Hymers micro level theory of multinational enterprise

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I will critically analyze Stephen Hymer’s contribution to the micro-level theory of Multinational Enterprise, especially on the concept of Ownership Advantage in his theory. Hymer raised debates on most important issue, what we call as ‘ globalisation’ today. He observed the changes around the world in different times within his short life of 39 years, and critically analyzed the situations in different market structures and reflected his ideas in his thesis. It was originally completed in 1960, but was only published in 1976. MIT refused to sponsor the publication, as the thesis seemed too simple and straightforward and said it lacked quantitative and analytical framework and seemed to be a mere ‘ ideology’. Despite all the arguments, Hymer’s contribution obtained a ‘ cult’ status in the context of International business studies. Most theorists like Buckley, Casson, Dunning and Rugman derived their ideas from Hymer’s work. By the time of his tragic death in a car accident in1974, Hymer published over 40 articles in top journals like American Economic Review, The Journal of Political Economy, The Review of Economics and Statistics and The Economic Journal.

Need for a Micro Level Theory

As per the macro-level theory of Foreign Direct Investment (FDI), industries in the developed countries will invest in developing economies, but labour intensive countries in order to maximise efficiency and profits at the same time. So, as per the theory, FDI can move only in one direction i. e. from developed to developing economies. But post Second World War, FDI was moving only between two major developed nations, US & UK. One thing to be noted in capital rich countries is there is availability of capital, but fewer opportunities to invest in and vice-versa in capital poor countries. Going by this, any country should either export or import FDI, but not do both at the same time. And if capital availability is the only factor, major investments must be made in almost all the industries. But only some industries like pharmacy, automobile and technology were attracting more FDI in different countries and sectors like construction, aviation were less successful. As per the macro level theory, FDI is concerned only with transfer of capital from capital rich countries to capital poor countries. But it was observed that many firms were raising capital from the financial markets overseas. This was again not compatible with the actual FDI theory.

As the existing macro-level theory was not able to explain and substantiate the actual situation around the world, Hymer suggested a micro-level theory at a firm level, emphasising that there are some other factors which are unrelated to capital appears to determine the firm level FDI decisions.

In his thesis, Hymer focused more on International production rather than International trade, deriving ideas from Coase's Nature of the firm (1937) which analyses firms in context of International activities and allocation of resources in various locations. Hymer also drew his ideas on the limitations

of the neo-classical FDI theory, suggesting that it was not sufficient to explain the movements and formation of MNEs around the world, and there seems to be some other factors driving firms to invest overseas.

Ownership Advantages

As per Hymer, Ownership advantage is one of the most important factors that would help a firm to grow and survive as an MNE. Hymer argued that traditional theory was based on the idea of perfectly competitive market, in which all the firms earn normal profits when there is equilibrium and earn super normal profits when there is an increase in the demand. Going by this, the foreign firms will earn super normal profits until that point, where the demand meets supply again. Once this happens, the foreign firms will be driven out of the business due to excess transactional costs of being foreign. Therefore, Hymer suggested that firms need to do something more that would offset the disadvantage of being foreign. As per Hymer, MNE’s can survive only in imperfect markets with firms having Ownership advantages compared to other firms in the same industry. This tells us that the driver of MNE’s lie within the firm, rather than capital availability of a country.

With the help of Hymer’s micro-level theory and Dunning’s eclectic frame work, we will observe different market situations and see how Hymer’s micro level theory demonstrates the importance of ownership advantages.

Perfectly Competitive market

Assume an industry exists in 2 countries (A& B) and in both, conforms to the conditions of perfect competition. This means that there are huge numbers

of firms that are using exact same technology to produce the same product. Therefore, all the firms in both the countries should charge the same amount to their customers and also face same costs of production. So in this case, all the firms in both the countries earn normal profits in industry equilibrium. Under these circumstances, no firm has an ownership advantage.

Though the industries in both the countries are identical and produce the same type of product, some institutional factors such as labour markets, legal framework will differ between both the countries. Hymer argues these factors are major contributors towards disadvantages of being foreign.

Now, assume something happens in country B and there is a sudden raise in the demand for the product. In this scenario, demand exceeds supply and firms charge higher prices to their customers and thus earn higher profits. Since the technology to produce the product is same in country A, firms in that country will enter the market in country B. With the new entrants in the market producing more of the same product, the supply will catch up the demand and the market will be driven back to equilibrium. Local firms in B will survive as they are familiar with the market conditions and normal profits will be sufficient for them in order to survive. But firms from country A will not survive this, as they will incur huge transactional costs of being foreign. They cannot compete with the local firms and will be forced to leave the market soon as they do not have firm-level ownership advantage.

Imperfectly Competitive market

Assume the same situation in countries A&B, but the market conditions are imperfect. Again there is large number of firms competing, but the product is

no longer identical. The products provide same kind of value to the end customers. Therefore, some customers are attracted to buy some products and others prefer cheaper products that would satisfy their needs. Thus, few firms are successful than others. The firms which are successful are distinguished by their strong ownership ad or advantages such as technology, product quality or management practices.

Now, assume there is a sudden raise in the demand in country B and firms are able to earn super normal profits. Now, firms in country A with strong ownership advantages such as technology will be able to enter the market and survive, as there is a huge gap between them and other competitors. Firms from country A may not be able to dominate the market, but can compete with middle and weak local firms, who have low level of ownership advantages. Hymer argues that these powerful ownership advantages of firms from A will compensate for the disadvantage of being foreign. The main reason for this is in imperfect competition, firms differ in their size and capabilities. Thus, Hymer emphasises that those with strong ownership advantages are more likely to become and survive as MNEs.

Oligopolistic Structure

Hymer and some other early theorists suggested that an oligopolistic market structure will be ideal environment for MNEs to grow. We will now see how an oligopolistic structure helps a firm to grow as an MNE.

Assume that a particular industry is dominated by few major firms, who are very large in size and are very profitable, and the market is very much concentrated. These firms are virtually immune to the entry of new firms

within the same economy. This is because these firms have invested huge amounts to create competitive advantages which they can use at a very low cost now. This will create huge entry barriers to new firms within the same economy. As per Hymer, these investments may go into 3 major factors.

Technology

Firms invest large sums of money in research and development in the initial stages to develop their own technology which they can now use to produce goods at zero marginal costs. This will distinguish them from other small players in the economy, who are not capable to invest such amounts in R&D. And such technologies are normally protected by patent laws, so they are not easily imitable by other firms.

Marketing

As the firms invest largely in R&D, same efforts will be put into building the brand name and other marketing activities such as distribution, advertising campaigns. This will incur huge costs in the initial stages, but will prove good later when the firm establishes its brand value in the market. Again, it is a costly affair and will not be possible for other new firms who want to enter the market.

Management

These firms have top management teams at important roles, and the techniques and practices that they use will be very expensive to put together, but are now available to run and firm successfully, without further investment in management.

So, it is very expensive for a new firm to enter into such an industry since it needs huge amounts of investments in the initial stages. But, firms in other economies which are established and invested in the same areas on their own countries are competitive and are tempted by the profitability of the industry in the first country. Though they would incur huge amounts to setup management, human resources and marketing operations, it will be less expensive compared to creation of a totally new firm. The firms with strong ownership advantages will enter the market and become MNEs.

Once these firms enter the market in a foreign country, the local firms in that country identify the dominance of new players in the industry and the ones with strong OAs will retaliate by entering into the home markets of their new competitors. Thus, the competition between the strong players in the industry will shift from national stage to an international stage.

Hymer observed this kind of patterns post Second World War, where first entry into European market by a US firm in particular industry lead to the first entry of a European firm into the US in that industry. Other European firms with stronger ownership advantages felt the best way to defend their position is through retaliatory entry of the competitors home country.

One important thing to be noted in the oligopolistic structure is that all the firms in a particular industry will closely observe the behaviour of their rivals, i. e. their pricing policies, marketing strategy or expansion etc… Being only few players, everyone tries to match their competitors move. For example, in an Airline industry with 3 major players A, B & C, and if A reduce their fares,

others will soon follow their path as more people will be attracted towards A and will affect the sales of B & C.

Criticisms

Hymer derived micro level theory of FDI, focusing on the market structures that would enable different firms to become MNEs and his market-power approach gives us different situations in which MNEs can or cannot survive and grow. But Dunning & Rugman (1985) raised their doubts saying that Hymer focused more on market-power approach and ownership advantages and location advantages, but ignored the transaction costs. As per them, firms need to have transaction specific assets to minimise the costs, whereas Hymer included tradable type advantages such as technology and economies of scale. Yamin (2000) extended the argument saying that Hymer's micro-level theory helps us to analyze why firms become MNEs by investing abroad, but his theory does not focus on how the firms can operate efficiently in other countries using their firm level advantages.

Yamin observed that Hymer assumes firms to be reactive to the structural market failures, but in fact, firms are proactive in using their firm level advantages. Yamin also observed that Hymer's theory focuses only on profit earning, where firms around the world try to develop their assets to improve their internal efficiency. He also criticised Hymer's approach towards oligopolistic markets, saying they succeeded through their size, rather than possessing ownership advantages and the purpose of oligopolies is to remove conflict. Yamin also disagreed with Hymer's idea of using ownership advantages in oligopolies to reduce the competition, saying such changes in

the oligopolies are inherent and natural consequences of dealing in a market.

Conclusion

Despite the criticisms and arguments saying that Hymer’s theory is too simple and straightforward, we cannot ignore his contribution towards the economic theories of understanding a global firm and phenomenon of formation of MNEs around the world. At a time when everyone accepted the existing theory of FDI, Hymer stood up and challenged it and appealed there is a need to understand the MNEs at a micro level in order to study their evolution over a period of time. Hymer derived his ideas of Micro level theory from Coase, focusing on international movements of local firms by transferring their assets to other countries and their ability to minimise conflict.

Due to his tragic death, his thesis was not popularised till 1976. The limitations of his theory cannot overshadow his achievement. Though his thesis was not accepted unanimously by all the economists, it provided a base for economists such as John Dunning to elaborate on the theory. As mentioned earlier, Stephen Hymer’s micro-level theory attained a cult status in the context of International Business. This should be enough for anyone to understand his contribution towards the framework to understand the global firm.