

Why and how do firms become multinational economics essay



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The term multinational consists of two different words, 'multi' and 'national'. Multi means many while the word national refers to nations or countries. Therefore a multinational company means a company that has head quarters in one country but which has operations in one or more countries.

While examining the emergence and evolution of Multinational Enterprise (MNEs), it is clear that MNEs rapidly spread since the Second World War due to investments in resource based activities and import substituting manufacturing in South East Asia. Before the World War, MNEs were limited to the U. S which accounted for not more than 18 percent of the global stock of outward FDI in 1914, that was a share much lower than that of the largest home country, UK with more than 45 percent(Dunning, 1983)

Analysing why do firms become multinational:

The determinants for firms to become multinational are viewed relative to respective country's absolute (Adam Smith, 1776) and comparative advantage (David Ricardo, 1817). The former advantage states that the country should have a strong capability to deliver a good or service whereas the latter states that it should be superior to the same good or service produced in other country.

To protect themselves from the risks and uncertainties of the domestic business cycle; if the economy of the country is slow or demand is falling down in one country and chances are there to succeed in another country. By setting up operations in another country, multinational companies can diminish the negative effects of economic swing in the home country. It is <https://assignbuster.com/why-and-how-do-firms-become-multinational-economics-essay/>

widely used by Japanese as it is a form of international diversification, for example Japanese MNEs have found that their home economy has been in economic slump since 1990s but their US operations have done quite well.

Increasing worldwide demand for goods and services. For example many MNEs have targeted United States because of its large population and high per capita income. In 2001, china entered world trade organization and this was accepted by the market and made China more attractive for MNEs. By setting up operations close to the foreign customer, these companies can reduce transportation cost, avoid overhead expenses such as charges of having intermediaries to handle the product and take advantage of local resources. This process is known as “ internalization” of control.

Firms become MNEs to increase foreign competition and a desire to protect their home market share. Using a “ follow the competitor” strategy, a growing number of MNEs set up operations in the home countries of their major competitors..

It is a chance to take advantage of technological expertise by manufacturing goods directly rather than allowing others to do it under a license agreement. In recent years some MNEs have concluded that it is unwise to give another firm access to proprietary information such as patents, trademarks, or technological expertise and they have allowed current licensing agreements to lapse.

Another main reason is Foreign Direct Investment (FDI) which is a major index for the growth of multinational enterprise and as a mixture of

Greenfield investment, mergers and acquisition, therefore FDI acts to <https://assignbuster.com/why-and-how-do-firms-become-multinational-economics-essay/>

transitory business cycles. “ The aggregate stock of FDI in the world economy has doubled to more than 10percent of the total output within the last two decades, therefore within this rising trend there are several regional features deserving attention”. (Barrel and Pain, 1997)

FDI in eastern Europe has gained advantage of acquiring access to high levels of technological expertise and chances of gaining from the wider diffusion of technological exchange associated with the single European Market(Bora, 2002)

Firms become multinational in order to take advantage of lower labour costs that results from the firms enhanced ability to ‘ divide and rule’: by producing in various countries firms divide their workforce, thereby obtain lower labour cost. As capitalist open up new markets overseas, they also locate production facilities overseas, particularly in colonies or former colonies (Helpman, 1985). After all, where labour costs are lower than in the home countries of the MNEs, thereby minimizing returns to labour and maximizing profits.

“ Efficiency-seeking FDI is to rationalize the structure of established resource based or market seeking investment in such a way that the investing company can gain from the common governance of geographically dispersed activities.” (Dunning, 2008). The intention of efficiency-seeking MNE is to take advantage of different factor endowments, cultures demand patterns, economic policies and market structures by concentrating production in a limited number of locations to supply wide markets.

Market seeking firms will invest in foreign markets when the local markets are saturated. These firms go multinational in order to maintain the growth level of the firm when the competitor has moved to foreign market and thus local demand and needs for the same products will be satisfied.

Strategic asset seeking firms invest in assets for the planning and review of the company. These investments are basically based on research and development and usage of new technology for the development of new products, hence achieve long term goals by MNEs.

The other reasons for any firm to go multinational are the three types of advantages benefiting a multinational corporation are ownership specific, internalization specific and location specific advantages. Ownership specific advantages are property rights or intangible assets, including patents, trademarks, organizational and marketing expertise, production technology that form the basis for a company's advantage over other firms.

Internalization specific advantages include support from government regulations and laws, compensate for the future markets. Location specific advantages include access to raw materials, cheap labour, technology and infrastructure in order to carry out business operations smoothly.

Analysing how do firms become multinational: .

Basically how a firm becomes multinational is through the means and ways of FDI. FDI refers to an investment which is made to serve the business interests of the investor in a company, which is in a different nation distinct from the investor's country of origin. There are three types of FDIs, they are:

Horizontal, Vertical and diversified.

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Horizontal FDIs means the firm investing in the same industry abroad as that in which a firm operates at home, but in a foreign market. This means the overseas company which produces similar or same goods and services is taken over by the domestic firm and thus invest in these firms. Hence, product differentiation is the critical element of market structure for horizontal FDI

Vertical FDI is classified into two forms as Backward and Forward FDI.

Backward vertical FDI is an investment in an overseas company that provides inputs for a firm's domestic production processes. Forward vertical FDI occurs when an overseas company sells the outputs of a firm's domestic production processes, this is less common when compared to backward vertical FDI. For example, US car manufacturers found it hard to market their products in Japan because most of the Japanese car dealers have close and good relationships with Japanese car makers, therefore it was difficult for US to promote foreign cars. To prevail over this problem, American car dealers embarked on a campaign to establish their own network of dealerships in Japan to market their products.

In a conglomerate, one company owns a stake in a number of smaller companies, which conduct business separately. Each of a conglomerate's management businesses is worked independently of the other business divisions, but the subsidiaries management reports to senior management at the parent company.

Mergers and take over's are also a part of business expansion to attain a status of MNE. For example, Lakshmi Mittal – CEO of Arcelor Mittal., for

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example has moved his first step of expansion of his family business of steel by buying assets of a run out steel firm in Indonesia.

Joint venture is an agreement between two or more companies that share the ownership of a business undertaking. In case of Goodyear Tire and Rubber, it has involved in a 51 percent owned tier manufacturing joint venture with Pernos, a Malaysian company.

Licensing agreement is a right given by one company to another company to use their assets such as trademarks, copyrights, patents or know-how for a certain amount of fee. For example, U. S MNC has entered into joint venture with a chemical, rayon and other fibre manufacturer in Peru. Along with this agreement, the company negotiated a licensing agreement which states that royalty as a percent of the process and technology, and percentage of profits earned should be paid to the local partner.

Franchising is another common method for the firms to go international which involves little investment of capita, it is similar to licensing agreement. The franchiser is paid loyalty fees and also they receive a part of share of the company. Dominos, for example a franchising company has emerged as the largest food chain.

CONCLUSION

Today's MNEs success depends upon close relationship between domestic banks and FDI and wholly owned operations and their management. Future success will definitely involve international cooperation that aims to raise the overall competitiveness of domestic industries.

Therefore when we consider all the above reasons and causes ' why' and ' how' firms become multinational enterprise it can be said that the firms structure, objectives and goals, target market and ethical values of the firm are the main reasons.