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2 October 2019

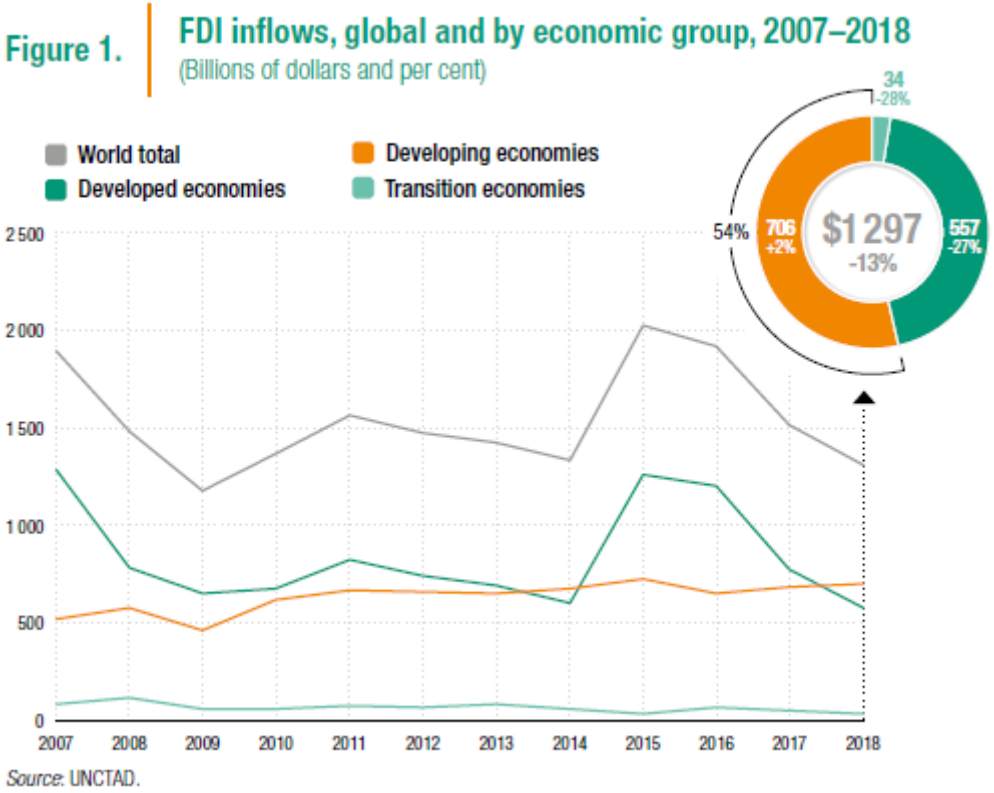
POSTGRADUATE MODULE ECM120
THE ECONOMICS OF
THE MULTINATIONAL ENTERPISE

Definitions

- The Multinational Enterprise (MNE) as “ a firm which owns or controls value-adding activities in two or more countries”.
- Value-added activities
- Two or more countries
- “own or control”
- MNE theory encompasses many factors of production
- Foreign Direct Investment (FDI) versus portfolio investment: Control central in the distinction: FDI includes lasting interest in an overseas operation+ effective voice in management (from the part of the investor)//portfolio -----share in profits

Global Trends: UNCTAD, 2019

- Global foreign direct investment (FDI) flows continued their slide in 2018, falling by 13 per cent to $1.3 trillion (figure 1). The decline – the third consecutive year's fall in FDI – was mainly due to large-scale repatriations of accumulated foreign earnings by United States multinational enterprises (MNEs) in the first two quarters of 2018, following tax reforms introduced in that country at the end of 2017.

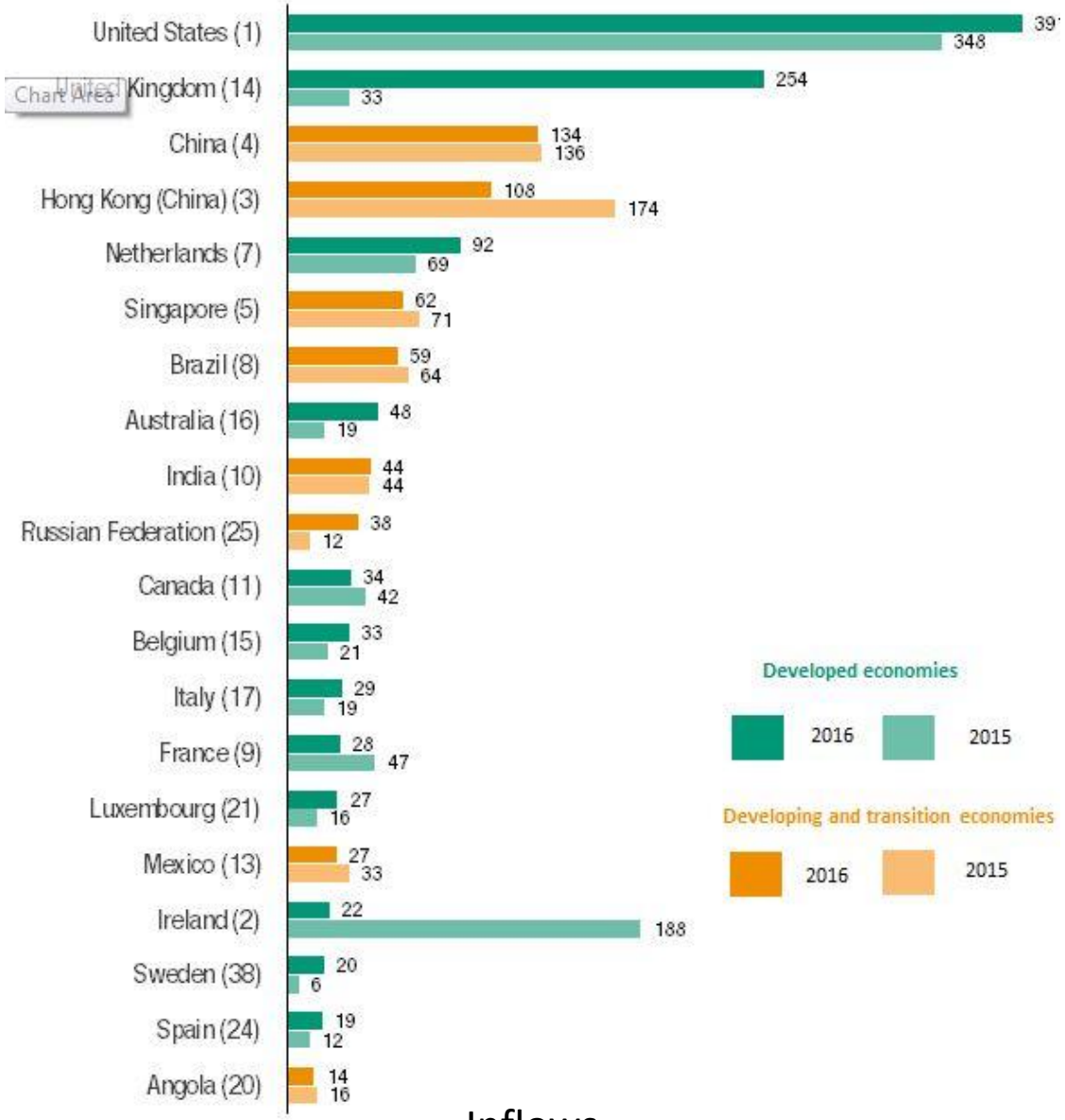


Host region	1914	1938	1960	1990
Developed countries	37,2%	34,3%	67,3%	71,8%
Developing countries	62,8%	65,7%	32,3%	28,1%

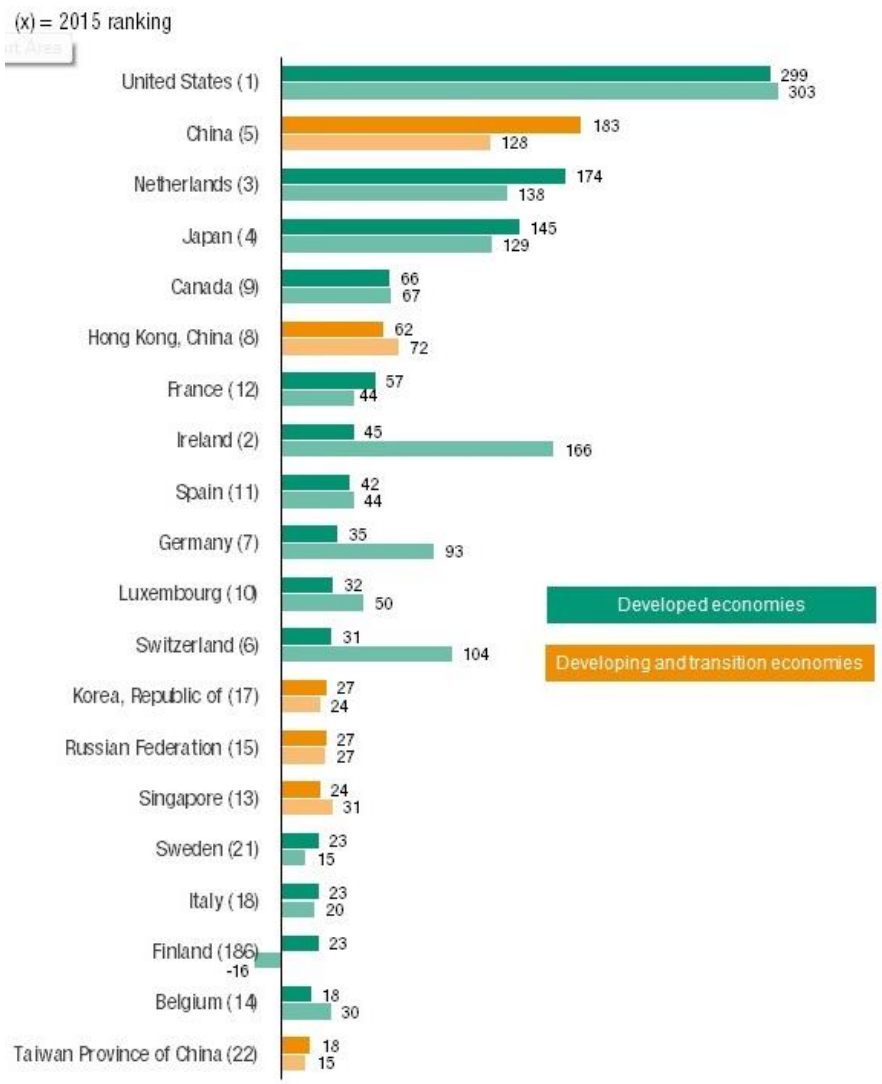
Source: Ietto/Gillies (2005) adapted from table 2.3 page 30

The historical evolution of FDI

Inflows and outflows of FDI: Top countries UNCTAD. Source: UNCTAD, World Investment Report 2017.

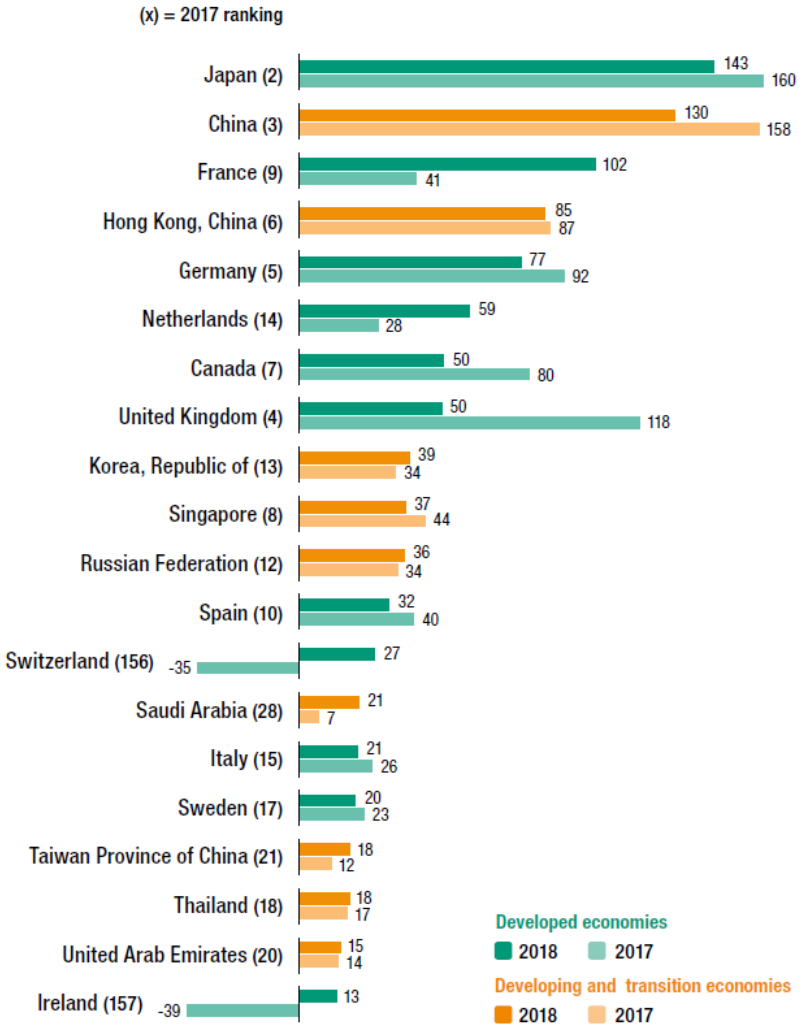


Inflows



Outflows

Figure 3. **FDI outflows, top 20 home economies, 2017 and 2018**
(Billions of dollars)



Stephen Hymer

- PhD thesis 1960
- Limitations of the macro-level theories of FDI
- FDI------capital flow from low return-on capital country to high profitability countries
- Developed versus Developing countries

- MNE as a micro agent that transfers capital and other productive factors

Theory of Relative Factor Endowments (Heckscher-Ohlin) Heckscher (1919)-Ohlin (1933) Theory

- **Factor endowments vary among countries**
- **Products differ according to the types of factors that they need as inputs**
- **A country has a comparative advantage in producing products that intensively use factors of production (resources) it has in abundance**
- **Factors of production: labor, capital, land, human resources, technology**

Hymer (1)

<u>From a macro-level theory of FDI to a micro-level theory of the MNE.</u>

The macro theory of FDI predicted FDI would flow from capital-rich developed economies to capital poor less-developed economies. Reflected the reality of the half-century up to 1914.

In retrospect we can now explain that reality better using aspects of OLI.

Based on his research in the 1950s, Hymer demonstrated ways in which the macro-level FDI theory did not work. Four are relevant here.

1. **The dominant FDI flows were two-way across the Atlantic. Between capital-rich economies.**
2. **Most developed economies both *made* and *received* FDI.**
3. **There was an *industry*-level influence. Some industries were much more prone to generate FDI than others.**
4. **Some acts of FDI were financed in the host country. There were no cross-border capital flows.**

Thus Hymer turns the analytical focus to the firm- and industry-level.

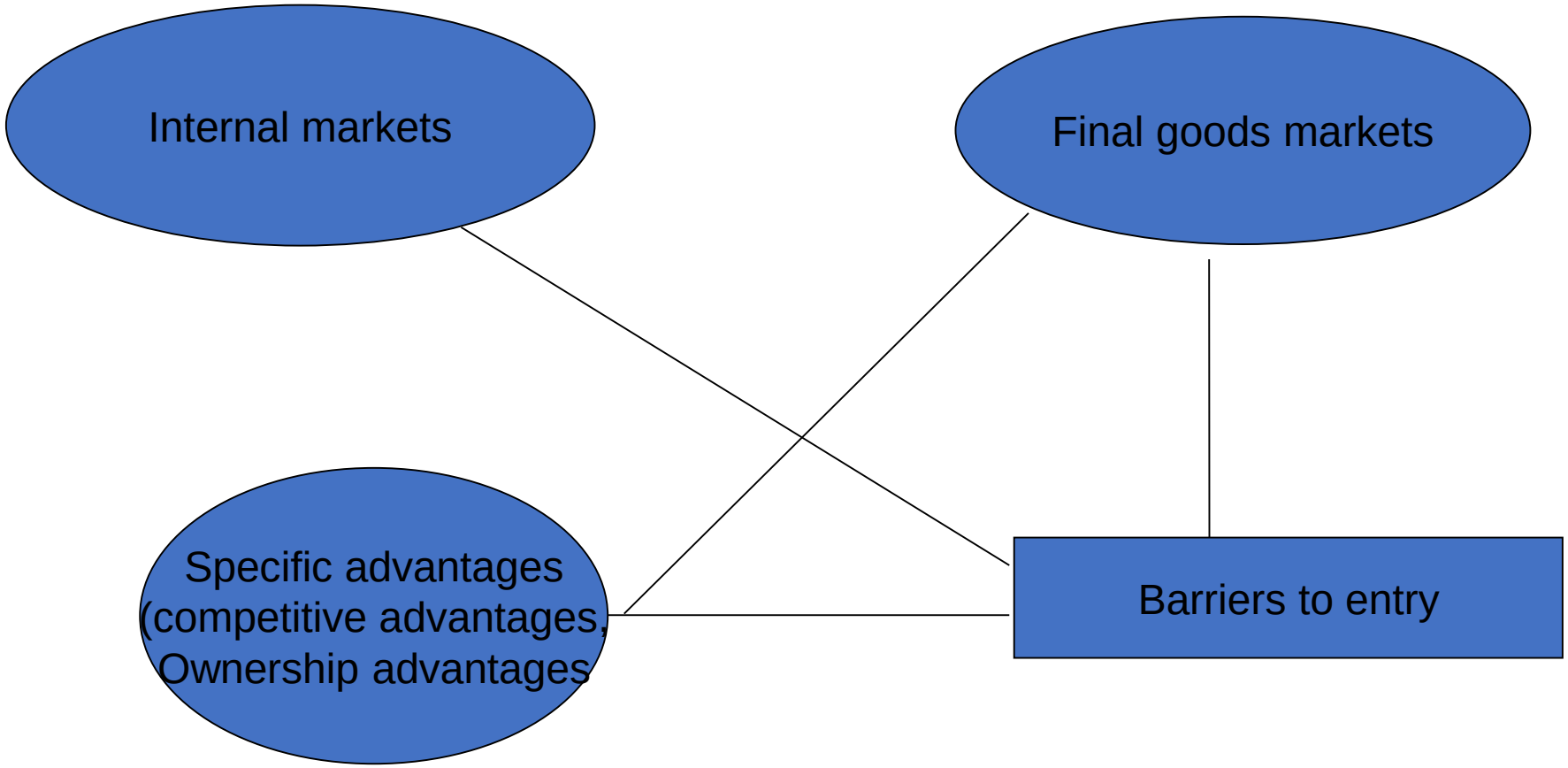
Bain, Joe 1956 (Bain, J. S. (1956). *Barriers to new competition* Cambridge, MA: Harvard University Press.)

- Barriers to entry-
- Product differentiation (advertising, patents, R&D)
- Absolute cost advantages (past experience, patents, secret production processes, access to cheaper financing)
- Economies of scale--- discourage new entrants who might think of entrance with small scale…

- See also: Buckley, P. J. (2011). The theory of international business pre-Hymer. *Journal of World Business*, *46*(1), 61-73.

Market imperfections

- Two types



Lead to

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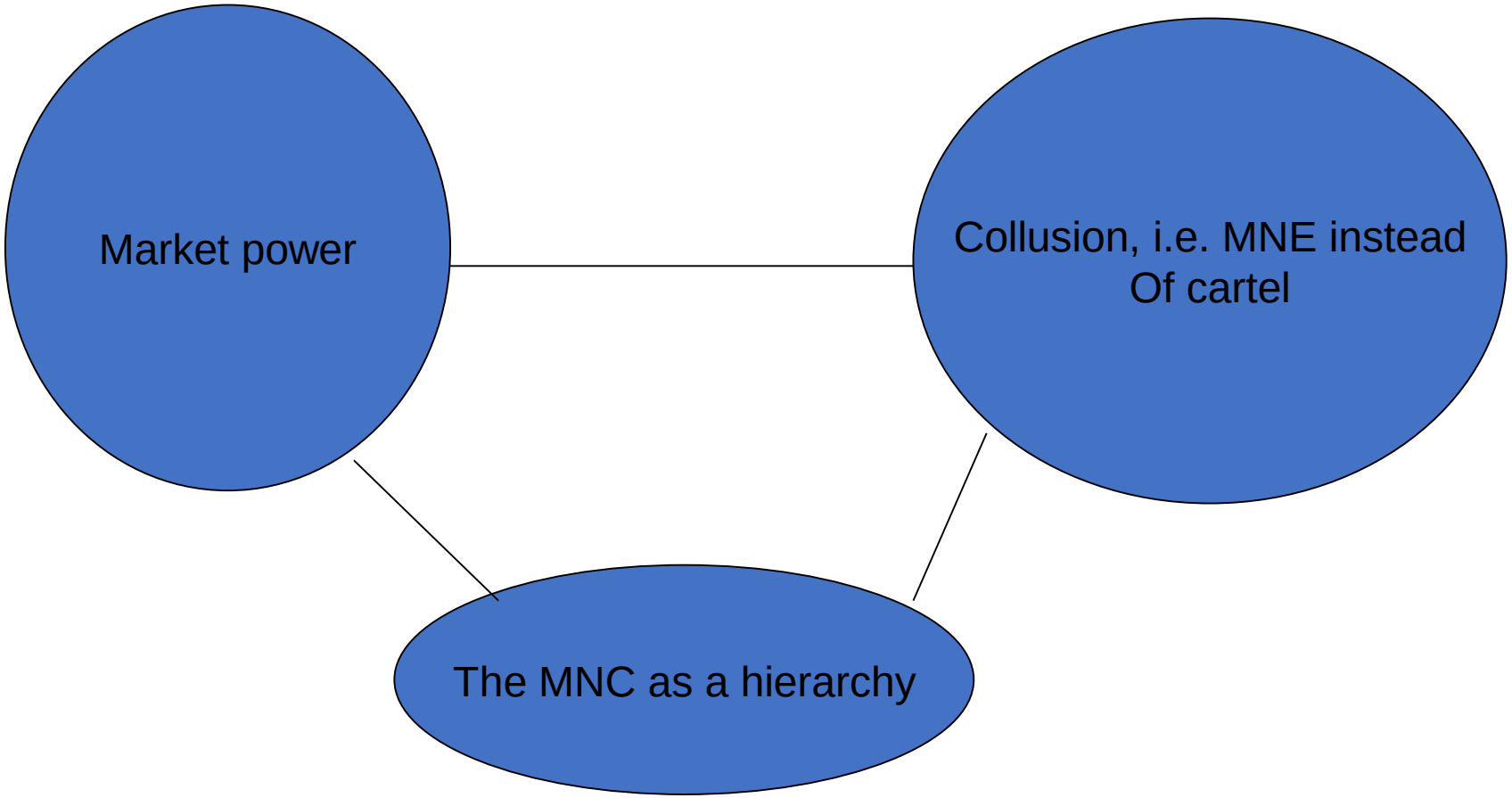
Market power
Collusion, i.e. MNE instead
Of cartel
The MNC as a hierarchy

Hymer (2)

<u>Concentrated industries and ownership advantage.</u>

The OA strand of OLI proves that MNEs cannot exist in perfectly competitive *final product* markets.

The most useful demonstration of this then relates them to concentrated market structures and oligopoly.

Pre-FDI a national industry is dominated by a very small number of very large firms, each of which makes a healthy level of profits. Due to oligopoly forces they forego any aggressive competitive moves. They also feel immune to the entry of new *domestic* competitors as they possess 'barriers to entry' (Bain, 1956).

Analytically here these ‘barriers to entry’ will become OAs in IB thinking. Their essential characteristic is that they are expensive to create and inexpensive to use once possessed. Major examples are:

1. Technology.
2. Top level management teams, structures and practices.
3. Marketing abilities, distribution networks and reputation.

The likelihood of a newly created domestic entrant emerging is considered implausible by the incumbent oligopolists.

But the industry also exists in another country where its established firms have made these fixed-cost expenditures and have fully-formulated competitive advantages. One of these can decide to initiate FDI by using these advantages (OAs) to enter the first economy.

The costs of doing this are not negligible. Technology will need to be adapted and locally-focused management, marketing and distribution set up. But the firm brings genuinely original perspectives in the economy. It can build secure bases and share in the industry's profitability – as an MNE.

Now the cosy oligopoly is disrupted. How can it respond? A more adventurous firm decides its advantages can be used as OAs and it can retaliate by entering the aggressor's own domestic market, and undermine *its* profitability there. Other firms from both economies then feel a need to follow these moves and penetrate the other economy.

The industry now becomes a two-country one that is integrated by its firms having become MNEs.

We have two-way flows of FDI between very similar economies – which Hymer said we needed to explain.

Definition revisited

- Liability of foreignness
- Embeddedness

- MNE are viewed as “a coordinated system or network of cross-border value-creating activities, some of which are carried out within the hierarchy of the firm, and some of which are carried out through informal social ties or contractual relationships”

Cantwell, J., Dunning, J.H., and Lundan., S.M. (2010). An evolutionary approach to understanding international business activity: The co-evolution of MNEs and the institutional environment. *Journal of International Business Studies* 41: 567-586.