Chapter 18

Pricing for International Markets

CHAPTER OUTLINE

Global Perspective: The Price War

Pricing Policy

- Pricing Objectives
- Parallel Imports

Approaches to International Pricing

- Full-Cost versus Variable-Cost Pricing
- Skimming versus Penetration Pricing

Price Escalation

- Costs of Exporting
- Taxes, Tariffs, and Administrative Costs
- Inflation
- Deflation
- Exchange Rate Fluctuations
- Varying Currency Values
- Middleman and Transportation Costs

Sample Effects of Price Escalation

Approaches to Reducing Price Escalation

- Lowering Cost of Goods
- Lowering Tariffs
- Lowering Distribution Costs
- Using Foreign Trade Zones to Lessen Price Escalation
- Dumping

Leasing in International Markets

Countertrade as a Pricing Tool

- Problems of Countertrading
- The Internet and Countertrading

Price Quotations

Administered Pricing

- Cartels
- Government-Influenced Pricing

Getting Paid: Foreign Commercial Transactions

- Letters of Credit
- Bills of Exchange
- Cash in Advance
- Open Accounts
- Forfaiting

CHAPTER LEARNING OBJECTIVES

What you should learn from Chapter 18:

LO1 Components of pricing as competitive tools in international marketing

LO2 How to control pricing in parallel import or gray markets

LO3 Price escalation and how to minimize its effect

LO4 Countertrading and its place in international marketing practices

LO5 The mechanics of price quotations

LO6 The mechanics of getting paid

Global Perspective

THE PRICE WAR

The battle between Procter & Gamble and Kimberly-Clark brought Pampers and Huggies, respectively, to places they have never been, forcing down diaper prices worldwide, and expanding the global market for disposable diapers. A battle in Brazil between the two giants gives an interesting glimpse of the global markets of tomorrow. Disposable diapers are still considered a luxury by the vast majority of Brazil's 194 million people, whose average annual income is under $8,000. Before P&G and Kimberly arrived, rich and poor alike generally made do with cloth or nothing at all. The disposables that were available were expensive, bulky, and leaky.

When less than 5 percent of the Brazilian mass market used disposable diapers, P&G launched Pampers Uni, a no-frills, unisex diaper. Before Uni, it cost more to pay for disposable diapers than to pay for a maid to wash the cloth ones. The introduction of the relatively cheap, high-quality Uni fundamentally changed the economics of the diaper market for most middle-class Brazilians.

The plan was to put such nonessentials as disposable diapers within the reach of millions of Brazilians for the first time. At the same time, the Brazilian economy was on the upswing—inflation had subsided, and overnight, the purchasing power of the poor increased by 20 percent. Low-priced products flew off the shelves. P&G had to truck in diapers from Argentina as it struggled to open new production lines.

But the good days did not last. Kimberly-Clark entered the market and began importing Huggies from Argentina. With the help of a Unilever unit as its Brazilian distributor, Kimberly-Clark gained immediate distribution across the country and quickly made deep inroads into the market. Unilever agreed to work with Kimberly-Clark because its archrival in soap was P&G, and Kimberly-Clark's archrival in diapers was P&G. The two companies previously had entered into a global alliance to look for win–win situations when it was in both their best interests to partner and help each other, from a competitive standpoint, against the dominant P&G. The Brazilian market was the perfect case for cooperation.

With Unilever's help, Kimberly-Clark "push girls" invaded markets to demonstrate the diaper's absorption. Sales rose rapidly and began to exceed production. To increase market share, Kimberly-Clark formed an alliance with Kenko do Brazil, P&G's largest home-grown rival, and created the "Monica" brand. "Monica's Gang," a comic strip similar to "Peanuts" in the United States, sells widely in Brazil. São Paulo malls were crowded with thousands of kids waiting to get an Easter photo taken with actors in Monica suits, an honor that required the purchase of three packs of diapers. Monica diapers were a big hit, and Kimberly-Clark became number one in the Brazilian market.

It was a tough blow to P&G. The company had devoted an entire page of its annual report to how Pampers Uni had tripled its market share in Brazil, helping P&G "retain the number one position in a market that has grown fivefold." Now it suddenly found itself on the defensive. First it cut prices, a step P&G loathes. "Price cutting is like violence: No one wins," said the head of its Brazilian operation. Then it broadened its product range, rolling out an up-market diaper called Super-Seca, priced 25 percent higher than Pampers Uni. Later, in a flanking move, it also unveiled Confort-Seca, a bikini-style diaper originally developed for Thailand and priced 10 to 15 percent lower than the already-inexpensive Uni.

Kimberly-Clark fired back, matching the price cut and then introducing a cheaper version of Monica called Tippy Basic. Four weeks later, P&G cut prices another 10 percent on Super-Seca and Confort-Seca. Despite the price cuts, the two brands were still relatively expensive; then a wave of really cheap diapers arrived. Carrefour, a French retailer that is now Brazil's biggest supermarket chain, sells crudely made Bye-Bye Pipi diapers from Mexico. Despite their inferior quality, the cheap imports pulled down diaper prices across the board.

The real war started when lower prices became so attractive that consumers who otherwise could not afford diapers came into the market. As prices continued to drop, the market grew; that attracted more producers, which were mostly small, local Brazilian companies that offered even lower-priced competitive diapers. One such company, Mili, saw its market share increase from 4.8 percent to 16.2 percent over a three-year period. What accounts for growth of these smaller companies? One analyst suggests that the multinationals are too sophisticated and, thus, too expensive for the Brazilian market: "Smaller companies are just supplying what consumers need at a price they can afford." But it also can be said that as prices drop, products become more attractive to a larger segment of the total market.

Sources: Raju Narisetti and Jonathan Friedland, "Disposable Income: Diaper Wars of P&G and Kimberly-Clark Now Heat Up in Brazil," *The Wall Street Journal*, June 4, 1997, p. A1; "Brazil: Procter & Gamble Increased Market Share," *SABI* (South American Business Information), May 31, 2000; Jonathan Birchall, "New Tactics in the Battle for Babies' Bottoms," *Financial Times*, http://www.FT.com, August 24, 2006. For more information, see Kimberly-Clark's Web site at http://www.kimberly-clark.com, and Procter & Gamble's at http://www.pg.com; also see Matthew Bird and Rosabeth Moss Kanter, "Procter & Gamble Brazil (A): 2 ½ Turnarounds," *Harvard Business School Cases*, January 1, 2008, for details about the firms' decision-making approaches.

Setting and changing prices are key strategic marketing decisions. Prices both set values and communicate in international markets.[1] For example, Hong Kong Disneyland's early attendance was lower than expected, in part driven by what some called an unaffordable opening-day price of $32 a ticket.[2] Setting the right price for a product or service can be the key to success or failure. Even when the international marketer produces the right product, promotes it correctly, and initiates the proper channel of distribution, the effort fails if the product is not properly priced. Although the quality of U.S. products is widely recognized in global markets, foreign buyers, like domestic buyers, balance quality and price in their purchase decisions. An offering's price must reflect the quality and value the consumer perceives in the product. Of all the tasks facing the international marketer, determining what price to charge is one of the most difficult. It is further complicated when the company sells its product to customers in multiple country's markets.

LO1

Components of pricing as competitive tools in international marketing

As globalization continues, competition intensifies among multinational and home-based companies. All are seeking a solid competitive position so they can prosper as markets reach full potential. The competition for the diaper market among Kimberly-Clark, P&G, and the smaller companies illustrates how price becomes increasingly important as a competitive tool and how price competition changes the structure of a market. Whether exporting or managing overseas operations, the manager's responsibility is to set and control the price of goods in multiple markets in which different sets of variables are to be found: different tariffs, costs, attitudes, competition, currency fluctuations, and methods of price quotation.

This chapter focuses on the basic pricing policy questions that arise from the special cost, market, and competitive factors found in foreign markets. A discussion of price escalation and its control and factors associated with price setting and leasing is followed by a discussion of the use of countertrade as a pricing tool and a review of the mechanics of international price quotation. We close the chapter with a brief discussion about the mechanics of getting paid the prices charged—letters of credit and such.

Pricing Policy

Active marketing in several countries compounds the number of pricing problems and variables relating to price policy. Unless a firm has a clearly thought-out, explicitly defined price policy, expediency rather than design establishes prices. The country in which business is being conducted, the type of product, variations in competitive conditions, and other strategic factors affect pricing activity. Price and terms of sale cannot be based on domestic criteria alone.

Pricing Objectives

In general, price decisions are viewed two ways: pricing as an active instrument of accomplishing marketing objectives, or pricing as a static element in a business decision. If prices are viewed as an active instrument, the company *sets* prices (rather than *following* market prices)[3] to achieve specific objectives,[4] whether targeted returns on profit, targeted sales volumes, or some other specific goals.[5] The company that follows the second approach, pricing as a static element, probably exports only excess inventory, places a low priority on foreign business, and views its export sales as passive contributions to sales volume. When U.S. and Canadian international businesses were asked to rate, on a scale of 1 to 5, several factors important in price setting, total profits received an average rating of 4.70, followed by

[1]Lorraine Eden and Peter Rodriguez, "How Weak Are the Signals? International Price Indices and Multinational Enterprises," *Journal of International Business Studies* 36, no. 1 (2004), pp. 61–74.

[2]Don Lee, "Disneyland's Cost a Hurdle for Chinese," *Los Angeles Times*, September 10, 2005, pp. C1, C3.

[3]Carl Arthur Solberg, Barbara Stottinger, and Attila Yaprak, "A Taxonomy of the Pricing Practices of Exporting Firms: Evidence from Austria, Norway, and the United States," *Journal of International Marketing* 14 (2006), pp. 23–48.

[4]Andrew LaVallee, "Unilever to Test Mobile Coupons," *The Wall Street Journal*, May 29, 2009, p. B8.

[5]S. Tamer Cavusgil, Kwog Chan, and Chun Zhang, "Strategic Orientations in Export Pricing: A Clustering Approach to Create Firm Taxonomies," *Journal of International Marketing* 11, no. 1 (2003), p. 47; Christopher K. Hsee, Jean-Pierre Dube, and Yan Zhang, "The Prominence Effect in Shanghai Apartment Prices," *Journal of Marketing Research* 45, no. 2 (2008), pp. 133–44.

CROSSING BORDERS 18.1 Inside the iPhone Gray Market

You could buy one (indeed, more than one) in Beijing even though they had not yet been shipped there by Apple or AT&T. The gray market for iPhones in China was bustling. Apparently 800,000 to 1 million iPhones, or about one-fourth of the total sold, were "unlocked"—that is, altered to be able to run on networks other than those of Apple's exclusive partners.

This iPhone aftermarket did not take long to develop. By the time the device went on sale on June 29, 2007, software hackers and companies that specialize in unlocking cell phones had already begun searching for ways to make the iPhone work on unsanctioned networks. Within weeks, online forums were buzzing with an answer that emanated from a tiny company based in Prague, Czech Republic.

Pavel Zaboj is a 36-year-old former math student who, together with friends, developed an electronic device called Turbo SIM that was designed to turn cell phones into mobile payment systems. Turns out, Turbo SIM also could be used to trick the iPhone into thinking it was operating on AT&T's network. By mid-August, Zaboj's 10-person firm, Bladox, was flooded with orders, particularly from Canada and Mexico, where Apple addicts did not have to venture far to get an iPhone. Bladox was totally unprepared and could not fill all the orders that rolled in. "We just sat there, open-mouthed," Zaboj says.

Bladox has sold devices used to unlock phones in roughly 100 countries, including French Polynesia and Afghanistan, Brazil, Canada, the Dominican Republic, Indonesia, Israel, Nigeria, Peru, Poland, Russia, and the United Arab Emirates.

The boom was fueled not just by the short supply of a hot product but also by scant evidence of interference from Apple or its partners. Apple-authorized partners—AT&T, O2, Orange, and Deutsche Telekom's T-Mobile—lost hundreds of dollars in monthly fees per subscriber when they avoided a two-year contract in favor of unlocking. But the bulk of the unlocking seems to have been occurring in places where customers had no authorized carrier to choose from anyway.

Apple took in hundreds of dollars per iPhone sale when customers activated service with one of its partners, but most analysts say the unlocking craze also helps spread Apple's brand awareness.

The gray market got another push forward from exchange rates. With the dollar falling, consumers from Europe and elsewhere could get a better deal on an iPhone during a trip to the United States than from buying it at home. Gray marketers saw the same opportunity and began recruiting a range of people to secure iPhones.

Sometimes, it is as simple as asking friends and family members to reach their iPhone limit: five phones at Apple and three at AT&T. One reseller admits he got a friend to print business cards and pose as a small business owner to dupe an Apple Store manager into letting him buy 100 iPhones for his "employees." Chinese retailers also admitted to "getting people like airline stewardesses to bring the iPhones over for us."

Some iPhones on the gray market may have leaked from points closer to the source: the big Chinese factories where they are assembled.

Most recently Apple is selling iPhones through its new partner Unicom (Hong Kong) but is still facing stiff competition from other smart phones.

Sources: Peter Burrows, "Inside the iPhone Gray Market," *BusinessWeek*, February 12, 2008; John Markoff, "Friends and Smugglers Meet Demand for iPhones," *The New York Times*, February 18, 2008, pp. A1, A8; "Lukewarm Reception," *Business China*, January 4, 2010, p. 5.

return on investment (4.41), market share (4.13), and total sales volume (4.06). Liquidity ranked the lowest (2.19).

The more control a company has over the final selling price of a product, the better it is able to achieve its marketing goals. However, controlling end prices is not always possible. The broader the product line and the larger the number of countries involved, the more complex is the process of controlling prices to the end user.

Parallel Imports

LO2

How to control pricing in parallel import or gray markets

In addition to having to meet price competition country by country and product by product, companies have to guard against competition with their own subsidiaries or branches. Because of the different prices possible in different country markets, a product sold in one country may be exported to another and undercut the prices charged in that country. For example, to meet economic conditions and local competition, an American pharmaceutical company might sell its drugs in a developing country at a low price and then discover that these discounted drugs are being exported to a third country, where, as parallel imports, they are in direct competition with the same product sold for higher prices by the same firm. This practice is lucrative when wide margins exist between prices for the same products in different countries. A variety of conditions can create a profitable opportunity for a parallel market.

Restrictions brought about by import quotas and high tariffs also can lead to parallel imports and make illegal imports attractive. India has a three-tier duty structure on computer parts ranging from 50 to 80 percent on imports. As a result, estimates indicate that as much as 35 percent of India's domestic computer hardware sales are accounted for by the gray market.

The possibility of a **parallel market** occurs whenever price differences are greater than the cost of transportation between two markets. In Europe, because of different taxes and competitive price structures, prices for the same product vary between countries. When this situation occurs, it is not unusual for companies to find themselves competing in one country with their own products imported from another European country at lower prices. Pharmaceutical companies face this problem in Italy, Greece, and Spain because of price caps imposed on prescription drugs in those countries. For example, the ulcer drug Losec sells for only $18 in Spain but goes for $39 in Germany. The heart drug Plavix costs $55 in France and sells for $79 in London. Presumably such price differentials would cease once all restrictions to trade were eliminated in the European Union, and in most cases, this is true. However, the European Union does not prevent countries from controlling drug prices as part of their national health plans.

The drug industry has tried to stop parallel trade in Europe but has been overruled by European authorities. Now the industry is trying a different approach, restricting supplies to meet only local demand according to formulas based on prior demand and anticipated growth. The idea is that a country should receive just enough of a drug for its citizens. Wholesalers that order more with the intention of shipping the drugs to higher-priced markets will not have enough to do so. A number of major pharmaceutical companies have imposed similar restrictions. The companies say these measures are intended to streamline distribution, help prevent medicine shortages, and curtail excess inventory, whereas distributors claim the strategy is aimed at thwarting cross-border drug trading. The fact is, "half of all demand in Britain of several products is being met by imports from low-priced countries" and companies are attempting to curtail parallel imports.

Gray market pharmaceuticals moved from Canada to the United States are estimated to represent about $427 million annually—not a large amount when compared to the $135 billion U.S. drug market, but it can be substantial for specific drugs like Paxil, Zyban, and Viagra. Although importing prescription drugs from a foreign country, including Canada, is against U.S. law, a person can travel to Canada or Mexico to make purchases or buy over the Internet. Technically, buying over the Internet and having the drugs mailed to the United States is illegal. However, the government has taken a relatively lax view toward such purchases, provided the supply does not exceed 90 days.

Naturally, drug companies that have been hit the hardest want to put a stop to the traffic. Glaxo SmithKline, the prescription drug maker, has asked all Canadian pharmacies and wholesalers to "self-certify" that they are not exporting its drugs outside Canada. The company also is warning U.S. customers about imported drugs in a new advertising campaign.[6] Those that fail to comply will have their Glaxo supplies cut off—"Glaxo products are approved by Health Canada for sale in Canada only." Some feel that this move will not solve the problem even if Glaxo is able to stop Canadian sales because Americans will be able to find less expensive drugs in other markets, like Australia and Ireland. The Internet trade will be hard to shut down as long as large price differentials persist among markets. Furthermore, U.S. legislators are passing laws that allow such drug imports.[7]

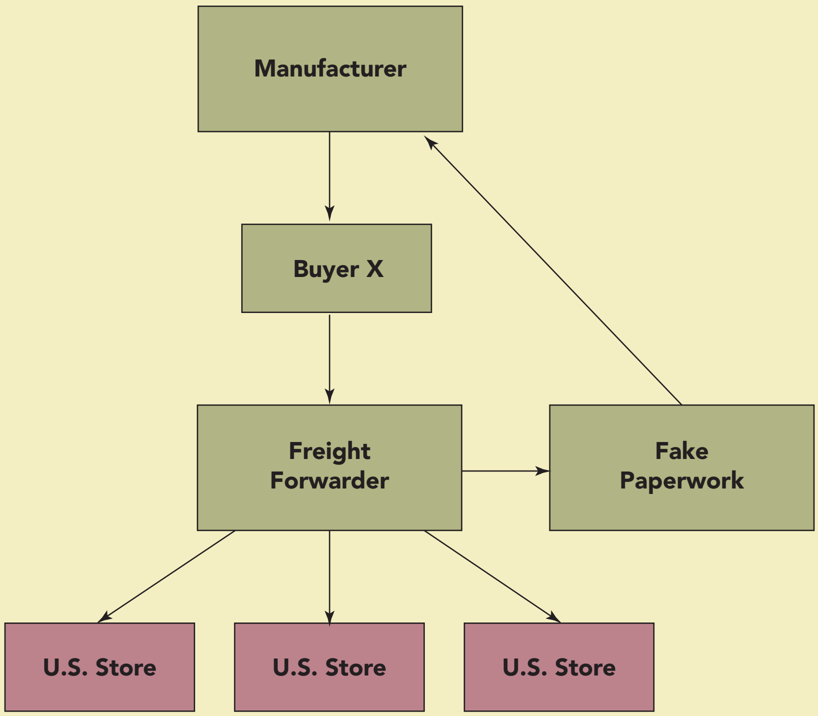
Exclusive distribution, a practice often used by companies to maintain high retail margins to encourage retailers to provide extra service to customers, to stock large assortments, or to maintain the exclusive-quality image of a product, can create a favorable condition for parallel importing. Perfume and designer brands such as Gucci and Cartier are especially

[6]Barrie McKenna, "New Shot Fired in Net Drug Battle," *Toronto Globe and Mail*, June 2, 2005, p. B3.

[7]"Senate Passes Bill to Keep Drug Import Bans Out of Trade Deals," *FDA Week* 11, no. 37 (September 16, 2005).

Exhibit 18.1

How Gray Market Goods End Up in U.S. Stores



1. A major manufacturer agrees to sell its products, at a price competitive for an overseas market, to "Buyer X" who promises to sell the products overseas.
2. The manufacturer ships the goods to Buyer X.
3. Buyer X has a local freight forwarder at the port take possession of the goods.
4. Instead of shipping the goods to their supposed destination, the freight forwarder (at the behest of Buyer X) sends them to smaller distributors and discount outlets in the United States.
5. The freight forwarder sends a bogus bill of lading to the manufacturer, so the company believes the goods have been sold overseas.

prone to gray markets. To maintain the image of quality and exclusivity, prices for such products traditionally include high profit margins at each level of distribution; characteristically, there are differential prices among markets and limited quantities of product, and distribution is restricted to upscale retailers. Wholesale prices for exclusive brands of fragrances are often 25 percent more in the United States than wholesale prices in other countries. These are ideal conditions for a lucrative gray market for unauthorized dealers in other countries who buy more than they need at wholesale prices lower than U.S. wholesalers pay. They then sell the excess at a profit to unauthorized U.S. retailers but at a price lower than the retailer would have to pay to an authorized U.S. distributor.

The high-priced designer sportswear industry is also vulnerable to such practices. Nike, Adidas, and Calvin Klein were incensed to find their products being sold in one of Britain's leading supermarket chains, Tesco. Nike's Air Max Metallic trainers, which are priced at £120 ($196) in sports shops, could be purchased at Tesco for £50 ($80). Tesco had bought £8 million in Nike sportswear from overstocked wholesalers in the United States (Exhibit 18.1). To prevent parallel markets from developing when such marketing and pricing strategies are used, companies must maintain strong control over distribution and prices.

Companies that are serious about restricting the gray market must establish and monitor controls that effectively police distribution channels. In some countries they may get help from the courts. A Taiwan court ruled that two companies that were buying Coca-Cola in the United States and shipping it to Taiwan were violating the trademark rights of both the Coca-Cola Company and its sole Taiwan licensee. The violators were prohibited from importing, displaying, or selling products bearing the Coca-Cola trademark. In other countries, the courts have not always come down on the side of the trademark owner. The reasoning is that once the trademarked item is sold, the owner's rights to control the trademarked item are lost. In a similar situation in Canada, the courts did not side with the Canadian exporter who was buying 50,000 cases of Coke a week and shipping them to Hong Kong and Japan. The exporter paid $4.25 a case, plus shipping of $1.00 a case, and sold them at $6.00, a nifty profit of 75 cents a case. Coca-Cola sued, but the court ruled that the product was bought and sold legally.

Parallel imports can do long-term damage in the market for trademarked products.[8] Customers who unknowingly buy unauthorized imports have no assurance of the quality of the item they buy, of warranty support, or of authorized service or replacement parts. Purchasers of computers, for example, may not be able to get parts because authorized dealers have no obligation to service these computers. In the case of software, the buyer may be purchasing a counterfeit product and will not be authorized for technical support. Furthermore, when a product fails, the consumer blames the owner of the trademark, and the quality image of the product is sullied.

Approaches to International Pricing

Whether the orientation is toward control over end prices or net prices, company policy relates to the net price received. Cost and market considerations are important; a company cannot sell goods below cost of production and remain in business, and it cannot sell goods at a price unacceptable in the marketplace. Firms unfamiliar with overseas marketing and firms producing industrial goods orient their pricing solely on a cost basis. Firms that employ pricing as part of the strategic mix, however, are aware of such alternatives as market segmentation from country to country or market to market, competitive pricing in the marketplace, and other market-oriented pricing factors,[9] including cultural differences in perceptions of pricing.[10]

Full-Cost versus Variable-Cost Pricing

Firms that orient their price thinking around cost must determine whether to use variable cost or full cost in pricing their goods. In **variable-cost pricing**, the firm is concerned only with the marginal or incremental cost of producing goods to be sold in overseas markets. Such firms regard foreign sales as bonus sales and assume that any return over their variable cost makes a contribution to net profit. These firms may be able to price most competitively in foreign markets, but because they are selling products abroad at lower net prices than they are selling them in the domestic market, they may be subject to charges of dumping. In that case, they open themselves to antidumping tariffs or penalties that take away from their competitive advantage. Nevertheless, variable-cost (or *marginal-cost*) pricing is a practical approach to pricing when a company has high fixed costs and unused production capacity. Any contribution to fixed cost after variable costs are covered is profit to the company.

In contrast, companies following the **full-cost pricing** philosophy insist that no unit of a similar product is different from any other unit in terms of cost and that each unit must bear its full share of the total fixed and variable cost. This approach is suitable when a company has high variable costs relative to its fixed costs. In such cases, prices are often set on a cost-plus basis, that is, total costs plus a profit margin. Both variable-cost and full-cost policies are followed by international marketers.

Skimming versus Penetration Pricing

Firms must also decide when to follow a skimming or a penetration pricing policy. Traditionally, the decision of which policy to follow depends on the level of competition, the innovativeness of the product, market characteristics, and company characteristics.[11]

A company uses **skimming** when the objective is to reach a segment of the market that is relatively price insensitive and thus willing to pay a premium price for the value received. If limited supply exists, a company may follow a skimming approach to maximize revenue and to match demand to supply. When a company is the only seller of a new or innovative

[8]For an interesting look at how enforcement efforts work, see Kersi D. Anita, Mark E. Bergen, Shantanu Dutta, and Robert J. Fisher, "How Does Enforcement Deter Gray Market Incidence?" *Journal of Marketing* 70 (2006), pp. 92–106.

[9]Pradeep K. Chintagunta and Ramaroa Desiraju, "Strategic Pricing and Detailing Behavior in International Markets," *Marketing Science* 24, no. 1 (2005), pp. 67–80.

[10]Lee C. Simmons and Robert M. Schindler, "Cultural Superstitions and the Price Endings Used in Chinese Advertising," *Journal of International Marketing* 11, no. 2 (2003), pp. 101–111; Manoj Thomas and Vick Morwitz, "Penny Wise and Pound Foolish: The Left-Digit Effect in Price Cognition," *Journal of Consumer Research* 32, no. 2 (2005), pp. 54–64.

[11]Cavusgil, Chan, and Zhang, "Strategic Orientations in Export Pricing."

CROSSING BORDERS 18.2

Don't Squeeze the Charmin, Mr. Whipple—Or Change the Color

The British pay twice the price as the Germans and the French, and nearly two-and-a-half times as much as Americans, for a standard four-roll pack of toilet paper. Why? Is it price gouging, the impact of the euro, the relative value of the English pound, or just culture?

The answer is rather simple: British consumers insist on a softer, more luxurious texture than their less discriminating continental and American cousins. British toilet paper is four grams heavier per square meter because it contains more fiber than European tissues. Extensive consumer testing has established that British consumers are not willing to be fobbed off with anything less.

Another factor distinguishes the British preference for a special toilet paper roll. Go to any supermarket, and you will be confronted by an extraordinary choice of more than 50 colors, sizes, and brands. Honeysuckle, warm pink, summer peach, pearl white, meadow green, breeze blue, and magnolia are just some of the shades on offer. The reason for this variety apparently is that the British shopper insists that toilet paper match the color scheme of the bathroom. On the continent, consumers settle happily for white, with pink thrown in as a wild alternative.

Procter & Gamble captured 10 percent of the market in less than five months after offering a stronger Charmin, but it may have gone too far. There were complaints that the "wet strength" of Charmin was unsuitable for U.K. toilets. The U.K. sewage system could handle Charmin alone, but the issue was whether the system would get clogged if several rival tissues adopted the stronger tissue. Procter & Gamble agreed to halve the strength of its Charmin toilet tissue, but will the price come down? And most recently, the P&G product has also been rated worst on a forest-friendly scale by Greenpeace. Complying with this latest criticism will surely raise costs.

Sources: "Going Soft," *The Economist*, March 4, 2000; "P&G Unblocks Sewage Row with Toilet Paper Revamp," *Reuters*, May 10, 2000; Timothy Kenny, "Eurasia: Of Toilet Paper, Escalators and Hope," *The Wall Street Journal Europe*, September 16, 2005, p. A9; "Skip it, Eco-Worrier," *The Times (London)*, December 1, 2007, p. 11.

product, a skimming price may be used to maximize profits until competition forces a lower price.[12] Skimming often is used in markets with only two income levels: the wealthy and the poor. Costs prohibit setting a price that will be attractive to the lower-income market, so the marketer charges a premium price and directs the product to the high-income, relatively price-insensitive segment. Apparently this was the policy of Johnson & Johnson's pricing of diapers in Brazil before the arrival of P&G. Today such opportunities are fading away as the disparity in income levels is giving way to growing middle-income market segments. The existence of larger markets attracts competition and, as is often the case, the emergence of multiple product lines, thus leading to price competition.

A **penetration pricing policy** is used to stimulate market and sales growth by deliberately offering products at low prices. Penetration pricing most often is used to acquire and hold share of market as a competitive maneuver. However, in country markets experiencing rapid and sustained economic growth, and where large shares of the population are moving into middle-income classes, penetration pricing may be used to stimulate market growth even with minimum competition. Penetration pricing may be a more profitable strategy than skimming if it maximizes revenues as a base for fighting the competition that is sure to come.

Regardless of the formal pricing policies and strategies a company uses, the market sets the effective price for a product. Said another way, the price has to be set at a point at which the consumer will perceive value received, and the price must be within reach of the target market. As a consequence, many products are sold in very small units in some markets to bring the unit price within reach of the target market. Warner-Lambert's launch of its five-unit pack of Bubbaloo bubble gum in Brazil failed—even though bubble gum represents over 72 percent of the overall gum sector—because it was priced too high for the target market. A relaunch of a single-unit "pillow" pack brought the price within range and enabled the brand to quickly gain a respectable level of sales.

[12] Caroline Bingxin Li and Julie Juan Li, "Achieving Superior Financial Performance in China: Differentiation, Cost Leadership, or Both?" *Journal of International Marketing* 16, no. 3 (2008), pp. 1–22.

Chinese wait to enter Beijing's first Walmart outlet. Thousands crowded the Sam's Club store on the far western edge of Beijing as the world's biggest retailer made its first foray into a major Chinese city. Walmart now has more than 200 stores elsewhere in China; the first opened in 1996. The low-price-for-good-quality strategy of Walmart and other mass retailers such as Costco and Carrefour, the French supermarket chain, have resulted in lower retail prices in China, Japan, and other Asian countries they have entered.

As a country's economy grows and the distribution of wealth becomes more equitable, multiple income levels develop, distinct market segments emerge, and multiple price levels and price/quality perceptions increase in importance. As an example, the market for electronic consumer goods in China changed in just a few years. Instead of a market for imported high-priced and high-quality electronic goods aimed at the new rich versus cheaper, poorer quality, Chinese-made goods for the rest of the market, a multitiered market reflecting the growth of personal income has emerged.

Sony of Japan, the leading foreign seller of high-priced consumer electronic goods, was upstaged in the Chinese market when Aiwa, a competitor, recognized the emergence of a new middle-tier market for good-quality, modestly priced electronic goods. As part of a global strategy focused on slim margins and high turnover, Aiwa of Korea began selling stereo systems at prices closer to Chinese brands than to Sony's. Aiwa's product quality was not far behind that of Sony and was better than top Chinese brands, and the product resembled Sony's high-end systems. Aiwa's recognition of a new market segment and its ability to tap into it resulted in a huge increase in overall demand for Aiwa products.

Pricing decisions that were appropriate when companies directed their marketing efforts toward single market segments will give way to more sophisticated practices. As incomes rise in many foreign markets, the pricing environment a company encounters will be similar to that in the United States. As countries prosper and incomes become more equitably distributed, multiple market segments develop. As these segments emerge, Walmart, Carrefour, and other mass retailers enter the market to offer price-conscious customers good value at affordable prices. This scenario seems to repeat itself in country after country. Within these markets, an effective pricing strategy becomes crucial.

Price Escalation

LO3

Price escalation and how to minimize its effect

People traveling abroad often are surprised to find goods that are relatively inexpensive in their home country priced outrageously high in other countries. Because of the natural tendency to assume that such prices are a result of profiteering, manufacturers often resolve to begin exporting to crack these new, profitable foreign markets only to find that, in most cases, the higher prices reflect the higher costs of exporting. A case in point is a pacemaker for heart patients that sells for $2,100 in the United States. Tariffs and the Japanese distribution system add substantially to the final price in Japan. Beginning with the import tariff, each time the pacemaker changes hands, an additional cost is incurred. The product passes first through the hands of an importer, then to the company with primary responsibility for sales and service, then to a secondary or even a tertiary local distributor, and finally to the hospital. Markups at each level result in the $2,100 pacemaker selling for over $4,000 in Japan. Inflation results in price escalation, one of the major pricing obstacles facing the MNC marketer. This escalation is true not only for technical products like the pacemaker but for such products as crude oil, soft drinks, and beer. Estimates indicate that if tariffs and trade barriers on these products were abolished, the consumer would enjoy savings of 6.57 trillion yen.

Costs of Exporting

Excess profits exist in some international markets, but generally the cause of the disproportionate difference in price between the exporting country and the importing country, here termed **price escalation**, is the added costs incurred as a result of exporting products from one country to another. Specifically, the term relates to situations in which ultimate prices are raised by shipping costs, insurance, packing, tariffs, longer channels of distribution, larger middlemen margins, special taxes, administrative costs, and exchange rate fluctuations. The majority of these costs arise as a direct result of moving goods across borders from one country to another and often combine to escalate the final price to a level considerably higher than in the domestic market.

Taxes, Tariffs, and Administrative Costs

A tariff, or duty, is a special form of taxation. Like other forms of taxes, a tariff may be levied for the purpose of protecting a market or for increasing government revenue. A tariff is a fee charged when goods are brought into a country from another country. The level of tariff is typically expressed as the rate of duty and may be levied as specific, ad valorem, or compound. A specific duty is a flat charge per physical unit imported, such as 15 cents per bushel of rye. Ad valorem duties are levied as a percentage of the value of the goods imported, such as 20 percent of the value of imported watches. Compound duties include both a specific and an ad valorem charge, such as $1 per camera plus 10 percent of its value. Tariffs and other forms of import taxes serve to discriminate against all foreign goods.

A Japanese wholesale store manager of a meat market in Tokyo arranges packs of beef imported from Australia. Earlier in the day, the government had announced Japan plans to raise its tariff on refrigerated beef imports to 50 percent from 38.5 percent, following a spike in imports. The price tag reads: "Premium beef, sirloin steak from Australia @ 258 yen per 100 grams." Tariffs are one of the main causes of price escalation for imported products.

Fees for import certificates or for other administrative processing can assume such levels that they are, in fact, import taxes. Many countries have purchase or excise taxes that apply to various categories of goods; value-added or turnover taxes, which apply as the product goes through a channel of distribution; and retail sales taxes. Such taxes increase the end price of goods but in general do not discriminate against foreign goods. Tariffs are the primary discriminatory tax that must be taken into account in reckoning with foreign competition.

In addition to taxes and tariffs, a variety of administrative costs are directly associated with exporting and importing a product. Export and import licenses, other documents, and the physical arrangements for getting the product from port of entry to the buyer's location mean additional costs. Although such costs are relatively small, they add to the overall cost of exporting.

Inflation

In countries with rapid inflation or exchange variation, the selling price must be related to the cost of goods sold and the cost of replacing the items. Goods often are sold below their cost of replacement plus overhead, and sometimes are sold below replacement cost. In these instances, the company would be better off not to sell the products at all. When payment is likely to be delayed for several months or is worked out on a long-term contract, inflationary factors must be figured into the price. Inflation and lack of control over price were instrumental in an unsuccessful new-product launch in Brazil by the H. J. Heinz Company; after only two years, Heinz withdrew from the market. Misunderstandings with the local partner resulted in a new fruit-based drink being

Shoppers look at stacks of discount clothing jutting out on a sidewalk to attract potential buyers at Tokyo's Sugamo shopping district. With the stock market plunging to 16-year lows, talk of deflationary dangers, and a morass of confusion in its political leadership, Japan appeared to be headed toward a serious economic crisis. The central bank played down the possibility of deflation, saying that falling prices show the market is finally opening up to competition.

sold to retailers on consignment; that is, they did not pay until the product was sold. Faced with a rate of inflation of over 300 percent at the time, just a week's delay in payment eroded profit margins substantially. Soaring inflation in many developing countries has made widespread price controls a constant threat in many countries.

Because inflation and price controls imposed by a country and/or the global marketplace[13] are beyond the control of companies, they use a variety of techniques to inflate the selling price to compensate for inflation pressure and price controls. They may charge for extra services, inflate costs in transfer pricing, or break up products into components and price each component separately.

Inflation causes consumer prices to escalate, and consumers face ever-rising prices that eventually exclude many of them from the market. In contrast, deflation results in ever-decreasing prices, creating a positive result for consumers, but both put pressure to lower costs on everyone in the supply chain.

Deflation

The Japanese economy was in a deflationary spiral for a number of years. In a country better known for $10 melons and $100 steaks, McDonald's now sells hamburgers for 52 cents, down from $1.09; a flat screen 32-inch color television is down from $4,000 to $2,400; and clothing stores compete to sell fleece jackets for $8, down from $25 two years earlier. Consumer prices have dropped to a point that they are similar to those Japanese once found only on overseas shopping trips. The high prices prevalent in Japan before deflation allowed substantial margins for everyone in the distribution chain. As prices continued to drop over several years, those less able to adjust costs to allow some margin with deflated prices fell by the wayside. Entirely new retail categories—100-yen discount shops, clothing chains selling low-cost imported products from China, and warehouse-style department stores—have become the norm. Sales at discount stores grew by 78 percent in the late 1990s. Discounting is the way to prosper in Japan, which again helps fuel deflation. While those in the distribution chain adjusted to a different competitive environment or gave up, Japanese consumers were reveling in their newfound spending power. Japanese tourists used to travel to the United States to buy things at much cheaper prices, but as one consumer commented, "Nowadays, I feel prices in Japan are going down and America is no longer cheaper." Although she was accustomed to returning from trips to the United States carrying suitcases of bargains, she returned from her last two-week vacation with purchases that fit in one fanny pack.

In a deflationary market, it is essential for a company to keep prices low and raise brand value to win the trust of consumers. Whether experiencing deflation or inflation, an exporter has to place emphasis on controlling price escalation.

Exchange Rate Fluctuations

At one time, world trade contracts could be easily written because payment was specified in a relatively stable currency. The American dollar was the standard, and all transactions could be related to the dollar. Now that all major currencies are floating freely relative to one another, no one is quite sure of the future value of any currency. Increasingly, companies are insisting that transactions be written in terms of the vendor company's national currency, and forward hedging is becoming more common. If exchange rates are not carefully considered in long-term contracts, companies find themselves unwittingly giving 15 to 20 percent discounts. The added cost incurred by exchange rate fluctuations on a day-to-day basis must be taken into account, especially where there is a significant time lapse between signing the order and delivery of the goods. Exchange rate differentials mount. Whereas Hewlett-Packard gained nearly half a million dollars additional profit through

[13]Neil Shah, "Fears Rise of Euro Government Default," *The Wall Street Journal*, February 4, 2010, online.

During the mid-1990s, Mexico knocked three zeroes off the peso in response to a major devaluation. Venezuela did the same in 2008.[14] In 2005 Turkey knocked six zeroes off its lira toward its potential alignment with the European Union. Both actions affected perceptions of key constituencies. Both bills are worth about 75¢.

exchange rate fluctuations in one year, Nestlé lost a million dollars in six months. Other companies have lost or gained even larger amounts.

Varying Currency Values

In addition to risks from exchange rate variations, other risks result from the changing values of a country's currency relative to other currencies,[15] such as consumers' perceptions of value.[16] Consider the situation in Germany for a purchaser of U.S. manufactured goods from mid-2001 to mid-2003. During this period, the value of the U.S. dollar relative to the euro went from a strong position (U.S.$1 to € 1.8315) in mid-2001 to a weaker position in mid-2003 (U.S.$1 to €0.8499). A strong dollar produces price resistance because a larger quantity of local currency is needed to buy a U.S. dollar. Conversely, when the U.S. dollar is weak, demand for U.S. goods increases because fewer units of local currency are needed to buy a U.S. dollar. The weaker U.S. dollar, compared with most of the world's stronger currencies, that existed in mid-2003 stimulated exports from the United States. Consequently, when the dollar strengthens, U.S. exports will soften.

When the value of the dollar is weak relative to the buyer's currency (i.e., it takes fewer units of the foreign currency to buy a dollar), companies generally employ cost-plus pricing. To remain price competitive when the dollar is strong (i.e., when it takes more units of the foreign currency to buy a dollar), companies must find ways to offset the higher price caused by currency values. When the rupee in India depreciated significantly against the

[14]Annually *The Economist* publishes its Big Mac index, which predicts currency fluctuations. See "Cheesed Off," July 8, 2009, p. 74.

[15]Klaus Wertenbrouch, Dilip Soman, and Amitava Chattopadhyay, "On the Perceived Value of Money: The Reference Dependence of Currency Numerosity Effects," *Journal of Consumer Research* 34 (2007), pp. 1–10.

[16]"Venezuela: Chavez's New Currency Targets Inflation," *Tulsa World*, January 1, 2008, p. A6.

A woman looks at a poster offering a half-priced bacon and lettuce hamburger, reduced from U.S.$3.20 to $1.60 during a monthly discount at a McDonald's restaurant in downtown Tokyo. McDonald's Japan announced that it would reduce the price of hamburgers by 30 percent for a month to return to customers the profit the company made by the strong yen against U.S. dollars in importing the raw materials from abroad. McDonald's move created goodwill among its customers at a time when it is forced to lower prices to "hike" sales in an economy that is suffering a major downturn. This move is a good example of how differences in the value of currencies can be positive for a company, as in this case, or negative when the value of the dollar is much stronger than the local currency.

U.S. dollar, PC manufacturers faced a serious pricing problem. Because the manufacturers were dependent on imported components, their options were to absorb the increased cost or raise the price of PCs.

Currency exchange rate swings are considered by many global companies to be a major pricing problem. Because the benefits of a weaker dollar are generally transitory, firms need to take a proactive stance one way or the other. For a company with long-range plans calling for continued operation in foreign markets that wants to remain price competitive, price strategies need to reflect variations in currency values.

Innumerable cost variables can be identified depending on the market, the product, and the situation. The cost, for example, of reaching a market with relatively small potential may be high. High operating costs of small specialty stores like those in Mexico and Thailand lead to high retail prices. Intense competition in certain world markets raises the cost or lowers the margins available to world business. Only experience in a given marketplace provides the basis for compensating for cost differences in different markets. With experience, a firm that prices on a cost basis operates in a realm of reasonably measurable factors.

Middleman and Transportation Costs

Channel length and marketing patterns vary widely, but in most countries, channels are longer and middleman margins higher than is customary in the United States. The diversity of channels used to reach markets and the lack of standardized middleman markups leave many producers unaware of the ultimate price of a product.

Besides channel diversity, the fully integrated marketer operating abroad faces various unanticipated costs because marketing and distribution channel infrastructures are underdeveloped in many countries. The marketer can also incur added expenses for warehousing and handling of small shipments and may have to bear increased financing costs when dealing with underfinanced middlemen.

Because no convenient source of data on middleman costs is available, the international marketer must rely on experience and marketing research to ascertain middleman costs. The Campbell Soup Company found its middleman and physical distribution costs in the United Kingdom to be 30 percent higher than in the United States. Extra costs were incurred because soup was purchased in small quantities—small English grocers typically purchase 24-can cases of assorted soups (each case being hand-packed for shipment). In the United States, typical purchase units are 48-can cases of one soup purchased by the dozens, hundreds, or carloads. The purchase habits in Europe forced the company into an extra wholesale level in its channel to facilitate handling small orders.

Exporting also incurs increased transportation costs when moving goods from one country to another. If the goods go over water, insurance, packing, and handling are additional costs not generally added to locally produced goods. Such costs add yet another burden because import tariffs in many countries are based on the landed cost, which includes transportation, insurance, and shipping charges. These costs add to the inflation of the final price. The next section details how a price in the home market may more than double in the foreign market.

Sample Effects of Price Escalation

Exhibit 18.2 illustrates some of the effects the factors discussed previously may have on the end price of a consumer item. Because costs and tariffs vary so widely from country to country, a hypothetical but realistic example is used.

Exhibit 18.2
Sample Causes and Effects of Price Escalation

	Domestic Example	Foreign Example 1: Assuming the Same Channels with Wholesaler Importing Directly	Foreign Example 2: Importer and Same Margins and Channels	Foreign Example 3: Same as 2 but with 10 Percent Cumulative Turnover Tax
Manufacturing net	$ 5.00	$ 5.00	$ 5.00	$5.00
Transport, CIF	n.a.	6.10	6.10	6.10
Tariff (20 percent CIF value)	n.a.	1.22	1.22	1.22
Importer pays	n.a.	n.a.	7.32	7.32
Importer margin when sold to wholesaler (25 percent on cost)	n.a.	n.a.	1.83	1.83 +0.73
Wholesaler pays landed cost	5.00	7.32	9.15	9.88
Wholesaler margin ($33\frac{1}{3}$ percent on cost)	1.67	2.44	3.05	3.29 +0.99
Retailer pays	6.67	9.76	12.20	14.16
Retail margin (50 percent on cost)	3.34	4.88	6.10	7.08 +1.42
Retail price	$10.01	$14.64	$18.30	$22.66

Notes: All figures in U.S. dollars; CIF = cost, insurance, and freight; n.a. = not applicable. The exhibit assumes that all domestic transportation costs are absorbed by the middleman. Transportation, tariffs, and middleman margins vary from country to country, but for the purposes of comparison, only a few of the possible variations are shown.

It assumes that a constant net price is received by the manufacturer, that all domestic transportation costs are absorbed by the various middleman and reflected in their margins, and that the foreign middlemen have the same margins as the domestic middlemen. In some instances, foreign middleman margins are lower, but it is equally probable that these margins could be greater. In fact, in many instances, middlemen use higher wholesale and retail margins for foreign goods than for similar domestic goods.

Notice that the retail prices in Exhibit 18.2 range widely, illustrating the difficulty of price control by manufacturers in overseas retail markets. No matter how much the manufacturer may wish to market a product in a foreign country for a price equivalent to US$10, there is little opportunity for such control. Even assuming the most optimistic conditions for Foreign Example 1, the producer would need to cut its net by more than one-third to absorb freight and tariff costs if the goods are to be priced the same in both foreign and domestic markets. Price escalation is everywhere: A man's dress shirt that sells for $40 in the United States retails for $80 in Caracas. A $20 U.S. electric can opener is priced in Milan at $70; a $35 U.S.-made automatic toaster is priced at $80 in France.

Unless some of the costs that create price escalation can be reduced, the marketer is faced with a price that may confine sales to a limited segment of wealthy, price-insensitive customers. In many markets, buyers have less purchasing power than in the United States and can be easily priced out of the market. Furthermore, once price escalation is set in motion, it can spiral upward quickly. When the price to middlemen is high and turnover is low, they may insist on higher margins to defray their costs, which, of course, raises the price even higher. Unless price escalation can be reduced, marketers find that the only buyers left are the wealthier ones. If marketers are to compete successfully in the growth of markets around the world, cost containment must be among their highest priorities. If costs can be reduced anywhere along the chain, from manufacturer's cost to retailer markups, price escalation will be reduced. A discussion of some of the approaches to reducing price escalation follows.

Approaches to Reducing Price Escalation

Three methods used to reduce costs and lower price escalation are lowering the cost of goods, lowering tariffs, and lowering distribution costs.

Lowering Cost of Goods

If the manufacturer's price can be lowered, the effect is felt throughout the chain. One of the important reasons for manufacturing in a third country is an attempt to reduce manufacturing costs and thus price escalation. The impact can be profound if you consider that the hourly cost of skilled labor in a Mexican maquiladora is less than $3 an hour including benefits, compared with more than $10 in the United States.

In comparing the costs of manufacturing microwave ovens in the United States and in Korea, the General Electric Company found substantial differences. A typical microwave oven cost GE $218 to manufacture compared with $155 for Samsung, a Korean manufacturer. A breakdown of costs revealed that assembly labor cost GE $8 per oven and Samsung only 63 cents. Perhaps the most disturbing finding for GE was that Korean laborers delivered more for less cost: GE produced four units per person, whereas the Korean company produced nine.

Although Korea remains an important offshore manufacturing location, China has emerged as a global manufacturing powerhouse backed by an inexpensive labor force, rapidly improving production quality, new sources of capital, a more dynamic private sector, and a deliberately undervalued currency. China supplies a growing range of products to the global marketplace. Japan, the land of zero-defect quality control, is increasingly happy with the competence of Chinese workers. Star Manufacturing, a Japanese precision machine tool manufacturing company, moved 30 percent of its production to China because China's cheap labor and cheap resources reduced its production costs by 20 percent.

Eliminating costly functional features or even lowering overall product quality is another method of minimizing price escalation. For U.S.-manufactured products, the quality and additional features required for the more developed home market may not be necessary in countries that have not attained the same level of development or consumer demand. In the price war between P&G and Kimberly-Clark in Brazil, the quality of the product was decreased to lower the price. Remember that the grandmother in the grocery store chose the poorest quality and lowest priced brand of diaper. Similarly, functional features on washing machines made for the United States, such as automatic bleach and soap dispensers, thermostats to provide four different levels of water temperature, controls to vary water volume, and bells to ring at appropriate times, may be unnecessary for many foreign markets. Eliminating them means lower manufacturing costs and thus a corresponding reduction in price escalation. Lowering manufacturing costs can often have a double benefit: The lower price to the buyer may also mean lower tariffs, because most tariffs are levied on an ad valorem basis.

Lowering Tariffs

When tariffs account for a large part of price escalation, as they often do, companies seek ways to lower the rate. Some products can be reclassified into a different, and lower, customs classification.[17] An American company selling data communications equipment in Australia faced a 25 percent tariff, which affected the price competitiveness of its products. It persuaded the Australian government to change the classification for the type of products the company sells from "computer equipment" (25 percent tariff) to "telecommunication equipment" (3 percent tariff). Like many products, this company's products could be legally classified under either category. One complaint against customs agents in Russia is the arbitrary way in which they often classify products. Russian customs, for instance, insists on classifying Johnson & Johnson's 2-in-1 Shower Gel as a cosmetic with a 20 percent tariff rather than as a soap substitute, which the company considers it, at a 15 percent tariff.

How a product is classified is often a judgment call. The difference between an item being classified as jewelry or art means paying no tariff for art or a 26 percent tariff for jewelry. For example, a U.S. customs inspector could not decide whether to classify a $2.7 million Fabergé egg as art or jewelry. The difference was $0 tariff versus $700,000. An experienced freight forwarder/customs broker saved the day by persuading the customs agent that the

[17]Matthew Dolan, "To Outfox the Chicken Tax, Ford Strips Its Own Vans," *The Wall Street Journal*, September 22, 2009, pp. A1, A14.

CROSSING BORDERS 18.3 What Does It Mean To Be Human? 5.2 Percent, That's What

"What does it mean to be human?" asked Judge Barzilay in her chambers at the U.S. Court of International Trade. At the heart of the problem were some 60 little plastic figures of Marvel Enterprises' X-Men and other comic figures.

Marvel subsidiary Toy Biz Inc. sought to have its heroes from a range of comic characters declared nonhuman. At the time, tariffs were higher on dolls (12 percent) than toys (6.8 percent). According to the U.S. tariff code, human figures are dolls, whereas figures representing animals or "creatures," such as monsters and robots, are deemed toys.

Thus began the great debate over the figures' true being. Barbie is a doll. Pooh Bear's a toy. That much is easy. But what about Wolverine, the muscular X-Man with the metal claws that jut out from his fists? Wolverine has known many forms in his more than 40 years as a Marvel character. But is he human? Or consider Kraven, a famed hunter, who once vanquished Spiderman, thanks in part to the strength he gained from drinking secret jungle elixirs.

Toy Biz argued that the figures "stand as potent witnesses for their status as nonhuman creatures." How could they be humans if they possessed "tentacles, claws, wings or robotic limbs"? The U.S. Customs Service argued that each figure had a "distinctive individual personality." Some were Russians, Japanese, black, white, women, even handicapped. Wolverine, the government insisted, was simply "a man with prosthetic hands."

To weigh the question, Judge Barzilay sat down with a sheaf of opposing legal briefs and more than 60 action figures, including Wolverine, Storm, Rogue, Kraven, and Bonebreaker. Judge Barzilay described in her ruling how she subjected many of the figures to "comprehensive examinations." At times, that included "the need to remove the clothes of the figure." The X-Men, oddly, gave her the least trouble. They are mutants, she declared, who "use their extraordinary and unnatural powers on the side of good or evil." Thus, the X-Men are "something other than human." Tougher for the judge were figures from the Fantastic Four and Spiderman series. After careful examination and thought, the judge found Kraven exhibited "highly exaggerated muscle tone in arms and legs." He wore a "lion's mane-like vest." Both features helped relegate him to the netherworld of robots, monsters, and devils. Case closed.

Toy Biz Inc. was elated, but fans were incensed—no way are X-Men mere creatures. "Marvel's superheroes are supposed to be as human as you or I. They live in New York. They have families and go to work. And now they're no longer human?" The current author of Marvel's *Uncanny X-Men* comic book series is also incredulous. He worked hard for a year, he says, to emphasize the X-Men's humanity, to show "that they're just another strand in the evolutionary chain." But "Don't fret, Marvel fans, a decision that the X-Men figures indeed do have 'nonhuman' characteristics further proves our characters have special, out-of-this world powers."

Although this scenario may seem trivial, it highlights just how arbitrary tariff classification can be. It pays to argue your case if you believe a product can be classified at a lower rate. For every $100,000 of plastic figures Toy Biz imports, the reclassification saves it $5,200. Not a bad day's work, considering the hundreds of thousands of dollars worth of figures the company imports annually—not to mention the undisclosed sum Toy Biz can recoup from years of overpaid tariffs.

Sources: Niel King Jr., "Is Wolverine Human? A Judge Answers No; Fans Howl in Protest," *The Wall Street Journal*, January 20, 2003; Marie Beerens, "Marvel's Two Movies Should Fuel Demand," *Investor's Business Daily*, February 19, 2008; Paul Bond, "Hasbro, Marvel Will Play Together through '17," *Hollywood Reporter*, February 18, 2009, p. 8.

Fabergé egg was a piece of art. Because the classification of products varies among countries, a thorough investigation of tariff schedules and classification criteria can result in a lower tariff.

Besides having a product reclassified into a lower tariff category, it may be possible to modify a product to qualify for a lower tariff rate within a tariff classification. In the footwear industry, the difference between "foxing" and "foxlike" on athletic shoes makes a substantial difference in the tariff levied. To protect the domestic footwear industry from an onslaught of cheap sneakers from the Far East, the tariff schedules state that any canvas or vinyl shoe with a foxing band (a tape band attached at the sole and overlapping the shoe's upper by more than one-quarter inch) be assessed at a higher duty

Hugh Jackman portraying Wolverine, an X-Men fictional character from Marvel Enterprises. A tariff classification issue arose when the company declared the imported toy characters as nonhuman toys and U.S. Customs said that they were human figure dolls—tariffs on dolls at that time were 12 percent versus 6.8 percent for toys. U.S. Customs alleged that the X-Men figures were human figures and thus should be classified as dolls, not figures featuring animals or creatures, which would mean that they could be classified as toys. Product classifications are critical when tariffs are determined. See Crossing Borders 18.3 for more details on this case.

rate. As a result, manufacturers design shoes so that the sole does not overlap the upper by more than one-quarter inch. If the overlap exceeds one-quarter inch, the shoe is classified as having a foxing band; less than one-quarter inch, a foxlike band. A shoe with a foxing band is taxed at 48 percent and one with a foxlike band (one-quarter inch or less overlap) is taxed a mere 6 percent.

There are often differential rates between fully assembled, ready-to-use products and those requiring some assembly, further processing, the addition of locally manufactured component parts, or other processing that adds value to the product and can be performed within the foreign country. For example, a ready-to-operate piece of machinery with a 20 percent tariff may be subject to only a 12 percent tariff when imported unassembled. An even lower tariff may apply when the product is assembled in the country and some local content is added.

Repackaging also may help to lower tariffs. Tequila entering the United States in containers of one gallon or less carries a duty of $2.27 per proof gallon; larger containers are assessed at only $1.25. If the cost of rebottling is less than $1.02 per proof gallon, and it probably would be, considerable savings could result. As will be discussed shortly, one of the more important activities in foreign trade zones is the assembly of imported goods, using local and frequently lower cost labor.

Lowering Distribution Costs

Shorter channels can help keep prices under control. Designing a channel that has fewer middlemen may lower distribution costs by reducing or eliminating middleman markups. Besides eliminating markups, fewer middlemen may mean lower overall taxes. Some countries levy a value-added tax on goods as they pass through channels. Goods are taxed each time they change hands. The tax may be cumulative or noncumulative. A cumulative value-added tax is based on total selling price and is assessed every time the goods change hands. Obviously, in countries where value-added tax is cumulative, tax alone provides a special incentive for developing short distribution channels. Where that is achieved, tax is paid only on the difference between the middleman's cost and the selling price. While many manufacturers had to cut prices in wake of Japan's deflation, Louis Vuitton, a maker of branded boutique goods, was able to increase prices instead. A solid brand name and direct distribution have permitted Vuitton's price strategy. Vuitton's leather monogrammed bags have become a Japanese buyer's "daily necessity," and Vuitton distributes directly and sets its own prices.

Using Foreign Trade Zones to Lessen Price Escalation

Some countries have established foreign or free trade zones (FTZs) or free ports to facilitate international trade.[18] More than 300 of these facilities operate throughout the world, storing or processing imported goods. As free trade policies in Africa, Latin America, eastern Europe, and other developing regions expand, an equally rapid expansion has taken place in the creation and use of foreign trade zones. In a free port or FTZ, payment of import duties is postponed until the product leaves the FTZ area and enters the country. An FTZ is, in essence, a tax-free enclave and not considered part of the country as far as import regulations are concerned. When an item leaves an FTZ and is imported officially into the host country of the FTZ, all duties and regulations are imposed.

Utilizing FTZs can to some extent control price escalation resulting from the layers of taxes, duties, surcharges, freight charges, and so forth. Foreign trade zones permit many of

[18]Liu Li, "Free Trade Zone in Pipeline in Xinjiang," *China Daily*, September 20, 2005.

Exhibit 18.3

How Are Foreign Trade Zones Used?

There are more than 100 foreign trade zones (FTZs) in the United States, and FTZs exist in many other countries as well. Companies use them to postpone the payment of tariffs on products while they are in the FTZ. Here are some examples of how FTZs in the United States are used.

- A Japanese firm assembles motorcycles, jet skis, and three-wheel all-terrain vehicles for import as well as for export to Canada, Latin America, and Europe.
- A U.S. manufacturer of window shades and miniblinds imports and stores fabric from Holland in an FTZ, thereby postponing a 17 percent tariff until the fabric leaves the FTZ.
- A manufacturer of hair dryers stores its product in an FTZ, which it uses as its main distribution center for products manufactured in Asia.
- A European-based medical supply company manufactures kidney dialysis machines and sterile tubing using raw materials from Germany and U.S. labor. It then exports 30 percent of its products to Scandinavian countries.
- A Canadian company assembles electronic teaching machines using cabinets from Italy; electronics from Taiwan, Korea, and Japan; and labor from the United States, for export to Colombia and Peru.

In all these examples, tariffs are postponed until the products leave the FTZ and enter the United States. Furthermore, in most situations the tariff is at the lower rate for component parts and raw materials versus the higher rate that would be charged if products were imported directly as finished goods. If the finished products are not imported into the United States from the FTZ but are shipped to another country, no U.S. tariffs apply.

Sources: Lewis E. Leibowitz, "An Overview of Foreign Trade Zones," *Europe*, Winter–Spring 1987, p. 12; "Cheap Imports," *International Business*, March 1993, pp. 98–100; "Free-Trade Zones: Global Overview and Future Prospects," http://www.stat-usa.gov, 2010.

these added charges to be avoided, reduced, or deferred so that the final price is more competitive. One of the more important benefits of the FTZ in controlling prices is the exemption from duties on labor and overhead costs incurred in the FTZ in assessing the value of goods.

By shipping unassembled goods to an FTZ in an importing country, a marketer can lower costs in a variety of ways:

- Tariffs may be lower because duties are typically assessed at a lower rate for unassembled versus assembled goods.
- If labor costs are lower in the importing country, substantial savings may be realized in the final product cost.
- Ocean transportation rates are affected by weight and volume; thus unassembled goods may qualify for lower freight rates.
- If local content, such as packaging or component parts, can be used in the final assembly, tariffs may be further reduced.

All in all, a foreign or free trade zone is an important method for controlling price escalation. Incidentally, all the advantages offered by an FTZ for an exporter are also advantages for an importer. U.S. importers use over 100 FTZs in the United States to help lower their costs of imported goods. See Exhibit 18.3 for illustrations of how FTZs are used.

Dumping

A logical outgrowth of a market policy in international business is goods priced competitively at widely differing prices in various markets. Marginal (variable) cost pricing, as discussed previously, is a way prices can be reduced to stay within a competitive price range. The market and economic logic of such pricing policies can hardly be disputed, but the practices often are classified as dumping and are subject to severe penalties and fines. Various economists define **dumping** differently. One approach classifies international shipments as dumped if the products are sold below their cost of production. Another approach characterizes dumping as selling goods in a foreign market below the price of the same goods in the home market.

World Trade Organization (WTO) rules allow for the imposition of a dumping duty when goods are sold at a price lower than the normal export price or less than the cost in the country of origin, increased by a reasonable amount for the cost of sales and profits, when this price is likely to be prejudicial to the economic activity of the importing country. A **countervailing duty** or *minimum access volume (MAV)*, which restricts the amount a country will import, may be imposed on foreign goods benefiting from subsidies, whether in production, export, or transportation.

For countervailing duties to be invoked, it must be shown that prices are lower in the importing country than in the exporting country and that producers in the importing country are being directly harmed by the dumping. A report by the U.S. Department of Agriculture indicated that levels of dumping by the United States hover around 40 percent for wheat and between 25 and 30 percent for corn, and levels for soybeans have risen steadily over the past four years to nearly 30 percent. These percentages, for example, mean that wheat is selling up to 40 percent below the cost of production. For cotton, the level of dumping for one year rose to a remarkable 57 percent, and for rice, it then stabilized at around 20 percent. The study indicated that these commodities are being dumped onto international markets by the United States in violation of WTO rules. The report found that after many years of accepting agricultural dumping, a few countries have begun to respond by investigating whether some U.S. agricultural exports are dumped. Brazil is considering a case against U.S. cotton before the WTO. Canada briefly imposed both countervailing and antidumping duties on U.S. corn imports; the United States did the same for Chinese apple juice concentrate.

Dumping is rarely an issue when world markets are strong. In the 1980s and 1990s, dumping became a major issue for a large number of industries when excess production capacity relative to home-country demand caused many companies to price their goods on a marginal-cost basis. In a classic case of dumping, prices are maintained in the home-country market and reduced in foreign markets.

Today, tighter government enforcement of dumping legislation is causing international marketers to seek new routes around such legislation. Assembly in the importing country is a way companies attempt to lower prices and avoid dumping charges. However, these *screw-driver plants*, as they are often called, are subject to dumping charges if the price differentials reflect more than the cost savings that result from assembly in the importing country. Another subterfuge is to alter the product so that the technical description will fit a lower duty category. To circumvent a 16.9 percent countervailing duty imposed on Chinese gas-filled, nonrefillable pocket flint lighters, the manufacturer attached a useless valve to the lighters so that they fell under the "nondisposable" category, thus avoiding the duty. Countries see through many such subterfuges and impose taxes. For example, the European Union imposed a $27 to $58 dumping duty per unit on a Japanese firm that assembled and sold office machines in the European Union. The firm was charged with valuing imported parts for assembly below cost.

The U.S. market is currently more sensitive to dumping than in the recent past. In fact, the Uruguay Round of the GATT included a section on antidumping that grew out of U.S. insistence on stricter controls on dumping of foreign goods in the United States at prices below those charged at home. Changes in U.S. law have enhanced the authority of the Commerce Department to prevent circumvention of antidumping duties and countervailing duties that have been imposed on a country for dumping. The United States and European Union have been the most ardent users of antidumping duties. A question asked by many though: Are dumping charges just a cover for protectionism? Previously, when an order was issued to apply antidumping and countervailing duties on products, companies charged with the violation would get around the order by slightly altering the product or by doing minor assembly in the United States or a third country. This effort created the illusion of a different product not subject to the antidumping order. The new authority of the Department of Commerce closes many such loopholes.

Leasing in International Markets

An important selling technique to alleviate high prices and capital shortages for capital equipment or high-priced durable goods[19] is the leasing system. The concept of equipment leasing has become increasingly important as a means of selling capital equipment in overseas markets. In fact, an estimated $50 billion worth (original cost) of U.S.-made and foreign-made equipment is on lease in western Europe.

The system of leasing used by industrial exporters is similar to the typical lease contracts used in the United States. Terms of the leases usually run one to five years, with

[19]Edward Taylor, "BMW to Cut Production, Raise Prices World-Wide," *The Wall Street Journal*, August 2–3, 2008, online.

payments made monthly or annually; included in the rental fee are servicing, repairs, and spare parts. Just as contracts for domestic and overseas leasing arrangements are similar, so are the basic motivations and the shortcomings. For example:

- Leasing opens the door to a large segment of nominally financed foreign firms that can be sold on a lease option but might be unable to buy for cash.
- Leasing can ease the problems of selling new, experimental equipment, because less risk is involved for the users.
- Leasing helps guarantee better maintenance and service on overseas equipment.
- Equipment leased and in use helps sell other companies in that country.
- Lease revenue tends to be more stable over a period of time than direct sales would be.

The disadvantages or shortcomings take on an international flavor. Besides the inherent disadvantages of leasing, some problems are compounded by international relationships. In a country beset with inflation, lease contracts that include maintenance and supply parts (as most do) can lead to heavy losses toward the end of the contract period. Furthermore, countries where leasing is most attractive are those where spiraling inflation is most likely to occur. The added problems of currency devaluation, expropriation, or other political risks are operative longer than if the sale of the same equipment were made outright. In light of these perils, leasing incurs greater risk than does outright sale; however, there is a definite trend toward increased use of this method of selling internationally, so the benefits must exceed the risk.

Countertrade as a Pricing Tool

LO4 Countertrading and its place in international marketing practices

Countertrade is a pricing tool that every international marketer must be ready to employ, and the willingness to accept a countertrade will often give the company a competitive advantage. The challenges of countertrade must be viewed from the same perspective as all other variations in international trade. Marketers must be aware of which markets will likely require countertrades, just as they must be aware of social customs and legal requirements. Assessing this factor along with all other market factors will enhance a marketer's competitive position.

One of the earliest barter arrangements occurred between the Soviet Union and PepsiCo before the ruble was convertible and before most companies were trading with the USSR. PepsiCo wanted to beat Coca-Cola into the Russian market. The only way possible was for PepsiCo to be willing to accept vodka (sold under the brand name Stolichnaya) from Russia and bottled wines (sold under the brand name of Premiat) from Romania to finance Pepsi bottling plants in those countries. From all indications, this arrangement was very profitable for Russia, Romania, and PepsiCo. Pepsi continues to use countertrade to expand its bottling plants. In a recent agreement between PepsiCo and Ukraine, Pepsi agreed to market $1 billion worth of Ukrainian-made commercial ships over an eight-year period. Some of the proceeds from the ship sales will be reinvested in the shipbuilding venture, and some will be used to buy soft-drink equipment and build five Pepsi bottling plants in the Ukraine. PepsiCo dominates the cola market in Russia and all the former Soviet republics in part because of its exclusive countertrade agreement with Russia, which locked Coca-Cola out of the Russian cola market for more than 12 years. After the Soviet Union was dismembered, the Russian economy crashed, and most of the Russian payment system broke down into barter operations. Truckloads of aspirin were swapped by one company, then traded for poultry, which in turn was bartered for lumber, in turn to be exchanged for X-ray equipment from Kazakhstan—all to settle debts. Many of these transactions involved regional electricity companies that were owed money by virtually everyone.

Although cash may be the preferred method of payment, countertrades have been an important part of trade with eastern Europe, the newly independent states, China,[20] and, to a varying degree, some Latin American and African nations. **Barter**, or countertrades, still constitute between 20 and 40 percent of all transactions in the economies of the former

[20]"Trade Financing and Insurance: Countertrade," *Economist Intelligence Unit–Country Finance*, January 22, 2008, p. 101.

Soviet bloc. Corporate debts to suppliers, payments and services, even taxes—all have a noncash component or are entirely bartered. Many of these countries constantly face a shortage of hard currencies with which to trade and thus resort to countertrades when possible. A recent purchase of 48 F-16 Falcons from Lockheed Martin was pegged at $3.5 billion. The financial package included soft loans and a massive offset program—purchases from Polish manufacturers that more than erased the costs of the deal in foreign exchange. With an economy once short of hard currency, Russia has offered a wide range of products in barter for commodities it needed. For example, Russian expertise in space technology was offered for Malaysian palm oil and rubber, and military equipment was exchanged for crude palm oil or rice from Indonesia.[21] Today, an international company must include in its market-pricing toolkit some understanding of countertrading.

Problems of Countertrading

The crucial problem confronting a seller in a countertrade negotiation is determining the value of and potential demand for the goods offered as payment. Frequently there is inadequate time to conduct a market analysis; in fact, it is not unusual to have sales negotiations almost completed before countertrade is introduced as a requirement in the transaction.

Although such problems are difficult to deal with, they can be minimized with proper preparation. In most cases where losses have occurred in countertrades, the seller has been unprepared to negotiate in anything other than cash. Some preliminary research should be done in anticipation of being confronted with a countertrade proposal. Countries with a history of countertrading are identified easily, and the products most likely to be offered in a countertrade often can be ascertained. For a company trading with developing countries, these facts and some background on handling countertrades should be a part of every pricing toolkit. Once goods are acquired, they can be passed along to institutions that assist companies in selling bartered goods.

Barter houses specialize in trading goods acquired through barter arrangements and are the primary outside source of aid for companies beset by the uncertainty of a countertrade. Although barter houses, most of which are found in Europe, can find a market for bartered goods, this effort requires time, which puts a financial strain on a company because capital is tied up longer than in normal transactions.

In the United States, there are companies that assist with bartered goods and their financing. Citibank has created a countertrade department to allow the bank to act as a consultant as well as to provide financing for countertrades. It is estimated that there are now about 500 barter exchange houses in the United States, many of which are accessible on the Internet. Some companies with a high volume of barter have their own in-house trading groups to manage countertrades. The 3M Company (Minnesota Mining and Manufacturing), for example, has a wholly owned division, 3M Global Trading (www.3m.com/globaltrading), which offers its services to smaller companies.

The Internet and Countertrading

The Internet may become the most important venue for countertrade activities. Finding markets for bartered merchandise and determining market price are two of the major problems with countertrades. Several barter houses have Internet auction sites, and a number of Internet exchanges are expanding to include global barter.

Some speculate that the Internet may become the vehicle for an immense online electronic barter economy, to complement and expand the offline barter exchanges that take place now. In short, some type of electronic trade dollar would replace national currencies in international trade transactions. This e-dollar would make international business considerably easier for many countries, because it would lessen the need to acquire sufficient U.S. or other hard currency to complete a sale or purchase.

TradeBanc, a market-making service, has introduced a computerized technology that will enable members of trade exchanges to trade directly, online, with members of other trade exchanges anywhere in the world, as long as their barter company is a TradeBanc affiliate (www.tradebanc.com). The medium of exchange could be the Universal Currency proposed by the International Reciprocal Trade Association (IRTA; www.irta.com), an association of

[21] Zakki P. Hakim, "Ministry Eyes Rice-for-Planes Trade Deal," *Jakarta Post*, September 20, 2005, p. 13.

trade exchanges with members including Russia, Iceland, Germany, Chile, Turkey, Australia, and the United States. The IRTA has proposed to establish and operate a Universal Currency Clearinghouse, which would enable trade exchange members to easily trade with one another using this special currency. When the system is in full swing, all goods and services from all the participating affiliates would be housed in a single database. The transactions would be cleared by the local exchanges, and settlement would be made using IRTA's Universal Currency, which could be used to purchase anything from airline tickets to potatoes.[22]

Price Quotations

LO5

The mechanics of price quotations

In quoting the price of goods for international sale, a contract may include specific elements affecting the price, such as credit, sales terms, and transportation. Parties to the transaction must be certain that the quotation settled on appropriately locates responsibility for the goods during transportation and spells out who pays transportation charges and from what point. Price quotations must also specify the currency to be used, credit terms, and the type of documentation required. Finally, the price quotation and contract should define quantity and quality. A quantity definition might be necessary because different countries use different units of measurement. In specifying a ton, for example, the contract should identify it as a metric or an English ton and as a long or short ton. Quality specifications can also be misunderstood if not completely spelled out. Furthermore, there should be complete agreement on quality standards to be used in evaluating the product. For example, "customary merchantable quality" may be clearly understood among U.S. customers but have a completely different interpretation in another country. The international trader must review all terms of the contract; failure to do so may have the effect of modifying prices even though such a change was not intended.

[22]You may want to visit the American Countertrade Association, http://www.countertrade.org, for a detailed discussion of the services offered by a countertrader.

CROSSING BORDERS 18.4 Psychological Pricing in China, the Lucky 8

Retailers in the United States often use prices ending in 99, and this tactic has been shown to be effective in a number of consumer studies. One explanation has to do with consumers' tendency to ignore the digits after the first rather than bothering to round to the closest number. Thus, $2.99 seems more like $2 than $3. Another explanation suggests the prices ending in 99 signal a sale price, and are therefore more attractive to consumers interested in sale prices.

A psychological pricing tactic in Chinese cultures is to include eights in the prices. Eight is attractive to Chinese consumers because it is the luckiest number among all, and the more eights the better. The number eight (八, *ba*) said in Chinese Mandarin sounds like the word for "prosperity" (发, fa), and it works similarly in Cantonese as well.

Thus, the 88th floor is a lucky and more valuable one in high-rise buildings in the region – in Hong Kong buildings that have far fewer floors can still get premium prices of the penthouse on the 88th floor by simply skipping "unlucky" floors omitting intermediate floors, particularly the unlucky numbers such as four. And automobile license plates and phone numbers with consecutive 8s can be worth hundreds of thousands of dollars. Finally, the opening ceremonies for the Olympic Games in Beijing began at 8 seconds, 8 minutes after 8pm (local time) on 8/8/08, thus guaranteeing the success of the Games.

Research has also shown a systematic bias in both advertised prices and stock prices for the number eight in Chinese markets. For example, among 499 prices for a variety of products listed in newspapers in Shanghai, Hong Kong, and Taiwan, 39.9% ended in 8, and the next most common ending number was 14.7% for 5. The unlucky number 4 (related to death) appeared at the end of only 1.4% of the prices. A similar study was conducted on Shanghai and Shenzen stock exchange data, and found a strong preference for share prices ending in 8, and an aversion to prices ending in the number 4.

Sources: See C. Simmons and Robert M. Schindler, "Cultural Superstitions and the Price Endings Used in Chinese Advertising," *Journal of International Marketing*, 11(2), 2003, pp. 101-111; N. Mark Lam and John L. Graham, *China Now: Doing Business in the World's Most Dynamic Market* (New York: McGraw-Hill, 2007); Philip Brown and Jason Mitchell, "Culture and Stock Price Clustering: Evidence for the Peoples' Republic of China," *Pacific-Basin Finance Journal*, 16(1/2), 2008, pp. 95–120.

Administered Pricing

Administered pricing is an attempt to establish prices for an entire market. Such prices may be arranged through the cooperation of competitors; through national, state, or local governments; or by international agreement. The legality of administered pricing arrangements of various kinds differs from country to country and from time to time. A country may condone price fixing for foreign markets but condemn it for the domestic market, for instance.

In general, the end goal of all administered pricing activities is to reduce the impact of price competition or eliminate it. Price fixing by business is not viewed as an acceptable practice (at least in the domestic market), but when governments enter the field of price administration, they presume to do it for the general welfare to lessen the effects of "destructive" competition.

The point at which competition becomes destructive depends largely on the country in question. To the Japanese, excessive competition is any competition in the home market that disturbs the existing balance of trade or gives rise to market disruptions. Few countries apply more rigorous standards in judging competition as excessive than Japan, but no country favors or permits totally free competition. Economists, the traditional champions of pure competition, acknowledge that perfect competition is unlikely and agree that some form of workable competition must be developed.

The pervasiveness of price-fixing attempts in business is reflected by the diversity of the language of administered prices; pricing arrangements are known as agreements, arrangements, combines, conspiracies, cartels, communities of profit, profit pools, licensing, trade associations, price leadership, customary pricing, or informal interfirm agreements.[23] The arrangements themselves vary from the completely informal, with no spoken or acknowledged agreement, to highly formalized and structured arrangements. Any type of price-fixing arrangement can be adapted to international business, but of all the forms mentioned, cartels are the most directly associated with international marketing.

Cartels

A **cartel** exists when various companies producing similar products or services work together to control markets for the types of goods and services they produce. The cartel association may use formal agreements to set prices, establish levels of production and sales for the participating companies, allocate market territories, and even redistribute profits. In some instances, the cartel organization itself takes over the entire selling function, sells the goods of all the producers, and distributes the profits.

Oil prices quadrupled in the mid-1970s because of OPEC's control of supplies. The $100+ per barrel oil you see in this picture was caused by burgeoning demand in China and around the world in 2008. Pertamina is the Indonesian national oil company.

The economic role of cartels is highly debatable, but their proponents argue that they eliminate cutthroat competition and rationalize business, permitting greater technical progress and lower prices to consumers. However, most experts doubt that the consumer benefits very often from cartels.

The Organization of Petroleum Exporting Countries (OPEC) is probably the best known international cartel. Its power in controlling the price of oil has resulted from the percentage of oil production it controls. In the early 1970s, when OPEC members provided the industrial world with 67 percent of its oil, OPEC was able to quadruple the price of oil. The sudden rise in price from $3 a barrel to $11 or more a barrel was a primary factor in throwing the world into a major recession. In 2000, OPEC members lowered production, and the oil price rose from $10 to over $30, creating a dramatic increase in U.S. gasoline prices. Non-OPEC oil-exporting countries benefit from the price increases, while net importers of foreign oil face economic repercussions.

One important aspect of cartels is their inability to maintain control for indefinite periods. Greed by cartel members and other problems generally weaken the control of the

[23]Dana Nunn and Miklos Sarvary, "Pricing Practices and Firms' Market Power in International Cellular Markets: An Empirical Study," *International Journal of Research in Marketing* 21, no. 4 (2004), pp. 377–95.

cartel. OPEC members tend to maintain a solid front until one decides to increase supply, and then others rapidly follow suit. In the short run, however, OPEC can affect global prices. Indeed, at this writing, world oil prices are above $100 a barrel, but most analysts attribute this increase more to burgeoning demand[24] than OPEC's ability to control supply.[25]

A lesser-known cartel, but one that has a direct impact on international trade, is the cartel that exists among the world's shipping companies. Every two weeks about 20 shipping-line managers gather for their usual meeting to set rates on tens of billions of dollars of cargo. They do not refer to themselves as a cartel but rather operate under such innocuous names as "The Trans-Atlantic Conference Agreement" (www.tacaconf.com). Regardless of the name, they set the rates on about 70 percent of the cargo shipped between the United States and northern Europe. Shipping between the United States and Latin American ports and between the United States and Asian ports also is affected by shipping cartels. Not all shipping lines are members of cartels, but a large number are; thus they have a definite impact on shipping. Although legal, shipping cartels are coming under scrutiny by the U.S. Congress, and new regulations may soon be passed.

Another cartel is the diamond cartel controlled by De Beers. For more than a century, De Beers has smoothly manipulated the diamond market by keeping a tight control over world supply.[26] The company mines about half the world's diamonds and takes in another 25 percent through contracts with other mining companies. In an attempt to control the other 25 percent, De Beers runs an "outside buying office" where it spends millions buying up diamonds to protect prices. The company controls most of the world's trade in rough gems and uses its market power to keep prices high.

The legality of cartels at present is not clearly defined. Domestic cartelization is illegal in the United States, and the European Union also has provisions for controlling cartels. The United States does permit firms to take cartel-like actions in foreign markets, though it does not allow foreign-market cartels if the results have an adverse impact on the U.S. economy. Archer Daniels Midland Company, the U.S. agribusiness giant, was fined

[24]"CPC to Continue Freeze on Oil Prices," *China Post*, March 2, 2008; Neil King Jr., Chip Cummins, and Russell Gold, "Oil Hits $100, Jolting Markets," *The Wall Street Journal*, January 3, 2008, p. A1.

[25]Robert J. Samuelson, "The Triumph of OPEC," *Newsweek*, March 17, 2008, p. 45.

[26]Eric Onstad, "De Beers May Spurn Low-Margin Russian Supply," *Reuters News*, July 20, 2007.

The De Beers company is one of the world's largest cartels, and for all practical purposes, it controls most of the world's diamonds and thus is able to maintain artificially high prices for diamonds. One of the ways in which it maintains control is illustrated by a recent agreement with Russia's diamond monopoly, in which De Beers will buy at least $550 million in rough gem diamonds from Russia, or about half of the country's annual output. By controlling supply from Russia, the second largest producer of diamonds, the South African cartel can keep prices high.

$205 million for its role in fixing prices for two food additives, lysine and citric acid. German, Japanese, Swiss, and Korean firms were also involved in that cartel. The group agreed on prices to charge and then allocated the share of the world market each company would get—down to the tenth of a decimal point. At the end of the year, any company that sold more than its allotted share was required to purchase in the following year the excess from a co-conspirator that had not reached its volume allocation target.

Although EU member countries have had a long history of tolerating price fixing, the European Union is beginning to crack down on cartels in the shipping, automobile, and cement industries, among others. The unified market and single currency have prompted this move. As countries open to free trade, powerful cartels that artificially raise prices and limit consumer choice are coming under closer scrutiny. However, the EU trustbusters are fighting tradition—since the trade guilds of the Middle Ages, cozy cooperation has been the norm. In each European country, companies banded together to control prices within the country and to keep competition out.

Government-Influenced Pricing

Companies doing business in foreign countries encounter a number of different types of government price setting. To control prices, governments may establish margins, set prices and floors or ceilings, restrict price changes, compete in the market, grant subsidies, and act as a purchasing monopsony or selling monopoly.[27] The government may also influence prices by permitting, or even encouraging, businesses to collude in setting manipulative prices. As an aside, of course, some companies need no help in price fixing—which often is illegal.[28]

The Japanese government traditionally has encouraged a variety of government-influenced price-setting schemes, However, in a spirit of deregulation that is gradually moving through Japan, Japan's Ministry of Health and Welfare will soon abolish regulation of business hours and price setting for such businesses as barbershops, beauty parlors, and laundries. Under the current practice, 17 sanitation-related businesses can establish such price-setting schemes, which are exempt from the Japanese Anti-Trust Law.

Governments of producing and consuming countries seem to play an ever-increasing role in the establishment of international prices for certain basic commodities. There is, for example, an international coffee agreement, an international cocoa agreement, and an international sugar agreement. And the world price of wheat has long been at least partially determined by negotiations between national governments.

Despite the pressures of business, government, and international price agreements, most marketers still have wide latitude in their pricing decisions for most products and markets.

Getting Paid: Foreign Commercial Payments

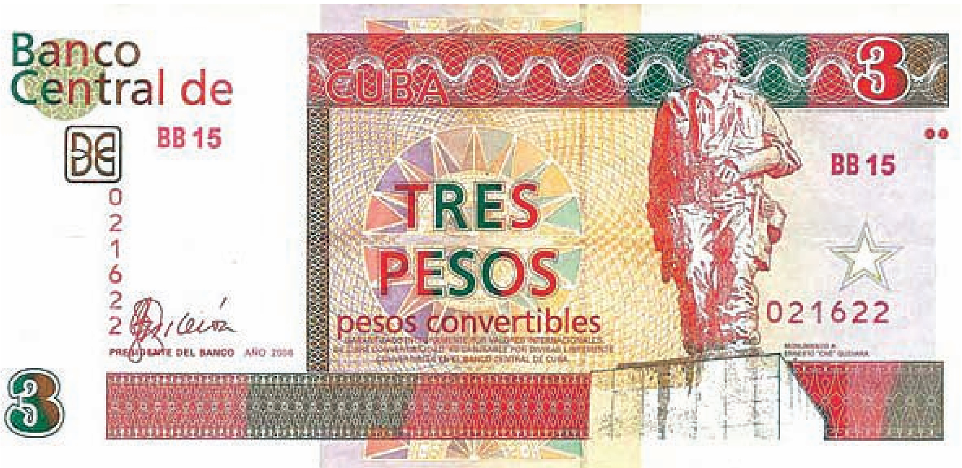
LO6

The mechanics of getting paid

The sale of goods in other countries is further complicated by additional risks encountered when dealing with foreign customers. Risks from inadequate credit reports on customers, problems of currency exchange controls, distance, and different legal systems, as well as the cost and difficulty of collecting delinquent accounts, require a different emphasis on payment systems. In U.S. domestic trade, the typical payment procedure for established customers is an *open account*—that is, the goods are delivered, and the customer is billed on an end-of-the-month basis. However, the most frequently used term of payment in foreign commercial transactions for both export and import sales is a letter of credit, followed closely in importance by commercial dollar drafts or bills of exchange drawn by the seller on the buyer. Internationally, open accounts are reserved for well-established customers, and cash in advance is required of only the poorest credit risks or when the character of the merchandise is such that not fulfilling the terms of

[27]"Apple, EU Reach iTunes Pricing Deal," *The Wall Street Journal*, January 9, 2008, online.

[28]"Canada Probes Allegations of Chocolate Price-Fixing," *The Wall Street Journal*, November 28, 2007, online; John R. Wilke, "Two U.K. Airlines Settle Price-Fixing Claims," *The Wall Street Journal*, February 15, 2008, p. A4.



"That's as worthless as a three-dollar bill"—so the old saying goes. Cuba actually has two currencies, the Cuban peso and the Cuban convertible peso. The latter is what you see above and you can exchange it for euros or Canadian dollars, but not U.S. dollars. The non-convertible Cuban peso's current value is about U.S.$1.08. The Cuban peso can be used only for domestic transactions and is worth about one-sixth of its convertible brother.

the contract may result in heavy loss. Because of the time required for shipment of goods from one country to another, advance payment of cash is an unusually costly burden for a potential customer and places the seller at a definite competitive disadvantage.

Terms of sales are typically arranged between the buyer and seller at the time of the sale. The type of merchandise, amount of money involved, business custom, credit rating of the buyer, country of the buyer, and whether the buyer is a new or old customer must be considered in establishing the terms of sale. The five basic payment arrangements—letters of credit, bills of exchange, cash in advance, open accounts, and forfaiting—are discussed in this section.

Letters of Credit

Export **letters of credit** opened in favor of the seller by the buyer handle most American exports. Letters of credit shift the buyer's credit risk to the bank issuing the letter of credit. When a letter of credit is employed, the seller ordinarily can draw a draft against the bank issuing the credit and receive dollars by presenting proper shipping documents.[29] Except for cash in advance, letters of credit afford the greatest degree of protection for the seller.

The procedure for a letter of credit begins with completion of the contract. (See Exhibit 18.4 for the steps in a letter-of-credit transaction.) Letters of credit can be revocable or irrevocable. An *irrevocable letter of credit* means that once the seller has accepted the credit, the buyer cannot alter it in any way without permission of the seller. Added protection is gained if the buyer is required to confirm the letter of credit through a U.S. bank. This irrevocable, confirmed letter of credit means that a U.S. bank accepts responsibility to pay regardless of the financial situation of the buyer or foreign bank. From the seller's viewpoint, this step eliminates the foreign political risk and replaces the commercial risk of the buyer's bank with that of the confirming bank. The confirming bank ensures payment against a confirmed letter of credit. As soon as the documents are presented to the bank, the seller receives payment.

The international department of a major U.S. bank cautions that a letter of credit is not a guarantee of payment to the seller. Rather, payment is tendered only if the seller complies exactly with the terms of the letter of credit. Because all letters of credit must be exact in their terms and considerations, it is important for the exporter to check the terms of the letter carefully to be certain that all necessary documents have been acquired and properly completed.

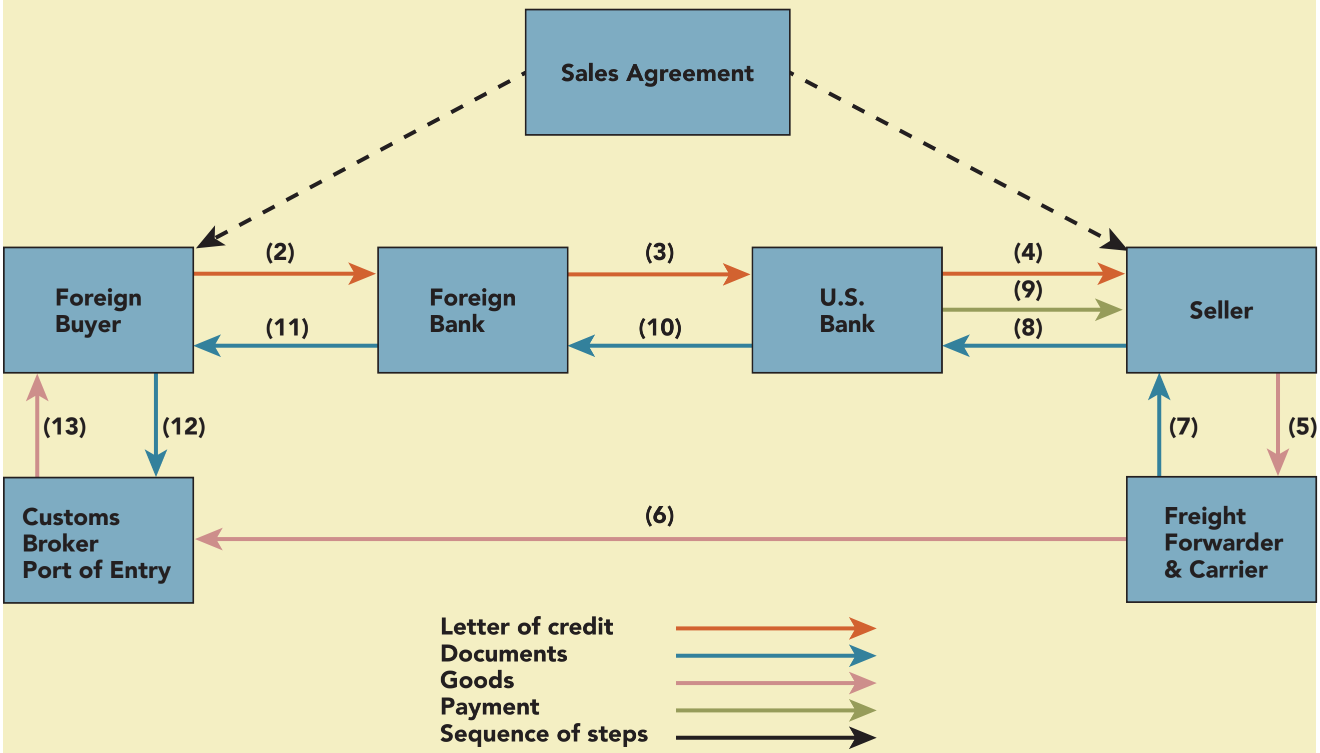
The process of getting a letter of credit can take days, if not weeks. Fortunately, this process is being shortened considerably as financial institutions provide letters of credit on

[29]Unless, of course, the letter of credit is revoked: "Neuocrine Biosciences: $5M Letter of Credit Cancelled," *Dow Jones Corporate Filings Alert*, January 14, 2008.

Exhibit 18.4
A Letter-of-Credit Transaction

Here is what typically happens when payment is made by an irrevocable letter of credit confirmed by a U.S. bank. Follow the steps in the illustration below.

1. Exporter and customer agree on terms of sale.
2. Buyer requests its foreign bank to open a letter of credit.
3. The buyer's bank prepares an irrevocable letter of credit (LC), including all instructions, and sends the irrevocable letter of credit to a U.S. bank.
4. The U.S. bank prepares a letter of confirmation and letter of credit and sends to seller.
5. Seller reviews LC. If acceptable, arranges with freight forwarder to deliver goods to designated port of entry.
6. The goods are loaded and shipped.
7. At the same time, the forwarder completes the necessary documents and sends documents to the seller.
8. Seller presents documents, indicating full compliance, to the U.S. bank.
9. The U.S. bank reviews the documents. If they are in order, issues seller a check for amount of sale.
10. The documents are airmailed to the buyer's bank for review.
11. If documents are in compliance, the bank sends documents to buyer.
12. To claim goods, buyer presents documents to customs broker.
13. Goods are released to buyer.



Source: Based on "A Basic Guide to Exporting," U.S. Department of Commerce, International Trade Administration, Washington, DC.

the Internet. As one example, AVG Letter of Credit Management LLC uses eTrade Finance Platform (ETFP), an e-commerce trade transaction system that enables exporters, importers, freight forwarders, carriers, and trade banks to initiate and complete trade transactions over the Internet. The company advertises that the efficiencies afforded by the Internet make it possible to lower the cost of an export letter of credit from $500-plus to $25.[30]

Bills of Exchange

Another important form of international commercial payment is **bills of exchange** drawn by sellers on foreign buyers. In letters of credit, the credit of one or more banks is involved,

[30] "QuestaWeb Offers Totally Automated Letter of Credit Feature," *Business Wire*, March 3, 2008.

but with bills of exchange (also known as *dollar drafts*), the seller assumes all risk until the actual dollars are received. The typical procedure is for the seller to draw a draft on the buyer and present it with the necessary documents to the seller's bank for collection. The documents required are principally the same as for letters of credit. On receipt of the draft, the U.S. bank forwards it with the necessary documents to a correspondent bank in the buyer's country; the buyer is then presented with the draft for acceptance and immediate or later payment. With acceptance of the draft, the buyer receives the properly endorsed bill of lading that is used to acquire the goods from the carrier.

Dollar drafts have advantages for the seller because an accepted draft frequently can be discounted at a bank for immediate payment. Banks, however, usually discount drafts only with recourse; that is, if the buyer does not honor the draft, the bank returns it to the seller for payment. An accepted draft is firmer evidence in the case of default and subsequent litigation than an open account would be.

Cash in Advance

The portion of international business handled on a cash-in-advance basis is not large. Cash places unpopular burdens on the customer and typically is used when credit is doubtful, when exchange restrictions within the country of destination are such that the return of funds from abroad may be delayed for an unreasonable period, or when the American exporter for any reason is unwilling to sell on credit terms. Although full payment in advance is employed infrequently, partial payment (from 25 to 50 percent) in advance is not unusual when the character of the merchandise is such that an incomplete contract can result in heavy loss. For example, complicated machinery or equipment manufactured to specification or special design would necessitate advance payment, which would be, in fact, a nonrefundable deposit.

Open Accounts

Sales on open accounts are not generally made in foreign trade except to customers of long standing with excellent credit reputations or to a subsidiary or branch of the exporter. Open accounts obviously leave sellers in a position where most of the problems of international commercial finance work to their disadvantage. Sales on open accounts are generally not recommended when the practice of the trade is to use some other method, when special merchandise is ordered, when shipping is hazardous, when the country of the importer imposes difficult exchange restrictions, or when political unrest requires additional caution.

Forfaiting

Inconvertible currencies and cash-short customers can kill an international sale if the seller cannot offer long-term financing. Unless the company has large cash reserves to finance its customers, a deal may be lost. **Forfaiting** is a financing technique for such a situation.

The basic idea of a forfaiting transaction is fairly simple: The seller makes a one-time arrangement with a bank or other financial institution to take over responsibility for collecting the account receivable. The exporter offers a long financing term to its buyer but intends to sell its account receivable, at a discount, for immediate cash. The forfaiter buys the debt, typically a promissory note or bill of exchange, on a nonrecourse basis. Once the exporter sells the paper, the forfaiter assumes the risk of collecting the importer's payments. The forfaiting institution also assumes any political risk present in the importer's country.[31]

Forfaiting is similar to factoring, but it is not the same. In *factoring*, a company has an ongoing relationship with a bank that routinely buys its short-term accounts receivable at a discount—in other words, the bank acts as a collections department for its client. In forfaiting, however, the seller makes a one-time arrangement with a bank to buy a specific account receivable.

All these ways of payment and the associated fees and, of course, the prices to be paid are most often negotiated between buyers and sellers. This leads us to the topic of the next chapter, international negotiations.

[31]For more information about forfaiting, visit http://www.afia-forfaiting.org.

Summary

Pricing is one of the most complicated decision areas encountered by international marketers. Rather than deal with one set of market conditions, one group of competitors, one set of cost factors, and one set of government regulations, international marketers must take all these factors into account, not only for each country in which they are operating but often for each market within a country. Market prices at the consumer level are much more difficult to control in international than in domestic marketing, but the international marketer must still approach the pricing task on a basis of established objectives and policy, leaving enough flexibility for tactical price movements. Controlling costs that lead to price escalation when exporting products from one country to another is one of the most challenging pricing tasks facing the exporter. Some of the flexibility in pricing is reduced by the growth of the Internet, which has a tendency to equalize price differentials between country markets.

The continuing growth of Third World markets coupled with their lack of investment capital has increased the importance of countertrades for most marketers, making countertrading an important tool to include in pricing policy. The Internet is evolving to include countertrades, which will help eliminate some of the problems associated with this practice.

Pricing in the international marketplace requires a combination of intimate knowledge of market costs and regulations, an awareness of possible countertrade deals, infinite patience for detail, and a shrewd sense of market strategy. Finally, letters of credit and other issues related to getting paid are discussed.

Key Terms

Parallel market
Gray market
Exclusive distribution
Variable-cost pricing
Full-cost pricing
Skimming
Penetration pricing policy
Price escalation
Dumping
Countervailing duty
Countertrade
Barter
Administered pricing
Cartel
Letters of credit
Bills of exchange
Forfaiting

Questions

1. Define the key terms listed above.
2. Discuss the causes of and solutions for parallel imports and their effect on price.
3. Why is it so difficult to control consumer prices when selling overseas?
4. Explain the concept of price escalation and why it can mislead an international marketer.
5. What are the causes of price escalation? Do they differ for exports and goods produced and sold in a foreign country?
6. Why is it seldom feasible for a company to absorb the high cost of international transportation and reduce the net price received?
7. Price escalation is a major pricing problem for the international marketer. How can this problem be counteracted? Discuss.
8. Changing currency values have an impact on export strategies. Discuss.
9. "Regardless of the strategic factors involved and the company's orientation to market pricing, every price must be set with cost considerations in mind." Discuss.
10. "Price fixing by business is not generally viewed as an acceptable practice (at least in the domestic market), but when governments enter the field of price administration, they presume to do it for the general welfare to lessen the effects of 'destructive' competition." Discuss.
11. Do value-added taxes discriminate against imported goods?
12. Explain specific tariffs, ad valorem tariffs, and compound tariffs.
13. Suggest an approach a marketer may follow in adjusting prices to accommodate exchange rate fluctuations.
14. Explain the effects of indirect competition and how they may be overcome.
15. Why has dumping become such an issue in recent years?
16. Cartels seem to rise, after they have been destroyed. Why are they so appealing to business?
17. Discuss the different pricing problems that result from inflation versus deflation in a country.
18. Discuss the various ways in which governments set prices. Why do they engage in such activities?
19. Discuss the alternative objectives possible in setting prices for intracompany sales.
20. Why do governments so carefully scrutinize intracompany pricing arrangements?
21. Why are costs so difficult to assess in marketing internationally?
22. Discuss why countertrading is on the increase.

23. Discuss the major problems facing a company that is countertrading.
24. If a country you are trading with has a shortage of hard currency, how should you prepare to negotiate price?
25. Of the four types of countertrades discussed in the text, which is the most beneficial to the seller? Explain.
26. Why should a "knowledge of countertrades be part of an international marketer's pricing toolkit"? Discuss.
27. Discuss the various reasons purchasers impose countertrade obligations on buyers.
28. Discuss how FTZs can be used to help reduce price escalation.
29. Why is a proactive countertrade policy good business in some countries?
30. Differentiate between proactive and reactive countertrade policies.
31. One free trade zone is in Turkey. Visit www.esbas.com.tr and discuss how it might be used to help solve the price escalation problem of a product being exported from the United States to Turkey.
32. Visit Global Trading (a division of 3M) at www.mmm.com/globaltrading/edge.html and select "The Competitive Edge" and "Who We Are." Then write a short report on how Global Trading could assist a small company that anticipates having merchandise from a countertrade.