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Impact of Economic Policy Uncertainty on Merger and Acquisition Decisions: Evidence from Chinese A-Shares

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Abstract

Economic policy uncertainty (EPU) has emerged as a critical factor influencing capital market dynamics and corporate strategic decisions. This study employs the latest EPU index and M&A transaction data from Chinese A-share listed companies spanning from 2014 to 2018 to empirically investigate the impact of EPU on corporate behavior within China's capital market. The empirical results reveal that EPU significantly inhibits firms' willingness to undertake M&A decisions. Further analysis indicates that EPU exerts this inhibitory effect primarily by undermining managerial confidence and then reducing corporate risk-taking propensity. This study contributes to the literature by extending the analysis of EPU's impact to the micro-level behavior of managers particularly in the context of M&A decisions. The findings provide novel empirical evidence for understanding how policy uncertainty shapes corporate strategy in emerging markets and offer insights for policymakers and corporate managers.

Keywords: Economic Policy Uncertainty; M&A Decisions; Management Behavior

1. Introduction

Economic policy uncertainty (EPU) is a factor that has been widely recognized as an important factor affecting macroeconomic performance (Baker et al, 2016). Any change in economic policy may affect the macroeconomic environment, thereby significantly affecting the decision-making behavior of market participants. Therefore, it is widely believed that similar effects of EPU may also exist at the microeconomic level. Many studies have investigated this effect. In particular, these studies have confirmed that EPU affects the business activities of enterprises (such as investment and donation decisions) by affecting their operating costs, financing constraints, and financing availability (Julio and Yook, 2012; Gulen and Ion, 2016; Chun et al, 2023). Enterprises

are important market participants at the microeconomic level. Based on behavioral economics, the behavior of individuals is affected by the environment. In order to fully understand the impact of EPU at the microeconomic level, it is necessary to extend existing research by investigating other types of market participants. This study aims to fill this research gap by observing how corporate management is affected by EPU.

Existing literature has extensively explored how economic policy uncertainty (EPU) influences corporate domestic investment (Julio and Yook, 2012; Baker et al, 2016; Gulen and Ion, 2016; Nguyen and Phan, 2017; Liu et al, 2019). While most studies argue that EPU dampens corporate investment—citing risk aversion (Bernanke, 1983; Bloom et al, 2007), reduced operational efficiency (Boutchkova et al, 2012), and macroeconomic contractions (Baker et al, 2016)—institutional variability remains underexamined. For instance, electoral cycles moderate the impact of EPU: Jens (2017) documents post-election investment rebounds associated with incumbent re-election, a finding that contrasts with the parliamentary-system evidence presented by Julio and Yook (2012). These discrepancies highlight EPU's heterogeneous effects across political regimes. Mechanistically, EPU disrupts investment via two pathways: exaggerated future cash flow uncertainty (Riddick and Whited, 2009) and amplified financing constraints (Jeong, 2002). In China's policy-driven market, managerial risk aversion intensifies under EPU, as ambiguous policies hinder strategic planning (Stokey, 2016).

This study advances the literature by examining managerial behavior in M&A decisions under EPU. Using a sample of 4,188 Chinese A-share transactions (2004–2018), we find EPU suppresses mergers by reducing corporate risk tolerance. Mediation analysis reveals that acquirers' prior M&A experience mitigates this effect, underscoring organizational learning. Methodologically, we integrate event-study methodology with Probit regression to link EPU to short-term market reactions and long-term synergies. Our findings reveal that EPU's adverse impacts concentrate in policy-sensitive sectors, challenging conventional wisdom that uncertainty uniformly deters investment. Practically, the results inform policymakers seeking to stabilize investor confidence in volatile regimes, while theoretically bridging macroeconomic uncertainty with micro-level decision-making in emerging markets.

2. Theoretical Analysis and Research Hypotheses

The M&A decision is the starting point of the M&A transaction. The decision of the enterprise to acquire or not is the result of identifying synergies. If the acquirer believes that synergies can be obtained through M&A, it will initiate M&A.

On the one hand, the increase in economic policy uncertainty inhibits enterprises from making M&A decisions. First, economic policy uncertainty affects the value of M&A options. Based on real options, when economic policy uncertainty is high, the value of waiting options increases, and the value of identifiable M&A synergies decreases, which inhibits enterprises from making M&A decisions. Based on real options theory, when economic policy uncertainty is high, the waiting option value is greater. Specifically, the higher the degree of uncertainty, the greater the return on waiting for future investment, so the value of waiting is higher. In turn, companies

reduce their current investment expenditures, which will inhibit corporate mergers and acquisitions. According to real options theory, uncertainty will weaken companies' enthusiasm for any form of investment, uncertainty increases the value of waiting, and makes companies cautious in making investment decisions. Therefore, for the acquirer, the increase in economic policy uncertainty makes the value created by mergers and acquisitions uncertain, and the value of the waiting option is greater. For the acquirer, he believes that the merger synergy he has identified is less than the value of the waiting option. The optimal behavior is the "wait-and-see" strategy, and the merger and acquisition will be carried out when the external environment is clearer and more information is available. Therefore, for companies facing high uncertainty, it is best to limit investment and increase cash holdings to prepare for delaying investment to the next period (Bernanke, 1983; Abel and Eberly, 1996; Bloom et al, 2007). Secondly, economic policy uncertainty affects the risk-bearing capacity of enterprises, requiring them to be willing to initiate mergers and acquisitions only when they identify greater synergies. In the presence of uncertainty, corporate decisions tend to avoid risks, which is mainly due to the risk aversion of management and is positively correlated with the level of uncertainty. From the perspective of corporate management, the increase in economic policy uncertainty may make it difficult for corporate management teams to judge future economic policy performance, thereby affecting corporate investment decisions (Stokey, 2016). The uncertainty of future cash flows caused by economic policy uncertainty will reduce the profitability of companies (Kahle and Stulz, 2013). As the implementer of investment decisions, vague or pessimistic prospects will cause corporate management to become conservative. Management will abandon certain high-risk and high-return investment opportunities and maintain a low level of risk-taking (Kim and Kung, 2017). Therefore, under economic policy uncertainty, management is unwilling to take too much risk of M&A failure due to risk aversion, and instead adopts a corresponding conservative investment strategy. Only when the acquirer identifies sufficiently high synergies will it make M&A decisions. Finally, economic policy uncertainty affects the ability of companies to pay and inhibits companies from making M&A decisions. The greater the economic policy uncertainty, the higher the company's cash holdings (Demir and Ersan, 2017).Im et al. (2017) showed that uncertainty significantly affects a company's cash holdings and dividends. Under high uncertainty, companies tend to hold more cash. In these periods, cash is more valuable, and cash retention serves as a precautionary measure for companies and investors. Therefore, the source of funds for corporate mergers and acquisitions mainly comes from external financing, but the increase in the level of economic and political uncertainty increases the difficulty of project financing (Gulen and Ion, 2016) and financing costs (Pástor and Veronesi, 2012, 2013; Jens, 2017). Government policy uncertainty reduces the capital supply of the economy and increases friction in financial markets. These effects have been verified during the spread of the COVID-19 pandemic. Companies under high economic policy uncertainty choose to be more conservative or are forced to become more conservative due to market conditions (Bloom, 2009, 2014). Based on the risk premium effect of capital under uncertainty, economic policy uncertainty increases financing costs and weakens the marginal rate of return on capital (Tan and Zhang, 2017), making it impossible for companies to initiate mergers and acquisitions.

On the other hand, rising economic policy uncertainty prompts acquirers to make merger and acquisition decisions. First, economic policy uncertainty affects option value. Based on the growth option theory, higher economic policy uncertainty increases the identifiable merger and acquisition synergies, which encourages companies to make merger and acquisition decisions. Due to China's highly competitive environment, it is more appropriate to explain the reasons for mergers and acquisitions in enterprises under economic policy uncertainty based on growth options (Gadiesh, 2008). Based on the theoretical logic of the growth option theory, the acquirer can identify higher synergies under economic policy uncertainty, that is, when opportunities appear in the future market, the acquirer (option holder) can exercise the right to convert the synergies brought by mergers and acquisitions into market advantages, such as producing a new generation of products through horizontal mergers and acquisitions, opening up new markets through mixed mergers and acquisitions, etc. At the same time, the cost paid is fixed. It can be said that economic policy uncertainty increases the marginal benefits that can be obtained from successful mergers and acquisitions, and the returns increase significantly based on the long-term perspective. Therefore, economic policy uncertainty promotes the acquisition synergies identified by the acquirer. The best choice is to bear the risk of economic policy uncertainty and execute the merger and acquisition decision. Secondly, economic policy uncertainty affects the willingness of enterprises to merge and acquire. First, the higher the economic policy uncertainty, the lower the probability of changes in corporate executives. Stable management is conducive to better development of enterprises. Management will believe that they will not be at risk of being fired, thereby increasing the risk-bearing capacity of enterprises. Second, in order to avoid the possible uncertainty brought about by the new policy orientation and implementation effect affecting the sustainability of the company's endogenous growth, companies seize the market or enter new markets through mergers and acquisitions to achieve strategic transformation and enhance their risk resistance. In order to better develop and avoid the impact of policy changes on their industry, companies may strengthen their leading advantages in the industry through horizontal and vertical mergers and acquisitions, or enter new fields through mixed mergers and acquisitions.

Based on theoretical analysis, economic policy uncertainty has multiple impact mechanisms on corporate merger and acquisition decisions, and will lead to different results. Therefore, based on the above analysis, this paper proposes the following competitive hypotheses:

H1: The increase in economic policy uncertainty inhibits companies from making merger and acquisition decisions.

H2: The increase in economic policy uncertainty promotes companies to make merger and acquisition decisions.

3. Data, Variables and Methodology

3.1. Data

This research analyzes a dataset which includes Chinese M&As announced over the period of January 2014 to December 2018. The dataset is collected from China’s Stock Market and Accounting Research database (CSMAR). The acquirers included in this study are all public firms,

while there is no limitation on the targets which could be public, private, or subsidiary firms. Following Golubov et al. (2012)'s study, we exclude the deals classified as bankruptcy acquisitions, liquidations, leveraged buyouts, privatizations, repurchases, restructurings, reverse takeovers and going private transactions as we are interested in the transactions which can represent a transfer of control. We are interested in the transactions which can represent a transfer of control, so we exclude some deals following Golubov et al. (2012)'s study. In order to have controls over deal characteristics, the M&As dataset must include information on complete deal status. Filtered by these requirements, in total, there are 4188 M&A deals left in the test period.

3.2. Variables

In order to solve the research problem of this paper, the variables are defined as follows.

(1) Dependent variable

M&A decision: A dummy variable indicating that the acquirer decides to initiate a merger. Drawing on the research methods of Caiazza et al. (2016), if the company has at least one merger in the year, it takes 1; otherwise, it takes 0.

(2) Independent variable

The EPU index: This paper uses the China Economic Policy Uncertainty Index compiled by Huang and Luk (2020) to measure. Huang and Luk (2020) constructed an overall economic policy uncertainty index for China based on the text of mainland Chinese newspapers. The index selected ten mainland Chinese newspapers through the electronic newspaper information database provided by Wisenews: Beijing Youth Daily, Guangzhou Daily, Jiefang Daily, People's Daily (Overseas Edition), Xinwen Morning Post, Southern Metropolis Daily, Beijing News, Jinwanbao, Wenhui Daily and Yangcheng Evening News. The frequency of articles containing economy, uncertainty and policy was recorded with reference to the method of Baker et al. (2016). This paper follows the approach of Wang et al. (2014), converts the monthly data into annual data by taking the arithmetic mean, and divides it by 100 to obtain the annual economic policy uncertainty index. Because the decision-making of mergers and acquisitions is not made overnight and takes a lot of time, the index of the year before the merger is used for measurement.

(3) Control variables

In order to control other factors that affect merger and acquisition decisions, such as company characteristics, this paper refers to existing studies to study the variables that may affect merger and acquisition decisions, including company financial characteristics and corporate governance characteristics, and shrinks the continuous variables in the above control variables at the 1% level.

Table 1. Definition and description of main variables

Category	Variable Symbol	Variable Name	Variable Definition
Dependent	Decision	M&A Decision	Takes 1 if the firm initiates a merger or

Variable			acquisition in the given year, 0 otherwise.
Independent Variable	EPU	Economic Policy Uncertainty	Annual indicator calculated as the arithmetic average of monthly EPU indices in the year prior to the M&A, divided by 100.
Control Variables	Size	company size	Ln(Number of employees+1)
	Lev	capital structure	Total liabilities/ Total assets
	Roa	Return on assets	Return on assets = net profit after tax / total assets
	BM	Book-to-Market Ratio	Total assets divided by (market capitalization of the stock × 1,000).
	Growth	Growth rate of sales	Sales- sales / sales
	Board	Board size	Ln(Number of directors+1)
	INdep	Proportion of independent directors	Number of independent directors /Number of directors
	State	Ownership Nature	Takes 1 if the firm is state-owned, 0 otherwise.

3.3. Empirical model

The empirical model is shown in model (1). Given that the M&A decision is a binary variable, the Probit model is used for estimation. Among them: i represents the enterprise, t is the year, is whether the i company has an M&A in year t; EPU is the economic policy uncertainty in the year before the M&A; is other control variables that affect the M&A decision; is the corresponding estimated coefficient of each variable; INDUSTRY is an industry dummy variable, according to the latest version of the China Securities Regulatory Commission's industry classification standards in 2012; refer to the method of Nguyen and Phan (2017), given that the independent variable is an annual variable, only the industry fixed effect is controlled.

$$Decision_{i,t} = \beta_0 + \beta_1 EPU + \beta_n \sum Controls_{i,t-1} + \sum INDUSTRY + \varepsilon_0 \quad (1)$$

4. Results

4.1. Descriptive Statistics

Table 2 reports the descriptive statistics of each research variable. The correlation coefficients between variables are all less than 0.65, which meets the requirements. The high significance indicates that the model does not have serious multicollinearity interference and the control variables are reasonably selected.

Table 2. Descriptive statistics of variables

Variable	Observed	Mean	SD	Minimum	Maximum
Decision	30037	0.290758	0.454116	0	1
EPU	30037	1.301384	0.290791	0.759958	1.657432
Size	30037	22.02444	1.239267	19.59805	25.83009
Lev	30037	0.460083	0.198649	0.062455	0.8869212
Roa	30037	0.040611	0.056805	-0.17534	0.21202
BM	30037	1.043784	0.962224	0.105536	5.420781
Growth	30037	0.195782	0.456768	-0.5745	3.020718
Board	30037	2.167177	0.20225	1.609438	2.70805
Indep	30037	0.368045	0.051912	0.272727	0.5714286
State	30037	0.229351	0.420419	0	1

4.2. Regression Results

Table 3 reports the regression results of economic policy uncertainty on corporate M&A decisions. It can be seen from the table that the regression coefficient of economic policy uncertainty EPU is -0.046, which is significantly negative at the 1% level, that is, if the policy uncertainty is high in this year, the possibility of corporate M&A in the next year is small, indicating that the economic policy uncertainty in the previous year will reduce the M&A decision of the company in the next year. This result verifies hypothesis H1. The marginal effect of EPU obtained by the margins command in Stata is -0.00096, indicating that for every 1 percentage point increase in economic policy uncertainty, the possibility of corporate M&A decreases by 9.6 percentage points.

Table 3. Regression Results for EPU on M&A decision

	Decision
EPU	-0.046***
	[-5.08]
Size	0.131***

	[21.37]
Lev	0.399***
	[10.74]
Roa	0.528***
	[4.59]
BM	-0.118***
	[-14.70]
Growth	0.133***
	[11.02]
Board	-0.330***
	[-10.26]
Indep	-0.686***
	[-5.70]
State	-0.142**
	[-1.55]
INDUSTRY	YES
_cons	-2.484**
	[-2.96]
N	30037
adj. R2	0.0499

Note: The values in brackets are t values, * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

5. Discussion

Risk-taking refers to the choice of the expected return level and the degree of willingness to bear losses when making investment decisions. It indicates the willingness and ability of enterprises to bear uncertainty and reflects the willingness and tendency of enterprises to pay the price when pursuing high profits (Lumpkin, 1996). With the development of research, the connotation of corporate risk-taking has continued to develop, including more diverse management decisions, and has become a manifestation of managers' reasonable control of risks

and optimization of corporate decisions. The uncertainty of economic fundamentals will significantly change the risk preferences of economic entities (Bekaert et al., 2009), and the increase in economic policy uncertainty increases the uncertainty of corporate economic fundamentals. It can be inferred that economic policy uncertainty can change the risk preferences of economic entities. The existence of the risk aversion effect of corporate investment makes risk-taking a possible path for economic policy uncertainty to affect corporate behavior (Bloom, 2009). Companies with low risk-taking will only make M&A decisions when they identify higher synergies. Therefore, economic policy uncertainty affects M&A decisions by affecting corporate risk-taking. Most existing literature measures corporate risk-taking through the volatility of corporate profits (Boubakri et al, 2013), but the volatility of corporate profits is the result of risk-taking and is based on a rearview mirror perspective. At the same time, other factors in the macro environment will also affect the volatility of corporate profits. Therefore, corporate risk-taking measured by the volatility of corporate profits cannot test the impact path of economic policy uncertainty on M&A decisions.

Corporate risk-taking is a variety of management methods for managers to reasonably control risks and optimize corporate decisions. Its essence is a choice of investment (Hilary and Hui, 2009). Behavioral finance theory believes that social individuals generally have an overconfident psychological bias (Taylor and Brown, 1988; Yu et al, 2006; Jiang et al, 2009). Overconfident managers are likely to bring more risk-taking to the company (Baker et al, 2012). Overconfident managers choose active investment strategies under stronger risk preferences, thereby increasing the company's risk-taking level. Therefore, this section selects the pre-factor that affects corporate risk-taking—management overconfidence—as a proxy variable for corporate risk-taking to test the impact path of economic policy uncertainty on M&A decisions.

Overconfidence will affect companies' M&A decisions. Management overconfidence makes them overestimate their abilities and importance to the company, and they believe that they will not be at risk of being fired in the case of economic policy uncertainty, thereby increasing the company's risk-taking capacity and willingness to make riskier investments, such as innovation, mergers and acquisitions, etc. From the perspective of risk response, in order to avoid the adverse effects of new policy orientations and implementation effects on the sustainable endogenous growth of enterprises, companies will enter new markets or consolidate existing markets by initiating mergers and acquisitions to resist possible risks. However, overconfident managers will ignore negative news in mergers and acquisitions. This overconfidence also makes it impossible for management to objectively evaluate the benefits of mergers and acquisitions (Malmendier and Tate, 2008; Malmendier and Nagel, 2011), ignoring risks and insisting on implementing M&A decisions.

Economic policy uncertainty is a macro environment, and managers, as social individuals, are also affected by the external environment. Managers' overconfidence is not static. Individuals will deal with external changes based on the limited information and capabilities they have, and form subjective expectations for the future. This expectation will react to form managers' confidence, thereby affecting whether they make M&A decisions. Therefore, this section examines whether the path of "economic policy uncertainty affects M&A decisions by affecting corporate risk-

taking" is established by testing whether the mediating effect of management overconfidence exists.

This article refers to the research of Tang et al. (2017) and uses the executive shareholding change index to measure executive overconfidence (OC) after excluding objective reasons such as additional share issuance and equity incentives. In order to test whether the mediating effect of executive overconfidence is established, shareholding changes should occur before the merger, but it is difficult to match the time of company announcements and the time of executive shareholding changes one by one. This article uniformly examines the explanatory variables in the year before the announcement of the merger. That is, if the executive still increases his holdings of the company's stock when the basic earnings per share growth rate in the previous year is negative, the value is assigned to 1, representing overconfidence, otherwise it is 0.

Based on the test method proposed by Wen et al. (2004), this paper constructs the following model to verify whether the mediation effect exists:

$$Decision_{i,t} = \beta_0 + \beta_1 EPU + \beta_n \sum Controls_{i,t-1} + \sum INDUSTRY + \varepsilon_0 \quad (2)$$

$$OC = \gamma_0 + \gamma_1 EPU + \gamma_n \sum Controls_{i,t-1} + \sum INDUSTRY + \varepsilon_0 \quad (3)$$

$$Decision_{i,t} = \delta_0 + \delta_1 EPU_{t-1} + \delta_2 OC + \delta_n \sum Controls_{i,t-1} + \sum INDUSTRY + \varepsilon_0 \quad (4)$$

The regression results based on the mediation effect test procedure are as follows. First, column (1) of Table 4 lists the regression results of the premise estimation model (2), that is, the regression coefficient of economic policy uncertainty EPU is significantly negative at the 5% level. Secondly, column (2) lists the impact of economic policy uncertainty EPU on the mediating variable OC in the estimation model (3), that is, whether economic policy uncertainty affects management overconfidence. The regression coefficient is not significant. At this time, a further Sobel test is required. Table 5 reports the results of the Sobel test. The Sobel test P value of the mediating effect is less than 0.1, indicating that the mediating effect of management overconfidence exists. This shows that economic policy uncertainty can affect managers' M&A decisions by "shaping (suppressing)" their psychological emotions of overconfidence. Therefore, the path of "economic policy uncertainty affects M&A decisions by affecting corporate risk-taking" is established.

Table 4. EPU, Managers overconfident and M&A decision

	(1)	(2)
	Decision	OC
EPU	-0.046**	-0.042
	[-2.08]	[-1.29]

Size	0.131***	0.028***
	[21.37]	[3.25]
Lev	0.399***	-0.797***
	[10.74]	[-15.23]
Roa	0.528***	0.905***
	[4.59]	[5.67]
BM	-0.118***	0.117***
	[-14.70]	[10.42]
Growth	0.133***	0.005
	[11.02]	[0.26]
Board	-0.330***	0.006
	[-10.26]	[0.12]
Indep	-0.686***	0.313*
	[-5.70]	[1.90]
State	-0.142***	-0.243***
	[-9.55]	[-10.74]
INDUSTRY	YES	YES
_cons	-2.484***	-1.988***
	[-16.96]	[-9.38]
N	28183	28183
adj. R2	0.043	0.0316

Note: The values in brackets are t values, * p < 0.1, ** p < 0.05, *** p < 0.01

Table 5. Sobel Test

	Coef	Std Err	Z	P>|Z|
Sobel	0.00154916	0.00031077	4.985	6.201e-07
Goodman-1 (Aroian)	0.00154916	0.00031217	4.963	6.955e-07
Goodman-2	0.00154916	0.00030938	5.007	5.518e-07

	Coef	Std Err	Z	P>|Z|
a coefficient =	0.027055	0.004423	6.11637	9.6e-10
b coefficient =	0.05726	0.006656	8.60255	0
Indirect effect =	0.001549	0.000311	4.98484	6.2e-07
Direct effect =	0.029887	0.006993	4.2735	0.000019
Total effect =	0.031436	0.006996	4.4936	7.0e-06
Proportion of total effect that is mediated:	0.0492801			
Ratio of indirect to direct effect:	0.05183451			
Ratio of total to direct effect:	1.0518345			

6. Conclusions

Economic policy uncertainty inhibits corporate M&A decisions. Through the test of the mediating effect of management overconfidence, the establishment of the mediating effect shows that economic policy uncertainty has a "shaping" effect on managers' overconfidence. A high level of economic policy uncertainty can "shape" (inhibit) managers' overconfidence and thus affect their M&A decisions. Therefore, the path that "economic policy uncertainty inhibits M&A decisions by affecting corporate risk-taking" is established.

Author Contributions:

Conceptualization, W. C.; methodology, W. C.; software, W. C.; validation, W. C.; formal analysis, W. C.; investigation, W. C.; resources, W. C.; data curation, W. C.; writing—original draft preparation, W. C.; writing—review and editing, W. C.; visualization, W. C.; supervision, W. C.; project administration, W. C.; funding acquisition, W. C. All authors have read and agreed to the published version of the manuscript.

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