

## Understanding and Managing the Multinational Firm

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The multinational firm possesses certain kinds of advantages that set it apart from purely domestic firms. This article establishes the economic advantages of the multinational firm, describes the various strategies and organizational structures that can be used to maximize its advantages relative to local firms in the foreign countries in which it operates, and outlines the various sociopolitical issues that it needs to attend to in order to successfully operate in a foreign market. Increased attention to the fundamental economic, strategic, organizational, and sociopolitical principles of multinational management is proposed as the best way to avoid the costly mistakes that may be made because of the greater speed of international business resulting from globalization and the use of information technologies.

### Introduction

The multinational firm is one of the most pervasive types of firms in the global economy. If we define it as a firm with assets or employees in more than one country, there are more than 61,000 companies in the world that qualify as multinationals, and they control nearly half a million subsidiaries worldwide. Some of them are relatively small, and employ fewer than 250 workers. Others are sprawling organizations with more than 250,000 employees scattered across more than 100 countries. The 500 largest multinationals account for about 25 percent of world product, and nearly half of total world trade. Multinationals own most of the technology in the world, and they receive about 80 percent of all technological royalties and fees. Multinationals are becoming more important relative to the size of the global economy, about three times as prominent today as twenty years ago. More than 85 percent of all multinationals are based in the rich countries of Western Europe, the U.S., Canada, Australia, and Japan. During the last decade, new multinationals have emerged from countries such as South Korea, Taiwan, Spain, Mexico, Argentina, and Brazil.

It is precisely because of its sheer success around the world that the multinational firm is the subject of close scrutiny and scathing disparagement. Critics of the multinational enterprise range from those accusing it of being an 'octopus', 'agent of imperialism', 'dog of capitalism', or 'cultural dictator', to those convinced that it is a 'dinosaur' on the verge of extinction because of its unwieldy size, bureaucratic inertia, and inability to adapt and innovate. The apologists of the multinational, perhaps fewer in number and less adept at finding colorful metaphors, call it a 'dolphin', 'leader of modernization', 'job creator', or 'boon to mankind'.

Managing a multinational enterprise requires a different set of conceptual tools than in the case of purely domestic firms. In particular, it is important to understand the fundamental economic, strategic, organizational, and sociopolitical issues that have an impact on the process of international expansion of the firm, on the linkages between foreign subsidiaries and corporate headquarters in the home country, and on the relationship between the multinational firm and interest groups in the foreign countries, including the government, labor unions, and suppliers.

### **Economic Advantages of the Multinational Firm**

Multinational firms exist because certain economic conditions make it possible for a firm to profitably undertake production of a good or service in a foreign location. It is important to distinguish between vertical and horizontal foreign expansion by a firm in order to fully understand the basic economic principles that underlie the activities of multinational firms. Vertical expansion occurs when the firm locates assets or employees in a foreign country with the purpose of securing the production of a raw material or input (backward vertical expansion) or the distribution and sale of a good or service (forward vertical expansion). The necessary condition for the occurrence of an act of vertical expansion by a multinational firm is that there is a comparative advantage in the foreign location. The advantage typically has to do with the prices or productivities of production factors such as capital, labor or land. For instance, a clothing firm may consider production in a foreign location to take advantage of lower labor costs.

It is important, though, to realize that the mere existence of a comparative advantage in a foreign location does not mean that the firm ought to vertically expand. The necessary condition of lower factor costs or higher factor productivity, or both, is not sufficient. After all, the firm may benefit from the comparative advantage in the foreign location simply by asking a local producer to become its supplier. The sufficient condition justifying the act of foreign investment by the firm is that there are powerful reasons to undertake the foreign production by itself rather than rely on others to do the job. The main two reasons are uncertainty about the supply or asset specificity, i.e. the situation in which the firm and the foreign supplier would need to develop joint assets in order for the supply operation to take place. If uncertainty is high, the firm would prefer to integrate backward into the foreign location so as to make sure that the supply chain functions smoothly, and that delivery timetables are met. If asset specificity is high, the firm would like to expand backward in order to avoid the “hold-up” problem, i.e. opportunistic behavior on the part of the foreign supplier trying to extract rents from the firm. These necessary and sufficient conditions also apply in the case of forward vertical expansion into a foreign location. Uncertainty and asset specificity with, say, a foreign distributor, would compel the firm to take things in its own hands and invest in the foreign location in order to make sure that the goods or services reach the buyer in the appropriate way and at the appropriate price. These relationships are summarized in Figure 1.

Horizontal expansion occurs when the firm sets up a plant or service delivery

facility in a foreign location with the goal of selling in that market, and without abandoning production of the good or service in its home country. The decision to engage in horizontal expansion is driven by forces different than those for vertical expansion, a point that many managers tend to forget. Production of a good or service in a foreign market is desirable in the presence of protectionist barriers, high transportation costs, unfavorable currency exchange rate shifts, or requirements for local adaptation to the peculiarities of local demand that make exporting from the home country unfeasible or unprofitable. Like in the case of vertical expansion, these obstacles are merely a necessary condition for horizontal expansion, but not a sufficient one. The firm should ponder the relative merits of licensing a local producer in the foreign market before committing to a foreign investment. The sufficient condition for setting up a proprietary plant or service facility has to do with the possession of intangible assets—brands, technology, know-how, and other firm-specific skills—that makes licensing a risky option because the licensee might misappropriate, damage or otherwise misuse the firm's assets.<sup>1</sup>

In addition to the fundamental necessary and sufficient conditions for vertical and horizontal expansion summarized in Figure 1, there are three important economic aspects to the activities of multinational firms that deserve careful attention. First, foreign investment tends to occur more frequently among firms that compete in an oligopoly in the home country. Thus, firms in highly concentrated industries such as oil, chemicals, automobiles, semiconductors or banking have been observed to follow each other to foreign locations once one of the oligopolists makes the first move. A pattern of action-reaction, and move-countermove results from the dynamics among firms in industries with only a limited number of (large) competitors. Oligopolistic reaction is driven by the fear that if the foreign investment of one of the firms in the oligopoly is not matched by the others, a permanent loss in competitive advantage might occur.<sup>2</sup> Examples of oligopolistic reaction in foreign direct investment abound. The 'seven sisters' in the oil industry, the 'big three' automobile makers in the U.S., Coke and Pepsi in the cola industry, the three German chemical giants (BASF, Bayer, Hoechst), and the largest banks in the Netherlands (ABN, AMRO, ING), Spain (BSCH and BBVA) or Switzerland (Credit Suisse, Swiss Bank, UBS) have over the years made foreign investment decisions driven by oligopolistic reaction.

A second important economic aspect of the multinational firm is that the process of foreign expansion is often, though not always, driven by product life-cycle dynamics.

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<sup>1</sup> For a summary of the basic economic model of the multinational firm, see Richard E. Caves, *Multinational Enterprise and Economic Analysis*. New York: Cambridge University Press, 1996. Stephen Hymer was the first to observe that firms expand horizontally to protect (and monopolize) their intangible assets. See Stephen Hymer, *The International Operations of National Firms: A Study of Direct Foreign Investment*. Cambridge, MA: The MIT Press, [1960] 1976.

<sup>2</sup> The classic statement of the oligopolistic reaction thesis appears in Hymer, op. cit. The most complete elaboration is by Frederick Knickerbocker, *Oligopolistic Reaction and Multinational Enterprise*. Boston: Division of Research, Harvard Business School, 1973.

Firms tend to come up with ideas for new products and services based on stimuli coming from their home markets. They do not pursue foreign markets until the home market has become saturated. Given that the good or service reflects features of the home market, the firm pursues foreign opportunities in a sequential way, targeting first those foreign markets that are most similar to the home market. The reason is that it is in relatively similar foreign markets that home grown innovations are most likely to succeed and be profitable. One important implication of this way of looking at foreign expansion is that the firm ought to approach it as an incremental, gradual, one-step-at-a-time process. Thus, multinational firms would be wise to escalate their commitment to foreign markets slowly, starting perhaps by exporting, considering licensing before they set up a plant, and building up their knowledge and presence in foreign markets over time.<sup>3</sup> It is important to note that the slow and cautious process of foreign expansion derived from product life-cycle theory may not be appropriate when the firm competes in an oligopoly, or when the industry is characterized by strong first-mover advantages due to technological or marketing peculiarities. Under these circumstances, moving fast may be a more appropriate response.

A third distinctive economic aspect of multinational firms is that they may benefit from their “multinationality” in that it is only firms with operations in several countries that can use their network of subsidiaries to arbitrage differences in prices or adverse shocks, such as a sudden currency realignment. From this point of view, multinational firms ought to consider foreign expansion as a process by which the firm acquires “real” options. Like financial options, real options give the firm the right, but not the obligation, to use an asset in the future. Real options are particularly valuable under conditions of uncertainty. An important implication of an options-based theory of the multinational firm is that the option value of a foreign plant or service delivery facility is higher the greater the uncertainty associated with the foreign location. This logic runs contrary to the traditional prescription that the multinational firm ought to calculate country risks carefully, and either avoid dangerous locations or protect itself against the possible materialization of the risk. According to the real options perspective on the multinational, however, the firm will benefit from exposing itself to uncertainty and volatility.<sup>4</sup>

### **Strategic-Organizational Configurations of the Multinational Firm**

All multinational firms need to make two fundamental strategic decisions in order to ensure that they have a competitive advantage over purely domestic firms. First, the firm must decide where to locate assets and employees. This decision can be fruitfully approached from an economic perspective, as summarized in Figure 1, and will lead the

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<sup>3</sup> See Raymond Vernon, “The Product Cycle Hypothesis in a New International Environment,” *Oxford Bulletin of Economics and Statistics*, 41(4) (November 1979):255-267.

<sup>4</sup> See Bruce Kogut and Nalin Kulatilaka, “Operating Flexibility, Global Manufacturing, and the Option Value of a Multinational Network.” *Management Science* 40(1) (January 1994):123-139.

firm to be more or less geographically dispersed throughout the world. Second, the firm must decide whether its operations dispersed throughout the world need to be managerially coordinated or not. Depending on the degrees of geographical dispersion and organizational coordination, the firm will adopt one of four possible strategies (see Figure 2a).<sup>5</sup>

The simplest strategy for a multinational firm is to be a global exporter (cell 1 in Figure 2a). This strategy entails a relatively low degree of dispersion (the firm produces in one country), and a high degree of coordination of the marketing and sales activities that the firm undertakes with its own employees in foreign markets. If foreign markets are very different from each other the firm may think about an exporter strategy with decentralized marketing, whereby production is still largely concentrated in the home country but marketing and sales managers in foreign markets are given autonomy so that they can adapt to local market conditions in terms of price, advertising, promotion, and service (cell 2). Functional organizational structures—in which purchasing, manufacturing, sales, and service are the key departments—or worldwide product divisions are the ideal organizational structures to pursue an exporting strategy.

If the multinational firm, however, needs to disperse operations because of the necessary and sufficient conditions identified in Figure 1, then the issue of coordination of the dispersed activities becomes even more of an issue calling for managerial attention. A multidomestic strategy enables the firm to focus on local adaptation because cross-border organizational coordination is kept to a minimum (cell 3). The downside is, of course, that many activities will be replicated in each country and redundancies may proliferate, with the associated escalation in costs. Multidomestic strategies are best implemented with a country-based organizational structure in which self-standing national subsidiaries are headed by an autonomous country manager. Finally, a transnational strategy allows the multinational to simultaneously pursue local adaptation and global coordination (cell 4). This strategy, however, requires a complicated matrix structure in order to work.<sup>6</sup>

The managerial tradeoffs between the various strategy-structure configurations in Figure 2a are important to note. Exporting strategies based on functional or product divisional structures are relatively simple but inflexible. Multidomestic strategies and country-based organizational structures help the firm adapt to local circumstances but are limited when it comes to learning and cost control. Finally, transnational strategies based on the matrix organizational structure are costly and conflict-prone, but very good at gathering and integrating information from various locations.

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<sup>5</sup> For the full exposition of this approach, see Michael E. Porter, “Changing Patterns of International Competition.” In David J. Teece, ed., *The Competitive Challenge*. Cambridge: Ballinger, 1987, pp. 27-57.

<sup>6</sup> For a discussion of the virtues and pitfalls of a transnational strategy based on the matrix structure, see Christopher Bartlett and Sumantra Ghoshal, *Managing Across Borders: The Transnational Solution*. Boston: Harvard Business School Press, 1989.

It is important to note that the dimensions of dispersion and coordination are continuous in nature, and not dichotomous, as Figure 2a might be seen as suggesting. The Appendix at the end of this article proposes ways of measuring dispersion and coordination, and provides numerical illustrations.

The tension between local responsiveness and global integration can be more thoroughly examined with the diagram in Figure 2b. Multinationals are presented as organizations designed to strike some kind of a balance between two conflicting sets of demands. On the one hand, every multinational firm needs to deliver what the customer wants, even if it requires costly local adaptation and responsiveness. On the other, multinational firms seek to improve the efficiency of their operations by integrating across borders so as not to be outperformed by local players in each national market.<sup>7</sup>

When adapting to local peculiarities represents the key competitive advantage, and few gains can be obtained from global integration (because national markets are large enough to reap the benefits of economies of scale, for instance), multinational firms pursue a strategy of national differentiation (cell 3 in Figure 2b). Branded packaged goods such as consumer non-durables, food, and beer are good examples of this situation. Product or service characteristics, however, may be such that there is no real need to be locally responsive, while efficiency pressures on a global scale are the main source of competitive advantage. Consumer electronics products tend to be presented as an example of this situation. Firms in this industry tend to adopt a strategy geared towards global integration in order to achieve cost reductions and be able to invest large sums of money on R&D (cell 1). Cells 1 and 3 in Figure 2b pose no intrinsic managerial dilemma to the extent that competitive advantage derives only from global integration, or only from local responsiveness.

When both integration and responsiveness are equally important sources of competitive advantage, then the firm needs to strike a strategic and operational balance between the two (cell 4). The telecommunications equipment industry is generally presented as an example of such competing demands on the firm. Finally, when neither local responsiveness nor global integration provide competitive advantage, a strategy of pure local adaptation is generally followed, the example being commodity products such as cement (cell 2).<sup>8</sup>

### **Sociopolitical Aspects of the Multinational Firm**

Managing a multinational firm requires not only realizing its economic advantages and adopting an appropriate strategy-structure configuration, but also understanding the role that its foreign subsidiaries play in the foreign countries in which it operates. Local actors such as the government, labor unions, suppliers and the community have tended to

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<sup>7</sup> See C. K. Prahalad and Yves L. Doz, *The Multinational Mission: Balancing Local Demands and Global Vision*. New York: Free Press, 1987.

<sup>8</sup> See Mauro F. Guillén, "What Is the Best Global Strategy for the Internet?" *Business Horizons* (May-June 2002):39.46.

keep a critical eye on foreign multinationals because of their unrivalled ability to develop technology, reap economies of scale, avoid high wages, reduce transaction costs, shift from saturated to emerging markets, exploit tax loopholes, and leverage their power in negotiations with governments, labor unions, local communities, suppliers, and customers.

There is one important contrast between advanced and developing countries that needs to be borne in mind. The debate over the presence of foreign multinationals tends to be more heated in developing countries than in advanced ones. There are three main reasons for this. First, developing countries tend to be rich in natural resources and/or cheap labor that multinationals find lacking in their home countries. This resource asymmetry typically results in conflicts over how to divide up the pie between the providers of natural resources or labor, on the one hand, and the owners of technology and capital, on the other. Second, during the Cold War many developing countries were ruled by authoritarian regimes. Dictatorships tend to repress labor and mollify its political and economic demands, in part to satisfy local and foreign business interests. There is hard evidence, for example, indicating that multinationals obtain higher rates of return in developing countries ruled by an authoritarian regime. In addition, the presence of multinationals frequently boosts the international legitimacy of an unpopular authoritarian regime. Not surprisingly, labor unions in countries ruled by authoritarian regimes often accuse the government of allying itself with the multinationals for mutual gain. The fact that most multinationals tend to be headquartered in democratic countries tends to add insult to injury. And third, developing countries often perceive multinationals as limiting national sovereignty or being the agents of neocolonialism.

Only a thorough understanding of the role that multinationals play in different development contexts can guarantee an effective management of the relationships between the local subsidiary and local interest groups. Two dimensions are especially relevant to understanding the level and operational mode of multinational activity in a given host country. First, whether the host government's economic strategy pursues export-led growth or import substitution. Under export-led growth costs and incentives are aligned so that local production is competitive in global markets in terms of either price or quality, or both. Under import substitution the goal is to generate economic growth by replacing imports with local production. The second dimension is whether policies toward foreign multinationals are permissive or restrictive. For example, host governments often restrict multinational activity by imposing a certain level of domestic ownership, limiting profit repatriation, demanding minimum local product content and technological transfers, or requiring production to be exported. Figure 3 lays out the four contexts that result from cross-classifying these two dimensions, each associated with a different view, image or ideology about the multinational firm.<sup>9</sup>

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<sup>9</sup> See: Stephan Haggard, *Pathways from the Periphery: The Politics of Growth in the Newly Industrializing Countries*. Ithaca, NY: Cornell University Press, 1990; Mauro F. Guillén, *The Limits of Convergence: Globalization & Organizational Change in Argentina, South Korea, and Spain*. Princeton: Princeton University Press, 2001.

Import-substitution policies can be accompanied by permissive or liberal foreign investment policies (cell 1 in Figure 3). In this situation multinationals gain access to a protected domestic market in exchange for import-substituting investments that create jobs and save hard currency. The arrival of foreign multinationals to invest jointly with local businesses as “necessary evils” is justified because import-substitution in growth or new industries—e.g., automobiles or electronics—usually requires technology and capital that the average developing country lacks. The cases of Indonesia and Spain during the 1940s and 1950s, or of India, Brazil, Argentina, and Mexico until the early 1980s illustrate this situation. In this context, multinationals expect an industrial relations system that promotes adequate levels of purchasing power inside the protected domestic market given that exports of local production are not encouraged. However, multinationals attracted to an import-substitution environment will rarely make the most innovative products, transfer the most sophisticated technology, or spend large sums on worker training given that trade protection allows them to sell at high prices and thus obtain large profit margins even with mature or plainly obsolete products. The multinationals’ readiness to enter into coalitions with other inward-looking interest groups to preserve protectionist measures or even to perpetuate friendly governments in power regardless of their legitimacy may also cause tensions with labor unions that feel excluded from the political process.

Countries pursuing an import-substitution strategy sometimes give way to nationalist sentiment and prevent multinationals from operating in the country. They justify such policies by reference to autarkical versions of dependency and world-system theories. This is the situation captured by cell 2 of Figure 3. Countries as diverse in their resource endowments as Argentina, Venezuela, Mexico or India periodically adopted utterly restrictive policies towards the multinationals. In this situation, multinationals are depicted as ‘villains’ that plunder the country’s riches, thwarting its economic potential and limiting its national sovereignty. Typical policy initiatives are expropriations of the subsidiaries of foreign multinationals, especially in such highly visible industries as oil, mining or public utilities. At least in the short run, workers and their unions have often celebrated the wage increases and enhanced job security afforded by state ownership, especially when compared to the shortsighted attitude of multinationals under import-substitution conditions.

Like import substitution, the export-oriented strategy can also be accompanied by either permissive or restrictive policies towards the multinationals. Export-led growth with restricted foreign direct investment (cell 3) typically takes the form of export processing zones, original equipment manufacturing (OEM) contracts, and minority joint ventures.<sup>10</sup> These special arrangements allow multinationals to take advantage of the natural resources or cheap labor so plentiful in developing economies but imposes on

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<sup>10</sup> Foreign firms in export processing zone hire local workers to assemble components of foreign origin for re-export. By contrast, in an original equipment manufacturing (OEM) contract a foreign firm supplies a local company with the technology and most sophisticated components so that it can manufacture goods that the foreign firm will market under its own brand in international markets.

them a number of limitations on the production process and the sale of the output, as proposed by late-industrialization theory. Under such restrictive export-oriented conditions multinationals become “arm’s length collaborators,” precisely because the state prefers to follow a strategy of “indebted” industrialization rather than one based on the attraction of equity capital, i.e. foreign multinationals. Multinationals are attracted to this situation by low wages, labor docility, and the absence of unions. The cases of South Korea and Indonesia stand out as instances of this strategy. The emphasis on exporting products manufactured with cheap labor will often lead to friction between workers and multinationals over wages and working conditions that may escalate into serious political conflict, especially under repressive authoritarian regimes.

An export-led strategy accompanied by permissive policies towards foreign multinationals results in the “partner” image (cell 4). This context is only feasible in countries that are willing to ignore or downplay ownership issues and to pursue full integration with the global economy or trade blocs in exchange for economic growth and job creation, as preached by modernization and neoclassical theories of development. The cases of Singapore, Puerto Rico, Ireland, Spain, and, more recently, Mexico illustrate the image of multinationals as partners. Multinationals will stay in an export-oriented country only if they can develop a long-term labor strategy geared towards flexibility, skill formation, and stability, i.e., they can invest in a workforce capable of adapting to changes in the global economy. Tensions may also arise in this context. The government, labor unions, and other interest groups may feel that multinationals are not fulfilling their part of the partnership contract if they decide to cut jobs or divest altogether. Another area of friction might be acquisitions of domestic firms by multinationals, which could restrict competition in the host industry.

The conceptual scheme summarized in Figure 3 helps managers better understand the different roles that multinationals play in various country contexts. This approach can also be used to elucidate the most important issue of bargaining power between a local government and the multinational. The key idea is that the multinational possess assets—technology, brands, capital, skills—that gives it leverage to the extent that they are critical to the foreign subsidiary’s success but are not accessible to the host country. Conversely, the host country has leverage over the foreign multinational to the extent that it possesses resources desired by the foreign investor, including a large domestic market, inexpensive and/or skilled labor, and natural resources. The host’s bargaining power also increases with the degree of competition among foreign firms for access to these resources.

It is imperative to distinguish among extractive, import-substituting, and export-led foreign investments in order to fully understand the relative bargaining power of the multinational relative to the host government. In addition, the multinational’s bargaining power also depends on whether the investment is already in place or not (see Figure 4).<sup>11</sup> In extractive industries the interests of multinationals and home countries are inherently in conflict, but there is still the possibility of mutual benefit. Bargaining occurs over the

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<sup>11</sup> See Haggard, *op. cit.* pp. 220-222.

distribution of the benefits. Once the initial fixed investment is made by the multinational, however, the balance of power shifts in favor of the host-country government. When the foreign investment is in manufacturing, however, a shift in balance of power towards the host country is less likely or occurs more slowly than in the case of extractive industries. In the case of manufacturing investments that seek to substitute local production for imports, the balance of power shifts in favor of the multinational after the investment is made because suppliers, distributors, consumers, joint-venture partners, and labor provide a political base of support for the multinational. In the case of export-oriented manufacturing investments, the balance of power favors the multinational throughout the investment cycle to the extent that such investments are relatively small and the assets involved mobile. Large fixed-asset manufacturing investments tend to give the host government a little more bargaining power after they have been undertaken (Figure 4).

### **The Challenges of a Fast-Moving Global Economy**

Multinational firms possess certain economic advantages over purely domestic firms. Understanding the necessary and sufficient conditions to sustain those advantages over time is the first step for any multinational manager to take. Economic fundamentals, however, are not enough to successfully manage a multinational firm. Managers need to decide to what extent foreign operations need to be coordinated across borders. The key managerial dilemma facing multinational managers is that of the balance between local responsiveness and global integration. Identifying and implementing the correct strategy-structure configuration in terms of responsiveness and integration is perhaps the most important task for multinational managers. They also need to pay attention to the dynamics of the relationship between the firm and local interest groups in the foreign countries in which it operates, including the government, labor unions, suppliers and the community. The distinction between extractive, import-substitution, and export-led investments is useful when assessing the relative bargaining power of the multinational firm over the investment cycle.

The management of the multinational firm should obey certain fundamental economic, strategic, organizational, and sociopolitical principles. Globalization and new information technologies are not undermining such principles, but rather creating new opportunities and threats to multinational firms. Globalization has both erased differences across countries because of falling trade barriers and convergence in technical standards, but also sharpened certain key political, social, and cultural differences in the world. The fact that foreign direct investment by multinational firms has increased markedly over the last two decades indicates that the effects of globalization do not affect countries uniformly—firms still find it useful and profitable to locate assets and employees in various countries, often replicating operations and creating redundancies.<sup>12</sup>

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<sup>12</sup> See Mauro F. Guillén, “Is Globalization Civilizing, Destructive or Feeble? A Critique of Five Key Debates in the Social-Science Literature.” *Annual Review of Sociology* 27 (2001):235-260.

New information technologies have enabled multinationals to gather and diffuse knowledge more effectively and more quickly than in the past. An obvious consequence of this technological revolution has been the acceleration of the cycle of new product development and introduction in different markets throughout the world. While during the 1960s the typical multinational would take between five and ten years to introduce a new product in more than 50 national markets worldwide, today the cycle has been reduced to less than 3 years, and in many cases multinationals launch new products simultaneously in dozens of markets. There has also been a reduction in the time that a firm would take to have a significant share of its assets, employees, and revenues located outside of its home country. In the recent past, it would take two generations of managers for the firm to fully develop its foreign operations. Nowadays, some firms become full-fledged multinationals within a few years, reaching very quickly the critical threshold of having more than half of their assets and employees outside of the home country.

Clearly, the speed at which international business takes place has increased, but the basic principles governing the dynamics of foreign expansion remain relevant. In fact, multinational managers need to pay more attention to economic, strategic, and organizational imperatives than in the past because the cost of making a mistake is much higher today than it used to be twenty or thirty years ago. The cost of reversing a wrong decision—for example to set up a plant in a given foreign country, or not to establish the plant—is today much more onerous precisely because of the higher speed of international business decision-making. When the firm and its competitors move fast, mistakes are much more expensive than when things move more slowly. While the firm fixes the problem, the competitors will surge ahead. Thus, avoiding mistakes—and learning from the failures as well as the successes—becomes terribly important. Only a careful consideration of the economic, strategic, organizational, and sociopolitical principles driving foreign expansion can help the firm avoid costly mistakes in a fast-moving global economy. Those who believe that the fundamental principles of multinational management no longer apply in a high-speed world are doomed to fail.

Managing across borders is not easy. The international dimension complicates the already difficult issues of strategy formulation and implementation in purely local firms. Multinational managers, however, should try to find and exploit the opportunities hidden in the complexities of international situations. It is precisely because multinationals tap into such opportunities that they successfully expand throughout the world, and that they develop a sustainable competitive advantage over local firms.

**Figure 1: The Economic View of the Multinational Enterprise (MNE)**

<b>Type of Foreign Expansion:</b>	<b>Necessary conditions for the existence of the MNE</b>	<b>Sufficient conditions for the existence of the MNE</b>
<b>Vertical</b>	<ul style="list-style-type: none"> <li>• <b>Cost &amp; productivity of production factors (theory of comparative advantage).</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Asset specificity.</b></li> <li>• <b>Uncertainty.</b></li> </ul>
<b>Horizontal</b>	<ul style="list-style-type: none"> <li>• <b>Transportation costs.</b></li> <li>• <b>Trade protectionism.</b></li> <li>• <b>Exchange rate shifts.</b></li> <li>• <b>Need to customize.</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Intangible assets: patents, brands, know-how, and other firm-specific skills.</b></li> </ul>

Adapted from: Richard E. Caves, *Multinational Enterprise and Economic Analysis*. New York: Cambridge University Press, 1996.

**Figure 2: The Strategic View of the Multinational Enterprise (MNE)**

**(a) The Dispersion-Coordination Framework**

		Geographical Dispersion	
		High	Low
Organizational Coordination	High	<b>Transnational Strategy</b> [matrix organization]	<b>Global Exporter Strategy</b> [global functional or product divisions]
	Low	<b>Multidomestic Strategy</b> [country-based organization]	<b>Exporter Strategy with Decentralized Marketing</b> [global functional or product divisions]

Adapted from: Michael E. Porter, "Changing Patterns of International Competition." In David J. Teece, ed., *The Competitive Challenge*. Cambridge: Ballinger, 1997, pp. 27-57.

Figure 2 (continued)

(b) The Integration-Responsiveness Framework

		Local Responsiveness	
		High	Low
Global Integration	High	<b>Transnational Cost-Adaptive Strategy</b> 4	<b>Global Low Cost Strategy</b> 1
	Low	<b>Nationally Differentiated Strategy</b> 3	<b>Pure Local Adaptation Strategy</b> 2

Adapted from: C. K. Prahalad, and Yves L. Doz, *The Multinational Mission: Balancing Local Demands and Global Vision*. New York: Free Press, 1987.

**Figure 3: The Sociopolitical View of the Multinational Enterprise (MNE)**

Policies Towards MNEs:	Strategy of Economic Development	
	Export-Led Growth	Import Substitution
Permissive	<p>Foreign MNEs seen as “partners” in outward-oriented economic development.                      Acquisitions in mature industries.                      Wholly-owned in growth industries.                      MNE Labor Requirements:                      Flexibility, skill formation, stability.</p>	<p>Foreign MNEs seen as “necessary evils” in the effort to sustain and deepen import-substitution.                      Joint ventures (JVs) in mature industries.                      Wholly-owned or JVs in growth industries.                      MNE Labor Requirements:                      Enhanced purchasing power, stability.</p>
Restrictive	<p>Foreign MNEs seen as “arm’s length collaborators” to obtain the technology and marketing skill needed to increase exports.                      Export Processing Zones (XPZs).                      Manufacturing contracts (OEM); Minority JVs.                      MNE Labor Requirements:                      Low wages, docility, union avoidance.</p>	<p>Foreign MNEs seen as “villains” to be avoided so as to preserve national sovereignty and independence.                      Exodus of MNEs in the face of hostile incentives, expropriations or nationalizations.</p>

- FDI: Foreign direct investment.
- JVs: Joint ventures.
- MNEs: Multinational enterprises.
- OEM: Original equipment manufacturing.
- SMEs: Small and medium enterprises.
- SOEs: State-owned enterprises.
- XPZs: Export processing zones.

Adapted from: Mauro F. Guillén, *The Limits of Convergence*. Princeton: Princeton University Press, 2001.

**Figure 4: The Bargaining Power of the Multinational Enterprise (MNE) relative to the Host Government in the Foreign Country**

<b>Case</b>	<b>Before investing</b>	<b>After investing</b>
Extractive investments	Large & long term investment helps MNE extract commitments from host government, unless there is competition to invest.	Balance of power shifts to host government as it learns about the production process and investment cost is sunk.
Import-substituting investments	MNE is weak because host government can decide who can establish operations inside the protected market.	Balance of power shifts to MNE as it develops links to suppliers, buyers, and joint-venture partners.
Export-oriented investments	Host government is weak if labor cost is the locational advantage; somewhat stronger if investment is capital-intensive.	Balance of power does not shift so long as locational advantages do not change, and assets are mobile (e.g. machinery).

Adapted from: Stephan Haggard, *Pathways from the Periphery*. Ithaca: Cornell University Press, 1990, pp. 220-222.

## Appendix: Measuring the Dispersion and Coordination of a Multinational Firm

This appendix offers different ways of measuring the degrees of dispersion and of coordination of a multinational firm. It also offers numerical examples.

### Dispersion

The first way to measure dispersion is to calculate unity minus the Herfindahl index, using either the company's assets or employees by country as the raw data:

$$D = 1 - \sum_{i=1}^n (\pi_i)^2$$

where:

$n$  is the number of countries (including the home country  $i=1$ , and

$\pi$  is the share of each country in the company's total assets or employees [0 ~ 1].

The index ranges between **zero** (minimum dispersion, i.e. when all of the company's assets or employees are in just one country), and a number approaching **unity** as  $n$  becomes larger (maximum dispersion, i.e. when assets or employees are evenly divided among the  $n$  countries).

*Examples:*

A first company has subsidiaries in 5 countries (including the home country). The home country accounts for 80% of its assets, and the remaining 20% are evenly distributed across the other four countries. In this first case:

$$D = 1 - \sum_{i=1}^n (\pi_i)^2 = 1 - 0.65 = 0.35$$

A second company also has subsidiaries in 5 countries. Its assets are evenly distributed across the five countries. In this second case:

$$D = 1 - \sum_{i=1}^n (\pi_i)^2 = 1 - 0.20 = 0.80$$

A second way of measuring dispersion requires less information. If the breakdown of assets or employees by country is not known, a simpler measure would be the Stopford index of dispersion:

$$D_S = \frac{\sum_{i=2}^n Y_i}{X_p}$$

where:

$Y_i$  is the firm's production in each country (excluding the home country  $i=1$ ),  
 $X_p$  are exports from the parent company in the home country.

*Example:*

The following table contains an illustration of the Stopford index of dispersion for groups of multinational firms classified by country of origin:

<b>Average for Firms from:</b>	<b>1977</b>	<b>1981</b>	<b>1990</b>
USA	5.88	6.25	6.67
Europe	2.00	2.27	2.27
UK	3.12	4.17	5.88
France	1.72	1.59	1.75
Germany	0.57	0.72	0.92
Japan	0.25	0.27	0.62

Source: John Stopford, "European Multinationals' Competitiveness." In David Mayes, ed., *The External Implications of European Integration* (New York: Simon & Schuster, 1993), p. 57.

## Coordination

If the specific magnitude of inter-subsidary relationships is known, then one can calculate Kobrin's index of global integration:

$$C_k = \frac{\sum_{i,j=2;i \neq j}^n (S_i \rightarrow S_j) + \sum_{i=2}^n (S_i \rightarrow S_p) + \sum_{i=2}^n (S_p \rightarrow S_i)}{X_p + \sum_{i=2}^n S_i}$$

where  $n$  is the number of subsidiaries (including the home country parent company,  $i=1$ ), and the terms in the numerator are, respectively, subsidiary-to-subsidary sales, subsidiary-to-parent sales, and parent-to-subsidary sales, and those in the denominator are parent's exports ( $X_p$ ) and total subsidiary sales.

Source: Stephen J. Kobrin, "An Empirical Analysis of the Determinants of Global Integration." *Strategic Management Journal* 12 (Summer 1991), pp. 17-31.

*Examples:*

A first company has two foreign subsidiaries (A and B) in addition to the parent company (P). In a given year, A sells \$25 million to B, B sells \$35 to A, A and B each sell \$10 to P, and P sells \$20 to each A and B. P's total exports are \$40. Finally, A's total sales amount to \$40 and B's to \$50. In this case, Kobrin's index is:

$$C_k = \frac{(25 + 35) + (10 + 10) + (20 + 20)}{40 + (40 + 50)} = 0.92$$

A second company also has two foreign subsidiaries (A and B). The only differences with the first company is that A does not sell to B, B sells just \$10 to A, and P does not sell to either A or B. In this case, the firm is much less coordinated:

$$C_k = \frac{(0 + 10) + (10 + 10) + (0 + 0)}{40 + (40 + 50)} = 0.23$$

A second way of measuring coordination uses the concept of network. If the

specific magnitude of inter-subsidary relationships is not known, but the existence *and* direction of a link is known, then one can calculate the **coordination density** in the network of the company's subsidiaries with the simple formula:

$$C_d = \frac{m}{n(n-1)}$$

where:

$n$  is the number of subsidiaries (including the home country).

$m$  is the number of actual existing directed links.

This measure ranges between **zero** (lowest coordination, i.e. no links), and **unity** (highest coordination, i.e. all possible directional links exist).

*Examples:*

A first company has 5 subsidiaries (A through E, including the home country). A sends information to B; D to E; and E to A. No other information exchanges exist. In this first case:

$$C_d = \frac{m}{n(n-1)} = \frac{3}{5(5-1)} = 0.15$$

A second company also has 5 subsidiaries (A through E). A sends information to B, C and D; B sends to A, C and D; C to A, B and D; and D to A, B and C. No other information exchanges exist. In this second case:

$$C_d = \frac{m}{n(n-1)} = \frac{12}{5(5-1)} = 0.60$$