations on a regional basis has resulted in what are now referred to as continental trading blocs (Gibb, 1994; Michalak, 1994). A second and related issue is that trade liberalization has resulted in a new kind of protectionism (Rugman and Verbeke, 1991). The rise of regional trading blocs begs the question of whether markets are really open. The issue becomes one of who is included (protected). Some nations receive preferential treatment and become insiders while others lack such treatment and are excluded — become outsiders.³ The rise of regional trade liberalization therefore begs the question of how liberalizing these trade agreements really are.⁴ It remains controversial whether multilateral/global trade liberalization will fracture into discriminatory regional blocs, or regional trading arrangements will provide momentum for continued world trade liberalization (Frankel, Stein and Wei, 1996). According to Carlo Perroni and John Whalley (1996, p. 57) “history shows that cooperation is the handmaiden of subsequent conflict”. Dani Rodrik (1998, pp. 4-5) notes that “international economic integration is politically contentious from the start. … For reasons that are not fully understood, national borders continue to act as barriers to economic exchange even in the absence of formal restrictions”. In this “stumbling blocks versus building blocks” debate, Jeffrey A. Frankel (1997) observes that preferential trade arrangements are indeed concentrating trade regionally and that enhancement rather than reduction of global welfare is dependent on a decrease in barriers between blocs. Frankel allows for the possibility that regionalization becomes “excessive”, whereby

³ According to Baldwin (1993), the incentive for outsiders to join a trade agreement is positive and increases for each subsequent member. A “domino” scenario is portrayed for entry.

⁴ To some degree “liberalization” is a misnomer. Whether an arrangement results in greater trade and investment liberalization or continued restriction is a matter of perspective (Gibb, 1994).
detrimental effects of trade diversion outweigh the positive effects of trade creation. The ultimate compatibility between regional trade arrangements and global trade liberalization is not presently known for certain. Frankel calls for the taking of all possible measures to ensure that regional trade evolves in a manner consistent with global trade liberalization.

With the rise of trade blocs, a number of complaints have been voiced warning that these cooperative agreements are “competitive tacks” and “strategic posturings” to exclude firms of particular countries from certain markets. There is a certain amount of irony in this since complaints about trade restrictions often come from those countries that have entered some kind of regional trade agreement or that practice protectionist measures. Indeed, Jagdish Bhagwati and Arvind Panagariya (1996, p. 82) point out that trade agreements “as distinct from non-discriminatory trade liberalization, could harm both member country and world welfare” — that is trade blocs could be trade diverting rather than trade creating. The determination of welfare effects revolves around conditions of physical distance — and therefore transport costs — among members; and the initial level of trade that may itself be the result of artificial inducements. Welfare calculations also invariably involve estimating trade in the absence of trade agreements. In practice, determining alleged levels of trade (what trade would have occurred) in lieu of the present trade arrangements is a matter of pure — though perhaps well informed — speculation.

With countries choosing to enter regional agreements, the multilateral negotiations under GATT have slowed or stalled (Gibb, 1994). John H. Dunning (1995) notes that the growth in intra-regional economic activity in the Americas, Europe and Asia is greater than the growth in inter-regional economic activity. Although Dunning (1995, p. 126) is hopeful — “like ripples in a pond, regionalization may spread outward” — the stand-off between regional interests and global ones should not be entirely surprising: “the unilateral behavior of governments, which is geared to promote the good of their own citizens, may not maximize welfare globally because of the possible adverse affects, or negative externalities” (Dunning, 1995, p. 133). In the end, the movement towards bilateral/regional trade liberalization may

---

5 From the session on “Improving the design of regional trade agreements”, see the papers by Frankel, Stein and Wei; Perroni and Whalley; and Wonnacott. From the session on “Regionalism versus multilateralism”, see the papers by Bhagwati and Panagariya; Sampson; and Levy and Srinivasan in the American Economic Review, 1996 Papers and Proceedings.
force the decision to again move towards multilateral/global trade liberalization. Some in fact are already calling for a new vehicle if world trade liberalization is to continue.\textsuperscript{6} This impasse may be avoidable. Shang-Jin Wei and Jeffrey A. Frankel (1998) assert that, if trade blocs are to fit harmoniously with the aim of multilateral/global trade liberalization, two criteria must be met: there must be trade liberalization \textit{vis-à-vis} non-members; and there must be no decrease in trade between members and non-members after formation of the bloc.

\textbf{The relationship between trade liberalization and competition}

A cycle exists in which trade liberalization and increased competition feed off each other. Competition — especially in an environment of TNCs — has had a significant impact on the development of trade liberalization. The converse also holds. Trade liberalization has had a direct impact on global and regional competition among firms. As economic integration and trade liberalization increased under the continuing efforts of GATT, firms in countries undergoing trade liberalization were faced with an increasingly competitive environment. The result was that some of the firms within these countries recognized that their proportional share of economic growth was being eroded by a rise in the economic growth of firms from other countries. That is, despite this being a positive sum game on the whole, for some firms the result was a loss or at least a reduction in growth.\textsuperscript{7} One way to counter this was through bilateral/regional trade agreements, i.e. protection in the form of free trade and investment within their own region (Gibb, 1994). At the nation-state level this same logic as held by fearful firms has been expressed. In 1982, in response to the situation in Europe, the United States made it apparent that it was “willing to dance” with interested parties; shortly thereafter the United States-Israel Trade Agreement and Caribbean Basin Initiative were formed.

Firms believing that their profitability was being eroded took action. Those that were already competitive (most able to capitalize on increased competition) pressured governments for

\textsuperscript{6} Ironically GATT’s success — the opening of markets resulting in greater competition — may have led to its demise.

\textsuperscript{7} It is at this point that industry rationalization is often observed — some firms look for assets to acquire while other firms look for buyers. Paulson (2001, p. vii) finds that some firms “design their corporate strategy specifically to become attractive acquisition candidates”.

\textit{Transnational Corporations}, vol. 10, no. 1 (April 2001) 95
lower trade barriers. For them, free trade could provide greater access to existing or new markets and improve their opportunities for growth. Firms that were less-competitive — or in certain industries/sectors — were often the ones in favour of retaining the status quo, i.e. the shelter from competition provided by trade barriers. Through iterations of this process, winners and losers begin to emerge. Those firms thriving under heightened competition generally favour greater trade liberalization. Those firms unable to adjust wish to shore up their positions or consider selling and search for buyers. When barriers do come down there may be a rush to act. Greenfield entry may be too slow to establish a market presence; alliance or acquisition might be preferred modes, each with their own unique distribution of strengths and weaknesses.

Even in a world with a “growing pie”, competition reveals a mixture of winners and losers at the firm, industry and country levels. In terms of trade liberalization efforts, the result of this fear — rational or otherwise — can be a standoff (with no further liberalization) or else movement to a new stage that may include bilateral/regional trade liberalization rather than multilateral/global trade liberalization. To a large extent, this is arguably what has happened with the emergence of three conspicuous trading blocs (Gibb, 1994; Michalak, 1994).

With the world moving towards regions of economic integration, competition will continue to increase within each trade bloc as well as among trade blocs. Firms competing across trade blocs (from one trade bloc to another) will find trade and investment barriers an interference — a hindrance to their ability to compete — but firms conducting business within a trading bloc will be sheltered, at least to some degree. With increased access to markets and the opportunity to generate and capitalize on competitive advantage, insider firms may be most able to achieve a competitive position within the regional bloc. That enviable insider status may not be attainable through greenfield entry or even alliance. Since competition increases within the bloc, firms face even greater challenges in the new environment of regional trade liberalization. Based on this discussion, it is possible to conclude that an increase in competition is directly related to economic integration (Humbert, 1993; Nunnenkamp, Gundlach and Agarwal, 1994).

Porter (1990) and others have suggested that it would be rational for a firm to welcome the opening of its markets to new competition as this allows the firm to develop its advantages; in essence, become more competitive.
Trade liberalization as a driving force for FDI

Bilateral/regional trade liberalization — resulting in an environment of greater economic integration — has a pronounced impact on FDI. In order to understand the relationship between trade liberalization and FDI, it is important to first recognize that international trade has undergone a transformation. Today, a large share of international trade is accounted for by intra-firm trade rather than market-based trade. Robert C. Feenstra (1998, p. 34) observes that “the disintegration of production itself leads to more trade, as intermediate inputs cross borders several times during the manufacturing process”. There is also a pattern of more intra-industry trade. Traditional (early) trade theory provided a justification for market-based trade by examining factor costs and market opportunities. While not universal, there is acceptance that “trade clearly arises for reasons of both comparative advantage and imperfect substitution” (Frankel, Stein and Wei, 1996, p. 54). To understand intra-firm and intra-industry trade will require different explanations or at a minimum, extensions to existing theory.

It is also important to understand that both trade and investment have increased dramatically in recent years. Growth in FDI has increased even more dramatically than the volume of trade or growth in GDP (Chesnais, 1993). For many years, economists saw trade and FDI as substitutes. Explanations for FDI were often based on the need to overcome trade restrictions. The argument was that FDI was undertaken to avoid tariffs and therefore replaced trade. In an environment of declining trade barriers or freer trade, FDI was expected to decline and be replaced by an increase in trade (Cox and Harris, 1986; Dunning, 1993). In light of bilateral/regional trade liberalization and changes in the nature of trade, this view is being revised. Data showing that FDI and trade have increased help to support the conclusion that trade and investment are complements, not substitutes. One does not necessarily replace or offset the other; they can be compatible.

In an era of TNCs, it is important to remember that FDI consists of reinvestment and new investment. Both are important and not always easily distinguished. A TNC increasing its established position may build or acquire assets in a manner similar to that of a new entrant. When examining FDI after trade liberalization, many take FDI decisions as if they were made tabula rasa when in fact significant unrecoverable costs may exist. Resources may have been extended that are intractable or imperfectly so. It may not be the case, therefore, that trade could
simply replace investment. First, the context is all-important. Second, few decisions a firm makes are isolated. Third, a single firm may increase both international trade and FDI. Moreover, although trade restrictions are reduced, tariff or non-tariff barriers may still be significant enough to warrant direct investment.

Finally, it is worthwhile to consider the significant role that innovation — improvement in technology — plays in these relationships. Technological advance has an influence on competition. In turn, technology has a bearing on trade and investment. Growth in international trade and the number of TNCs supports such a conclusion. Additionally, technology has had an impact on trade liberalization — both directly and indirectly. The prevalence of TNCs and intra-firm trade attests to the fact that decisions are often based on technological considerations. The opposite is true too. Trade liberalization has had an effect on advances in technology. In summary, such innovation may be the outcome of heightened competition due to trade liberalization, it may be an input in raising the level of competition, or perhaps it is both.

From this discussion, it is apparent that competition, trade, FDI, and technology have a major impact — both individually and collectively — on trade liberalization. Trade liberalization — based on major economic policy changes — creates a new and more competitive external environment. It leads to a change in environmental conditions such that the market is freer, more efficient, more competitive in the sense of economy. The result is that firms will have to become more competitive; they will have to respond and make adjustments to economic integration. The next two sections suggest why cross-border acquisitions may be the appropriate response to trade liberalization.

Firm response to bilateral/regional trade liberalization: a search for competitive advantage through cross-border acquisitions

A firm faces a number of strategic and organizational challenges during bilateral/regional trade liberalization. Under the heightened competition of trade liberalization, a firm must search for ways to increase as well as capitalize on advantages. Either to capitalize on or add to these advantages, it may be necessary for the firm to make direct investments internationally. In many cases, this will require the firm undertake a cross-border acquisition. A Business International (1971, p. 5) report indicates
that “firms are turning to the acquisition route as the surest, fastest, and cheapest way of increasing their foreign markets.” This same report indicates that, in addition to certainty, speed and cost, cross-border acquisitions are advantageous to the firm “seeking to expand its human and technological resources … [and] may offer a well-developed distribution network” (Business International, 1971, p. 7). Such findings persist: “Cisco Systems realize that developing technology using internal resources may not be the least expensive or least risky course when compared to acquiring” (Paulson, 2001, p. vii).

Bilateral/regional trade liberalization also leads to greater market opportunities. Firms will need to respond to an expanded market. With freer entry — for trade and investment — the “local market” is no longer several markets but one regional market. A firm’s way of viewing the market will have to change. To respond to opportunities created during bilateral/regional trade liberalization, a firm may need to increase trade and investment within the region. The optimum way for some firms may be through cross-border acquisitions.9

In the search for competitive advantage during bilateral/regional trade liberalization, a firm must respond to increased competition and greater market opportunities. Factors influencing this response are summarized in figure 1. The diagram suggests that a firm may need to internationalize (with an eye towards competitors and the new market) and rationalize operations (with an eye towards increasing productivity and lowering costs). In essence, the decision to internationalize is a demand-side reaction while the decision to rationalize is a supply-side response. Both of these are opportunities for a firm to exploit or gain competitive advantage. Decision making in either internationalization or rationalization of operations should incorporate considerations of the internal and external environment. Orthogonal to these, a firm’s response must be to maximize advantages and minimize disadvantages. A cross-border acquisition can help a firm maximize advantages — both firm specific advantages (its own and those of a target) and location-specific advantages (in the home country as well as host country). A cross-border acquisition can also be used to minimize pre-acquisition disadvantages — both those it faces within the firm as well as those in the home

9 Although significant, determining whether an acquisition is needed primarily for proactive or defensive purposes will not be examined in this note. Neither will divestitures — the selling of controlled assets — be examined.
country. With the same caveat as applied to the vertical axes, decision making along the horizontal axes involves a consideration of both the internal and external environment.

Figure 1. Firm response to trade liberalization: a search for competitive advantage

Internationalize operations

The challenges of competition and an expanded market can create the need for a cross-border acquisition. With this new level of economic integration, firms will have a keen awareness of the importance of the prevailing opportunities (Crookell, 1990). With a bilateral/regional trade agreement, firms have a larger market. Essentially, the result is an opening of markets abroad but there may also be an impact on markets at home. Home markets must be reexamined in light of increased competition. Adjustments are going to come during a search for ways to expand market scale and scope within the region. This search may take the form of increasing a firm’s share of an existing market, finding new markets to serve, or both. In many industries/sectors, responding to market opportunity abroad will become a priority.

Such opportunities — the result of a major economic policy change, in this case trade liberalization — may pull a firm into FDI. There may be market and policy factors that make other countries in the preferential trade area attractive. These may include:
the relatively greater size and diversity of the ... market; ... political risk perceived to be lower ... ; greater productivity and cheaper factor costs ... ; investment incentives (often given by ... governments ... ); and the opportunity to customize products and identify niches for successful marketing (Rugman, 1987, p. 11).

There may also be factors in the home country that push a firm to make a direct investment in a host country. These specific factors come from markets and policies in the home country. As Rugman (1987, p. 11) states:

They encourage firms to make direct investments abroad in order to maintain or enhance a competitive position. They may include: differential costs for factors such as labor and capital; tax and related policies affecting the investment climate; economic regulations and other government-related cost factors; and the increasing ability of the maturing ... managerial and economic system to support outward investment.

These factors do not operate in isolation but pull factors are primarily market-driven while push factors are often secondary factors.

With the opening of a larger market, a firm becomes an insider. The “foreign” market is now part of the “home” market. In order to serve that market, the firm may need to become a “local” player. Becoming a local participant through acquisition can provide benefits that could not otherwise be achieved. In some cases, serving this new market may not be profitable or even feasible through trade; this shifts the decision to a consideration of entry mode. Issues of proximity take on greater significance in an environment of trade liberalization (Crookell, 1990).

**Rationalize operations**

An increase in competition and the expansion of markets — including “guaranteed access” to new markets — also means reassessing operations, primarily but not exclusively production. Depending upon the specific firm and industry, this will result in a readjustment — either a contraction or expansion — of facilities.
There is a consensus in the literature that bilateral/regional trade liberalization will generally result in the need to rationalize production (Bishop and Crookell, 1986; Burgenmeier and Mucchielli, 1991; McFetridge, 1986; Panic, 1991). Rationalization implies that, with increased competition and greater market efficiency, a firm will need to reassess its organization of production and recalculate its factor costs. For some firms, this may require changes such as the closing of operations. For others this may require adding or expanding an international operation to take advantage of economic integration resulting from trade liberalization (Gibb, 1994). Again, depending on issues of speed, timing and available options, acquisitions may be the only or preferred course of action. While an alliance may even be quicker and meet other criteria, there may be overriding concerns (e.g. protection or procurement of proprietary assets) that preclude this option. In an environment of bilateral/regional trade liberalization, rationalizing operations means that changes occur on an international basis.

Paul M. Bishop and Harold Crookell (1986, p. 313) state that “rationalization is a strategy open only to multinationals. There must be both a parent and a subsidiary”. If TNCs lower their costs through rationalization, national firms may face a loss of market share if they do not respond. A national firm may have to respond by making a cross-border direct investment and it will have to do so quickly, precluding the use of a greenfield investment. In addition, as Bishop and Crookell (1986, p. 313) point out, “rationalization ... requires the administrative arrangements of a single large firm”. Such an administrative requirement (hierarchy) eliminates the choice of an alliance.

With rationalization, productivity considerations become of paramount importance (McFetridge, 1986). A firm will rationalize to gain economies. Serving a larger market makes it possible to have longer production runs and greater efficiency. Product lines are narrowed in some facilities (from multi-product to single product), at others they are widened. Specialization may occur at some facilities as redundancies are made apparent and efficiencies realized. In the rationalization process, the assignment of operations is based on the optimum use of resources (transferable and non-transferable) and the optimum allocation of factors (mobile and immobile) (Panic, 1991).

In the end, rationalization may result in significant changes in an industry internationally. These changes, however, can bring new opportunities and challenges for firms in that industry. As Michael E. Porter (1990, p. 48) states, “every significant structural
change in an industry creates opportunities for new early movers”. From a strategic standpoint, rationalization will require an assessment of product and market segments. In such an environment, a cross-border acquisition may need to be undertaken.

**Maximize advantages**

The search for competitive advantage takes on heightened significance in an environment of trade liberalization. Greater competition and market opportunities mean that a firm will increasingly need to focus on firm-specific advantages — both its own and those of a “target”. Research and theory suggest that these advantages — resources and capabilities — are an important source of competitive advantage (Collis, 1991; Mahoney and Pandian, 1992; Peteraf, 1993; Wernerfelt, 1984). Rajneesh Narula (1996) suggests that many of these assets have mobility. He also indicates that, in today’s environment, “created assets” (those that depend on learning) are often the ones that generate the most value for a firm. The firm will also need to maximize advantages that are location-specific — both those of the base country and those of a host country. The immobility of these assets suggests that a cross-border acquisition may be the requisite choice (Narula, 1996). Exploitation (capitalizing on existing advantage) and exploration (increasing or building new advantage) represent distinct motives. Either or both may indicate acquisition as the requisite mode of entry.

A cross-border acquisition may be necessary due to the nature of resources and capabilities. In many cases, these assets are intangible; in many cases they are inimitable. As Jay B. Barney (1988) proposes, value is created for the acquirer when unique inimitable synergies exist between the acquirer and target. Based on the nature of these assets, the best way or perhaps the only way to obtain them is with an acquisition. The immobility of certain assets across borders and the mobility of still other assets only though the internal structure (hierarchy) of a TNC may explain the uniqueness of value creation in international acquisitions.

Dunning (1993) indicates that advantages may be gained through firm-specific resources and capabilities associated with organization, location and internalization. A cross-border acquisition may be desirable because many of a firm’s own competences and abilities can effectively be spread internationally with minimal additional cost. There are also many advantages
that are generated simply because of a firm’s international activity. A cross-border acquisition permits the advantages due to internationalization of firm resources to be spread out over a region.

If a firm chooses to respond to new market opportunities resulting from trade liberalization, the best way to serve the market may be to acquire locally resident assets. Advantages may be gained by acquiring resources in distribution or sales that a target has built up in its own market. In an environment of heightened competition, it may be necessary to gain a local presence in a market already being served.

Minimize disadvantages

The counterpart to maximizing advantages is limiting the impact of disadvantages. In the decision-making process, such considerations not only involve assessing one’s own firm-specific and location-specific disadvantages but should include an assessment of the external environment as well. In the search for competitive advantage during trade liberalization, a firm must undertake a thorough assessment since there may be some way to minimize weaknesses with a cross-border acquisition.

The key to regulating possible harm from disadvantages is identification of current and prospective problems. Consequences due to a lack of experience or knowledge can be reduced through foresight and planning; learning will occur and information can be gathered by operating internationally. In many ways, greenfield entry involves starting from nothing whereas this need not be the case through acquisitions. Issues of control may also give rise to acquisitions, that is, if maintaining control is crucial then acquisitions may be the single feasible solution. The need for product/market diversification, as well as the need to overcome cultural or physical distance, may point to a cross-border acquisition.

Drivers of cross-border acquisitions during bilateral/ regional trade liberalization

The drivers identified in this study are reasons why cross-border acquisitions are necessary in an environment of bilateral/regional trade liberalization. They explain why such acquisitions are a superior mode of FDI. They delineate the attributes that enable firms to capitalize on existing or capture new competitive
advantage through cross-border acquisitions. These drivers are shown in figure 2. As with the previous diagram, they are discussed separately for purposes of illumination. Although it is correct to draw the conclusion that there is merit in giving attention to these as individual considerations, ending there without a collective consideration of the four drivers would not be prudent. The firm may generate its greatest strength not in identifying these as distinct drivers but in making connections between them. That is, the individual drivers provide advantage but it is in combination that they may give the firm its optimal competitive advantage.

Figure 2. Drivers of cross-border acquisitions during trade liberalization

Market share/market power

An environment of economic integration — with the accompanying increase in competition and expansion of markets — will put pressure on firms to examine their strategic position relative to rivals. This means that a firm’s response may include adjustments to improve that position. Growth and expansion strategies will probably include some way to capture more of the market at home and abroad. At a minimum, reinforcing market position will be desirable.
Market share and market power considerations can be a powerful driver during bilateral/regional trade liberalization. Depending upon what factors characterize a firm's industry, cross-border acquisitions can be the means of increasing market share and improving market power. There are a number of significant factors that influence the need for adjustment through cross-border acquisitions. First, there may be a significant amount of rivalry among firms. This will result in competition for market share (Chesnais, 1993). Second, a firm may be faced with a saturated or tight market. There may be no way to increase position without an acquisition. If a firm is entering such a market for the first time, there may be little choice from among the direct investment options. If there is no room for additional competitors (i.e. greenfield investment) and partnering is not suitable, the firm will have to acquire assets already serving that market. Third, a concentrated market structure in a firm's home country may dictate a cross-border acquisition as the only viable option (see, Barton and Sherman, 1984). Fourth, if there is excess capacity, a firm may need to buy a competitor's market share to consolidate the market/industry. Consolidation, the buying up of excess capacity, may result in changing the industry context generating oligopolistic conditions. There may also be other factors such as entry barriers that can best be overcome through an acquisition (Chesnais, 1993). In general, cross-border acquisitions for market reasons — to compete via market share and market power — will be acquisitions that are either horizontal or vertical; and, if vertical, then usually downstream assets.\(^\text{10}\)

In addition to gaining market share abroad, cross-border acquisitions may be undertaken to improve a firm's position in the home market. Such an acquisition may help a firm gain new insight for revitalizing products that are failing at home. Buying ideas, technology etc. to obtain unique assets or resources such as brands or distribution channels may help a firm maintain or increase its market share and market power at home. Sometimes these benefits are indirect but ultimately they may help a firm in its search for competitive advantage. As Porter (1990) suggests, just being in an environment of rivalry can enhance a firm's performance.

In an environment of heightened competition during trade liberalization, acquisitions may be a primary means of realizing a growth or expansion strategy. Industry and market conditions,

\(^{10}\) See Delios (1998) for a discussion of the importance of accessing downstream assets when entering new markets.
however, will dictate the influence that this driver — market share and market power — has on a firm’s response. Issues of timing and speed will also influence the choice of mode. In some cases, cross-border acquisitions may be the only route to quickly seize opportunities that arise in the host market.

Intra-firm linkages and inter-firm linkages

Another very powerful driver of cross-border acquisitions during bilateral/regional trade liberalization is linkages. This includes two kinds of linkages: intra-firm linkages and inter-firm linkages. In an environment of bilateral/regional trade liberalization, the need for both types of linkages is clearly evident. The need to respond to increased competition and a larger market suggest why the benefits of linkages are a driver of cross-border acquisitions. In contemplating cross-border acquisitions, the calculus of build vs. buy includes issues of speed, availability of linkages, price, and probability of returns.

Intra-firm linkages. Transnational network linkages describe the way a firm’s operations are organized. Although a TNC has separate affiliates located in different geographical locations, it can achieve benefits from the management of these units as a coordinated transnational network (Ensign, 1999). The benefits from such an organizational network — an internal network — have been supported by both theory and research. The work of Christopher A. Bartlett and Sumantra Ghoshal (1989), Bruce Kogut (1983) and others has provided strong support for the advantages of having transnational operations. Kogut (1983) describes the sequential advantages of these “options” that are unique to the TNC. Benefits are gained when a firm exercises such “options”. Numerous other studies related to internalization theory, intra-firm trade, retaining proprietary knowledge etc. support the argument that intra-firm linkages are a powerful driver of cross-border acquisitions.11

Inter-firm linkages. Understanding network theory can help to understand the need for inter-firm linkages during trade liberalization. Network theory stresses the importance of bridging strategies and forging connections and resource exchange with other firms in the task environment. It suggests an industrial network of “suppliers, producers, innovators, users, and others,


involved in developing, producing, and marketing a special product” (Forsgren, 1989, p. 145).

Cross-border acquisitions can be used to internalize linkages that build on already existing relationships or can be used to establish new relationships. As Peter McKiernan (1992, p. 106) states, “the strength of the individual organization depends, not on specific advantages as in the market-imperfection theories but on links, with customers, suppliers, distributors, competitors and so on”. For example: “Productive and marketing capacities of organizations are adjusted to match those of others in the network by an investment in physical and human assets which reinforces the bonding of the industrial network” (McKiernan, 1992, p. 106).

Technology/innovation

Technology has a powerful influence on today’s economic environment. Technology has a major impact on competition. Firms compete on the basis of technological progress. Technology also influences trade and investment (Clement et al., 1999). According to Robert Stobaugh and Louis T. Wells (1984, p. 12): “Just as extent of competition influences the choice of technology, it also affects the choice of the channel through which technology is transferred”. Growth in TNCs and trade is related to technological advances in communication and information gathering processes. Technology even exerts force on trade liberalization. To combat increasing competition — such as that owing to economic integration — firms focus on acquisition of technology in an effort to maintain or enhance their competitive position. In an environment that is changing rapidly, firms can be expected to undertake cross-border acquisitions to acquire technology, exploit the advantages of having superior technology, or both.

To maintain or gain competitive advantage requires constant attention to technological changes and innovation. In some cases, firms may not have a technological advantage or may not have the right one. It may not be possible to generate the necessary technological improvements within the firm. In this case, the firm will need to obtain these assets or capabilities outside the firm (exploration). Technology — like a commodity — may be purchased. But unlike a commodity, technology may not be

---

12 It has been suggested that rising technology would create a climate of greater economic integration even without the major changes in economic policy that result in trade liberalization.
suitably purchased as an end product, an output, a one-off transaction. A co-mingling with or internalization of the technology producing assets becomes necessary. Again, if an alliance is inferior or not viable then acquisition becomes the sole means for a firm to obtain access to innovative activity. If a firm is unable to acquire the necessary technology at home, it will need to look internationally. Even firms that compete exclusively in a domestic market may be forced to look beyond their own borders.

At times, technology can only be obtained through an acquisition. This may come as a direct purchase (e.g. patents, research scientists, specialists in engineering or software) or through buying into a network (e.g. acquiring a firm for trade knowledge, cross-licensing, proximity to suppliers and buyers). Acquisition of technology can also result from location, spillover, and agglomeration effects (Dunning, 1995; Porter, 1990). Simply being near the action — being a local player — may provide positive benefits and an increased awareness of competitors and their behaviours. Although there is no shortcut to involvement, a shortcut to gaining expertise may be through acquisition. In contrast, a firm may already have a technological advantage it wishes to utilize further. It may favour a cross-border acquisition to protect its technology, choosing to conduct trade within the firm rather than through the market. In either case, acquiring or transferring technology is an extremely powerful driver of cross-border acquisitions during economic integration.\(^\text{13}\)

**Cost/efficiency**

In an environment of regional economic integration, a firm will face increased pressure to be competitive. To do so will require attention to cost and improving efficiency. How a firm uses its resources will take on increased significance. Cost and efficiency can be powerful drivers of cross-border acquisitions during trade liberalization.

\(^{13}\) An insight provided by one of the referees is that technology/innovation seeking may follow from market share/market power seeking or cost/efficiency seeking. The degree to which the motives build off one another (or are independent or sequential) may be resolved empirically. Inkpen, Sundaram and Rockwood (2000, p. 50) provide evidence that some firms undertake acquisitions primarily for reasons of technology access — technology acquisitions in the United States accounted for over 20 per cent by number, 40 per cent by value, and during the 1990s non-United States firms made $250 billion worth of technology acquisitions in the United States.
Firms seeking cost and efficiency benefits may be able to rationalize the structure of established resource-based or market-based investments. In order to benefit, however, a firm will need geographically dispersed activities that are under its control — that is, transnational operations (Bishop and Crookell, 1986). For a domestic firm, this will require a cross-border acquisition. The benefits are essentially those of economies of scale and scope and risk diversification. These benefits are derived from cross-border product or process specialization, learning experiences that result from producing in a different location, and the options of arbitraging cost and price differentials across borders (markets) (McFetridge, 1986). As Dunning (1992, p. 59) states: “In order for ... rationalized foreign production to take place, cross-border markets must be both well developed and open. This is why it flourishes in regionally integrated markets”.

Firms may obtain cost and efficiency benefits by selectively picking locations based on factor endowments, institutional arrangements, financial systems and policies, and market structures that are country-specific (Dunning, 1993). Firms can arrange operations in a way that provides the best use of resources. To take advantage of differences in factors, a firm generally has two options. First, it may make a cross-border acquisition to take advantage of differences in the availability and cost of traditional factor endowments in different countries. As Ali M. Fatemi and Eugene P. Furtado (1987) note, factor markets and therefore costs are segmented internationally. In general, production that depends on capital, technology and information intensive value-added activities will be located in developed countries. Production that depends on cheaper labour and natural resource intensive activities, for example, may be located in developing countries (McFetridge, 1986). Second, a firm may make a cross-border acquisition in a country to take advantage of similarities in economic structure and income levels. In this case, an acquisition is utilized to take advantage of economies of scale and scope, supply capabilities, or perhaps differences in consumer tastes and supply capabilities. Crookell (1990) finds that cross-border acquisitions are ideally suited to take advantage of “created” competences and capabilities, the availability and quality of supporting industries, the characteristics of the local competition, the nature of consumer demand, and the macro and micro-policies of governments.

Efficiency may also be gained when a firm that makes a cross-border acquisition is able to use excess resources in multiple markets — i.e. home and host markets. Although Edith T. Penrose
(1995) observed that some resources are indivisible, value may be created because some resources can be transferred or used in another setting (exploitation). The recent emphasis on resources and capabilities helps to understand the importance of cost and efficiency as drivers of cross-border acquisition.

**Conclusions, implications and suggestions for further study**

This note is based on the premise that there is a relationship between corporate integration — the international integration of firm activities resulting from cross-border acquisitions — and economic integration of countries within a region. However, as John H. Dunning and Peter Robson (1988, p. 1) state, “so far there have been few attempts to analyze the interaction between the two kinds of integration ... or ... collect empirical data bearing specifically on this issue”. Very little attention has been focused on the behaviour of the firm in response to regional integration. This study has been a step toward understanding this relationship. Green (1990, p. 3) indicates that acquisition activity represents a “substantial transfer of assets and economic power across geographic areas and industries”. He admonishes that cross-border acquisitions do not represent an aspatial occurrence; as such, structural attributes (e.g. elements of physical location) and implications (e.g. adjustments in organization) should be considered. Future research must pick up where others have left off. Country of origin predicts entry mode; United States firms favour acquisitions whereas Japanese firms favour joint ventures, and both countries avoid greenfield (Delios and Ensign, 2000; Mansumitrchais, Minor and Prasad, 1999). Such future study might also consider the motive of the administrator charged with the acquisition decision (Seth, Song and Pettit, 2000).

This study discussed why cross-border acquisitions may be required in response to bilateral/regional trade liberalization. It was suggested that there are specific reasons or drivers that make such an adjustment — international restructuring or integration of a TNC’s operations — essential in an environment of regional economic integration. What is different in this new environment is that cross-border acquisitions can be used for regional competitive advantage. A firm's response may help it become more competitive within its own trading bloc. This regional advantage can be used to disadvantage outsiders and other insiders. Regional integration will also result in a different type of FDI, new trading patterns and an altered form of trade (managed trade) (Michalak, 1994). Finally, and perhaps most
importantly, firms will have a greater awareness of regional opportunities and threats that require a proactive response. Firms can no longer view their activities as independent and confined to a single nation. As a result of regional integration, their operations will be regional at the least, perhaps global. In terms of Canadian firms response to NAFTA, Alan Nymark and Emmy Verdun (1994, p. 139) report evidence of this logic for cross-border acquisitions: • “market penetration and market access, geographic expansion and diversification, and economies of scale were mentioned by the respondent firms as the major reasons”.

As a follow up to this note, research is needed to examine firm behaviour during bilateral/regional trade liberalization. In addition to the response by firms within a region, such investigation might also consider the behaviour of firms from outside a region of trade liberalization. An empirical study could be conducted to test whether the four drivers identified in this study are valid. It would help determine if firms that make cross-border acquisitions during regional integration are motivated by: market share and market power; linkages — both intra-firm and inter-firm; technology/innovation; and cost/efficiency. As proposed in this note, these are the four specific drivers that push a firm to respond with a cross-border acquisition during bilateral/regional trade liberalization. Such an empirical investigation could provide an understanding of how firms respond to a changing external environment.

References


