SCHOOL OF ECONOMICS
POSTGRADUATE MODULE ECM120
THE ECONOMICS OF
THE MULTINATIONAL ENTERPISE

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- Lecture 3a

Ownership advantages

- First element of Dunning's eclectic framework
- Much of the theorizing derives from Hymer's work
- Builds on the argument that for a company to become an MNE needs some kind of unique competitive advantage

A two model approach:

- Model 1a: MNEs cannot exist in perfect competition

MNEs can exist only in imperfectly competitive markets

We then assume:

1. An industry exists in two countries (A and B) and in both it conforms with perfect competition. This means that there is a large number of small firms using exactly the same technology to sell the same product.
2. They charge the same price and face the same costs
3. In industry equilibrium they make <u>normal</u> profits
4. Firms in A are identical to firms in B
5. Under perfect competition there is no OA.

Model #1: continued

6. Institutional aspects of A and B differ. As Hymer argues there are costly disadvantages to be foreign.

7. Something (e.g. transport costs, trade restrictions) totally excludes trade between A and B. (this is a so called “negative” location “advantage”).

8. Assume , there is a rise in demand in B so D>S..this will lead temporarily to supernormal profits thus new firms enter the industry..until eventually D=S, so price falls and profits return to normal.

Question:

- Will new firms entering industry in B come from A?
- Answer is NO: As profits will return to normal additional firms from B will cover their costs, however, firms from A will have to close down as they will face the costs of an unfamiliar environment (cost of disadvantage of foreigness) as they possess no OA.

Model 1b: Imperfect competition

- Many small firms competing but no identical products
- The goods provide consumers with the same service (e.g. soap) but differ in small ways.
- Some firms are more successful than other, many survive.

League Table of Success

- In both countries there are a few “star” firms with a top share of the market (e.g. 6% or 7%).
- Then several middle ranking firms with a smaller share (e.g. 3% or 7%).
- A large tail of marginal firms survive with a very small share of the market (e.g. 1%).
- The source of differentiation among these firms is the strength of the OA being technological superiority, or management skills, or marketing ability, etc.)

Question (revisited):

- Assume demand in B increases and supernormal profits are available:
- Then maybe top league firms from A, may enter B's market and survive. May not be successful against the top league firms of B but may be more successful against the middle or low league firms of B.
- As Hymer argued, the powerful Oas of firms from A will help them against the disadvantage of being foreign.
- Thus, they can become MNEs.
- Two complementary conditions:

1. To become an MNE a firm must possess some unique type of OA
2. MNES can emerge when market is less than perfectly competitive. Thus, MNEs exist where final product markets are imperfect

Model 2: Concentrated markets

- Previous model shows that MNEs may exist when market moves from perfect to imperfect competition.
- Hymer, nevertheless, argued that MNEs are “product” of highly imperfect markets.
- Assumptions of model 2:

1. In a particular country industry is dominated by a very small number of very large and profitable firms (3-4).
2. There are <u>barriers to entry in that particular industry.</u>
3. Real costs of creating barriers to entry are now sunk costs

e.g. in technology creation, management teams.

Oligolopolistic competition

Challenges to overcome

- Of course the marginal costs here will be far from negligible.
- The successful technologies may need to be adapted to adjust the goods and services to the tastes and regulations of the new host country
- Culturally-sensitive marketing and distribution procedures may also require adjustments to the firm’s accepted norms it is still likely to build on proven practices and an established reputation that goes before it.

Reciprocating

- We can now take this a step further, assume a firm from the second economy does enter the first and is able to quite quickly reveal itself as representing the type of new challenge that the incumbent firms had believed their ‘barriers to entry’ to preclude. Now these incumbents do need to address this new and very radical challenge.
- One logical way of doing this is, as suggested, to also see the strengths that previously constituted their barriers to entry as now being potential OAs. They can see themselves as in a new competitive context, where a plausible direct response to the new challenger is to enter *its* home domestic market and seek to undermine its profitability there.

Reciprocating

- But now other firms from *both* markets may feel challenged by this new mode of internationalised competitive aggression and feel the imperative to extend the viability of their OAs by expanding into the ‘foreign’ economy.
- From a pair of initially complacent and competitively-reserved domestic industries we now have an internationalised two-nation oligopoly populated by a still small number of big firms (now MNEs), that have been provoked into major new dimensions of proactive competitiveness.

Different types of OA

- Dunning ‘asset-based advantages’ (OA_a) which “come from ownership or access to income-generating assets” and ‘transactional advantages’ (OA_t) reflecting “the MNE’s ability to coordinate these assets with other assets across national boundaries in ways that created competitive advantage” .
- For Dunning and Lundan (2008, 100) ‘asset-specific advantages’ (OA_a) are those “that arise from the possession of particular intangible assets” which can be distinguished from ‘transaction cost-minimising advantages’ (OA_t) “that arise from the ability of a firm to coordinate multiple and geographically dispersed value-added activities and to capture the gains of risk diversification”.

FIGURE 1
The Endowment/Market Failure Paradigm of International Production