



## CHAPTER OVERVIEW

1. DRIVERS OF FOREIGN MARKET PRICING
2. MANAGING PRICE ESCALATION
3. PRICING IN INFLATIONARY ENVIRONMENTS
4. GLOBAL PRICING AND CURRENCY FLUCTUATIONS
5. TRANSFER PRICING
6. GLOBAL PRICING AND ANTIDUMPING REGULATION
7. PRICE COORDINATION
8. COUNTERTRADE

Global pricing is one of the most critical and complex issues that global firms face. Price is the only marketing mix instrument that creates revenues. All other elements entail costs. Thus, a company's global pricing policy may make or break its overseas expansion efforts. Furthermore, a firm's pricing policy is inherently a highly cross-functional process based on inputs from the firm's finance, accounting, manufacturing, tax, and legal divisions. Predictably, the interests of one group (say, marketing) may clash with the objectives of another group (say, finance).

Multinationals also face the challenge of how to coordinate their pricing policy across different countries. A lack of coordination will create a parallel trade or gray market situation (see Chapter 15). With parallel imports, middlemen make a profit by shipping products from low priced countries to higher priced markets. These imports will compete with the high-priced equivalent products offered by legitimate distributors. Efforts to trim big price gaps between countries may be hampered by stonewalling attempts of local country managers or distribution channels.

This chapter will focus on global pricing strategies. After presenting an overview of the key drivers of foreign market pricing, we will discuss several strategic international pricing issues. The chapter concludes with a discussion of countertrade, which is a form of non-cash pricing.

**EXHIBIT 12-1**

## RETAIL PRICE COMPARISON ACROSS CITIES

(Index = Recorded Price/Lowest Price × 100)

Item	New York	Hong		Seoul	Tokyo	Paris	London	Shanghai	Sydney	Date
		Kong								
Nikon D80 SLR Camera	103.9 (\$816)	<b>100.0</b> <b>(\$786)</b>		105.2 (\$827)	114.9 (\$903)	167.4 (\$1,316)	129.9 (\$1,021)	107.6 (\$846)	NA	March 2008
Davidoff Cigar Cutter	145.0 (\$322)	164.0 (\$364)	<b>100.0</b> <b>(\$222)</b>		202.7 (\$450)	137.3 (\$305)	124.3 (\$276)	164.4 (\$365)	154.9 (\$344)	December 2008
Listerine Mouthwash	131.1 (\$4.72)	121.4 (\$4.37)	<b>100.0</b> <b>(\$3.60)</b>		NA	215.3 (\$7.75)	164.7 (\$5.93)	NA	150.3 (\$5.41)	December 2008
iRobot Vacuum Cleaner	<b>100.0</b> <b>(\$324)</b>	182.4 (\$591)		115.7 (\$375)	232.7 (\$754)	130.9 (\$424)	109.6 (\$355)	NA	122.5 (\$397)	October 2008
Prada Nappa Gauffré Antik handbag	111.8 (\$2,915)	<b>100.0</b> <b>(\$2,607)</b>		116.5 (\$3,038)	111.9 (\$2,918)	NA	NA	112.1 (\$2,923)	113.0 (\$2,945)	November 2006
TaylorMade Golf Club	127.8 (\$216)	<b>100.0</b> <b>(\$169)</b>		NA	174.0 (\$294)	NA	NA	NA	140.0 (\$236)	November 2006
Jack Daniel's 750 ml Whiskey	106.0 (\$25.46)	156.4 (\$37.55)		200.0 (\$47.96)	126.0* (\$30.26)	<b>100.0*</b> <b>(\$24.01)</b>	141.3* (\$33.94)	NA	NA	November 2006
Sonicare Toothbrush	107.1 (\$120)	<b>100.0</b> <b>(\$112)</b>		108.9 (\$122)	103.6 (\$116)	139.3 (\$156)	158.9 (\$178)	156.2 (\$175)	NA	September 2008
BlackBerry Bold 9000	<b>100.0</b> <b>(\$571)</b>	115.1 (\$657)		116.7 (\$666)	NA	114.9 (\$656)	128.7 (\$735)	NA	132.0 (\$754)	April 2009
Brita Marella Jug	NA	222.0 (\$46.16)		231.5 (\$48.13)	207.7 (\$43.19)	121.6 (\$25.29)	108.4 (\$22.54)	NA	<b>100.0</b> <b>(\$20.79)</b>	November 2008

\*700 ml

Source: Based on various issues of the Weekend Journal of the *Wall Street Journal* ("Arbitrage")

## ◆ ◆ ◆ ◆ ◆ ◆ ◆ ◆ DRIVERS OF FOREIGN MARKET PRICING

In December 2008, the retail price recorded for a 500 ml bottle of Listerine mouthwash was \$3.60 (4,720 won) in Seoul, \$4.72 in New York, and \$11.27 (€8) in Rome; for a Davidoff cigar cutter was \$222 (323,000 won) in Seoul, \$322 in New York, and \$727 (25,900 baht) in Bangkok.<sup>1</sup> Even within the same geographic area such as the pan-European market, wide cross-border price differences are quite common. **Exhibit 12-1** shows retail price variations for a sample of other products around the world. What lies behind these enormous price variations? A hodgepodge of factors governs global pricing decisions. Some of the drivers are related to the 4 Cs: *Company* (costs, company goals), *Customers* (price sensitivity, segments, consumer preferences), *Competition* (market structure, intensity), and *Channels*. Aside from these, in many countries, multinationals' pricing decisions are often influenced by government policies (price controls, taxes, import duties). We now consider the main drivers that may affect global pricing.

### Company Goals

When developing a pricing strategy for its global markets, the firm needs to decide what it wants to accomplish with its strategy. These goals might include maximizing current profits, penetrating the market, projecting a premium image, and so forth. According to one study,<sup>2</sup> the most important pricing objectives of companies doing business in the

<sup>1</sup>Price data compiled from December 2008 issues in the "Arbitrage" section of the weekend edition of *Wall Street Journal*. Prices include taxes.

<sup>2</sup>S. Samiee, "Pricing in Marketing Strategies of U.S.- and Foreign-Based Companies," *Journal of Business Research*, vol. 15, 1987, pp. 17–30.

United States (including foreign-based firms) are (1) to achieve a satisfactory return on investment, (2) to maintain market share, and (3) to meet a specified profit goal (in that order). Company objectives will vary from market to market, especially in multinationals with a large degree of local autonomy. New Balance, the U.S.-based maker of high-tech running shoes, sells its shoes in France as haute couture items rather than simply athletic shoes (as it does in the United States for instance). To beef up the premium image, the price in France is almost twice the U.S.-price.<sup>3</sup> Company goals are likely to change over time. Initially, when a firm enters a country, it often sets a relatively low price (compared to other countries) to penetrate the market. Once the firm is well entrenched, it may shift its objectives and bring them in line with the goals pursued in other countries.

Company costs figure prominently in the pricing decision. Costs set the floor: the company wants to set at least a price that will cover all costs needed to make and sell its products. Cost differentials between countries can lead to wide price gaps. It is important that management considers all relevant costs of manufacturing, marketing and distributing the product. Company costs consist of two parts: variable costs, which change with sales volume, and fixed costs (e.g., overheads) that do not vary.

Export pricing policies differ depending on the way costs are treated.<sup>4</sup> Three basic options exist for setting export prices: (1) rigid cost-plus pricing, (2) flexible cost-plus pricing, and (3) dynamic incremental pricing.<sup>5</sup> With **rigid cost-plus pricing**, the export price is set by adding all costs accrued in selling the product to the international market and a gross margin. The second option, **flexible cost-plus pricing**, closely resembles the first method but adjusts prices to market conditions in the host market (e.g., level of competition). The final method, **flexible cost-plus pricing**, arrives at a price after removing domestic fixed costs. The premise is that these costs have to be borne anyway, as they are *sunk costs*, regardless of whether or not the goods are exported. Only variable costs generated by the exporting efforts and a portion of the overhead load (the “incremental” costs) should be recuperated. Examples of exporting-related incremental costs include manufacturing costs, shipping expenses, insurance, and overseas promotional costs. Although the last approach is more suitable from an economic perspective, it comes with certain risks. In the export market, situations where the export list price is far below the domestic price could trigger accusations of dumping, as discussed later.

When demand is highly price sensitive, the company needs to consider how it can reduce costs from a global perspective. Manufacturing scale economies provide an incentive to standardize product offerings or to consolidate manufacturing facilities. In some markets, logistics costs can be trimmed by centralizing distribution centers or warehouse facilities. By the same token, significant marketing costs may prompt a multinational operating in Europe to develop pan-European advertising campaigns. In many developing countries, high price sensitivity is a big hurdle. Hindustan Lever, Unilever’s India subsidiary, spends a large amount of its R&D money on developing new technologies to lower production costs. Companies operating in these countries typically try to source mainly from local suppliers. McDonald’s India imports only potato chips; all other ingredients are sourced locally. However, the company has set up a potato research unit to improve the quality of Indian potatoes.<sup>6</sup> Kellogg, on the other hand, entered India with costly packaging (seven-ply cartons, foil pouches, five colors), and expensive advertising. A local competitor, Champion, piggybacked on Kellogg’s marketing efforts and conquered the breakfast cereal market with products at one-fifth of Kellogg’s price.<sup>7</sup>

<sup>3</sup>“The Road to Richesse,” *Sales & Marketing Management* (November 1999), pp. 89–96.

<sup>4</sup>S. Tamer Cavusgil, “Unraveling the Mystique of Export Pricing,” *Business Horizons*, vol. 31, May–June 1988, pp. 54–63.

<sup>5</sup>See for instance, Kristiaan Helsen, “Pricing in the Global Marketplace,” in *The SAGE Handbook of International Marketing*, M. Kotabe and K. Helsen (eds.) (London: SAGE Publications, 2009).

<sup>6</sup>“Hard Sell to a Billion Consumers,” *Financial Times* (April 25, 2002), p. 14.

<sup>7</sup>“Slim Pickings for the Global Brand in India,” *Financial Times* (October 11, 2000), p. 14.

## Company Costs

**Customer Demand** Whereas costs set a floor, the consumers' willingness to pay for your product set a ceiling to the price. Consumer demand is function of buying power, tastes, habits and substitutes. These demand conditions will vary from country to country. Buying power is a key consideration in pricing decisions. Countries with low per-capita incomes pose a dilemma. Consumers in such countries are far more price-sensitive than in developed markets. Therefore, price premiums are often a major hurdle for most consumers in these markets. Foreign companies targeting the masses in emerging markets such as China or India offer cheaper products with lower costs by changing the product formula, packaging or size. One risk here is brand dilution, where a premium brand loses its cachet when a large number of consumers start using it. Another danger is cannibalization. This occurs when high-income customers switch to the cheaper products in the firm's product line. The marketing of Procter & Gamble's Crest toothpaste in China illustrates how companies can manage these issues. To lure the Chinese middle classes, P&G changed the brand's formulation and packaging to emphasize cavity prevention, a generic benefit. The whitening benefit was reserved for premium Crest products.<sup>8</sup> In Egypt, one of the moves that P&G undertook to revitalize the sales of Ariel, its high suds laundry detergent brand, was to downsize the package size from 200 grams to 150 grams, thereby lowering the cash outlay for ordinary consumers.<sup>9</sup>

Another strategic option is to be a niche player by charging prices in the same range as Western prices and target the upper-end of the foreign market. Marketers such as Starbucks and Häagen-Dazs follow this option in their global strategy. Starbucks charges by and large the same price worldwide, whether its coffee is sold in wealthy Western markets or poorer countries such as Thailand or China. A third option is to have a portfolio of products that cater to different income tiers. Hindustan Lever, Unilever's India subsidiary, dominates many consumer goods categories by following this road. One final option—which seldom works—is to sell older versions of the product at a lower price in markets with low buying power. For instance, in India, Daimler sold older Mercedes models; United Distillers sold passé brands such as Vat 69. Such a pricing strategy can backfire as it manifests a certain amount of arrogance toward the local population.<sup>10</sup>

Typically, the nature of demand will change over time. In countries that were entered recently, the firm may need to stimulate trial via discounting or a penetration pricing strategy. In more mature markets, the lion's share of customers will be repeat-buyers. Once brand loyalty has been established, price will play less of a role as a purchase criterion, and the firm may be able to afford the luxury of a premium pricing strategy. Obviously, the success of such a pricing strategy will hinge on the company's ability to differentiate its product from the competition.

Cultural symbolism can also influence pricing decisions. In Chinese cultures, the number "8" has an auspicious meaning as the word for "eight" (bā) sounds similar to the Chinese word for "wealth" (fā). As a result, special price offers in Chinese cultures often end with at least one 8 digit (see **Exhibit 12-2**). For instance, Bank of China, the world's third largest bank, set a mortgage arrangement fee of 8888 when it started offering mortgages to British house buyers. However, it switched to the more recognizable figure of 995.<sup>11</sup>

**Competition** Competition is another key factor in global pricing. Differences in the competitive situation across countries will usually lead to cross-border price differentials. The competitive situation may vary for a number of reasons. First, the number of competitors typically differs from country to country. In some countries, the firm faces very few

<sup>8</sup>"The Right Way to Appeal to the Masses," *Financial Times* (September 15, 2004): 10.

<sup>9</sup>Mahmoud Aboul-Fath and Loula Zaklama, "Ariel High Suds detergent in Egypt—A case study," *Marketing and Research Today*, May 1992, pp. 130–35.

<sup>10</sup>"Slim Pickings for the Global Brand in India," *Financial Times* (October 11, 2000), p. 14.

<sup>11</sup>"Bank of China Offers Mortgages to UK Borrowers," <http://www.ft.com>, accessed on July 29, 2009.

**EXHIBIT 12-2**  
PRICE PROMOTIONS IN CHINESE CULTURES WITH END-8 PRICES



Courtesy of Kristiaan Helsen



competitors (or even enjoys a monopoly position), whereas in others, the company has to combat numerous competing brands. Also, the nature of competition will differ: global versus local players, private firms versus state-owned companies. Even when local companies are not state-owned, they often are viewed as “national champions” and treated accordingly by their local governments. Such a status entails subsidies or other goodies (e.g., cheap loans) that enable them to undercut their competitors. In some markets, firms have to compete with a knock-off version of their own product. The presence of counterfeit products could force the firm to lower its price in such markets. Microsoft, for instance, slashed the Chinese price of its MS Office software suite by more than 70 percent from Rmb699 to Rmb199 (\$29) in 2008 to encourage consumers to purchase genuine software instead of pirated software. The piracy rate for personal computer software in China was estimated to be more than 80 percent in 2007.<sup>12</sup>

In developing countries, especially in rural areas, the nature of competition can also vary. An Indian villager is not just choosing between a bottle of Coca-Cola and Pepsi but also between buying one soft drink, a disposable razor or a tube of toothpaste.

The role of competition can be illustrated by taking a look at the pharmaceutical industry. The data in **Exhibit 12-3** show the average quarterly volume sales and selling price (charged by manufacturers) for three antidepressants (Prozac, Zoloft, Paxil) marketed in the United States, the UK, France, Italy, and Germany. Looking at the

<sup>12</sup>“Microsoft Aims to Undercut Chinese Pirates,” *Financial Times*, September 24, 2008, p. 22.

**EXHIBIT 12-3**

## AVERAGE QUARTERLY SALES &amp; EX-FACTORY SELLING PRICES OF ANTIDEPRESSANTS (1988, Q1–1999, Q1)

Brand	Manufacturer	United States	Germany	Italy	UK	France
Prozac	Eli (U.S.)	Lilly				
Sales		162.13	2.47	3.65	18.88	32.92
Price		1.62	1.48	0.99	1.18	0.84
Zoloft	Pfizer (U.S.)					
Sales		140.05	1.99	1.77	7.3	9.47
Price		1.59	1.0	0.92	1.4	0.70
Paxil	GSK (U.K.)					
Sales		110.46	1.66	4.04	16.70	21.94
Price		1.59	1.48	1.20	1.26	0.65

Source: Based on Table 1 (p. 73) of Pradeep K. Chintagunta and Ramarao Desiraju, “Strategic Pricing and Detailing Behavior in International Markets,” *Marketing Science* 24 (Winter 2005).

data, you can see that Prozac (from Eli Lilly based in the United States) charges a higher price than Paxil (from GlaxoSmithKline in the UK). However, the reverse is the case in the United Kingdom. An in-depth analysis of this particular industry found that pharmaceutical companies tend to behave much more aggressively toward their competitors in the home market as opposed to foreign markets.<sup>13</sup>

In many markets, legitimate distributors of global brands need to compete with smugglers. Smuggling operations put downward pressure on the price of the affected product. The strength of private labels (store brands) is another important driver. In countries where store brands are well entrenched, companies are forced to accept lower margins than elsewhere.

A company’s competitive position typically varies across countries. Companies will be price leaders in some countries and price takers in other countries. Heinz’s policy is to cut prices in markets where it is not the leading brand.<sup>14</sup> Finally, the rules of the game usually differ. Non-price competition (e.g., advertising, channel coverage) may be preferable in some countries. Elsewhere, price combats are a way of life. For example, in Western countries, a price war is to be avoided at all cost. In contrast, Chinese companies often see a price war as a strategic weapon to grab market dominance, as illustrated in **Global Perspective 12-1**.

## Distribution Channels

Another driver behind global pricing is the distribution channel. The pressure exercised by channels can take many forms. Variations in trade margins and the length of the channels will influence the ex-factory price charged by the company. The balance of power between manufacturers and their distributors is another factor behind pricing practices. Countries such as France and the United Kingdom are characterized by large retailers who are able to order in bulk and to bargain for huge discounts with manufacturers. In the pan-European market, several smaller retailers have formed cross-border co-ops to strengthen their negotiation position with their common suppliers. The power of large-scale retailers in Europe is vividly illustrated by the hurdles that several manufacturers faced in implementing every-day-low-pricing (EDLP). With EDLP, the manufacturer offers consistently lower prices to the retailer (and the ultimate shopper) instead of promotional price discounts and trade promotions.<sup>15</sup> Several German supermarket chains de-listed P&G brands like Ariel, Vizir, and Lenor detergent products, Bess toilet tissue

<sup>13</sup>Pradeep K. Chintagunta and Ramarao Desiraju, “Strategic Pricing and Detailing Behavior in International Markets,” *Marketing Science* 24 (Winter 2005): 67–80.

<sup>14</sup>“Counting costs of dual pricing,” *Financial Times*, July 9, 1990, p. 4.

<sup>15</sup>Trade promotions are promotions where the manufacturer offers monetary incentives to the channel (e.g., wholesalers, retailers) as a reward for activities (e.g., in-store displays, price discounts, advertising the manufacturer’s product) that will stimulate the sales of the product. The most common trade promotion tools include off-invoice allowances (discount off the list price on the invoice) and extra cases of merchandise for channels who order a minimum amount.



## GLOBAL PERSPECTIVE 12-1

### PRICE WARFARE IN CHINA'S COLOR TV MARKET

China's color TV industry was highly fragmented in early 1996, with more than 130 manufacturers. Of these, only 12 had annual sales of over 500,000 units. Among these, each player sold less than 120,000 units per year. As a result, very few manufacturers could enjoy economies of scale. A vast majority of these companies were owned by local governments. As a result, there was very little room to achieve scale economies through merger and acquisitions or market entry. At the time, China's TV market was a two-tier market with local brands at the low-end and foreign brands such as Sony serving the top-end of the market with a 20 percent price premium over local brands.

Among the Chinese producers, Changhong was at the time the largest and most cost efficient manufacturer, with a capacity that was at least double of the next biggest one. Being the largest producer of many key TV components (e.g., plastic injections, remote controls), the firm was also highly vertically integrated. In spite of its dominance, Changhong was very concerned about its long-term future. The company's success had made it a target of foreign competitors. Changhong had to find a way to shore up its competitive position. Based on inputs from pricing experts and market surveys the firm

decided that the best means to bolster its market share would be a price war. Several reasons were behind their thinking. First, a price war would squeeze out small, less efficient domestic players. Second, a price war would also enable Changhong to tackle its foreign (mainly Japanese) rivals. If they followed suit and lowered their prices, they might cheapen their brand image and hurt their profit margin. Further, any drastic price cut would require approval from headquarters, which could be a very time-consuming ordeal. Finally, a price war could also capitalize on Changhong's huge inventory and its integrated supply chain. On March 16, 1996, Changhong triggered a price war by announcing a discount of 8 percent to 18 percent for all its 17-inch to 29-inch color TVs. The war evolved largely according to plan. The four biggest domestic players did not follow suit until June 6, 1996. Three reasons were behind their slow response: (1) surprise, (2) the fragmented nature of the Chinese TV market, and (3) thin profit margins. Foreign brands decided to sit on the fence and focus on quality, not on price.

The price war drastically changed the competitive landscape in China's TV market. A few months after the price war, Changhong's market share had increased from 16.7 percent to 31.6 percent. The market share of small domestic brands tumbled. The Japanese players' market share also declined drastically.

*Source:* Z. John Zhang and Dongsheng Zhou, "The Art of Price War: A Perspective from China," Working Paper, The Wharton School of the University of Pennsylvania, 2006.

when P&G introduced EDLP in Germany in early 1996.<sup>16</sup> Likewise, Delhaize,<sup>17</sup> a large Belgian grocery chain, removed about 300 Unilever products from its stores claiming that they were priced too high. The banished products included major brands such as Dove soap and Axe deodorant.<sup>18</sup>

Large cross-country price gaps open up arbitrage opportunities that lead to **parallel imports (gray markets)** from low-price countries to high-price ones. These parallel imports are commonly handled by unauthorized distributors at the expense of legitimate trade channels. To curtail parallel trade, firms can consider narrowing cross-border price disparities. Thus, pre-emption of cross-border bargain hunting is often times a strong motivation behind a company's pricing practices.

Even after the launch of the euro, car prices in the European Union can still vary by up to 50 percent. One of the main reasons for these car price disparities is the sales tax rate for new cars. These vary from as low as 15 percent in Luxembourg up to 213 percent in Denmark. This taxation gap also has an impact on pre-tax car prices. In fact, most carmakers in Europe subsidize the pre-tax prices in high-tax countries by charging more in low-tax countries.<sup>19</sup>

## Government Policies

<sup>16</sup>"Heat's on value pricing," *Advertising Age International*, January 1997, pp. I-21, I-22.

<sup>17</sup>Delhaize also operates 1,500 stores in the United States, including the Food Lion chain.

<sup>18</sup>"Belgian Grocer Battles Unilever on Pricing," *The Wall Street Journal Asia*, February 12, 2009, p. 16.

<sup>19</sup>"Car price disparities highlighted," *Financial Times* (January 7, 1999), p. 2.





manufacturer and end-user) or because of exorbitant margins. In some circumstances, it is possible to shorten the channel. Alternatively, firms could look into channel arrangements that provide cost efficiencies. In recent years, several U.S. companies have decided to penetrate the Japanese consumer market through direct marketing (e.g., catalog sales, telemarketing, selling through the internet). This allows them to bypass the notorious Japanese distribution infrastructure and become more price-competitive.

2. **Eliminate costly features (or make them optional).** Several exporters have addressed the price escalation issue by offering no-frills versions of their product. Rather than having to purchase the entire bundle, customers can buy the core product and then decide whether or not they want to pay extra for optional features.
3. **Downsize the product.** Another route to dampen sticker shock is downsizing the product by offering a smaller version of the product or a lesser count.<sup>25</sup> This option is only desirable when consumers are not aware of cross-border volume differences. To that end, manufacturers may decide to go for a local branding strategy.
4. **Assemble or manufacture the product in foreign markets.** A more extreme option is to assemble or even manufacture the entire product in foreign markets (not necessarily the export market). Closer proximity to the export market will lower transportation costs. To lessen import duties for goods sold within European Union markets, numerous firms have decided to set up assembly operations in EU member states.
5. **Adapt the product to escape tariffs or tax levies.** Finally, a company could also modify its export product to bring it into a different tariff or tax bracket. When the United States levied a new 10 percent tax on over \$30,000 luxury cars, Land Rover increased the maximum weight of Range Rover models sold in America to 6,019 pounds. As a result, the Range Rover was classified as a truck (not subject to the 10 percent luxury tax) rather than a luxury car.

These measures represent different ways to counter price escalation. Alternatively, an exporter could exploit the price escalation situation and go for a premium positioning strategy. LEGO, the Danish toymaker, sells building block sets in India that are priced between \$6 and \$223, far more than most other toys that Indian parents can purchase. To justify the premium price, LEGO uses a marketing strategy that targets middle-class parents and stresses the educational value of LEGO toys.<sup>26</sup> Of course, for this strategy to work, other elements of the export marketing-mix should be in tandem with the premium positioning. In Europe and Japan, Levi Strauss sells its jeans mainly in upscale boutiques rather than in department stores.<sup>27</sup>

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## PRICING IN INFLATIONARY ENVIRONMENTS



When McDonald's opened its doors in January 1990, a Big Mac meal (including fries and a soft drink) in Moscow cost 6 rubles. Three years later, the same meal cost 1,100 rubles.<sup>28</sup> Rampant inflation is a major obstacle to doing business in many countries. Moreover, high inflation rates are usually coupled with highly volatile exchange rate movements. In such environments, price setting and stringent cost control become extremely crucial. Not surprisingly, in such markets, companies' financial divisions are often far more important than other departments.<sup>29</sup>

<sup>25</sup>Loyal Coca-Cola cross-border travelers may have noticed can-size differences of their favorite tippie. For instance, for Diet Coke, can sizes range from 325 ml (e.g., Malaysia, Thailand) up to 355 ml (U.S.A.). See <http://xoomer.virgilio.it/davide.andreani/Cokesize.htm> for a complete listing of Coke can sizes around the world.

<sup>26</sup>"LEGO building its way to China," *Advertising Age International*, March 20, 1995, p. I-29.

<sup>27</sup>"The Levi straddle," *Forbes*, January 17, 1994, p. 44.

<sup>28</sup>"Inflation bits Russians, who still bite into Big Mac," *Advertising Age International*, March 15, 1993, pp. I-3, I-23.

<sup>29</sup>"A rollercoaster out of control," *The Financial Times*, February 22, 1993.

There are several alternative ways to safeguard against inflation

1. **Modify components, ingredients, parts and/or packaging materials.** Some ingredients are subject to lower inflation rates than others. This might justify a change in the ingredient mix. Of course, before implementing such a move, the firm should consider all its consequences (e.g., consumer response, impact on shelf life of the product).
2. **Source materials from low-cost suppliers.** Supply management plays a central role in high inflation environments. A first step is to screen suppliers and determine which ones would be most cost efficient without cutting corners. If feasible, materials could be imported from low-inflation countries. Note, however, that high inflation rates are coupled with a weakening currency. This will push up the price of imports.
3. **Shorten credit terms.** In some cases, profits can be realized by juggling the terms of payment. For instance, a firm that is able to collect cash from its customers within fifteen days, but has one month to pay its suppliers, can invest its money during the 15-day grace period. Thus, firms strive to push up the lead time in paying their suppliers. At the same time, they also try to shorten the time to collect from their clients.<sup>30</sup>
4. **Include escalator clauses in long-term contracts.** Many business-to-business marketing situations involve long-term contracts (e.g., leasing arrangements). To hedge their position against inflation, the parties will include escalator clauses that will provide the necessary protection.
5. **Quote prices in a stable currency.** To handle high inflation, companies often quote prices in a stable currency such as the U.S. dollar or the euro.
6. **Pursue rapid inventory turnovers.** High inflation also mandates rapid inventory turnarounds. As a result, information technologies (e.g., scanning techniques, computerized inventory tracking) that facilitate rapid inventory turnovers or even just-in-time delivery will yield a competitive advantage.
7. **Draw lessons from other countries.** Operations in countries with a long history of inflation offer valuable lessons for ventures in other high-inflation countries. Cross-fertilization by drawing from experience in other high inflation markets often helps. Some companies—McDonald's<sup>31</sup> and Otis Elevator International,<sup>32</sup> for example—have relied on expatriate managers from Latin America to cope with inflation in the former Soviet Union. One of the lessons drawn from Brazil was that McDonald's negotiates a separate inflation rate with each supplier. These rates are then used for monthly realignments, instead of the government's published inflation figures.

To combat hyperinflation, governments occasionally impose price controls (usually coupled with a wage freeze). For instance, Brazil went through five price freezes over a six-year interval. Such temporary price caps could be selective, targeting certain products, but, in extreme circumstances, they will apply across-the-board to all consumer goods. Price freezes have proven to be very ineffective to dampen inflation—witness the experience of Brazil. Often, expectations of an imminent price freeze start off a rumor mill that will spur companies to implement substantial price increases, thereby setting off a vicious cycle. One consequence of price controls is that goods are diverted to the black market or smuggled overseas, leading to shortages in the regular market.

Companies faced with price controls can consider several action courses:

1. **Adapt the product line.** To reduce exposure to a government imposed price freeze, companies diversify into product lines that are relatively free of price controls.<sup>33</sup> Of

<sup>30</sup>“A rollercoaster out of control,” *Financial Times*, February 22, 1993.

<sup>31</sup>“Inflation lessons over a Big Mac,” *Financial Times*, February 22, 1993.

<sup>32</sup>“Russians up and down,” *Financial Times*, October 18, 1993, p. 12.

<sup>33</sup>Venkatakrisna V. Bellur, Radharao Chaganti, Rajeswararao Chaganti, and Saraswati P. Singh, “Strategic Adaptations to Price Controls: The Case of the Indian Drug Industry,” *Journal of the Academy of Marketing Science*, vol. 13, no. 1, Winter 1985, pp. 143–59.

course, before embarking on such a changeover, the firm has to examine the long-term ramifications. Modifying the product line could imply loss of economies of scale, an increase in overheads, and adverse reactions from the company's customer base.

2. **Shift target segments or markets.** A more drastic move is to shift the firm's target segment. For instance, price controls often apply to consumer food products but not to animal-related products. So, a maker of corn-based consumer products might consider a shift from breakfast cereals to chicken-feed products. Again, such action should be preceded by a thorough analysis of its strategic implications. Alternatively, a firm might consider using its operations in the high-inflation country as an export base for countries that are not subject to price controls.
3. **Launch new products or variants of existing products.** If price controls are selective, a company can navigate around them by systematically launching new products or modifying existing ones. Faced with price controls in Zimbabwe, bakers added raisins to their dough and called it "raisin bread," thereby, at least momentarily, escaping the price control for bread.<sup>34</sup> Also here, the firm should consider the overall picture by answering questions such as: Will there be a demand for these products? What are the implications in terms of manufacturing economies? Inventory management? How will the trade react? Furthermore, if these products are not yet available elsewhere, this option is merely a long-term solution.
4. **Negotiate with the government.** In some cases, firms are able to negotiate for permission to adjust their prices. Lobbying can be done individually, but is more likely to be successful on an industry-wide basis.
5. **Predict incidence of price controls.** Some countries have a history of price freeze programs. Given historical information on the occurrence of price controls and other economic variables, econometric models can be constructed to forecast the likelihood of price controls. Managers can use that information to see whether or not price adjustments are warranted, given the likelihood of an imminent price freeze.<sup>35</sup>

A drastic action course is simply to leave the country. Many consumer goods companies have chosen this option when they exited their South-American markets during the 1980s. However, companies that hang on and learn to manage a high-inflation environment will be able carry over their expertise to other countries. Further, they will enjoy a competitive advantage (due to entry barriers such as brand loyalty, channel and supplier ties) versus companies that reenter these markets once inflation has been suppressed.

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## GLOBAL PRICING AND CURRENCY FLUCTUATIONS



In May 1992, two of the most expensive car markets in the European Union were Spain and Italy. One year later, Italy and Spain were the two lowest priced markets.<sup>36</sup> Currency volatility within the European Union was mostly responsible for these car price reversals. With a few exceptions (e.g., some Caribbean islands, Ecuador), most countries have their own currency. Exchange rates reflect how much one currency is worth in terms of another currency. Due to the interplay of a variety of economic and political factors, exchange rates continuously float up- or downward. Even membership to a monetary union does not guarantee exchange rate stability. Given the sometimes-dramatic exchange rate movements, setting prices in a floating exchange rate world poses a tremendous challenge.<sup>37</sup> **Exhibit 12-4** lists several exporter strategies under varying currency regimes.

<sup>34</sup>"The Zimbabwean Model," *The Economist* (November 30, 2002), p. 72.

<sup>35</sup>James K. Weekly, "Pricing in Foreign Markets: Pitfalls and Opportunities," *Industrial Marketing Management*, vol. 21, 1992, pp. 173-79.

<sup>36</sup>"Fluctuating exchange rates main factor in European car price comparisons," *Financial Times*, July 5, 1993.

<sup>37</sup>Llewlyn Clague and Rena Grossfield, "Export Pricing in a Floating Rate World," *Columbia Journal of World Business*, Winter 1974, pp. 17-22.

### EXHIBIT 12-4 EXPORTER STRATEGIES UNDER VARYING CURRENCY CONDITIONS

#### When Domestic Currency is *WEAK* . . .

- Stress price benefits
- Costly features expand product line and add more
- Shift sourcing and manufacturing to domestic market
- Exploit export opportunities in all markets
- Conduct conventional cash-for-goods trade
- Use full-costing approach but use marginal-cost pricing to penetrate new/competitive markets
- Speed repatriation of foreign-earned income and collections
- Minimize expenditures in local, host-country currency
- Buy needed services (advertising, insurance, transportation, etc.) in domestic market
- Minimize local borrowing
- Bill foreign customers in domestic currency

#### When Domestic Currency is *STRONG* . . .

- Engage in nonprice competition by improving quality, delivery, and aftersale service
- Improve productivity and engage in vigorous cost reduction
- Shift sourcing and manufacturing overseas.
- Give priority to exports to relatively strong-currency countries
- Deal in countertrade with weak-currency countries
- Trim profit margins and use marginal-cost pricing
- Keep the foreign-earned income in host country, slow collections
- Maximize expenditure in local, host-country currency
- Buy needed services abroad and pay for them in local currency
- Borrow money needed for expansion in local market
- Bill foreign customers in their own currency

Source: S. Tamer Cavusgil, "Unraveling the Mystique of Export Pricing," reprinted from *Business Horizons* (May–June 1988). Copyright 1988 by the Foundation for the School of Business at Indiana University. Used with permission.

### Currency Gain/Loss Pass Through

Two major managerial pricing issues result from currency movements: (1) How much of an exchange rate gain (loss) should be passed through to our customers? and (2) In what currency should we quote our prices? Let us first address the **pass-through** issue. Consider the predicament of American companies exporting to Japan. In principle, a weakening of the U.S. dollar versus the Japanese yen will strengthen the competitive position of U.S.-based exporters in Japan. A weak dollar allows U.S.-based firms to lower the yen-price of American goods exported to Japan. This enables American exporters to steal market share away from the local Japanese competitors without sacrificing profits. By the same token, a stronger U.S. dollar will undermine the competitive position of American exporters. When the dollar appreciates versus the yen, we have the mirror picture of the previous situation: the retail price in yen of American exports goes up. As a result, American exporters might lose market share if they leave their ex-factory prices unchanged. To maintain their competitive edge, they may be forced to lower their ex-factory dollar prices. Of course, the ultimate impact on the exporter's competitive position will also depend on the impact of currency movement on the exporter's costs and the nature of the competition in the Japanese market. The benefits of a weaker dollar could be washed out when many parts are imported from Japan, since the weaker dollar will make these parts more expensive. When most of the competitors are U.S.-based manufacturers, changes in the dollar's exchange rate might not matter.

Let us illustrate these points with a numerical example. Consider the situation in **Exhibit 12-5**, which looks at the dilemmas that a hypothetical U.S.-based exporter to Japan faces when the exchange rate between the U.S. dollar and the Japanese yen changes. In the example we assume a simple linear demand schedule:

$$\text{Demand (in units) in Japanese export market} = 2,000 - 50 \times \text{yen price.}$$

We also make an admittedly dubious assumption: our exporter does not face any costs (in other words, total revenues equal total profits). Initially, one U.S. dollar equals 100

**EXHIBIT 12-5****A NUMERICAL ILLUSTRATION OF PASS THROUGH AND LOCAL CURRENCY STABILITY**

*Demand in Japan (Units) = 2000 - 50 × Price (in Yen)*  
*Costs = \$0.0*

<i>Panel A: 100% Pass Through</i>					
<i>Exchange Rate</i>	<i>Unit Price in US\$</i>	<i>Unit Price in Yen*</i>	<i>Units Sold</i>	<i>US\$ Revenue*</i>	
100 yen = \$1	\$30,000	3.0	1,850	\$55.50	
130 yen = \$1	30,000	3.9	1,805	54.15	
70 yen = \$1	30,000	2.1	1,895	56.85	

<i>Panel B: Local Currency Price Stability (in millions except units sold)</i>					
<i>Exchange Rate</i>	<i>Unit Price in US\$</i>	<i>Unit Price in Yen*</i>	<i>Units Sold</i>	<i>US\$ Revenue*</i>	<i>Revenue Gain(Loss) vs. 100% PT*</i>
100 yen = \$1	\$30,000	3.0	1,850	\$55.50	\$0.00
130 yen = \$1	23,077	3.0	1,850	42.69	(11.45)
70 yen = \$1	42,857	3.0	1,850	79.28	22.45

\*In millions.

*Note:* The dollar appreciation measures the movement of the U.S. producer price index relative to the Japanese and German producer price indices converted into dollars by the nominal exchange rate. The real retail price change measures the movement of the dollar retail price of specific auto models relative to the retail unit value of all domestically produced cars.

*Source:* Reprinted from Joseph A. Gagnon and Michael M. Knetter, "Markup Adjustment and Exchange Rate Fluctuations: Evidence from Panel Data on Automobile Exports," *Journal of International Money and Finance* 14 (2), p. 304. Copyright 1995, with kind permission from Elsevier Science Ltd., Langford Lane, Kidlington OX5 1GB, UK.

yen, and the firm's total export revenue is \$55.5 million. Suppose now that the U.S. dollar has strengthened by 30 percent versus the Japanese yen, moving from an exchange rate of 100 yen to 1 US\$ to a 130-to-1 exchange rate (row 2 in Exhibit 12-5). If the US\$ ex-factory price remains the same (i.e., \$30,000), Japanese consumers will face a 30-percent price increase. Total demand decreases (from 1,850 units to 1,805 units), and US\$ revenue goes down by \$1.35 m. Our American exporter faces the problem of whether or not to pass through exchange rate losses, and if so, how much, of the loss he should absorb. If our exporter does not lower the U.S. dollar ex-factory price, he is likely to lose market share to his Japanese (and/or European) competitors in Japan. Thus, to sustain its competitive position, the U.S.-based manufacturer would be forced to lower its ex-factory price. In this situation, American exporters face the trade-off between sacrificing short-term profits (maintaining price) and sustaining long-term market share in export markets (cutting ex-factory price). For example, in the extreme case, the U.S. firm might consider sustaining the yen-based retail price (i.e., 3 million yen). In that case, US\$ revenues would go down by \$11.45 million.

Generally speaking, the appropriate action will depend on four factors, namely: (1) customers' price sensitivity, (2) the size of the export market, (3) the impact of the dollar appreciation on the firm's cost structure, (4) the amount of competition in the export market, and (5) the firm's strategic orientation. The higher consumers' price sensitivity in the export market, the stronger the case for lowering the ex-factory price. One route to lower price sensitivity is by investing in brand equity. High brand equity provides a buffer to global price competition. With vast markets such as the United States, firms are usually more inclined to absorb currency losses than with smaller countries. A decline in costs resulting from the strengthening of the U.S. dollar (e.g., when many parts are imported from Japan) broadens the price adjustment latitude. The

**EXHIBIT 12-6**RETAIL PRICE CHANGES DURING DOLLAR APPRECIATIONS:  
JAPANESE AND GERMAN EXPORTS TO THE U.S. MARKET

<i>Model</i>	<i>Real Dollar Appreciation</i>	<i>Real Retail Price Change in U.S. Market</i>
Honda Civic 2-Dr. Sedan	39%	-7%
Datsun 200 SX 2-Dr.	39	-10
Toyota Cressida 4-Dr.	39	6
BMW 320i 2-Dr.	42	-8
BMW 733i 4-Dr.	42	-17
Mercedes 300 TD Sta. Wgn.	42	-39

more intense the competition in the export market, the stronger the pressure to cut prices. The fourth factor is the firm's strategic orientation. Firms could be market-share oriented or focus on short-term profits. Naturally, market-share oriented firms would tend to pass through less of the cost increase than their financial performance-oriented counterparts.<sup>38</sup> The bottom row of Exhibit 12-4 shows what happens when the U.S. dollar weakens by 30 percent. In that case we have the mirror picture of the previous scenario.

American exporters might lower their markups much higher in price-conscious export markets than in price-insensitive markets. This type of destination-specific adjustment of markup in response to exchange-rate movement is referred to as **pricing-to-market (PTM)**. PTM behaviors differ across source countries. One study of export pricing adjustments in the U.S. automobile market contrasted pricing decisions of Japanese and German exporters over periods where both the Japanese yen and the German mark depreciated against the U.S. dollar.<sup>39</sup> The results of the study showed that there was much more pass-through (and less PTM) by German exporters than by their Japanese rivals (see **Exhibit 12-6**).

Playing the PTM game carries certain risks. Frequent adjustments of prices in response to currency movements will distress local channels and customers. When local currency prices move up, foreign customers may express their disapproval by switching to other brands. On the other hand, when prices go down, it will often be hard to raise prices in the future. Therefore, often, the preferred strategy is to adjust mark-ups in such a way that local currency prices remain fairly stable. This special form of PTM has been referred to as **local-currency price stability (LCPS)** where markups are adjusted to stabilize prices in the buyer's currency.<sup>40</sup> A case in point is Heineken's pricing policy in the United States. In the three-year period since January 2002, the U.S. dollar lost about a third of its value against the euro. However, the U.S. wholesale price of Heineken and Amstel Light had been increased just twice during the same period, each time by a tiny 2.5 percent. U.S. beer drinkers' gain was Heineken's pain. According to analysts Heineken's annual operating profit from the United States must have fallen from €357 m to €119 m between 2002 and 2006.<sup>41</sup> The bottom panel of Exhibit 12-5 reports the revenue losses or gains of an exporter who maintains LCPS. To pass through exchange rate gains from U.S. dollar devaluations, U.S.-based exporters could resort to

<sup>38</sup>Terry Clark, Masaaki Kotabe, and Dan Rajaratnam, "Exchange Rate Pass-Through and International Pricing Strategy: A Conceptual Framework and Research Propositions," *Journal of International Business Studies*, 30 (Second Quarter 1999), pp. 249-68.

<sup>39</sup>Joseph A. Gagnon and Michael M. Knetter, "Markup adjustment and exchange rate fluctuations: evidence from panel data on automobile exports," *Journal of International Money and Finance*, vol. 14, no. 2, 1995, pp. 289-310.

<sup>40</sup>Michael M. Knetter, "International Comparisons of Pricing-to-Market Behavior," *American Economic Review*, vol. 83, no. 3, pp. 473-486.

<sup>41</sup>"Taking the Hit: European Exporters Find the Dollar's Weakness is Hard to Counter," *Financial Times* (May 3, 2005): 11.

temporary price promotions or other incentives (e.g., trade deals) rather than a permanent cut of the local currency regular price.

Another pricing concern that ensues from floating exchange rates centers on which currency unit is to be used in international business transactions. Sellers and buyers usually prefer a quote in their domestic currency. That way, the other party will have to bear currency risks. The decision largely depends on the balance of power between the supplier and the customer. Whoever yields will need to cover currency exposure risk through hedging transactions on the forward exchange market. A survey of currency choice practices of Swedish, Finish, and American firms found that firms using foreign currencies have higher export volumes and transaction values than exporters using their home currency. However, profit margins suffer.<sup>42</sup> Some firms decide to use a common currency for all their business transactions, world- or region-wide. In the wake of the euro, companies such as Siemens are switching to a euro-regime both for their internal (e.g., transfer pricing) and external (suppliers and distributors) transactions.

## Currency Quotation

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## TRANSFER PRICING



Most large multinational corporations have a network of subsidiaries spread across the globe. Sales transactions between related entities of the same company can be quite substantial, involving trade of raw materials, components, finished goods, or services. **Transfer prices** are prices charged for such transactions. Transfer pricing decisions in an international context need to balance off the interests of a broad range of stakeholders: (1) parent company, (2) local country managers, (3) host government(s), (4) domestic government, and (5) joint venture partner(s) when the transaction involves a partnership. Not surprisingly, reconciling the conflicting interests of these various parties can be a mind-boggling juggling act.

## Determinants of Transfer Prices

A number of studies have examined the key drivers behind transfer pricing decisions. One survey of U.S.-based multinationals found that transfer pricing policies were primarily influenced by the following factors (in order of importance):

1. Market conditions in the foreign country
2. Competition in the foreign country
3. Reasonable profit for foreign affiliate
4. U.S. federal income taxes
5. Economic conditions in the foreign country
6. Import restrictions
7. Customs duties
8. Price controls
9. Taxation in the foreign country
10. Exchange controls.<sup>43</sup>

Other surveys have come up with different rankings.<sup>44</sup> However, a recurring theme appears to be the importance of market conditions (especially, the competitive situation), taxation regimes, and various market imperfections (e.g., currency control,

<sup>42</sup>Saeed Samiee and Patrik Anckar, "Currency Choice in Industrial Pricing: A Cross-National Evaluation," *Journal of Marketing*, 62 (July 1998), pp. 112–27.

<sup>43</sup>Jane Burns, "Transfer Pricing Decisions in U.S. Multinational Corporations," *Journal of International Business Studies*, vol. 11, no. 2, Fall 1980, pp. 23–39.

<sup>44</sup>See, for example, Seung H. Kim and Stephen W. Miller, "Constituents of the International Transfer Pricing Decision," *Columbia Journal of World Business*, Spring 1979, p. 71.

custom duties, price freeze). Generally speaking, MNCs should consider the following criteria when making transfer-pricing decisions:<sup>45</sup>

- **Tax regimes.** Ideally, firms would like to boost their profits in low-tax countries and dampen them in high-tax countries. To shift profits from high-tax to low-tax markets, companies would set transfer prices as high as possible for goods entering high-tax countries and vice-versa for low-tax countries. However, manipulating transfer prices to exploit corporate tax rate differentials will undoubtedly alert the tax authorities in the high-tax rate country and, in the worst case, lead to a tax audit. Most governments impose rules on transfer pricing to ensure a fair division of profits between businesses under common control. We will revisit the taxation issue shortly.
- **Local market conditions.** Another key influence is local market conditions. Examples of market-related factors include the market share of the affiliate, the growth rate of the market, and the nature of local competition (e.g., non-price- versus price-based). To expand market share in a new market, multinationals may initially underprice intra-company shipments to a start-up subsidiary.<sup>46</sup>
- **Market imperfections.** Market imperfections in the host country, such as price freezes and profit repatriation restrictions, hinder the multinational's ability to move earnings out of the country. Under such circumstances, transfer prices can be used as a mechanism to get around these obstacles. Also, high import duties might prompt a firm to lower transfer prices charged to subsidiaries located in that particular country.
- **Joint venture partner.** When the entity concerned is part of a joint venture, parent companies should also factor in the interests of the local joint venture partner. Numerous joint venture partnerships have hit the rocks partly because of disputes over transfer pricing decisions.
- **Morale of local country managers.** Finally, firms should also be concerned about the morale of their local country managers. Especially when performance evaluation is primarily based on local profits, transfer price manipulations might distress country managers whose subsidiaries' profits are artificially deflated.

## Setting Transfer Prices

There are two broad transfer-pricing strategies: market-based transfer pricing and nonmarket-based pricing. The first perspective uses the market mechanism as a cue for setting transfer prices. Such prices are usually referred to as **arm's length prices**. Basically, the company charges the price that any buyer outside the MNC would pay, as if the transaction had occurred between two unrelated companies (at "arm's length"). Tax authorities typically prefer this method to other transfer pricing approaches. Since an objective yardstick is used—the *market price*—transfer prices based on this approach are easy to justify to third parties (e.g., tax authorities). The major problem with arm's length transfer pricing is that an appropriate benchmark is often lacking, due to the absence of competition. This is especially the case for intangible services. Many services are only available within the multinational. A high-stakes dispute between the U.S. Internal Revenue Service and GlaxoSmithKline PLC, the British pharmaceuticals company, illustrates the issue of valuing intangibles vividly.<sup>47</sup> According to the IRS, Glaxo's U.S. subsidiary overpaid its European parent for the royalties associated with scores of drugs, including its blockbuster Zantac drug. Glaxo allegedly had overvalued the drugs' R&D costs in Britain and undervalued the value of marketing activities in the United States, thereby artificially cutting the U.S. subsidiary's profits and tax liabilities. Glaxo vehemently denied this charge. As you can see, the case centered on the issue of where value is created and where credit is due—on the marketing or on the R&D front?

<sup>45</sup>S. Tamer Cavusgil, "Pricing for Global Markets," *Columbia Journal of World Business*, Winter 1996, pp. 66–78.

<sup>46</sup>Mohammad F. Al-Eryani, Pervaiz Alam, and Syed H. Akhter, "Transfer Pricing Determinants of U.S. Multinationals," *Journal of International Business Studies*, vol. 21, Third Quarter 1990, pp. 409–25.

<sup>47</sup>"Glaxo Faces Allegations of Tax Underpayment in U.S.," *Asian Wall Street Journal* (December 8, 2002), p. A7.



Nonmarket-based pricing covers various policies that deviate from market-based pricing, the most prominent ones being: **cost-based pricing** and **negotiated pricing**. Cost-based pricing simply adds a markup to the cost of the goods. Issues here revolve around getting a consensus on a “fair” profit split and allocation of corporate overhead. Further, tax authorities often do not accept cost-based pricing procedures. Another form of nonmarket based pricing is negotiated transfer prices. Here conflicts between country affiliates are resolved through negotiation of transfer prices. This process may lead to better cooperation among corporate divisions.<sup>48</sup>

One study showed that compliance with financial reporting norms, fiscal and custom rules, anti-dumping regulations prompt companies to use market-based transfer pricing.<sup>49</sup> Government imposed market constraints (e.g., import restrictions, price controls, exchange controls) favor nonmarket-based transfer pricing methods. To the question, which procedure works best, the answer is pretty murky: there is no “universally optimal” system.<sup>50</sup> In fact, most firms use a mixture of market-based and non-market pricing procedures.

Cross-country tax rate differentials encourage many MNCs to set transfer prices that shift profits from high-tax to low-tax countries to minimize their overall tax burden. This practice is sometimes referred to as international tax arbitrage. At the same time, MNCs need to comply with the tax codes of their home country and the host countries involved. Non-compliance may risk accusations of tax evasion and lead to tax audits. In January 2004, GlaxoSmithKline, the pharmaceuticals company, was presented with a \$5.2 billion bill for extra taxes and interest by the US government following an investigation of the firm’s transfer pricing policies. According to one estimate, the total tax loss in the United States due to “creative” transfer pricing was \$53 billion in 2001.<sup>52</sup> Therefore, the issue that MNCs face can be stated as follows: how do we as a company draw the line between setting transfer prices that maximize corporate profits and compliance with tax regulations?

To avoid walking on thin ice, experts suggest to set transfer prices that are as close as possible to the Basic Arm’s Length Standard (BALS). This criterion is now accepted by tax authorities worldwide as the international standard for assessing transfer prices. In practice, there are three methods to calculate a BALS price: comparable/uncontrollable price, resale price, and cost-plus. The first rule—comparable/uncontrollable—states that the parent company should compare the transfer price of its “controlled” subsidiary to the selling price charged by an independent seller to an independent buyer of similar goods or services. The problem is that such “comparable products” are often not around. The resale price method determines the BALS by subtracting the gross margin percentage used by comparable independent buyers from the final third-party sales price. Finally, the cost-plus method fixes the BALS by adding the gross profit mark-up percentage earned by comparable companies performing similar functions to the production costs of the controlled manufacturer or seller. Note that this rule is somewhat different from the cost method that we discussed earlier since, strictly speaking, the latter method does not rely on mark-ups set by third parties. The OECD has drawn up guidelines on transfer pricing that cover complex taxation issues. The latest version of these rules is presented in *Transfer Pricing Guidelines for Multinational Enterprises and for Tax Administrations*.<sup>53</sup>

### Minimizing the Risk of Transfer Pricing Tax Audits<sup>51</sup>

<sup>48</sup>R. Ackelsberg and G. Yukl, “Negotiated Transfer Pricing and Conflict Resolution in Organization,” *Decision Sciences*, July 1979, pp. 387–398.

<sup>49</sup>M. F. Al-Eryani, et al., “Transfer Pricing Determinants,” p. 422.

<sup>50</sup>Jeffrey S. Arpan, “International Intracorporate Pricing: Non-American Systems and Views,” *Journal of International Business Studies*, Spring 1972, p. 18.

<sup>51</sup>This section is based on John P. Fraedrich and Connie Rae Bateman, “Transfer Pricing by Multinational Marketers: Risky Business,” *Business Horizons*, Jan.–Feb. 1996, pp. 17–22.

<sup>52</sup>“A Big Squeeze for Governments: How Transfer Pricing Threatens Global Tax Revenues,” *Financial Times* (July 22, 2004): 11.

<sup>53</sup>A hard copy of this document is available via <http://www.oecdbookshop.org/oecd/display.asp?sf1=identifiers&st1=232001041P1>. The most recent version came out in early 2006 and also includes an electronic version.



anti-dumping cases are increasingly initiated in Japan, India and other developing countries. Economists often refer to this trend as a rise in protectionism.<sup>54</sup>

Several possible reasons can explain the growing popularity of anti-dumping litigation. The removal of traditional trade barriers (tariffs, quotas) has encouraged several countries to switch to non-tariff barriers such as anti-dumping to protect their local industries. A World Bank study showed that the impact of dumping duties in the U.S. manufactured goods sector has boosted average tariffs in that sector from a nominal 6 percent rate to 23 percent.<sup>55</sup> There is also a huge imbalance between plaintiffs (local producer[s]) and defendants (importer[s]) in anti-dumping cases. Plaintiffs typically face no penalties for frivolous complaints. Moreover, plaintiffs clearly have a home advantage (local legislation, local judge).<sup>56</sup> Anti-dumping action is often utilized as a tactical tool to foster voluntary export restraints (VER). Foreign competitors, faced with the prospect of anti-dumping action, may decide to fall back on VERs as the lesser of two evils.<sup>57</sup> Finally, the concept of a “fair” price is usually pretty murky. The U.S. trade law defines dumping to occur when imports are sold below the home-country price (price discrimination) or when the import price is less than the “constructed value” or average cost of production (“pricing below cost”). Either concept can be very vague. In some situations, the imported good is not sold in the home country so that no basis of comparison exists (absence of domestic price).

Anti-dumping actions will persist in the future. Multinationals need to take anti-dumping laws into account when determining their global pricing policy. Aggressive pricing may trigger anti-dumping measures and, thus, jeopardize the company’s competitive position. Global companies should also monitor changes in anti-dumping legislation and closely track anti-dumping cases in their particular industry.

To minimize risk exposure to anti-dumping actions, exporters might pursue any of the following marketing strategies:<sup>58</sup>

- **Trading-up.** Move away from low-value to high-value products via product differentiation. Most Japanese carmakers have stretched their product line upwards to tap into the upper-tier segments of their export markets.
- **Service enhancement.** Exporters can also differentiate their product by adding support services to the core product. Both moves—trading up and service enhancement—are basically attempts to move away from price competition, thereby making the exporter less vulnerable to dumping accusations.
- **Distribution and communication.** Other initiatives on the distribution and communication front of the marketing mix include: (1) the establishment of communication channels with local competitors, (2) entering into cooperative agreements with them (e.g., strategic alliances), or (3) reallocation of the firm’s marketing efforts from vulnerable products (that is, those most likely to be subjected to dumping scrutiny) to less sensitive products.

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## PRICE COORDINATION



When developing a global pricing strategy, one of the thorniest issues is how much coordination should exist between prices charged in different countries. This issue is especially critical for global (or regional) brands that are marketed with no or very few cross-border variations. Economics dictate that firms should price discriminate between markets such that overall profits are maximized. So, if (marginal) costs were

<sup>54</sup>Jagdish Bhagwati, *Protectionism*, Cambridge, MA: The MIT Press, 1988, Chapter 3.

<sup>55</sup>“Negotiators down in the dumps over US draft,” *The Financial Times*, November 25, 1993, p. 6.

<sup>56</sup>J. Bhagwati, *Protectionism*, pp. 48–49.

<sup>57</sup>James E. Anderson, “Domino Dumping, I: Competitive Exporters,” *American Economic Review*, vol. 82, no. 1, March 1992, pp. 65–83.

<sup>58</sup>Michel M. Kostecki, “Marketing Strategies between Dumping and Anti-dumping Action,” *European Journal of Marketing*, vol. 25, no. 12, 1991, pp. 7–19.

roughly equivalent, multinationals would charge relatively low prices in highly price sensitive countries and high prices in insensitive markets. Unfortunately, reality is not that simple. In most cases, markets cannot be perfectly separated. Huge cross-country price differentials will encourage gray markets where goods are shipped from low-price to high-price countries by unauthorized distributors. Thus, some coordination will usually be necessary. In deciding how much coordination, several considerations matter:

1. **Nature of customers.** When information on prices travels fast across borders, it is fairly hard to sustain wide price gaps. Under such conditions, firms will need to make a convincing case to their customers to justify price disparities. With global customers (e.g., multinational clients in business-to-business transactions), price coordination definitely becomes a must. General Motors applies “global enterprise pricing” for many of the components it purchases. Under this system, suppliers are asked to charge the same universal price worldwide.<sup>59</sup> In Europe, Microsoft sets prices that differ by no more than 5 percent between countries due to pressure from bargain-hunting multinational customers.<sup>60</sup>
2. **Amount of product differentiation.** The amount of coordination also depends on how well differentiated the product is across borders. Obviously, the less (cross-border) product differentiation, the larger the need for some level of price coordination and vice versa. Stains in Southern Europe differ from stains in Scandinavia because of different food habits. Also, the spin speed of washing machines varies across Europe. In cold, wet countries (e.g., Great Britain) the average spin speed is 1200 rpm – twice as fast as the 600-rpm speed of washers in Spain.<sup>61</sup> Henkel, the German conglomerate, adjusts the formula for its Persil laundry detergent brand to suit local market conditions. As a result, a detergent sold in one European country may not be suitable for washers elsewhere in Europe. Thus, product differentiation can pose a barrier for cross-border price comparison shopping.
3. **Nature of channels.** In a sense, distribution channels can be viewed as intermediate customers. So, the same logic as for end consumers applies here: price coordination becomes critical when price information is transparent and/or the firm deals with cross-border distribution channels. Pricing discipline becomes mandatory when manufacturers have little control over their distributors.
4. **Nature of competition.** In many industries, firms compete with the same rivals in a given region, if not worldwide. Global competition demands a cohesive strategic approach for the entire marketing mix strategy, including pricing. From that angle, competition pushes companies toward centralized pricing policies. On the other hand, price changes made by competitors in the local market often require a rapid response. Should the subsidiary match a given price cut? If so, to what extent? Local subsidiaries often have much better information about the local market conditions to answer such questions than corporate or regional headquarters. Thus, the need for alertness and speedy response to competitive pricing moves encourages a decentralized approach toward pricing decisions.
5. **Market integration.** When markets integrate, barriers to cross-border movement of goods come down. Given the freedom to move goods from one member state to another, the pan-European market offers little latitude for perfect price discrimination.<sup>62</sup> Many of the transaction costs plaguing parallel imports that once existed, have now disappeared. In fact, the European Commission imposes heavy penalties against companies that try to limit gray market transactions. The Commission fined Volkswagen almost \$110 million when it accused VW of competition abuses. VW

<sup>59</sup>“GM Powertrain suppliers will see global pricing,” *Purchasing* (February 12, 1998).

<sup>60</sup>“European Software-Pricing Formulas, Long Abstruse, Develop a Rationale,” *Wall Street Journal*, June 11, 1993.

<sup>61</sup>“A Shopping Contest for the Euro,” *Financial Times* (January 5/6, 2002), p. 7.

<sup>62</sup>Wolfgang Gaul and Ulrich Lutz, “Pricing in International Marketing and Western European Economic Integration,” *Management International Review*, vol. 34, no. 2, 1994, pp. 101–24.

had ordered its Italian dealers not to sell cars to citizens from outside Italy. Austrian and German shoppers tried to buy VW cars in Italy where they were 30 percent cheaper.<sup>63</sup>

Several multinationals doing business in the European Union harmonize their prices to narrow down price gaps between different member states. Mars and Levi Strauss reduced their pan-European price gaps to no more than 10 percent.<sup>64</sup>

6. **Internal organization.** The organization setup is another important influence. Highly decentralized companies pose a hurdle to price coordination efforts. In many companies, the pricing decision is left to the local subsidiaries. Moves to take away some of the pricing authority from country affiliates will undoubtedly spark opposition and lead to bruised egos. Just as with other centralization decisions, it is important to fine-tune performance evaluation systems, as necessary.
7. **Government regulation.** Government regulation of prices puts pressure on firms to harmonize their prices. A good example is the pharmaceutical industry. In many countries, multinationals need to negotiate the price for new drugs with the local authorities. Governments in the European Union increasingly use prices set in other EU member states as a cue for their negotiating position. This trend has prompted several pharmaceutical companies, such as Glaxo, to negotiate a common EU-price for new drugs.

Increasingly, purchasers demand **global-pricing contracts (GPCs)** from their suppliers. There are several reasons behind the shift toward GPCs: centralized buying, information technology that provides improved price monitoring, standardization of products or services. GPCs, however, can also benefit suppliers: global customers can become showcase accounts; a GPC can offer the opening toward nurturing a lasting customer relationship; small suppliers can use GPCs as a differentiation tool to get access to new accounts.

However, before engaging in a GPC with a purchaser it is important do your homework. To achieve successful GPC implementation, Narayandas and his colleague provide the following guidelines:

1. Select customers who want more than just the lowest price.
2. Align the supplier's organization with the customer's. Ideally, the supplier's account-management organization should mirror the client's procurement setup.
3. Hire global account managers who can handle diversity. Get team members who cannot just handle sales, but also market intelligence gathering, problem spotting, contract compliance monitoring.
4. Reward those global-account managers and local sales representatives who make the relationship work.
5. Allow for some price flexibility.
6. Build information systems to monitor the key variables (e.g., cost variations, competitive situation).

In the late 1990s Procter & Gamble was facing a severe parallel imports situation in Russia for its Always feminine protection brand. The price for Always was much higher than in the other Central European countries, especially Poland from which most parallel imports originated. To resolve the problem, P&G lowered the price for Always in Russia and increased it in Poland so that the cross-border price variation became no more than 10 percent. Given the pressure toward increased globalization, some degree

## Global-Pricing Contracts (GPCs)<sup>65</sup>

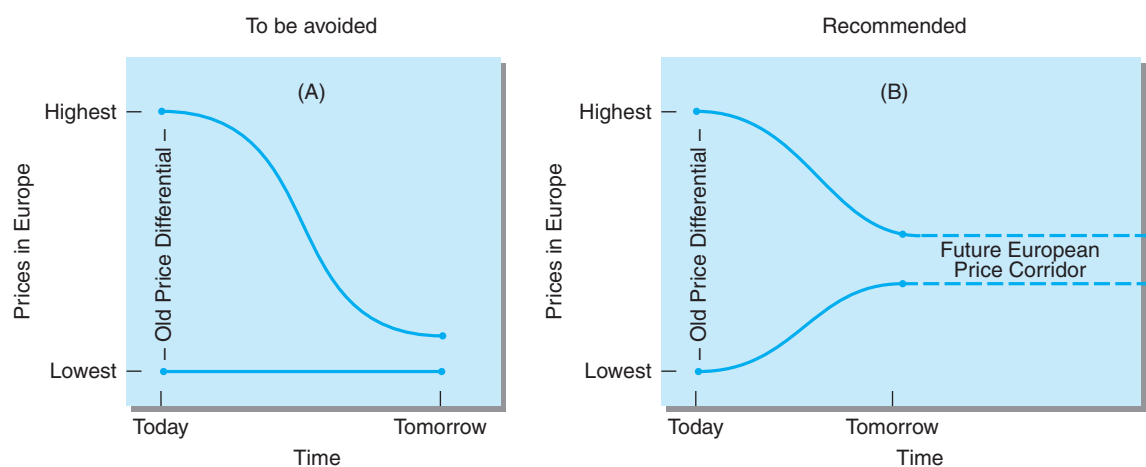
## Aligning Pan-Regional Prices

<sup>63</sup>“On the road to price convergence,” *Financial Times*, (November 12, 1998), p. 29.

<sup>64</sup>“Counting Costs of Dual Pricing in the Run-Up to 1992,” *Financial Times*, July 9, 1990, p. 4.

<sup>65</sup>This section benefited from Das Narayandas, John Quelch, and Gordon Swartz. “Prepare Your Company For Global Pricing,” *Sloan Management Review*, (Fall 2000), pp. 61–70.

### EXHIBIT 12-8 PAN-EUROPEAN PRICE COORDINATION



Courtesy Professor Hermann Simon

of price coordination becomes often very necessary. In some cases, firms set a uniform pricing formula that is applied by all affiliates. Elsewhere, coordination is limited to general rules that only indicate the desired pricing positioning (e.g., premium positioning, middle-of-the road positioning).

Simon and Kucher<sup>66</sup> propose a three-step procedure to align prices in regional markets with arbitrage opportunities. Pressure to narrow down price gaps could lead to two scenarios (see **Exhibit 12-8**). The disaster scenario (panel (A) in Exhibit 12-8) is a situation where all prices sink to the lowest price. Calculations by Lehman Brothers, an investment bank, have shown that, if all car prices in the euro area fell to the lowest levels, the revenues of the French carmakers, Peugeot and Renault would drop by 12 percent and 9 percent respectively.<sup>67</sup> At the other extreme, companies may try to sustain cross-border price gaps. The desired scenario (panel (B) in Exhibit 12-8) tries to find the middle ground by upping prices in low-price countries and cutting them in high-price countries. To pursue this scenario, firms should set a **pricing corridor** within the region.

The procedure works as follows:

- Step 1:** *Determine optimal price for each country.* Find out what price schedules will maximize overall profits. Given information on the demand schedule and the costs incurred in each market, managers are able to figure out the desirable prices in the respective markets.
- Step 2:** *Find out whether parallel imports (“gray markets”) are likely to occur at these prices.* Parallel imports arise when unauthorized distributors purchase the product (sometimes repackaged) in the low-price market and then ship it to high-price markets. The goal of step 2 is not to pre-empt parallel imports altogether but to boost profits to the best possible degree. Given the “optimal” prices derived in the first step, the manager needs to determine to what extent the proposed price schedule will foster parallel imports. Parallel imports become harmful insofar as they inflict damage on authorized distributors. They could also hurt the morale of the local sales force or country managers. Information is needed on the arbitrage costs of parallel importers. For instance, in the European drug industry, parallel importers target drugs with more than 20 percent price differentials. Conceivably, firms might decide to abandon (or

<sup>66</sup>Hermann Simon and Eckhard Kucher, “The European Pricing Time Bomb—And How to Cope With It,” *Marketing and Research Today*, February 1993, pp. 25–36.

<sup>67</sup>“Faster forward,” *The Economist* (November 28, 1998), pp. 83–84.

not enter) small, low-price markets thereby avoiding pricing pressure on high-price markets. MNCs should also consider the pros and cons of non-pricing solutions to cope with parallel imports. Possible strategies include: product differentiation, intelligence systems to measure exposure to gray markets, creating negative perceptions in the mind of the end-user about parallel imports.<sup>68</sup> In 1996 P&G changed the name in Northern Europe for one of its cleaner products from *Viakal* to *Antikal* to fight parallel imports sourced from Italy where the product was 30 percent cheaper.

**Step 3:** *Set a pricing corridor.* If the “optimal” prices that were derived in Step 1 are not sustainable, firms need to narrow the gap between prices for high-price and low-price markets. Charging the same price across-the-board is not desirable. Such a solution would sacrifice company profits. Instead, the firm should set a pricing corridor. The corridor is formed by systematically exploring the profit impact from lowering prices in high-price countries and upping prices in low-price countries, as shown in panel (B) of Exhibit 12-8. The narrower the price gap, the more profits the firm has to sacrifice. At some point, there will be a desirable trade-off between the size of the gray market and the amount of profits sacrificed.

Of course, this method is not foolproof. Competitive reactions (e.g., price wars) need to be factored in. Also, government regulations may restrict pricing flexibility. Still, the procedure is a good start when pricing alignment becomes desirable.

Global marketers can choose from four alternatives to promote price coordination within their organization, namely:<sup>69</sup>

1. **Economic Measures.** Corporate headquarters are able to influence pricing decisions at the local level via the transfer prices that are set for the goods that are sold to or purchased from the local affiliates. Another option is rationing, that is, headquarters sets upper limits on the number of units that can be shipped to each country. To sustain price differences, luxury marketers like Louis Vuitton set purchase limits for customers shopping at their European boutiques. Louis Vuitton products bought in Europe or Hawaii are often resold in Japan by discount stores as “loss leaders.”
2. **Centralization.** In the extreme case, pricing decisions are made at corporate or regional headquarters level. Centralized price decision-making is fairly uncommon, given its numerous shortcomings. It sacrifices the flexibility that firms often need to respond rapidly to local competitive conditions.
3. **Formalization.** Far more common than the previous approach is formalization where headquarters spells out a set of pricing rules that the country managers should comply with. Within these norms, country managers have a certain level of flexibility in determining their ultimate prices. One possibility is to set prices within specified boundaries; prices outside these bounds would need the approval from the global or regional headquarters.
4. **Informal Coordination.** Finally, firms can use various forms of informal price coordination. The emphasis here is on informing and persuasion rather than prescription and dictates. Examples of informal price coordination tactics include discussion groups, “best-practice” gatherings.

Which one of these four approaches is most effective is contingent on the complexity of the environment in which the firm is doing business. When the environment is fairly stable and the various markets are highly similar, centralization is usually preferable over the other options. However, highly complex environments require a more decentralized approach.

<sup>68</sup>Peggy A. Chaudhry and Michael G. Walsh, “Managing the Gray Market in the European Union: The Case of the Pharmaceutical Industry,” *Journal of International Marketing*, vol. 3, no. 3, 1995, pp. 11–33.

<sup>69</sup>Gert Assmus and Carsten Wiese, “How to Address the Gray Market Threat Using Price Coordination,” *Sloan Management Review*, Spring 1995, pp. 31–41.

## Implementing Price Coordination

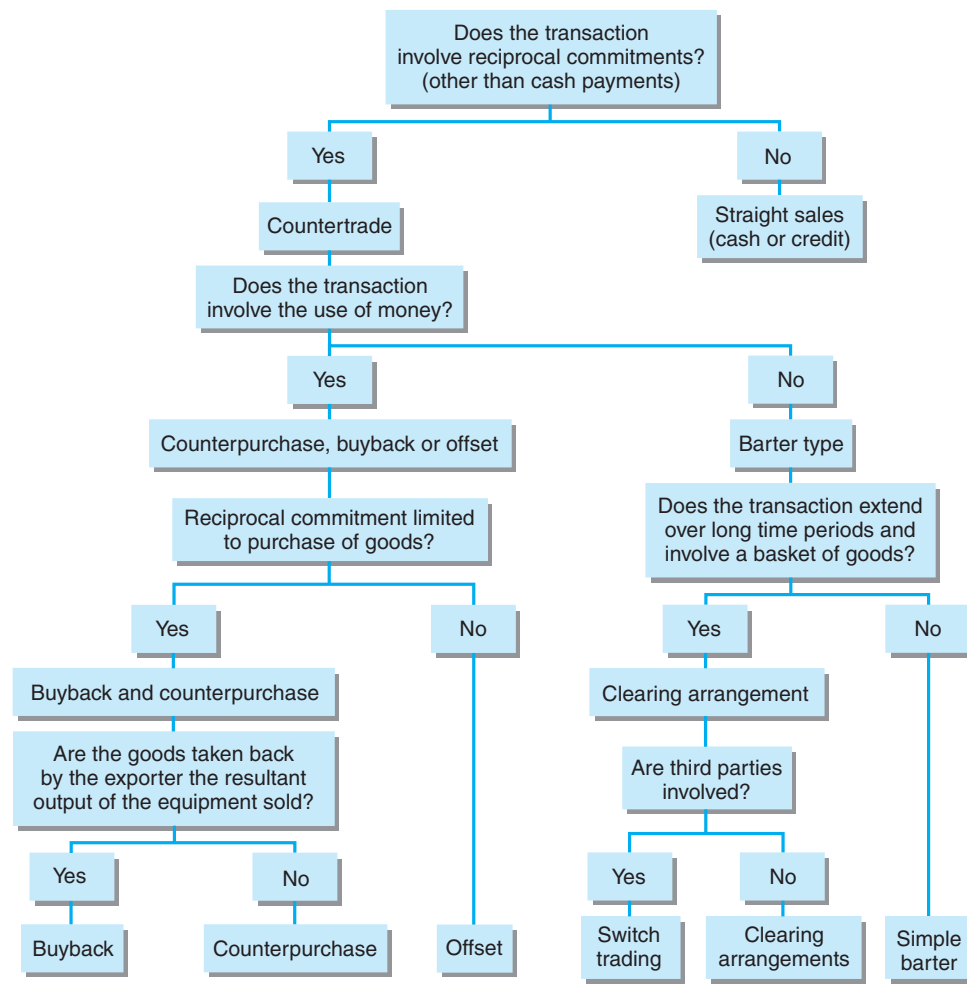
## COUNTERTRADE

**Countertrade** is an umbrella term used to describe unconventional trade-financing transactions that involve some form of non-cash compensation. During the last decade, companies have increasingly been forced to rely on countertrade. Estimates on the overall magnitude of countertrade vary but the consensus estimate is that it covers 10 to 15 percent of world trade.<sup>70</sup> One of the most publicized deals was PepsiCo’s \$3 billion arrangement with the former Soviet Union to swap Pepsi for profits in Stolichnaya vodka and ocean freighters and tankers.<sup>71</sup> Given the growth of countertrade, global marketers should be aware of its nuts and bolts.

### Forms of Countertrade

Countertrade comes in six guises: barter, clearing arrangements, switch trading, buyback, counterpurchase, and offset. **Exhibit 12-9** classifies these different forms of countertrade.

**EXHIBIT 12-9**  
CLASSIFICATION OF FORMS OF COUNTERTRADE



Source: Jean-François Hennart, “Some Empirical Dimensions of Countertrade,” *Journal of International Business Studies* Second Quarter 1990, p. 245.

<sup>70</sup>Jean-François Hennart and Erin Anderson, “Countertrade and The Minimization of Transaction Costs,” Working Paper no. 92-012R, The Wharton School, University of Pennsylvania, Philadelphia, PA.

<sup>71</sup>“Worldwide Money Crunch Fuels More International Barter,” *Marketing News*, March 2, 1992, p. 5.



The main distinction is whether or not the transaction involves monetary compensation. Let us look at each form in more detail:<sup>72</sup>

- **Simple barter.** Simple barter is a swap of one product for another product without the use of any money. Usually, no third party is involved to carry out the transaction. A single contract covers the entire transaction. Though one of the oldest forms of countertrade, it is very seldom used these days. It is most common in deals that involve subsistence economies. Barter is also sometimes introduced into existing contracts to recover debt through goods when the debtor cannot pay cash.
- **Clearing arrangement.** Under this form, two governments agree to import a set specified value of goods from one another over a given period. Each party sets up an account that is debited whenever goods are traded. Imbalances at the end of the contract period are cleared through payment in hard currency or goods. One clearing agreement between Indonesia and Iran specified that Indonesia would supply paper, rubber, and galvanized sheets in exchange for 30,000 barrels per day of Iranian crude oil.<sup>73</sup>
- **Switch trading.** This is a variant of clearing arrangements where a third party is involved. In such deals, rights to the surplus credits are sold to specialized traders (**switch traders**) at a discount. The third party uses then the credits to buy goods from the deficit country.

None of these types entail cash payment flows. The remaining forms involve some use of money. They lead to two parallel agreements: the original sales agreement between the foreign customer and supplier, and a second contract where the supplier commits himself to purchase goods in the customer's country.

- **Buyback (compensation).** Buyback arrangements typically occur with the sale of technology, turnkey plants, or machinery equipment. In such transactions, the seller provides the equipment and agrees to be paid (partially or fully) by the products resulting from using the equipment. Such agreements are much more mutually beneficial than the other forms of countertrade. A typical example of a buyback contract is an agreement that was settled between PALMCO Holdings, Malaysia's biggest palm oil refiner, and Japan's Kao Corporation. The contract set up a \$70 million joint venture to produce palm oil byproducts in Malaysia. Kao was to be compensated by 60 percent of the output that it could use as inputs for producing detergents, cosmetics, and toiletries.<sup>74</sup>
- **Counterpurchase.** Counterpurchase is the most popular form of countertrade. Similar to buyback arrangements, two parallel contracts are set up. Each party agrees to buy a specified amount of goods from the other for hard currency over a set period. Contrary to buybacks, the products are unrelated. Typically, the importer will provide a shopping list from which the exporter can choose. In October 1992, PepsiCo set up a joint venture in Ukraine with three local partners. Under the agreement, the partnership was to market ships built in Ukraine. Proceeds from the ship sales were to be used to buy soft-drink equipment, to build bottling plants, and to open Pizza Hut restaurants in Ukraine.<sup>75</sup>
- **Offset.** Offset is a variation of counterpurchase: the seller agrees to *offset* the purchase price by sourcing from the importer's country or transferring technology to the other party's country. Offset is very common with defense contracts but is also becoming more common in other sectors. There are two different types: direct and indirect offset. With **direct offset**, the supplier agrees to use materials or components sourced from the importing country. **Indirect offset** refers to a contractual arrangement that involves goods or services unrelated to the core goods to be exported. An offset contract between Indonesia and General Dynamics to buy F-16 aircraft, stipulated that some of the parts would be supplied by PT Nusantara, an Indonesian manufacturer.

<sup>72</sup>Costas G. Alexandrides and Barbara L. Bowers, *Countertrade. Practices, Strategies, and Tactics*, New York: John Wiley & Sons, 1987, Chapter 1.

<sup>73</sup>Aspy P. Palia, "Countertrade Practices in Indonesia," *Industrial Marketing Management*, vol. 21, 1992, pp. 273–79.

<sup>74</sup>Aspy P. Palia, "Countertrade Practices in Japan," *Industrial Marketing Management*, vol. 22, 1993, pp. 125–32.

<sup>75</sup>"PepsiCo to finance Ukraine expansion with ship exports," *Financial Times*, October 23, 1992.

## Motives behind Countertrade

Companies engage in countertrade for a variety of reasons. The most commonly cited benefits are:

- **Gain access to new or difficult markets.** Countertrade in many ways is a “necessary evil.” It can be very costly and risky. Nevertheless, being prepared to accept countertrade deals offers for many companies a competitive edge that allows them to penetrate markets with a lack of hard currency cash. Many exporters accept countertrade arrangements because their rivals offer it. A UK survey found that 80 percent of the exporters’ competitors were also involved in countertrade.<sup>76</sup>
- **Overcome exchange rate controls or lack of hard currency.** Shortages of hard currency often lead to exchange controls. To navigate around government imposed currency restrictions, firms use countertrade.
- **Overcome low country creditworthiness.** This benefit applies to trade with parties located in countries with low credit ratings. Under such conditions, the other party faces high interest rates or difficult access to credit financing. Countertrade allows both parties to overcome such hurdles.
- **Increase sales volume.** Firms with a substantial amount of overheads face a lot of pressure to increase sales. Despite the risks and costs of countertrade, such deals provide a viable opportunity to achieve full capacity utilization. Also, companies often engage in countertrade to dispose of surplus or obsolete products.
- **Generate long-term customer goodwill.** A final payoff is that willingness to accept countertrade deals fosters long-term customer goodwill. Once the credit and/or currency situation in the client’s country improves, sellers will be able to capitalize on the customer goodwill cemented over the years.

Among these marketing objectives, a survey of industrial firms located in twenty-three countries showed that the most important ones are: (1) sales increase (mean response of 3.91 on a 5-point scale), (2) increased competitiveness (3.90), and (3) entry to new markets (3.54).<sup>77</sup> A study of U.S. companies countertrading with Latin America found that the main reasons included (ranked in order of importance):<sup>78</sup>

1. Customers’ inadequate reserves of foreign currency
2. The only way business could be done
3. Demanded by customers
4. To gain a competitive advantage
5. Facilitating transactions with government and expanding business contacts
6. To achieve growth
7. Better capacity utilization
8. Expansion of distribution channels in significant markets
9. To release blocked funds
10. To avoid the impact of protectionist regulations.

Note that several of the motives listed above are long-term oriented (e.g., gaining entry to new markets, generate goodwill), while some of the other motives are short-term oriented (e.g., use excess production capacity). Firms that are driven by long-term benefits tend to be much more proactive in soliciting countertrade business and pursuing countertrade transactions than short-term oriented firms.<sup>79</sup> Whatever the

<sup>76</sup>David Shipley and Bill Neale, “Industrial Barter and Countertrade,” *Industrial Marketing Management*, vol. 16, 1987, pp. 1–8.

<sup>77</sup>Dorothy A. Paun, “An International Profile of Countertrading Firms,” *Industrial Marketing Management*, vol. 26, no. 1, 1997, pp. 41–50.

<sup>78</sup>John P. Angelidis, Faramarz Parsa, and Nabil A. Ibrahim, “Countertrading with Latin America: A Comparative Analysis of Attitudes of United States Firms,” *International Journal of Management* 21 (December 2004): 435–44.

<sup>79</sup>Dorothy A. Paun and Aviv Shoham, “Marketing Motives in International Countertrade: An Empirical Examination,” *Journal of International Marketing*, vol. 4, no. 3, 1996, pp. 29–47.

motive for entering a countertrade agreement, it is important to realize the drawbacks of such arrangements.

Not every exporter is willing to jump on the countertrade bandwagon. In many cases, the risks and costs of a countertrade deal far outweigh its potential advantages. Some of the shortcomings that have been identified by exporters include:<sup>80</sup>

## Shortcomings of Countertrade

- **No “in-house” use for goods offered by customers.** Exporters often face the problem of what to do with the goods they are offered. Goods that cannot be used in-house need to be resold. Getting rid of the goods can be a major headache, especially when the quality of the merchandise is poor or when there is an oversupply. Some firms will rely on specialist brokers to sell their goods.
- **Timely and costly negotiations.** Arranging a countertrade deal requires a time-consuming and complex bargaining process. A prospective customer with a long track record usually has a tremendous edge over an exporter with little negotiation skills. Parties will need to haggle over the goods to be traded, their respective valuation, the mixture cash/merchandise, the time horizon, and so on.
- **Uncertainty and lack of information on future prices.** When some of the traded goods involve commodities, firms run the risk that the price sinks before the goods can be sold. Apart from price uncertainty, there is uncertainty about the quality of the goods.
- **Transaction costs.** Costs flowing from countertrade quickly add up: cost of finding buyers for the goods (if there is no in-house use), commissions to middlemen (if any), insurance costs to cover risk of faulty or non-delivery, hedging costs to protect against sinking commodity prices.

The study of countertrading with Latin America cited earlier found that the most serious problems were (ranked in order of importance):<sup>81</sup>

1. Time-consuming negotiations
2. Complicated negotiations
3. Product mismatch
4. Cost increases
5. Inferior quality of goods
6. Difficulty in selling the received products
7. Profitability reduction
8. Price setting problems
9. Involvement of third parties
10. Loss of purchasing flexibility.

Given the potential risks and costs an exporter might run, one of the key questions is whether to handle deals in-house or to use specialist middlemen. This decision will basically be driven by a trade-off of the benefits of using outsiders (reduction of risks and transaction costs) with the costs to be incurred (mainly commission).

Countertrade has probably reached its peak now. In fact, some former East Bloc countries are trying to avoid such trade in order to signal their commitment to free markets.<sup>82</sup> Still, countertrade will survive, as many countries remain strapped for hard-currency cash.<sup>83</sup> Highly useful online resources on countertrade include the following websites:

<sup>80</sup>D. Shipley and B. Neale, “Industrial Barter and Countertrade,” pp. 5–6.

<sup>81</sup>John P. Angelidis, et al., “Countertrading with Latin America.”

<sup>82</sup>“A Necessary Evil,” *The Economist*, November 25, 1989, p. 79.

<sup>83</sup>“Worldwide money crunch fuels more international barter,” *Marketing News*, March 2, 1992, p. 5.

- www.barternews.com
- www.londoncountertrade.org
- www.apcatrade.org (Asia Pacific Countertrade Association)

Finally, here are a few guidelines:<sup>84</sup>

1. Always evaluate the pros and cons of countertrade against other options.
2. Minimize the ratio of compensation goods to cash.
3. Strive for goods that can be used in-house.
4. Assess the relative merits of relying on middlemen versus an in-house staff.
5. Check whether the goods are subject to any import restrictions.
6. Assess the quality of the goods.

<sup>84</sup>Based on D. Shipley and B. Neale, "Industrial Barter and Countertrade," *Industrial Marketing Management*, 16, 1987 and J. R. Carter and J. Gagne, "The Dos and Don'ts of International Countertrade," *Sloan Management Review*, Spring 1988.

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## SUMMARY

Two types of mistakes can be made when setting the price in foreign markets: pricing the product too high and pricing it too low. When the price is set too high, customers will stay away of the firm's products. As a result, profits will be far less than they might have been. In India, Procter & Gamble's Ariel detergent brand initially created huge losses, partly because P&G charged a retail price far higher than Unilever's Surf Ultra.<sup>85</sup> Setting prices too low might also generate numerous pains. Local governments may cry foul and accuse the firm of dumping. Local customers might view the low price as a signal of low quality and avoid your product. Local competitors may interpret the low price as an aggressive move to grab market share and start a price war. Or, they may see it as an opportunity to launch a knock-off version of your product. And when the price is far lower than in other markets, distributors (local and nonlocal) might spot an arbitrage opportunity, and ship the product from the low-price to your high-price markets,

thereby creating a gray market situation. Making pricing decisions is one of the most formidable tasks that international marketers face. Many different elements influence global pricing decisions. Aside of the roles played by the 4 Cs (customers, competition, channels and company), marketers also need to factor in the impact (direct or indirect) of local government decisions.

In this chapter, we covered the major global pricing issues that matter to marketers: export price escalation, inflation, currency movements, anti-dumping regulations, and price coordination. Even though pricing is typically a highly decentralized marketing decision, cross-border price coordination becomes increasingly a prime concern. We introduced several approaches through which international marketers can implement price coordination. Especially in industrial markets, firms increasingly become aware of the long-term rewards of countertrade as a way of doing business in the global arena. In many cases, countertrade is the sole means for gaining access to new markets. Companies that decide to engage in countertrade should bear in mind the numerous road bumps that these transactions involve.

<sup>85</sup>"Ariel share gain puts P&G India through the wringer," *Advertising Age International*, November 8, 1993, pp. I-3, I-22.

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## KEY TERMS

Arm's-length price	Countertrade	Local-currency price stability	Simple barter
Buyback	Dumping	Offset (direct, indirect)	Switch trade
Clearing arrangement	Dynamic incremental pricing	Price corridor	Transfer price
Cost-plus pricing	Exchange rate pass through	Price escalation	
Counterpurchase	Global-pricing contract	Pricing-to-market	

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## REVIEW QUESTIONS

1. What mechanisms can exporters use to curtail the risks of price escalation in foreign markets?
2. How does competition in the foreign market affect your global pricing decisions?



## SHORT CASES

### ASE 12-1

#### WHISTLE BLOWERS RAISE SOME SERIOUS QUESTIONS ABOUT SWATCH'S TRANSFER PRICING POLICIES

Swatch Group is one of the world's leading watchmakers. The group owns a stable of 17 watch brands, including Breguet and Omega. Just as many other multinational companies do, Swatch devotes considerable energy to devising tax arrangements that minimize its overall tax burden. In general, such practices (sometimes referred to as international tax arbitrage) are perfectly legal. However, in the summer of 2004, two whistleblowers who had left the company were asking U.S. tax authorities to have a closer look at Swatch's tax policies. They had built up their case with a stash of internal e-mails and company documents.

Concern had been raised about the activities of Swatch Group (Asia), a subsidiary based in Hong Kong and registered in the tax haven of the British Virgin Islands. Invoices indicated that goods shipped through this subsidiary received a major markup before being sent to other units of Swatch. For instance, Omega watches were given a 40 percent markup if they went out to Singapore and a 50 percent markup when bound for Japan. One company e-mail stated: "Externally for tax reasons we credit only 60 percent. That means that we have an internal credit note and different external credit note . . . The advantage of this procedure is that we have absolutely no negative impact on the internal [reporting] figures in Japan."

Tax lawyers interviewed about the matter said that to justify the mark-up differences as they pass through the subsidiary,

*Source:* "A Swiss Movement on Tax Bills," *Financial Times* (August 13, 2004): 18 and "Swatch Group Defends its Pricing Policy," *Financial Times* (August 13, 2004): 18.

the intermediary has to be adding value to the product, or incurring some risk by its role in the transaction. If not, the tax rate of the jurisdiction of origin should apply. Also, the values attributed to goods internally should be close to their market prices at the destination.

The e-mails signaled that Swatch staff had concerns about its transfer-pricing practices and how they might appear to tax authorities. One e-mail from a finance department official stated: "We have to be very cautious when the source is Swatch Group internal. I have not the intention to endanger the whole system." Mr. Rentsch, the group's general counsel, denied any wrongdoing. According to him, the two whistleblowers were former disgruntled employees who "were trying to build up something against the company." Still, the company was concerned about the allegations and decided to set up an internal investigation. In comments to the press, Swatch pointed out that transfer pricing is a very complex issue that depends on a large number of variables including: exchange rates, working conditions in different countries, and differing distribution structures. Also, as a matter of policy, Swatch tries to avoid major price gaps between markets in order to minimize the risks of gray markets where local traders sidestep authorized distributors.

#### DISCUSSION QUESTIONS

1. Explain why transfer pricing is so complicated especially for a company like Swatch.
2. What measures could Swatch implement to avoid similar predicaments in the future?

### ASE 12-2

#### CARLSBERG MALAYSIA—SELLING BEER IN A 60 PERCENT MUSLIM NATION

Malaysia's beer market has been under heavy pressure lately. From 2004 to 2006, the industry saw heavy increases in excise duties. With an excise duty of RM7.40 (US\$2) per liter, Malaysia now has the second highest beer tax in the world (Norway ranks first). The price increases have narrowed the price gap between

*Sources:* [www.euromonitor.com/Beer\\_in\\_Malaysia](http://www.euromonitor.com/Beer_in_Malaysia); "Guinness Confident of Warding Off Newcomer," [www.theedgedaily.com](http://www.theedgedaily.com), accessed on February 19, 2009; and "Malaysian Beer Brands Facing Pricing Problem," *Media*, November 27, 2008, p. 21.

beer and other alcoholic drinks such as wine. Beer drinkers have balked: consumption dropped from 1.4 million (2004) to 1.2 million hectoliters (2006) as a result of the price increases. Many beer and stout customers have turned to wine and liquor due to the narrowed price gap for these products with beer.

The tax increases have also reshaped the competitive landscape. Carlsberg bore the brunt of the price increases. Until recently, two big brewers carved up Malaysia's beer market: Carlsberg, which has been operating in Malaysia for over 35 years, and Guinness Anchor Berhad (GAB), the maker of Guinness,

Tiger and Anchor beer. In 2000 Carlsberg had a 55 percent market share while GAB had the remaining 45 percent. By mid-2006, GAB's share had risen to 55 percent. In 2007 a new local beer-maker under the name of Napex Corporation joined the two brewers selling a beer named Jaz Beer. Differences between the brand portfolios of GAB and Carlsberg partly explain the market share reversal. GAB sells pricier brands such as Guinness and Heineken while most of Carlsberg's sales came from the lower-priced Carlsberg green label. Buyers of premium brands are wealthier and less price sensitive than cheap beer consumers. Soren Jensen, managing director of Carlsberg Malaysia, explained the situation as follows: "Once you have high duties, you don't have much cheap beer. The premium brands have strengthened because the relative price difference is smaller." (*Media*, Nov. 27, 2008) Charles Ireland, the head of GAB, said: "We sell premium brands, they sell brands which are of lower prices; we have different business models and our consumer markets are different." ([www.theedgeasia.com](http://www.theedgeasia.com)).

To shore up Carlsberg's position, the firm overhauled its brand stable by adding new high-end offerings such as Tuborg, Skol Super, and Carlsberg Gold as well as importing Corona from Mexico. GAB also outspent Carlsberg in advertising during 2007: RM10.4 million (\$2.8 million) for GAB versus RM6.8 million (\$1.8 million) spent by Carlsberg on its core brand (see Table A). Television, radio, and outdoor are not

used. Print accounts for 70 percent of all advertising spending, cinema 19 percent, and point-of-sale 11 percent. Other promotional activities include relationship marketing, trade promotions, and sponsorships. Global brands such as Heineken and Carlsberg also get exposure through global sponsorship activities: Carlsberg with Liverpool, Heineken with the UEFA Champions soccer league.

#### Top five brands by adspend (000's)

Carlsberg	RM6,780 (Carlsberg)
Heineken	RM5,867 (GAB)
Tiger Beer	RM2,967 (GAB)
Skol	RM1,884 (Carlsberg)
Anchor	RM1,603 (GAB)

#### DISCUSSION QUESTIONS

1. What do you see as the main challenges that Carlsberg is facing in Malaysia?
2. From 2004 to 2006, the beer and stout market in Malaysia saw heavy increases in duties. Carlsberg bore the brunt of these increases, losing market share to GAB. What strategic initiatives would you recommend to Soren Jensen to meet the challenges Carlsberg is facing?

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