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Emerging market multinationals and internalisation theory

Mark Casson, Nigel Wadeson*

Centre for Institutions and Economic History, Department of Economics, University of Reading, P.O. Box 218, Reading RG6 6AA, UK

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ABSTRACT

There is ongoing debate about the applicability of internalisation theory to Emerging Market Multinationals (EMNEs). Internalisation theory normally describes multinationals exploiting superior knowledge directly abroad rather than licensing its use to foreign firms. We argue that EMNEs can be explained readily in terms of internalisation theory. This involves internalisation in the opposite direction: knowledge is internalised by EMNEs which then exploit it utilising home-country cost advantages. However, this is normally achieved by means that avoid the licensing of key technologies from leading firms. This clarifies the theoretical basis of EMNE strategic asset seeking investment. Market-seeking investments are also linked to technology-seeking investments through fixed costs. A model formalises the arguments, establishing conditions leading to different types of equilibria when an advanced-economy firm competes with an emerging-economy firm. The range of factors that it incorporates means that it is also compatible with other theories of the EMNE.

1. Introduction

Controversy remains over the applicability of internalisation theory, and of theories of international business more generally, to EMNEs regarding whether existing theories need to be amended or whether new theories are needed (Mathews, 2006; Cuervo-Cazurra, 2012; Ramamurti, 2012; Verbeke & Kano, 2015). The traditional approach originally sought to explain developed-country MNEs. The assumption was that it was leading firms that would become MNEs, internalising the exploitation of their knowledge abroad due to market failure in knowledge markets. Such internalisation by leading firms should then be all the more likely in emerging economies where intellectual property rights are weak. EMNEs have been heavily engaged in FDI in recent times (Pillania, 2009), including technology-seeking FDI. However, they do not match the traditional picture of the MNE as an advanced firm with leading technologies and expertise. Rather, they are more likely to have mid-level technologies. Some have claimed that EMNEs actually do have significant firm-specific advantages so that traditional theory still holds as an explanation of their FDI. However, these advantages are seen as being of a different nature to those of advanced-economy MNEs (Ramamurti, 2009, 2012; Verbeke & Kano, 2015). They include, for instance, understanding of emerging-economy consumers, labour intensive production methods, competencies in operating in difficult institutional environments, and products that are cheap, basic, and rugged.

Dunning described EMNE FDI in terms of strategic asset seeking FDI (Dunning & Narula, 1995) and of 'country specific ownership advantages', giving Chinese firms' access to ample financial assets as an example of the latter (Dunning, Kim, & Park, 2008). However, he saw such strategic asset seeking investment as augmenting existing ownership advantages. Narula (2012) argued that a threshold level of firm-specific assets is necessary before international expansion can take place and that emerging-economy firms have been pushed into strategic asset seeking FDI in order to help them survive in their home markets. Hennart (2012) argued that Dunning's OLI framework, which incorporates internalisation, has a basic flaw which limits its applicability to EMNEs. This is that it assumes that the location advantages of a country are freely available to all firms operating there. Hennart argued that location advantages are sometimes owned by particular firms, usually local ones. He claimed that many inputs are sold in imperfect markets in which their local owners have significant market power. This allows such local firms to make profits which can then be enhanced by undertaking intangible-seeking FDI in developed countries.

Rugman and Nguyen (2014: 54–55) criticised the concept of strategic asset seeking FDI as being inconsistent with the OLI framework. They viewed Dunning as having made a theoretical mistake because strategic asset seeking FDI is inconsistent with theories of the EMNE based on firms developing ownership advantages at home and then exploiting them abroad. They claimed that foreign firms would also be unlikely to be willing to sell advanced knowledge to emerging-economy firms. Buckley and Tian (2017) have argued that the debate on EMNEs has focussed on knowledge-based advantages and locational advantage and has failed to focus adequately on internalisation. It has therefore failed to coherently link internationalisation, strategic asset seeking,

* Corresponding author.
E-mail address: n.s.wadeson@reading.ac.uk (N. Wadeson).

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location, and profitability. We are therefore left with an unsatisfactory situation where the concept of strategic asset seeking investment has been used to explain the existence of EMNEs but this has not been properly incorporated into theory (Meyer, 2015). Fundamental to this is a failure to explicitly recognise that the concept of internalisation does not preclude that it can occur in the opposite direction to that traditionally assumed under certain circumstances. Internalisation theory is in fact flexible in that it recognises that the outcome depends on the costs and benefits of any particular case. In contrast to the normal description of internalisation theory, where a firm may have an incentive to internalise the exploitation of its knowledge abroad, it is possible that a firm has incentives to internalise knowledge from abroad.

Instead of the original owner of a technology exploiting it abroad through FDI, a firm domestic to the foreign country may instead internalise foreign knowledge. It will be argued below that there are incentives for this when the benefits of operating in a country are strong but there are high costs to foreign firms in taking advantage of them. This can allow an emerging-economy firm to be profitable in competition with advanced-economy firms despite employing inferior technology. Such conditions are present in emerging economies, as will be shown. The use of foreign knowledge by emerging-economy firms is then likely to be gained through means that avoid licensing by market-leading firms. It is necessary for the unit of analysis to be widened beyond that of the individual firm, to consider firms from different countries in competition, for the logic behind EMNEs to be properly understood.

A model is presented below in order to help to resolve the question of why emerging-economy firms can be profitable in competition with advanced-economy firms with superior technologies and the closely related issue of the logic for them undertaking technology-seeking FDI. The particular variety of internalisation theory employed in the model has been termed by Casson (2018) as "internalisation plus", and was introduced by Casson, Porter, and Wadeson, (2016). Instead of taking the firm as the unit of analysis, it focuses on equilibrium outcomes of competition between the firms in an industry. To do this it employs game theory, which has developed substantially since internalisation theory was first introduced. The debate over the EMNE centres on its existence in competition with firms with superior technologies. There has therefore been difficulty in applying the logic of internalisation theory to the EMNE, including its technology-seeking FDI, because the dominant firm-centred version of that logic involves firms with superior technologies being the ones that undertake FDI. We therefore argue that it is necessary to instead apply internalisation theory to competitive outcomes between firms. The internalisation plus approach is specifically designed to address such competitive outcomes using a game-theoretical approach. In the firm-centred approach, firms are seen as having given advantages. Many have viewed emerging-economy firms as tending to lack such advantages while some have argued that they have distinctive advantages, as explained above. In the internalisation plus approach the competitive outcome is endogenous. Any advantage that a firm has is partly a matter of the costs in the international business system, rather than being assumed to exist ex ante. A firm having a higher level of technology does not necessarily imply that it will win out in competition with a firm from another country.

The contribution of the article is therefore to formally model equilibria of competition between an advanced-economy firm and an emerging-economy firm and to use the equilibria and logic of the model to make related arguments about the EMNE. The model involves a set of alternative Nash equilibria. A Nash equilibrium exists when neither firm has an incentive to change its plans, given the plans of the other firm. Under certain conditions the emerging-economy firm becomes a multinational by engaging in FDI to the advanced economy. This can include technology-seeking FDI. The basis of the EMNE changes as the emerging economy becomes more open and developed. This is represented in the model in as much as different sets of parameter values lead to different types of equilibria. Note that in some industries EMNEs have had little impact on advanced-economy markets. This can also be explained through the model through relevant equilibria and related parameter values. An example is the contrast between recent car assembly in China and its manufacture and export of car parts, as will be discussed later. The formal maths of the model is presented in the appendix. The basic underpinnings of the model are explained in the next section. Following this, the different alternative types of equilibria in the model are presented. Consideration is then given to how real-world conditions can lead the emerging-economy firm to become multinational. The impact of technology-seeking FDI on the equilibrium outcome is then discussed.

2. The model: some basics

2.1. Competition between firms

Internalisation theory goes beyond the individual firm centred focus of much international business theory (Buckley, 2016; Buckley & Hashai, 2004; Casson et al., 2016). The model presented in this article (see Appendix A) assumes an industry consisting of an advanced-economy firm and an emerging-economy firm. This is because the main question that is being addressed is how the emerging-economy firm can find it profitable to become a multinational in competition with advanced-economy firm(s) with superior technologies. The model follows the "internalisation plus" approach introduced in Casson et al. (2016), as explained above, but involves price competition between differentiated goods, rather than perfect substitutes. The degree of substitutability between the two products depends on the levels of both vertical and horizontal differentiation, where vertical differentiation refers to objective differences in the level of quality and horizontal differentiation refers to differences over which buyers will vary in their rankings. For instance, consumers will prefer a vehicle that breaks down less frequently but they will vary over which body style they prefer. Consumers will, however, differ in their willingness to pay for both improvements in vertical quality and for better matches between their preferences and horizontal product features, one key influence on this being differences in incomes. The model is also more focussed than the Casson et al. (2016) model, with an industry consisting of one firm in each of two countries, instead of possibly many firms across many countries. This allows a set of different types of equilibria to be considered in more detail. The model also adds the possibility of technology-seeking FDI and explicitly incorporates a choice over the level of labour intensity of production.

The model involves a structure of costs within the international system, outcomes of competition between differentiated products, market sizes, and firm-specific factors. Proprietary technologies are assumed to require recurrent fixed R&D expenditures and so involve firm-level economies of scale. Because of the different factors involved, the model can be seen as synthesising different theories of the EMNE. It analyses the conditions that favour different equilibrium outcomes of competition between the advanced-economy firm and the emerging-economy firm. Each firm may or may not engage in internationalisation, may or may not close down, and if it does not close down then needs to decide its price in each of the markets that it serves. It is assumed that each firm can internationalise through exporting, FDI, or licensing. As the model is game theoretical, the equilibrium outcome for each firm depends also on the conditions facing the other firm. When the firms compete in a country's market it is assumed that standard results of oligopoly theory apply in determining the equilibrium outcome (Mazzeo, 2002) in terms of the price and sales of each firm given their products' relative positions in the product space. So, for instance, if the two firms compete head-on with close substitutes then if one firm has a cost advantage it will capture the market. However, a higher cost firm may be able to achieve significant sales if it offers a more differentiated product, either in the form of higher quality or of one horizontally differentiated to better serve the preferences of some