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# EXPORT AND IMPORT MANAGEMENT



## CHAPTER OVERVIEW

1. ORGANIZING FOR EXPORTS
2. INDIRECT EXPORTING
3. DIRECT EXPORTING
4. MECHANICS OF EXPORTING
5. ROLE OF THE GOVERNMENT IN PROMOTING EXPORTS
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Exporting is the most popular way for many companies to become international. The main reasons for this are: (1) exporting requires minimum resources while allowing high flexibility and (2) it offers substantial financial, marketing, technological, and other benefits to the firm. Because exporting is usually the first mode of foreign entry used by many companies, exporting early tends to give them first-mover advantage.<sup>1</sup> However, exporting requires experiential knowledge. Exporters must acquire foreign market knowledge (i.e., clients, market needs, and competitors) and institutional knowledge (i.e., government, institutional framework, rules, norms, and values) as well as develop operational knowledge (i.e., capabilities and resources to engage in international operations).<sup>2</sup> Selling to a foreign market involves numerous high risks arising from the lack of knowledge of and unfamiliarity with foreign environments, which can be heterogeneous, sophisticated and turbulent. Furthermore, conducting market research across national boundaries is more difficult, complex, and subjective than for its domestic counterpart.

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<sup>1</sup>Yigang Pan, Shaomin Li, and David K. Tse, “The Impact of Order and Mode of Market Entry on Profitability and Market Share,” *Journal of International Business Studies*, 30 (First Quarter 1999), pp. 81–104.

<sup>2</sup>Kent Eriksson, Jan Johanson, Anders Majkgård, D. Deo Sharma, “Effect of Variation on Knowledge Accumulation in the Internationalization Process,” *International Studies of Management and Organization*, 30, 2000, pp. 26–44.

For successful development of export activities, systematic collection of information is critical. Market information can be well-documented and come from public and private data sources, but it can also be so tacit that only seasoned marketing managers with international vision and experience could have a “gut-feel” in understanding it.<sup>3</sup> Market information helps managers to assess the attractiveness of foreign markets and decide whether to engage in exporting. After a firm has decided to start exporting, it requires information on how to handle the mechanics of it, including how to enter overseas markets and what adaptations to make to the marketing mix elements.<sup>4</sup> A recent study, which compared export leaders—defined as companies that distribute products or services to six or more countries—to export laggards, also shows that the more companies export, the more they spend in information technology. According to the same study, much of the investment the leading export companies make in IT is for e-business, from Web-based commerce and supply-chain networks to electronic marketplaces. This focus seems to be paying off.<sup>5</sup>

As presented in Chapter 2, the nature of international exports and imports has also improved since the beginning of this new century. From 1997 to 2007, global GDP grew more than 30 percent, while total global merchandise exports increased by more than 60 percent.<sup>6</sup> However, growth in world output and trade has decelerated since 2007. In 2007, weaker demand in the developed economies reduced global economic growth to 3.4 per cent from 3.7 per cent, roughly the average rate recorded over the last decade. Lower imports than in the preceding years were observed in North America, Europe, Japan, and the net oil importing developing countries in Asia. This downward trend outweighed the rapid import growth momentum observed in Central and South America, the Commonwealth of Independent States (CIS or former Soviet Republics), Africa, and the Middle East. The developing countries as a group accounted for more than one half of the increase in world merchandise imports in 2007. The excess of regional export growth over import growth can be attributed largely to the United States, where import volumes increased only marginally (1 percent), while exports expanded by 7 percent in 2007. Europe’s real merchandise export and import growth of 3.5 percent in 2007 continued to lag behind the global rate of trade expansion, as has been the case since 2002.<sup>7</sup> Then since late 2008, U.S. financial turmoil has spread throughout the world, resulting in an unprecedented global recession with plummeting international trade.<sup>8</sup> Weaker demand in the developed countries now provides a less favorable framework for the expansion of international trade than in preceding years.<sup>9</sup>

Although the United States is still relatively more insulated from the global economy than other nations (See Chapter 2), exports of goods and services combined represented 8.3 percent of the U.S. GDP as of 2007, yet account for more than 25 percent of U.S. economic growth in the past decade.<sup>10</sup> Roughly 10 percent of all U.S. jobs (approximately 12 million) rely on exports. In general, one factory job in five depends on international trade in the United States. Between 1990 and 2000, export-related jobs grew by 56 percent, an increase that is three times faster than the rate of job growth in the rest of the economy. These facts demonstrate that export is an important source of U.S. economic growth and job creation. Furthermore, jobs that depend on

<sup>3</sup>Gary A. Knight and Peter W. Liesch, “Information Internalization in Internationalizing the Firm,” *Journal of Business Research*, 55 (December 2002), pp. 981–95.

<sup>4</sup>Leonidas C. Leonidou and Athena S. Adams-Flourou, “Types and Sources of Export Information: Insights from Small Business,” *International Small Business Journal*, 17 (April–June 1999), pp. 30–48.

<sup>5</sup>Mary E. Thyfault, “Heavy Exporters Spend Big on Leading-Edge IT,” *InformationWeek*, Apr 23, 2001, p. 54.

<sup>6</sup>*World Trade Report 2007*, <http://www.wto.org/>, Geneva, World Trade Organization, 2007.

<sup>7</sup>*World Trade Report 2007* and *World Trade Report 2008*, <http://www.wto.org/>, accessed October 10, 2008.

<sup>8</sup>“World Trade to Shrink in 2009: World Bank,” [newsroomamerica.com](http://newsroomamerica.com), December 9, 2008.

<sup>9</sup>“A Turn for the Worse,” *Economist*, September 13, 2008, pp. 71–72.

<sup>10</sup>Computed from statistics in Central Intelligence Agency, *World Factbook 2008*, <https://www.cia.gov/library/publications/>.

trade pay between 13 to 18 percent more than the average wage, indicating that these employees generally earn more than the others.<sup>11</sup>

This chapter primarily considers the export function; it attempts to explain the import function as the counterpart of the export function, because for every export transaction there is, by definition, an import transaction as well. Aside from some differences between the procedure and rationale for exports and imports, both are largely the same the world over.

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## ORGANIZING FOR EXPORTS



### Research for Exports

For a firm exporting for the first time, the first step would be to research potential markets using available secondary data. Increasingly international marketing information is available in the form of electronic databases ranging from the latest news on product developments to new material in the academic and trade press. Well over 6,000 databases are available worldwide, with almost 5,000 available online. The United States is the largest participant in this database growth, producing and consuming more than 50 percent of these database services. When entering a culturally and linguistically different part of the world, managers need to understand a completely new way of commercial thinking that is based on a different culture and works on a different set of premises. Often seasoned managers' flexibility and adaptability acquired through experience and learning, prove to be important in building export contracts.<sup>12</sup> It is also to be noted that export research for markets such as China and the CIS must still be done largely in the field because very little prior data exist for them and when they are available, they are often not reliable.<sup>13</sup> See **Global Perspective 16-1** for how complex the task of exporting is relative to domestic sales.

The identification of an appropriate overseas market and an appropriate segment involves grouping by the following criteria:

1. Socioeconomic characteristics (e.g., demographic, economic, geographic, and climatic characteristics)
2. Political and legal characteristics
3. Consumer variables (e.g., lifestyle, preferences, culture, taste, purchase behavior, and purchase frequency)
4. Financial conditions

On the basis of these criteria, an exporter can form an idea of the market segments in a foreign market.<sup>14</sup> First, regions within countries across the world are grouped by macroeconomic variables indicating the levels of industrial development, availability of skilled labor, and purchasing power. For example, from an exporter's point of view the Mumbai–Thane–Pune area in Western India has more in common with the Monterrey area and the Mexico City area in Mexico and the Shanghai–Wuxi area in China than with other areas in India. All three areas already have a well-developed industrial base and purchasing power that is equal to that of the middle class in developed nations. Such economically homogeneous groups across the world are a result of the globalization of markets. These apparently similar markets can, however, differ along political and legal

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<sup>11</sup>National Council on Economic Education <http://www.econedlink.org/lessons/index.cfm?lesson=EM208>; Trade Resource Center [http://trade.businessroundtable.org/trade\\_2005/wto/us\\_economy.html](http://trade.businessroundtable.org/trade_2005/wto/us_economy.html); and Trade Resource Center [http://trade.businessroundtable.org/trade\\_basics/trade\\_jobs.html](http://trade.businessroundtable.org/trade_basics/trade_jobs.html), accessed January 15, 2006.

<sup>12</sup>Amal R. Karunaratna, Lester W. Johnson, and C. P. Rao, "The Exporter-Import Agent Contract and the Influence of Cultural Dimensions," *Journal of Marketing Management*, 17 (February), 2001, pp. 137–58.

<sup>13</sup>Peter G. P. Walters and Saeed Samiee, "Marketing Strategy in Emerging Markets: The Case of China," *Journal of International Marketing*, 11(1), 2003, pp. 97–106.

<sup>14</sup>For a comprehensive review of the export development process, see Leonidas C. Leonidou and Constantine S. Katsikeas, "The Export Development Process: An Integrative Review of Empirical Models," *Journal of International Business Studies*, 27 (Third Quarter 1996), pp. 517–51.



## GLOBAL PERSPECTIVE 16-1

### THE COMPLEXITIES OF EXPORTING VS. DOMESTIC SALES

Major differences exist in processing domestic and export sales but the two most important may be the complexity and the number of people involved in exporting products. These differences are also major contributors to new and better paying jobs for the domestic labor market.

**The Process for Domestic Sales:** The order is entered or given to a salesperson via e-mail, fax, internet, or phone. If the product is in stock, the salesperson sends the request to the shipping department where the order is filled and then boxed, crated, or skidded. The box is marked, labeled, and put on a truck for delivery the next day or as soon as possible.

**The Process for Export Sales:** An order entry person (usually bilingual) enters the order that is received via e-mail, fax, internet, or phone. An export compliance officer reviews all foreign inquiries, requests, and purchase orders. The officer also monitors Export Administration Regulations (EAR), tariffs, harmonized codes, export licenses, boycott, language, checklists for denied parties, and Shipper's Security Endorsement, etc. Engineering department reviews for compliance and product certifications. These tasks are usually outsourced to labs. Companies can use separate production lines designated specifically for export because of major differences in technical specifications, certifications, and designs. Different sources of outside suppliers may also be needed for exported goods. Drawings, designs, and instructions need to be translated and printed in several foreign languages. The Export Shipping Department is experienced in export packing, containerizing, and creating detailed packing lists. The department also references metric weights and measurements

while providing export labeling and routing that identifies the terms of shipment.

A freight forwarder is an export documentation specialist who handles Export Declarations, Certificates of Compliance, Consular, Origin, Chambers of Commerce signatures, export insurance, and airway and ocean bills of lading. In terms of transportation, trucks and railroad cars are used to deliver export containers to domestic ports in order to meet shipping schedules. The banking sector handles foreign open account payments, wire transfers, letters of credit, drafts and financing (short, medium and long term). Factoring houses, forfeiting agencies and insurance agencies (public and private) augment this process as well. U.S. government employees including U.S. Customs officers, Export Administration personnel (at the Bureau of Industry and Security), and Ex-Im Bank, Small Business Administration, World Bank, and USAID representatives, also may contribute to the export sales process. Other government agencies represented in this process include the Department of Commerce, Department of Treasury and Export Assistance. The monitoring of export sales (analysis and statistics) is completed by the Departments of State and Defense as well as the Nuclear Energy Commission and the Central Intelligence Agency. Other service providers include international telecommunications and foreign travel service agents as well as international newspapers, magazines and publications, and international credit reporting agencies such as FCIB. Finally, attorneys, accounting firms, tax experts, and consultants specializing in international markets provide their services.

So, the next time someone asks you the question whether export sales really are easy to handle, you may want to share a copy of this article.

*Source:* Richard Gref, "Are Export Sales Really Good for the U.S. Economy?" *Business Credit*, September 2000, p. 52.

dimensions. An exporter or importer that violates terms has legal recourse in India, and the court of adjudication is in India. Legal recourse is still largely wishful thinking in China. By addressing consumer and macroeconomic variables, the exporter can successfully segment the international market into homogenous segments where similar elements of the marketing mix can be applied.

Data for grouping along macroeconomic criteria are available from international agencies such as the World Bank, which publishes the *World Development Report*. In addition, the United Nations produces a series of statistical abstracts on a yearly basis covering economic, demographic, political, and social characteristics that are very useful for grouping analysis. The International Monetary Fund publishes data on international trade and finance quarterly and annually. Both the Organization for Economic Cooperation and Development (OECD—a group of advanced nations) and the European Union (EU) publish a variety of statistical reports and studies on their member countries.

### Export Market Segments

As discussed in Chapter 7, the grouping of countries and regions among countries enables a firm to link various geographical areas into one homogeneous market segment that the firm can cater to in meeting its export objectives. The next task is

to develop a product strategy for the selected export markets. The export market clusters obtained by clustering regions within different nations would fall into various levels: at the country level would be countries with the same characteristics as the U.S. market; at the regional level within nations, there would be geographical and psychographic segments in many different countries to which the firm can export the same core product it sells in domestic markets without any significant changes. It is a form of market diversification in which the firm is selling a standardized, uniform product across countries and regions.<sup>15</sup> Mercedes-Benz automobiles and Rolex watches sell to the same consumer segment worldwide. Another standardized product that sells worldwide is the soft drink. The Coca-Cola Company markets essentially one Coke worldwide.

Products that can be standardized could satisfy basic needs that do not vary with climate, economic conditions, or culture. A standardized product is the easiest to sell abroad logistically because the firm incurs no additional manufacturing costs and is able to use the same promotional messages across different regions in different countries across the world. If those different regions have comparable logistics and infrastructural facilities, the distribution requirements and expenses would also be similar.

Where it is not possible to sell standardized products, the firm could need to adapt its products for the overseas marketplace. In such instances, either the firm's product does not meet customer requirements or it does not satisfy the administrative requirements of foreign countries. Such markets can require modification of the product if it is to succeed in the foreign market.<sup>16</sup> Brand names, for example, need to be changed before a product can be sold, because the brand name could mean something detrimental to the product's prospect. Ford recently released its new European Ka model in Japan. Ka means "mosquito" in Japanese, a less than popular disease-carrying pest. Analysts called the Ka dead on arrival.<sup>17</sup> Beauty-products giant Estée Lauder found out that its perfume Country Mist would not sell in Germany because mist means manure in German slang. Sometimes, a new product has to be developed from a manufacturing viewpoint because the product is not salable as it is in the export market. For example, room air conditioner units being exported to Egypt must have special filters and coolers and have to be sturdy enough to handle the dust and heat of Egyptian summer.

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## INDIRECT EXPORTING



**Indirect exporting** involves the use of independent intermediaries or agents to market the firm's products overseas. These agents, known as export representatives, assume responsibility for marketing the firm's products through their network of foreign distributors and their own salesforce. It is not uncommon for a U.S. producer who is new to exporting to begin export operation by selling through an export representative. Many Japanese firms have also relied on the giant general trading companies known as *sogoshosha*. Use of agents is not uncommon when it is not cost effective for an exporter to set up its own export department. Such firms can initiate export operations through export representatives who know the market and have experience in selling to them. There are several types of export representatives in the United States. The most common are the combination export manager (CEM), export merchant, export broker, export commission house, trading company, and piggyback exporter.

The **combination export manager** (CEM) acts as the export department to a small exporter or a large producer with small overseas sales. CEMs often use the letterhead of

<sup>15</sup>Lloyd C. Russow, "Market Diversification: "Going International," *Review of Business*, 17 (Spring 1996), pp. 32–34.

<sup>16</sup>Roger J. Calantone, S. Tamer Cavusgil, Jeffrey B. Schmidt, and Geon-Cheol Shin, "Internationalization and the Dynamics of Product Adaptation—An Empirical Investigation," *Journal of Product Innovation Management*, 21 (May 2004), pp. 185–98.

<sup>17</sup>Keith Naughton, "Tora, Tora, Taurus," *Business Week* (April 12, 1999), p. 6.

the company they represent and have extensive experience in selling abroad and in the mechanics of export shipments. CEMs operate on a commission basis and are usually most effective when they deal with clients who have businesses in related lines. Because credit plays an increasingly important role in export sales, CEMs have found it increasingly difficult to consummate export sales on behalf of clients without their credit support. As more and more firms begin exporting on a regular basis, CEMs are becoming a vanishing breed. A list of CEMs can be found in the *American Register of Exporters and Importers* and in the telephone yellow pages.

**Export merchants**, in contrast to the CEM, buy and sell on their own accounts and assume all responsibilities of exporting a product. In this situation, the manufacturers do not control the sales activities of their products in export markets and depend entirely on the export merchant for all export activities. This loss of control over the export marketing effort is a major drawback to using export merchants. The **export broker**, as the name implies, is someone who brings together an overseas buyer and a domestic manufacturer for the purpose of an export sale and earns a commission for establishing a contact that results in a sale.

Foreign buyers of U.S. goods sometimes contract for the services of a U.S. representative to act on their behalf. This resident representative is usually an **export commission house** that places orders only on behalf of its foreign client with U.S. manufacturers and acts as a finder for its client to get the best buy. A **trading company** is a large, organization engaged in exporting and importing. It buys on its own account in one country and exports the goods to another country. Most of the well-known trading companies are Japanese or Western European in origin. Japanese trading companies, known as *sogoshosha*, such as Mitsui, Mitsubishi, Sumitomo, and Marubeni operate worldwide and handle a significant proportion of Japanese foreign trade. United Africa Company, a subsidiary of Unilever, operates extensively in Africa. Another European trading company is Jardine Matheson in Hong Kong, a major trading force in Southeast Asia. See **Exhibit 16-1** for the major types of trading companies.

**Piggyback exporting** refers to the practice by which carrier firms that have established export departments assume, under a cooperative agreement, the responsibility of exporting the products of other companies. The carrier buys the rider's products and

### EXHIBIT 16-1

#### MAJOR TYPES OF TRADING COMPANIES AND THEIR COUNTRIES OF ORIGIN

Type	Rationale for Grouping	Some Examples by Country of Origin
General Trading Company	Historical Involvement in generalized imports/exports	C. Itoh (Japan), East Asiatic (Denmark), SCOA (France), Jardine Matheson (Hong Kong)
Export Trading Company	Specific mission to promote growth of exporters	Hyundai (Korea), Interbras (Brazil), Sears World Trade (US)
Federated Export Marketing Group	Loose collaboration among exporting companies supervised by a third party and usually market specific	Fedec (UK), SBI Group (Norway), IEB Project Group (Morocco)
Trading arm of MNCs	Specific international trading operations in parent company operations	General Motors (US), IBM (US)
Bank-based or affiliated trading group	A bank at the center of a group extends commercial activities	Mitsubishi (Japan), Cobec (Brazil)
Commodity trading company	Long standing export trading in a specific market	Metallgesellschaft (Germany), Louis Dreyfus (France)

Source: Adapted from Lyn Amine, "Toward a Conceptualization of Export Trading Companies in World Markets," in S. Tamer Cavusgil, ed., *Advances in International Marketing*, vol. 2 (Greenwich, CT: JAI Press, 1987), pp. 199–208.

markets them independently. The rider plays a peripheral role in the export marketing overseas. Piggybacking can be an option to enter an export market, but is normally avoided by firms who wish to be in exports over the long haul because of the loss of control over the foreign marketing operations.

## DIRECT EXPORTING



**Direct exporting** occurs when a manufacturer or exporter sells directly to an importer or buyer located in a foreign market. It requires export managers' full commitment both in their attitudes and in their behavior for export success.<sup>18</sup> Direct exporting can manifest in various organizational forms, depending on the scale of operations and the number of years that a firm has been engaged in exporting. In its most simple form, a firm has an export sales manager with some clerical help responsible for the actual selling and directing of activities associated with the export sales. Most of the other export-marketing activities (advertising, logistics, and credit, for example) are performed by a regular department of the firm that also handles international trade transactions.

As export activities grow in scale and complexity, most firms create a separate **export department** that is largely self-contained and operates independently of domestic operations. An export department can be structured internally on the basis of function, geography, product, customer, or some other combination. Some firms prefer to have an **export sales subsidiary** instead of an export department in order to keep export operations separate from the rest of the firm. In terms of internal operations and specific operations performed, an export sales subsidiary differs very little from an export department. The major difference is that the subsidiary, being a separate legal entity, must purchase the products it sells in the overseas markets from its parent manufacturer. This means that the parent has to develop and administer a system of transfer pricing. A subsidiary has the advantage of being an independent profit center and is therefore easier to evaluate; it can also offer tax advantages, ease of financing, and increased proximity to the customer.

Instead of a foreign sales subsidiary, a firm also has the option of establishing a **foreign sales branch**. Unlike a subsidiary, a branch is not a separate legal entity. A foreign sales branch handles all of sales, distribution, and promotional work throughout a designated market area and sells primarily to wholesalers and dealers. Where it is used, a sales branch is the initial link in the marketing channel in the foreign market. Often the branch has a storage and warehousing facility available so it can maintain an inventory of products, replacement parts, and maintenance supplies.

Indirect exporting and direct exporting are compared in **Exhibit 16-2**. Both have advantages and disadvantages, although over the long-term, that is, for a firm

### EXHIBIT 16-2

#### COMPARISON OF DIRECT AND INDIRECT EXPORTING

##### *Indirect Exporting*

- Low set up costs
- Exporter tend not to gain good knowledge of export markets
- Credit risk lies mostly with the middlemen
- Since it is not in the interest of the middlemen doing the exporting, customer loyalty rarely develops

##### *Direct Exporting*

- High set up costs
- Leads to better knowledge of export markets and international expertise due to direct contact
- Credit risks are higher especially in the early years
- Customer loyalty can be developed for the exporter's brands more easily

<sup>18</sup>Rodney L. Stump, Gerard A. Athaide, and Catherine N. Axinn, "The Contingent Effect of the Dimensions of Export Commitment on Exporting Financial Performance: An Empirical Examination," *Journal of Global Marketing*, 12(1) (1998), pp. 7–25; and David L. Dean and Bulent Menguc, "Revisiting Firm Characteristics, Strategy, and Export Performance Relationship," *Industrial Marketing Management*, 29 (September 2000), pp. 461–77.





## Legality of Exports

Exporting starts with the search for a buyer abroad. It includes the research to locate a potential market, a buyer, and information concerning the process of closing a sale. We covered the process of getting an order earlier in this chapter. Once an export contract has been signed, the wheels are set in motion for the process that results in the export contract. The *first* stage has to do with the legality of the transaction. The exporter must determine whether the goods can actually be imported by the importing party—importing country licensing law can halt a transaction unless it is studied in advance.

Standard specifications for products and services are especially important in Europe and Japan as far as U.S. exporters are concerned. As far as export transactions to third-world countries are concerned, the convertibility of the importing country's currency must be determined even in this day of liberalization. If the country's currency is not convertible, the importing party must have permission to remit hard currency. Finally, the exporter must ensure that there are no export restrictions on the goods it proposes to export from the United States. Security concerns on encryption technology, for example, permit the exports of encryption technology that incorporates no more than 40 bits. All exports from the United States (except those to Canada and U.S. territories) require an **export license**, which can be a general export license or a validated export license. A **general license** permits exportation within certain limits without requiring that an application be filed or that a license document be issued. A **validated license** permits exportation within specific limitations; it is issued only on formal application. Most goods can move from the United States to the free world countries under a general license. A validated license is required to export certain strategic goods regardless of their destination. For most goods, the license is granted by the U.S. Department of Commerce's Bureau of Industry and Security. For certain specific products, however, the license is granted by other U.S. government agencies (See **Exhibit 16-3**).

As onerous as export validation procedure appears, large companies are proactively dealing with it. For example, Philips, with \$4 billion in annual exports to over 150 countries from some 260 U.S. locations, has automated its export process to a significant degree by implementing its PROTECT system, which is a database that permits export

### EXHIBIT 16-3

#### U.S. GOVERNMENT DEPARTMENTS AND AGENCIES WITH EXPORT CONTROL RESPONSIBILITIES

<i>Licensing Authority</i>	<i>Responsibility</i>
Department of State, Office of Defense Trade Controls (DTC)	Licenses defense services and defense (munitions) articles.
Department of the Treasury, Office of Foreign Assets Control (OFAC)	Administers and enforces economic and trade sanctions against targeted foreign countries, terrorism sponsoring organizations, and international narcotics traffickers.
Nuclear Regulatory Commission, Office of International Programs	Licenses nuclear material and equipment.
Department of Energy, Office of Arms Controls and Nonproliferation, Export Control Division	Licenses nuclear technology and technical data for nuclear power and special nuclear materials.
Department of Energy, Office of Fuels Programs	Licenses natural gas and electric power.
Defense Threat Reduction Agency—Technology Security	Responsible for the development and implementation of policies on international transfers of defense-related technology, and reviews certain dual-use export license applications.
Department of the Interior, Division of Management Authority	Controls the export of endangered fish and wildlife species.
Drug Enforcement Administration, International Drug Unit	Controls the import and export of listed chemicals used in the production of control substances under the Controlled Substances Act.
Food and Drug Administration, Office of Compliance	Licenses medical devices.
Food and Drug Administration, Import/Export	Licenses drugs.
Patent and Trademark Office, Licensing and Review	Oversees patent filing data sent abroad.
Environmental Protection Agency, Office of Solid Waste, International and Special Projects Branch	Controls toxic waste exports.

Source: Bureau of Industry and Security, U.S. Department of Commerce, <http://www.bis.doc.gov/reslinks.htm>, accessed August 5, 2009.

managers to simulate their export transaction before it is approved. The PROTECT database includes: 1) all Philips products that fall under any type of export control; 2) a full listing of proscribed or sensitive countries and customers; 3) all export control laws and regulations; and 4) concrete instruction on how to act in specific export control matters. In general, the Philips export management system clearly identifies who are its customers, how it takes orders, and who is responsible for exports to ensure that export activities follow the company's export compliance guidelines and procedures.<sup>22</sup>

Similarly, exporters from other countries also need to get export license in their countries in order to sell their products in foreign markets. For example, although many Chinese automobile companies planned to increase the number of vehicles they export, their efforts were not taken into reality because the Chinese government announced that it would limit the number of export licenses available to domestic automotive companies by 2008.<sup>23</sup> Triggered by the safety issues of Mattel toy made in China, the toy industry and government in China paid a lot of attention to efforts to correct problems that led to widespread recalls in 2007. One of the Chinese government's efforts was to revoke export licenses for hundreds of its estimated 3,500 export-oriented toy factories.<sup>24</sup>

## Export Transactions

The second pillar of an export transaction involves the logistics of the export transaction, which includes (1) the terms of the sale, including payment mode and schedule, dispute settlement mechanism, and service requirements (if applicable); (2) monitoring the transportation and delivery of the goods to the assigned party—the assignee in the bill of lading and obtaining proof of delivery—the **customs receipt**; and (3) shipping and obtaining the bill of lading.

When a company has a firm order for exports, it must execute the order by delivering the product or service promised to the overseas customer. A **bill of lading** is a contract between the exporter and the shipping company indicating that the shipping company has accepted responsibility for the goods and will provide transportation in return for payment. The bill of ownership can also be used as a receipt and to prove ownership of the merchandise, depending on the type of the bill of lading. A **straight bill of lading** is non-negotiable and is usually used in prepaid transactions. The goods are delivered to a specific individual or company. A **shipper's order bill of lading** is negotiable; it can be bought, sold, or traded while the goods are still in transit, (i.e., title of the goods can change hands). The customer usually needs the original or a copy of the bill of lading to take possession of the goods (depending on the terms of the export contract).

A **commercial invoice** is a bill for the goods stating basic information about the transaction, including a description of the merchandise, total cost of the goods sold, addresses of the buyer and the seller, and delivery and payment terms. The buyer needs the invoice to prove ownership and to arrange payment terms. Some governments also use commercial invoices to assess customs duties. Other export documentation that may be required includes export licenses, certificates of origin, inspection certification, dock and/or warehouse receipts, destination control certificates (to inform shippers and other foreign parties that the goods can be shipped only to a particular country), shippers' export declaration, and export packaging lists. To ensure that all required documentation is accurately completed and to minimize potential problems, firms entering the international market for the first time with an export order should consider using **freight forwarders** who are shipping agents and specialists in handling export documentation.

## Terms of Shipment and Sale

The responsibilities of the exporter, the importer, and the logistic provider should be spelled out in the export contract in terms of what is and what is not included in the price quotation and who owns title to the goods while in transit. **INCOTERMS 2000**,

<sup>22</sup>“AAEI Conference Highlights: How Microsoft, Philips Meet New Post-9/11 Compliance Requirements,” *Managing Exports*, August 2004, pp. 1–4.

<sup>23</sup>Christie Schweinsberg and Sol Biderman, “China Aims to Rein in Auto Exports,” *Ward's Auto World*, November 2006, pp. 34–34.

<sup>24</sup>Steve Toloken, “Toy Makers Reaping What They Have Sown,” *Plastics News*, February 4, 2008, p. 6.

## EXHIBIT 16-4

### TERMS OF SHIPMENT

<b>Ex-works (EXW)</b> at the point of origin	The exporter agrees to deliver the goods at the disposal of the buyer to the specified place on the specified date or within a fixed period. All other charges are borne by the buyer.
<b>Free Alongside Ship (FAS)</b> at a named port of export	Title and risk pass to buyer including payment of all transportation and insurance cost once delivered alongside ship by the seller. Used for sea or inland waterway transportation. The export clearance obligation rests with the seller.
<b>Free on Board (FOB)</b> at a named port of export	The exporter undertakes to load the goods on the vessel to be used for ocean transportation and the price quoted by the exporter reflects this cost.
<b>Free Carrier (FCA)</b> at a named place	It is mainly quoted for air transport and multimodal transport; the pricing conditions are very similar to those of FOB.
<b>Cost and Freight (CFR)</b> to a named overseas port of disembarkation	The exporter quotes a price for the goods including the cost of transportation to a named overseas port of disembarkation. The cost of insurance and the choice of the insurer are left to the importer.
<b>Carriage Paid To (CPT)</b> at named place of destination	It is mainly quoted for air transport and multimodal transport; the pricing conditions are very similar to those of CFR.
<b>Cost, Insurance and Freight (CIF)</b> to a named overseas port of disembarkation	The exporter quotes a price including insurance and all transportation and miscellaneous charges to the port of disembarkation from the ship. CIF costs are influenced by port charges (unloading, wharfage, storage, heavy lift, demurrage), documentation charges (certification of invoice, certification of origin, weight certificate) and other miscellaneous charges (fees of freight forwarder, insurance premiums)
<b>Carriage and Insurance Paid To (CIP)</b> at named place of destination	It is mainly quoted for air transport and multimodal transport; the pricing conditions are very similar to those of CIF.
<b>Delivery Duty Paid (DDP)</b> to an overseas buyer's premises	The exporter delivers the goods with import duties paid including inland transportation from the docks to the importer's premises

which went into effect on January 1, 2000 and is an acronym for International Commercial Terms, are the internationally accepted standard definitions for the terms of sale by the International Chamber of Commerce.<sup>25</sup> The commonly used terms of shipment are summarized in **Exhibit 16-4**.

The terms of shipment used in the export transaction and their acceptance by the parties involved are important to prevent subsequent disputes. These terms of shipment also have significant implications on costing and pricing. The exporter should therefore learn what terms of shipment importers prefer in a particular market and what the specific transaction requires. A CIF quote by an exporter clearly shows the importer the cost to get the product to a port in a desired country. An inexperienced importer may be discouraged by an EXW quote because the importer may not know how much the EXW quote translates in terms of landed cost at home.

The financing and payments of an export transaction constitute the third set of things to do with regard to an export transaction. For example, is export credit available from an Export-Import Bank (discussed later in the chapter) or a local agency supporting exports? What payment terms have been agreed on? Customary payment terms for noncapital goods transactions include advance payment, confirmed irrevocable letter of credit, unconfirmed irrevocable letter of credit, documents against payment (D/P), documents against acceptance (D/A), open account, and consignment basis payments. These terms are explained in **Exhibit 16-5**. The terms of payment between the exporter and the importer are a matter of negotiation and depend on a variety of factors including the buyer's credit standing, the amount of the sale transaction, the availability of foreign exchange in the buyer's country, the exchange control laws in the buyer's

## Payment Terms

<sup>25</sup><http://www.iccwbo.org/incoterms>, accessed August 10, 2009.

**EXHIBIT 16-5**  
TERMS OF PAYMENT IN AN EXPORT TRANSACTION

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<b>Advance Payment</b>	An importer pays exporter first; an exporter sends goods afterwards.
<b>Confirmed irrevocable letter of credit</b>	A letter of credit issued by the importer's bank and confirmed by a bank usually in the exporter's country. The obligation of the second bank is added to the obligation of the issuing bank to honor drafts presented in accordance with the terms of credit.
<b>Unconfirmed irrevocable letter of credit</b>	A letter of credit issued by the importer's bank. The issuing bank still has an obligation to pay.
<b>Documents against payment (D/P)</b>	An importer pays bills and obtains documents and then goods. Therefore, the exporter retains control of the goods until payment.
<b>Documents against acceptance (D/A)</b>	An importer accepts bills to be paid on due date and obtains documents and then goods. Therefore, the exporter gains a potentially negotiable financial instrument in the form of a document pledging payment within a certain time period.
<b>Open account</b>	No draft drawn. Transaction payable when specified on invoice
<b>Consignment</b>	A shipment that is held by the importer until the merchandise has been sold, at which time payment is made to the exporter.

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Sources: Lakshman Y. Wickremeratne, *ICC Guide to Collection Operations: For the ICC Uniform Rules for Collections*, (URC 522) (Paris, International Chamber of Commerce, 1996), pp. 22–26; and “Documentary Collections DC Payment Terms Offer Intermediate Level of Risk for International Collections,” *Managing Exports*, December 2002, pp. 4–5.

country, the risks associated with the type of merchandise to be shipped, the usual practice in the trade, and market conditions (i.e., a buyer's market or a seller's market and payment terms offered by competitors).

When negotiating payment terms with an importer, an exporter must consider the risks associated with the importer and the importer's country, including credit risks, foreign exchange risks, transfer risks, and the political risks of the importer's country. **Credit risk** is the risk that the importer will not pay or will fail to pay on the agreed terms. The exporter must consider this risk. **Foreign exchange risk** exists when the sale is in the importer's currency and that currency can depreciate in terms of the home currency, leaving the exporter with less in the home currency.<sup>26</sup> **Transfer risk** refers to the chances that payment will not be made due to the importer's inability to obtain foreign currency (usually, U.S. dollars) and transfer it to the exporter. **Political risk** refers to the risks associated with war, confiscation of the importer's business, and other unexpected political events.

If an exporter sells for cash, there is virtually no risk. The possible nominal risk is associated with the timing of the order, as compared to the receipt of payment. A sale on a **confirmed irrevocable letter of credit** has slightly more risk. The confirmation places a home bank or other known bank acceptable to the seller; the payment risk assumed by the exporter devolves almost completely to this bank. If the sale is in a foreign currency, the exporter is still exposed to the risk of depreciation of the foreign currency relative to the dollar. An **unconfirmed irrevocable letter of credit** exposes the exporter to the creditworthiness of the buyer's bank in the foreign country because the exporter's home bank is no longer guaranteeing payment. The exporter thus faces the additional risk of a change in the value of the foreign currency (if the sale is not in the exporter's home currency), the risk that the payment cannot be transferred to the exporter's

<sup>26</sup> A recent study shows that exporters who accept foreign currency as a medium of payment tend to sell a higher volume and have more satisfied customers (i.e., importers) but tend to have lower profit margins than those exporters who accept domestic currency. This is due probably to foreign exchange rate risk. For detail, see Saeed Samiee and Patrik Anckar, “Currency Choice in Industrial Pricing: A Cross-National Evaluation,” *Journal of Marketing*, 62 (July 1998), pp. 112–27.

home bank, and the risk that the political conditions in the buyer's country will change to the exporter's detriment.

**Documents against payment (D/P)** and **documents against acceptance (D/A)** are an importer's IOUs, or promises to pay. These payment terms (D/P and D/A) are much less expensive and easier for both exporters and importers to use than securing letters of credit. D/P and D/A are employed widely around the world but are historically underutilized by U.S. exporters.<sup>27</sup> Exports on a D/P are paid for by an importer at the time it accepts the exporter's export documents. Exports on a D/A are paid for by an importer on the due date of bill. Relative to a sale on a letter of credit, D/P basis increases the payment risk in an export transaction because no financial institution such as a bank has assumed the risk of payment. A D/A further escalates the risk because the buyer, by "accepting the bill," will receive the title documents and can pick up the goods without payment. Finally, an **open account** sale has no evidence of debt (promissory note, draft, etc.) and the payment may be unenforceable. Usually, conducted only on the basis of an invoice, an open account transaction is recommended only after the exporter and the importer have established trust in their relationship.

The fourth task of an exporter is to arrange a foreign exchange cover transaction with the banker or through the firm's treasury in case there is a foreign exchange risk in the export transaction. Such arrangements include reversing the forward currency transaction if required and hedging the foreign exchange risk using derivative instruments in the foreign exchange markets, for example, currency options and futures. In general, customer-oriented exporters tend to use invoicing in foreign currency. Thus, currency hedging becomes all the more important to customer-oriented exporters.<sup>28</sup> When the exporter is receiving some currency other than its domestic currency, covering a trade transaction through forward sales, currency options, and currency futures enables the exporter to lock in the domestic currency value of the export transaction up to a year in the future, thus ensuring more certain cash flows and forecasting. Due care needs to be exercised in the use of currency hedging, because an unwary or uninformed firm can lose large amounts of money. (See Chapter 3 for detail.)

## Currency Hedging

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## ROLE OF THE GOVERNMENT IN PROMOTING EXPORTS<sup>29</sup>



Government export promotion activities generally comprise (1) export service programs (e.g., seminars for potential exporters, export counseling, how-to-export handbooks, and export financing) and (2) market development programs (e.g., dissemination of sales leads to local firms, participation in foreign trade shows, preparation of market analysis, and export news letters).<sup>30</sup> In addition, program efforts can be differentiated as to whether the intent is to provide informational or experiential knowledge. Informational knowledge typically is provided through "how-to" export assistance, workshops, and seminars, while experiential knowledge is imparted through the arrangement of foreign buyers' or trade missions, trade and catalog shows, or participation in international market research.

<sup>27</sup>"Documentary Collections DC Payment Terms Offer Intermediate Level of Risk for International Collections," *Managing Exports*, December 2002, pp. 4–5.

<sup>28</sup>Patrik Anckar and Saeed Samiee, "Customer-Oriented Invoicing in Exporting," *Industrial Marketing Management*, 29 (November 2000), pp. 507–20.

<sup>29</sup>This section draws from Esra F. Gencturk and Masaaki Kotabe, "The Effect of Export Assistance Program Usage on Export Performance: A Contingency Explanation," *Journal of International Marketing*, 9(2), 2001, 51–72.

<sup>30</sup>William C. Lesch, Abdolreza Eshghi, and Golpira S. Eshghi, "A Review of Export Promotion Programs in the Ten Largest Industrial States," in S. Tamer Cavusgil and Michael R. Czinkota, eds. *International Perspectives on Trade Promotion and Assistance* (New York: Quorum Books, 1990), pp. 25–37.



U.S. government-sponsored trade-show exhibits. The government is actively involved in export promotion.

As stated at the beginning of this chapter, export is an important source of economic growth and job creation. Furthermore, jobs that depend on trade pay between 13 to 18 percent more than the average wage. Therefore, government efforts to promote exports seem to make sense. Although exports may be considered a major engine of economic growth in the U.S. economy, many U.S. firms do not export. Many firms, particularly small- to medium-size ones, appear to have developed a fear of international market activities. Their management tends to see only the risks—informational gaps, unfamiliar conditions in markets, complicated domestic and foreign trade regulations, absence of trained middle managers for exporting, and lack of financial resources—rather than the opportunities that the international market can present. These very same firms, however, may well have unique competitive advantages to offer that may be highly useful in performing successfully in the international market.

For example, small- and medium-size firms can offer their customers short response times. If some special situation should arise, there is no need to wait for the “home office” to respond. Responses can be immediate, direct, and predictable to the customer, therefore providing precisely those competitive ingredients that increase stability in a business relationship and reduce risk and costs. These firms also can often customize their operations more easily. Procedures can be adapted more easily to the special needs of the customer or to local requirements. One could argue that in a world turning away from mass marketing and toward niche marketing, these capabilities may well make smaller-size firms the export champions of the future.

Through the **Export Enhancement Act** of 1992, the U.S. government announced the National Export Strategy, a strategic, coordinated effort to stimulate exports.<sup>31</sup> In pursuit of this objective, the International Trade Administration of the U.S. Department of Commerce has devoted a substantial amount of the tax dollars allocated to it to help U.S. firms export their goods and services. For instance, the Japan Export Information Center (JEIC), established in April 1991, is the primary contact point within the Department of Commerce for U.S. exporters seeking business counseling and commercial information necessary to succeed in the Japanese market. The JEIC’s principal function is to provide guidance on doing business in Japan and information on market entry alternatives,

<sup>31</sup>Richard T. Hise, “Globe Trotting,” *Marketing Management*, 6 (Fall 1997), pp. 50–58.

market data and research, product standards and testing requirements, intellectual property protection, tariffs, and non-tariff barriers. The Japanese External Trade Organization (JETRO), affiliated with Japan's Ministry of Economy, Trade and Industry has also in recent years switched from promoting Japanese exports to helping U.S. and other foreign companies export and invest in Japan. The new emphasis on import promotion is part of the Japanese government's broader strategy to pull more foreign business into Japan, particularly from small to mid-size companies. These efforts are also an attempt to chip away at Japan's trade surplus with the United States and hopefully encourage a greater balance of trade for the future.<sup>32</sup>

In the United States, the Department of Commerce (DOC) also has industry specialists and country specialists in Washington, D.C. The industry specialists are available to give exporters information on the current state of the exporter's products overseas; comment on marketing and sales strategies; inform on trade missions, trade shows, and other events; and give other counsel. The country specialists are available to give information on the target country, any current trade issues with the United States, customs and tariff information, insight on the business climate and culture, and any other information on a country required by the exporter. For example, Purafil, a company based in Doraville, Georgia, that produces a dry chemical filtration system, benefited handsomely by participating in a DOC-sponsored trade mission to the Middle East for the first time. As part of the trade mission, the DOC provided a venue for Purafil and other companies to network and establish business relationships with prospective clients. One area in which the DOC is particularly helpful is in establishing credibility for the company marketing overseas. As a result, Purafil has been able to increase exports to 60 percent of all its revenues.<sup>33</sup>

Similarly, the DOC's Commercial Service has developed *BuyUSA.com*, an e-marketplace with a worldwide network of offices and expertise. The service offers online access to U.S. trade specialists who can assist buyers and sellers with exporting issues. For example, J. D. Streett & Company, a small auto lubricant and antifreeze manufacturer based in Maryland Heights, Missouri, spent some \$400 to list its products on BuyUSA.com, resulting in major sales to Vietnam in 60 days.<sup>34</sup> Clearly, the government helps exporters find business leads in foreign markets.

Other countries also develop governmental programs to promote exports. For example, China recently raised tax rebates for certain textile and garment exports to help producers cope with the paper-thin profit margins squeezed by the yuan's appreciation and higher costs. Export tax rebates for some textile and garment items, are increased by two percentage points to 13 percent from August 1, 2008. The country's textile and clothing exports rose 11.1 percent to US\$81.7 billion in the first half of 2008 from a year earlier. The tax rebate aims to increase would ease pressure and help boost exports.<sup>35</sup> Some governments even proactively engage in attracting inward foreign direct investment in the hope that their countries could increase exports. For example, Argentina, home to one of Latin America's most educated workforces and modern telecommunications, has the potential to become one of the region's leading software exporters. Hoping to lure software makers, the Argentine government enacted a law in 2005, offering technology companies tax benefits. The law has helped draw commitments of new investments of \$60 million over the next three years from Intel and Microsoft to develop software in Argentina. Software company executives have lauded Argentina as a potential software-producing leader.<sup>36</sup>

<sup>32</sup>Rosalind McLymont, "In an About Face, Japanese Group Provides Help to Foreign Exporters," *Journal of Commerce*, (April 19, 1999), p. 5A.

<sup>33</sup>"Clearing the Air," *Export America*, 3, September 2002, pp. 6-7.

<sup>34</sup>"Speeding to New Global Markets," *Export America*, 3, March 2002, p. 9.

<sup>35</sup>"China Increases Export Tax Rebates for Textile, Garment Product," *ChinaView*, July 31, 2008.

<sup>36</sup>"Argentina Has Potential to be Software Leader," *Reuters*, November 25, 2005.

## Export–Import Bank

The **Export-Import Bank (Ex-Im Bank)** is an independent U.S. government agency that plays a crucial role in promoting exports helping finance the sale of U.S. exports primarily to emerging markets throughout the world by providing loans, guarantees and insurance. In fiscal year 2007, Ex-Im Bank of the United States authorized \$12.6 billion in financing to support an estimated \$16 billion of U.S. exports worldwide.<sup>37</sup> Ex-Im Bank is not an aid or development agency, but a government held corporation, managed by a board of directors consisting of a chairman, vice chairman and three additional board members. Members serve for staggered terms and are chosen and serve at the discretion of the president of the United States.

Ex-Im Bank is designed to supplement, but not compete with private capital. Ex-Im Bank has historically filled gaps created when the private sector is reluctant to engage in export financing. Ex-Im Bank 1) provides guarantees of *working capital loans* for U.S. exporters, 2) guarantees the *repayment of loans* or makes loans to foreign purchasers of U.S. goods and services, and 3) provides *credit insurance* against non-payment by foreign buyers for political or commercial risk. To carry out the U.S. government's strategy for continuing export growth, the Ex-Im Bank is focusing on critical areas such as emphasizing exports to developing countries, aggressively countering the trade subsidies of other governments, stimulating small business transactions, promoting the export of environmentally beneficial goods and services, and expanding project finance capabilities.

The Ex-Im Bank also helps large U.S. companies to win contracts for major infrastructure projects, especially in the emerging markets. For example, it approved two long-term loan guarantees totaling \$57 million in 2002 to support the export by Siemens Transportation Systems Inc., Sacramento, CA, of \$62 million of equipment for light rail mass transportation systems in two Venezuelan cities.<sup>38</sup>

The Ex-Im Bank is also combating the “trade distorting” loans of foreign governments through the aggressive use of its Tied Aid Capital Projects Fund. The idea is that the Ex-Im Bank is willing on a case-by-case basis to match foreign tied-aid offers that are commercially viable and pending to be able to preemptively counter a foreign tied-aid offer. For instance, if a highway project in China gets a bid from a European or Japanese consortium of firms that offer to give concessional aid for the project but stipulate that in return for the aid the Chinese should buy machinery and materials from suppliers to be specified by the Europeans (or the Japanese), a U.S. firm bidding for the same project can depend on being able to provide concessional financing through the resources of the Ex-Im Bank. In addition, the U.S. government is no longer shy about openly representing U.S. firms and about being powerful advocates on behalf of U.S. businesses. Cabinet secretaries in the U.S. government have led groups of top business executives to many emerging markets. Accompanying administration officials on foreign missions give business executives a chance to get acquainted with decision makers in foreign governments, which awarded many infrastructure projects. The U.S. government lobbied hard to obtain airplane orders for Boeing from Singapore Airlines, Cathay Pacific, and Saudia, all of which were being lobbied hard by the French government to buy from the Airbus–European consortium.

Critics may cavil at this active role of the U.S. government in promoting exports; however, if U.S. firms are to retain their position in existing markets and if they are to gain access to new markets, they must have the same facilities that are available to firms from other nations. The Export-Import Bank of China, the third largest official credit institution in the world, following Japan Bank for International Cooperation (JBIC) and Export-Import Bank of the United States, inaugurated its Paris office in 2005 which would serve all the French-speaking countries in Western Europe, Northern Europe, and Africa. The Paris office plays a key role in promoting the bank's official loan business on behalf of the Chinese government to French-speaking countries, those in

<sup>37</sup>The Annual Report of the Export Import Bank of USA, <http://www.exim.gov>, accessed September 21, 2008.

<sup>38</sup>Press Releases from Export-Import Bank's web site, [www.exim.gov](http://www.exim.gov), accessed February 20, 2002.



Africa in particular, under favorable terms.<sup>39</sup> For this reason, the policy of advocacy on behalf of U.S. firms fighting to enter new markets or to retain existing markets is a cornerstone of the national export policy.

Other areas in which the government plays a role in promoting exports include the establishment and maintenance of foreign trade zones (FTZs) and the Export Trading Company Act of 1982.

**Foreign Trade Zone.** As discussed in detail in Chapter 15, foreign trade zones (free trade zones) enable businesses to store, process, assemble, and display goods from abroad without paying a tariff. Once these goods leave the zone and enter the United States, they are charged a tariff, but not on the cost of assembly or profits. If the product is re-exported, no duties or tariffs apply. Thus, a U.S. firm can assemble foreign parts for a camera in a Florida FTZ and ship the finished cameras to Latin America without paying duty.

**American Export Trading Company.** The Export Trading Company Act of 1982 encourages businesses to join together and form export-trading companies. The act provides antitrust protection for joint exporting and permits banking institutions to own interests in these exporting ventures. This act makes it practical for small- and medium-size exporting firms to pool resources without the fear of antitrust persecution and inadequate capitalization. A bank may hold up to 100 percent stock in an export trading company and is exempted from the collateral requirements contained in the Federal Reserve Act for loans to its export trading company.<sup>40</sup>

Although the U.S. government has become earnest in promoting exports, it also takes a hand in regulating exports. The Foreign Corrupt Practices Act of 1977 (as amended in 1986) imposes jail terms and fines for overseas payoffs that seek to influence overseas government decisions, although payments to expedite events that are supposed to take place under local laws are no longer illegal. Many U.S. exporters, especially exporters of big-ticket items, believe that the Foreign Corrupt Practices Act provides an unfair advantage to exporters from Europe and Japan that have been able to make such payments and get tax write-offs for the payments under export expenses. In 1996, under newly agreed provisions of WTO, firms from other countries were no longer allowed to make such payments without incurring penalties, thus leveling the playing field somewhat for U.S. exporters. Under the Wassenaar Arrangement of 1995 (see Chapter 5), domestic laws also exist that restrict exports of security-sensitive technology such as sophisticated machine tools and encryption technology for computer software and hardware (see **Global Perspective 16-2**).

Antitrust laws prevent U.S. firms from bidding jointly on major foreign projects. Human rights legislation and nuclear nonproliferation policies require that every year the federal government recertify the Normal Trade Relations (NTR)<sup>41</sup> status of major foreign trade partners (e.g., China). These are examples of the U.S. exporting its own rules to other nations under the aegis of WTO. To the extent that such actions result in the same rules for all nations engaging in international trade, such behavior benefits trade; however, such behavior can also be perceived as an infringement of national sovereignty by many nations.

Sometimes the actions of a foreign government can affect exports. These actions relate to tariffs and local laws relating to product standards and classification. For example, computer-networking equipment exported from the United States to the European Union is charged a 3.9 percent tariff. A recent EU ruling decided that computer

## Tariff Concessions

## Export Regulations

<sup>39</sup>“Export-Import Bank of China Opens Paris Office,” *Peoples’ Daily Online*, June 20, 2005.

<sup>40</sup>William W. Nye, “An Economic Profile of Export Trading Companies,” *Antitrust Bulletin*, 38 (Summer 1993), pp. 309–25.

<sup>41</sup>See Chapter 2 for details.



## GLOBAL PERSPECTIVE 16-2

### EXPORT CONTROL IN THE UNITED STATES: THE BALANCING ACT BETWEEN FREE TRADE AND TIGHT SECURITY

Control of high-tech exports has been regulated under a continuing executive order since 1994 when the Export Administration Act (EAA) of 1979 expired. In the past several years, the technology industry has argued that the current export control regime is outmoded. Current export control rules use a performance rating called “millions of theoretical operations per second” (MTOPS) to determine which microprocessors and computers must apply for export licenses to certain countries. Computing power has become so prolific, however, that it is nearly impossible to regulate by using performance-based controls such as MTOPS.

Indeed, the federal government has had to race with the market over the past several years to keep export control regulations from barring the export of readily available, mass-market computers. For example, as recently as 1999, microprocessors with an MTOPS rating of 1,200 and computers with a rating of 2,000 were subject to controls. Those limits have been raised repeatedly over the past few years. The limits on chips apply to export to certain countries such as China and the former Soviet countries. The limits on computers apply to so-called Tier III countries, which include China, Russia, Israel, Pakistan, and India.

In 2001, key senators introduced the Export Administration Act of 2001, aimed at balancing competing priorities: free trade and tight security. The bill attempted a narrower, more surgical application of controls on dual-use items—commercial exports

in aerospace, computers, encryption and machine tools that could be diverted to military use by overseas companies or countries. The bill would stiffen fines and prison terms for violators, both individual and corporate, in an attempt to bolster control of advanced technologies that are less widely dispersed. The bill also contained a provision that would eliminate the requirement that computer export controls be based on MTOPS levels. The House of Representatives was unable, however, to pass a similar bill.

The failure of Congress to enact a new EAA requires the president to continue to use his authority under the International Economic Emergency Powers Act (IEEPA) to regulate export controls. The Department of Commerce is currently working to establish a new metric to replace the MTOPS standard for high-performance computers. Meanwhile, the Bush Administration raised the MTOPS limit on computers from 85,000 to 190,000 MTOPS in March 2002. This rating would allow for the export of multi-processor servers with up to 32 Intel Itanium CPUs.

Since the September 11 terrorist attacks, U.S. companies have had to adjust to new export control challenges because license applications take longer, are rejected more often, and require more backup information. Microsoft, for instance, has outsourced certain export functions through partnering to achieve export efficiency in all processes. Furthermore, the company has implemented the SAP GTS system to conduct a country-screening process. Currently, Microsoft is proactively partnering with the U.S. government to secure global supply chains by participating in the C-TPAT (customers-Trade partnership Against Terrorism) program. Evidently, Microsoft is not the only company that has to adjust to the post 9/11 export paradigm shift.

*Sources:* Tam Harbert, “One Step Forward on Export Control,” *Electronic Business*, March 2002, p. 36; “AAEI Conference Highlights: How Microsoft, Philips Meet New Post-9/11 Compliance Requirements,” *Managing Exports & Imports*, August 2004, pp. 1-4; and “OEE 2005 Enforcement Actions and Fines Expected to Easily Surpass 2005,” *Managing Exports & Imports*, May 2005, p. 8.

networking equipment (e.g., adapters, routers, and switches) do not crunch data but transport them and so should be classified as telecommunication equipment. Telecommunication equipment, however, carries a higher tariff rate of 7.5 percent, increasing the landed price of these products in Europe.<sup>42</sup> Such actions by foreign governments are usually attempts to provide protection to local industry.

Finally, a government could tax exports with the purpose of satisfying domestic demand first or of taking advantage of higher world prices. For example, in 1998, two typhoons damaged trees in the northern Philippines, stripping away mature coconuts. Coconut oil shipments during the fourth quarter of 1998 were 60 percent below their normal level. The coconut oil market continued to face production declines and the threat of higher prices and Indonesia, the second largest producer, continued to impose

<sup>42</sup>“Europe’s Computer Networking Tariffs May Lead to U.S. Complaint to WTO,” *Wall Street Journal* (May 1, 1996), p. B7.

high export duties on coconut oil.<sup>43</sup> The goal of such measures was to curb exports and try to keep a lid on internal food industry costs as coconut oil prices soared. Similarly, a government could devise a mechanism by which to enforce collection of sales and/or value added tax owed by customers abroad. For instance, Australian exporters like Seawind International are influenced by the export regulations in Australia. One example is that Australian Tax Office will not allow buyers located in foreign countries to take delivery of their boat and cruise for months before shipping the boat home unless they pay value-added tax.<sup>44</sup>

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## MANAGING IMPORTS—THE OTHER SIDE OF THE COIN



So far the chapter has been devoted exclusively to exports, and we now turn to imports. For organizations in the United States importing is considerably easier than for most firms in the rest of the world. One of the primary reasons for this is the fact that unlike importers in most of the rest of the world, U.S. importers can pay the seller abroad in their own currency—the U.S. dollar—because the U.S. dollar is an internationally accepted denomination of exchange. Thus, unlike importers in Brazil or Indonesia who must find U.S. dollars (or other hard currencies) to pay for imports, an importer in the United States can manage by shelling out U.S. dollars. About 60 percent of the world's trade is still denominated in U.S. dollars; exporters want dollars in return for the goods or services sold.

However, denomination of trade in dollars is changing, especially in Europe, where the euro has emerged as the currency in which trade is denominated. Most of the time, therefore, a U.S. importer does not have to bother to hedge foreign exchange transactions or try to accumulate foreign currency to pay for imports. On occasion, a U.S. importer does not even need a letter of credit. This same advantage has become available to the European Union (EU) member countries. EU member countries are now able to pay in euro for their imports from other member countries. Similarly, in Asia the Japanese yen is emerging as the currency in which trade is denominated. Japan benefits from this on a more limited geographical basis. Japan is now able to pay in Japanese yen for much of its imports from Southeast Asia.

This is not to suggest that a firm can import anything for sale in the United States. There are restrictions on trade with countries such as Iran, Libya, Iraq, and Cuba. Iran and Libya are thought to be supporters of state-sponsored terrorism. The United States has been at war with Iraq (at the time of this writing), and Cuba has been a pariah for the United States since 1959. The same restrictions exist with respect to North Korea since the Korean War that ended in 1953. Production and marketing considerations also limit what can be imported and sold profitably in the United States. For soaps and cosmetics, for example, the demand for imports is minimal. However, the United States is a surplus producer of many categories of goods including aircraft, defense equipment, medical electronics, computer software, and agricultural goods.

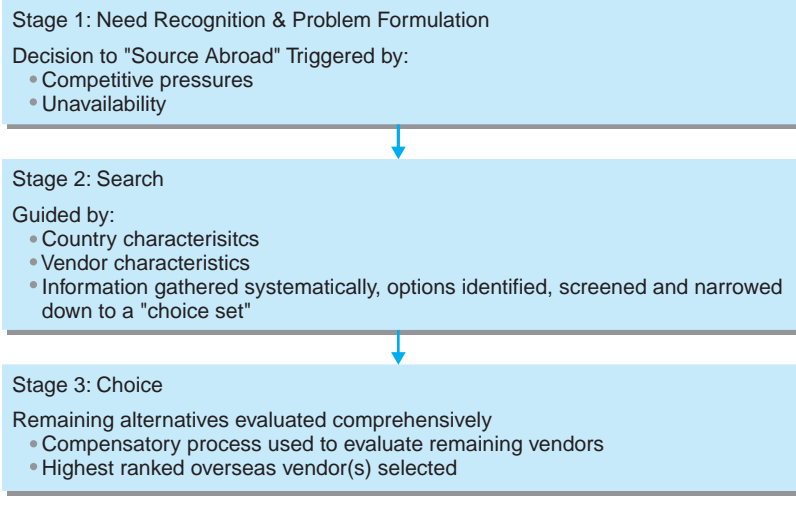
Importing any good is thus predicated upon the existence of a situation in which the domestic production of the good in question is not sufficient to satisfy demand. For example, annual sales of cut flowers in the U.S. is nearly \$10 billion, but domestic production meets only about 30 percent of the demand, with Americans purchasing flowers not just for special occasions but also for sending messages, as a token of friendship, as a get-well wish, or just to convey “have a nice day” to someone. Imports of cut flowers are primarily from Colombia, Mexico, Costa Rica, Ecuador, Peru, and Kenya.<sup>45</sup> The

<sup>43</sup>Jim Papanikolaw, “Coconut Oil Market Tightens because of Bad Weather in 1998,” *Chemical Market Reporter*, (January 25, 1999), p. 8.

<sup>44</sup>“ . . . But GST Puts a Damper on Exports,” *Manufacturers’ Monthly*, December 2007, p. 18.

<sup>45</sup>“Say it with Flowers,” *New Statesman*, February 16, 2004, pp. 22–23.

**EXHIBIT 16-6**  
**MODEL OF IMPORTER BUYER BEHAVIOR**



Source: Neng Liang and Rodney L. Stump, "Judgmental Heuristics in Overseas Vendor Search and Evaluation: A Proposed Model of Importer Buyer Behavior," *International Executive*, Copyright (November, 1996), pp. 779–806. Reprinted by permission of John Wiley & Sons, Inc.

imported flowers must satisfy the selective U.S. consumer and must comply with the U.S. Plant Protection Quarantine Inspection Program and antidumping regulations. Because the product is highly perishable, air transportation and rapid transit through customs must be ensured. Thus, the importer of flowers has to go through many hoops to locate a reliable seller and arrange the logistics. Importer behavior will, of course, depend on the category of goods being purchased abroad.

However, importer buyer behavior is a relatively under-researched area in the field of international trade partly because most nations are more interested in maximizing exports rather than imports, and restricting imports is relatively simple as compared to being a successful exporter. The most important of the organizational buying models is the BuyGrid model.<sup>46</sup> Besides elaborating on how the purchasing process evolves and highlighting the role of buyers' search in choice decisions, this framework was the first to categorize buy decisions as (1) straight buys, (2) modified rebuy, and (3) new tasks.

Although this framework was developed primarily for domestic purchases, it is applicable to import decisions as well. Applying the framework for an import decision and taking into account the increased uncertainty in international markets would translate into a procedure presented in **Exhibit 16-6**. This sequence of actions in an import situation appears logical, as it does for exports, but many international supplier relationships start with an "unsolicited export order" in which importers place an order with a selected foreign vendor without any systematic vendor search and evaluation. The lack of a systematic approach to vendor identification and evaluation can stem from a difficulty in accessing all relevant information and from the idea of bounded rationality—the notion that, due to limited cognitive abilities, humans tend to satisfy, not optimize. Thus, given the information available, which cannot be complete, managers will not be able to make the best decision.<sup>47</sup>

<sup>46</sup>Patrick J. Robinson, Charles W. Faris, and Yoram Wind, *Industrial Buying and Creative Marketing*, (Boston: Allyn and Bacon, 1967).

<sup>47</sup>Neng Liang and Rodney L. Stump, "Judgmental Heuristics in Overseas Vendor Search and Evaluation: A Proposed Model of Importer Buyer Behavior," *International Executive*, 38 (November/December 1996), pp. 779–806.

## MECHANICS OF IMPORTING



An import transaction is like looking at an export transaction from the other end of the transaction. Instead of an exporter looking for a prospective buyer, an importer looks for an overseas firm that can supply it the raw materials, components, or finished products that it needs for its business. Once an importer locates a suitable overseas exporter, it negotiates with the exporter the terms of the sale including, but not restricted to the following:

- Finding a bank that either has branches in the exporter's country or has correspondent bank located in the exporter's country and establishing a line of credit with the bank if this has not already been done.
- Establishing a letter of credit with a bank stating the terms of payment and how payment is to be made. This includes terms of clearing the goods from the docks/customs warehouse (sometimes with title for goods going temporarily to the bank), insurance coverage, terms of transfer of title, and so on.
- Deciding on the mode of transfer of goods from exporter to importer and transfer of funds from importer to exporter. Transportation partly provides proof of delivery to the exporter's bank or the exporter. The exporter (or its bank) presents the proof of delivery to the importer's bank (branch in importer's own country/correspondent bank). The importer's bank transfers funds to the exporter's bank and simultaneously debits the importer's account or presents a demand draft to the importer.
- Checking compliance with national laws of the importing country and the exporting country. Import restrictions into the U.S. include quotas on automobiles, textiles and steel and quarantine checks on food products as well as a ban on imports from Cuba, North Korea, and Iran.
- Making allowances for foreign exchange fluctuations by making covering transactions through the bank so that the dollar liability for the importer either remains fixed or decreases.
- Fixing liability for payment of import duties and demurrage and warehousing in case the goods are delayed due to congestion at ports. These payments are normally the responsibility of the importer.

An examination of these mechanics of an import transaction reveals that the transaction is materially the same as an export transaction. The differences that are of interest to managers involved in the import of goods into the United States include these:

- A difference in risk profile, meaning that an exporter faces the risk of receiving no payment due to a variety of factors, whereas nonpayment is not an issue in imports. However, the quality of goods and services imported can be an issue for imports, but this is not usually an issue in exports.
- The facility of being able to pay in its own currency (most of the time), which is not available to importers in almost any other country.
- Everything else being equal, the ease for a U.S. firm to import rather than to export because of the primacy of the U.S. dollar despite the gradual depreciation of the U.S. dollar over time.

When a shipment reaches the United States, the consignee (normally the importer) files entry documents with the port director at the port of entry. The bill of lading properly endorsed by the consignor in favor of the consignee serves as the evidence of the right to make entry. The entry documents also include an entry manifest, Customs Form 7533, Customs Form 3461, packing lists if appropriate, and the commercial invoice. The entry

### Import Documents and Delivery

should be accompanied by evidence that a bond is posted with customs to cover any potential duties, taxes, and penalties that may accrue. A **bond** is a guarantee by someone that the duties and any potential penalties will be paid to the customs of the importing country. In the event that a custom broker is employed for the purpose of making entry, the broker can permit the use of the bond to provide the required coverage.

Entry can be for immediate delivery, for ordinary delivery, or for a warehouse, or it can be not entered for a period of time. Merchandise arriving from Canada and Mexico, trade fair goods, perishable goods and shipments assigned to the U.S. government almost always utilize the **Special Permit for Immediate Delivery** on Customs Form 3461 prior to the arrival of the goods to enable fast release after arrival. An entry summary must be filed within 10 days of the release of the goods. Imported goods coming in under ordinary delivery use normal channels including Form 7533. Under warehousing, goods are placed in a custom-bonded warehouse if it is desired that the entry of the imported goods be delayed. The goods can remain in a bonded warehouse for a period of five years. At any time during the period warehoused goods may be re-exported without payment of duty or may be withdrawn for consumption upon the payment of duty. If the importer fails to enter the goods at the port of entry or the port of destination within five working days after arrival, they may be placed in the general warehouse at the risk and expense of the importer.

## Import Duties

Import duties that have to be paid are ad valorem, specific, or compound. An **ad valorem duty**, which is applied most frequently, is a percentage of the value of the merchandise, such as 5 percent ad valorem. Thus, an auto shipment worth \$100 million that has an ad valorem rate of 3.9 percent will pay \$3.9 million as customs duty. A **specific duty** rate is a specified amount per unit of weight or other quantity, such as 5.1 cents per dozen, 20 cents per barrel or 90 cents per ton. A **compound duty** rate is a combination of an ad valorem rate and a specific rate, such as 0.7 cents per kilogram plus 10 percent as valorem. Average import duty rates in Japan (3.4%), the United States (5.2%), and the European Union (7.7%) are relatively low compared to those in many other countries (e.g., Mexico with 18.0%),<sup>48</sup> but used to be much higher. After the Uruguay Round, the major global trade negotiations from 1986 to 1994, developed countries—the most important buyers of developing countries' exports—were opening their markets further. Their import duties for industrial products fell from 6.3 percent on average before the Uruguay Round to 3.8 percent afterward. Also due to the Uruguay Round, significantly more products exported to developed countries will enjoy zero import duties. The entry of imported merchandise into a foreign country is complete after customs clears the goods from the port of entry or the port of destination.

**Antidumping import duties** are assessed on imported merchandise sold to importers in a foreign country at a price that is less than the fair market value. The fair market value of merchandise is defined under articles of the World Trade Organization as the price at which the good is normally sold in the manufacturer's home market. In the United States, countervailing duties are assessed for some imported goods to counter the effects of subsidies provided by foreign governments, because without the **countervailing duty** the price of these imported goods in the U.S. market would be artificially low, causing economic injury to U.S. manufacturers.

The U.S. importer could even avoid payment of import duties by applying for a **duty-drawback** refund under Temporary Importation under Bond (TIB) in the United States. A duty drawback is a refund of up to 99 percent of all ordinary customs duties. It can be a direct identification drawback or a substitution drawback. *Direct identification drawback* provides a refund of duties paid on imported merchandise that is partially or totally used within five years of the date of import in the manufacture of an article that is exported. *Substitution drawback* provides a refund of duties paid on designated imported merchandise upon exportation of articles manufactured or produced with the use of substituted domestic or imported merchandise that is of the same quality as the

<sup>48</sup>“Trends in Market Openness,” *OECD Economic Outlook*, 65 (June 1999), pp. 207–21.

designated import merchandise.<sup>49</sup> All countries have procedures allowing for the temporary importation of goods for across their borders.<sup>50</sup>

As explained in Chapter 15, importing firms can also utilize foreign trade zones profitably. They can set up facilities in an FTZ to import finished goods, component parts, or raw materials for the eventual domestic consumption or import of merchandise that is frequently delayed by customs quota delays or import merchandise that must be processed, generating significant amounts of scrap. An important feature of foreign trade zones for foreign merchants entering the U.S. market is that the goods may be brought to the threshold of the market, making immediate delivery certain and avoiding the possible cancellation of orders due to shipping delays.

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## GRAY MARKETS



**Gray market** channels refer to the legal export/import transaction involving genuine products into a country by intermediaries other than the authorized distributors. From the importer's side, it is also known as a **parallel import**. Distributors, wholesalers, and retailers in a foreign market obtain the exporter's product from some other business entity. Thus, the exporter's legitimate distributor(s) and dealers face competition from others who sell the exporter's products at reduced prices in that foreign market. High-priced branded consumer goods (cameras, jewelry, perfumes, watches, and so on) whose production lies principally in one country are particularly prone to gray market imports. Brand reputation is a critical element in gray market goods exports, and the distribution is typically through exclusive wholesalers and distributors.<sup>51</sup>

In the information technology (IT) sector alone, gray market sales accounted for between 5 percent and 30 percent of total IT sales in 2007, with a value of about \$58 billion, according to a new report by audit firm KPMG LLP and The Alliance for Gray Market and Counterfeit Abatement.<sup>52</sup> A study of manufacturers of health and beauty aids determined that gray market sales amounted to 20 percent of authorized sales in some markets and as much as 50 percent of authorized sales in others. The gray market problem is so serious that multinational companies such as Motorola, HP, DuPont and 3M devote full-time managers and staff to dealing with gray market issues.<sup>53</sup> Gray market is pervasive across all industries. For example, if purchased on the gray market, a \$92,000 brand-new Mercedes-Benz SL55 AMG Convertible, which meets all U.S. safety and pollution control requirements, can be purchased for 20 percent less than the price (\$114,580) charged by the local authorized dealer. Similarly, in the luxury boat market, many foreign dealers of U.S. manufacturers are seriously affected by gray market activity. To avoid higher prices abroad, foreign retailers too often come to the United States and purchase their boat from a U.S. dealer, and then arrange their own transportation, circumventing the licensed dealer in their own home country.<sup>54</sup>

<sup>49</sup>Michael V. Cerny, "More Firms Establish Drawback Programs as \$1.5B Goes Unclaimed," *Managing Exports*, (October 2002): pp. 1–6.

<sup>50</sup>Lara L. Sowinski, "Going Global in a Flash," *World Trade*, 18 (August 2005), pp. 28–32.

<sup>51</sup>This section draws from Dale F. Duhan and Mary Jane Sheffet, "Gray Markets and the Legal Status of Parallel Importation," *Journal of Marketing*, 52 (July 1988), pp. 75–83; Tunga Kiyak, "International Gray Markets: A Systematic Analysis and Research Propositions," A paper presented at 1997 AMA Summer Educators' Conference, August 2–5, 1997; and Michael R. Mullen, C. M. Sashi and Patricia M. Doney, "Gray Markets: Threats or Opportunity? The Case of Herman Miler vs. Asal GMBH," in Tiger Li & Tamer S. Cavusgil, ed., *Reviving Traditions in Research on International Market*, Greenwich, CT: JAI Press, 2003.

<sup>52</sup>Scott Campbell, "Gray Matter," *VARbusiness*, July 28, 2008, p. 11.

<sup>53</sup>Kersi D. Antia, Mark Bergen, and Shantanu Dutta, "Competing with Gray Markets," *Sloan Management Review*, 46 (Fall 2004), pp. 63–69.

<sup>54</sup>Frank Reynolds, "Senior Management Apathy Could Sink U.S. Pleasure Boat Exports," *Journal of Commerce*, (March 24, 1999), p. 9A.

Although gray market products look similar to their domestic counterparts, they could not be identical and not carry full warranties. Nevertheless, the volume of gray market activities is significant. Three conditions are necessary for gray markets to develop. *First*, the products must be available in other markets. In today's global markets, this condition is readily met. *Second*, trade barriers such as tariffs, transportation costs, and legal restrictions must be low enough for parallel importers to move the products from one market to another. Again, under the WTO principles, the trade barriers have been reduced so low that parallel importation has become feasible. *Third*, price differentials among various markets must be great enough to provide the basic motivation for gray marketers. Such price differences arise for various reasons, including currency exchange rate fluctuations, differences in demand, legal differences, opportunistic behavior, segmentation strategies employed by international marketing managers, and more recently, the World Wide Web's information transparency.

- **Currency fluctuations.** The fluctuating currency exchange rates among countries often produce large differences in prices for products across national boundaries. Gray marketers can take advantage of changes in exchange rates by purchasing products in markets with weak currencies and selling them in markets with strong currencies.
- **Differences in market demand.** Similarly, price differences can be caused by differences in market demand for a product in various markets. If the authorized channels of distribution cannot adjust the market supply to meet the market demand, a large enough price difference could develop for unauthorized dealers to engage in arbitrage process, that is, buying the product inexpensively in countries with weak demand and selling it profitably in countries with strong demand. For example, Apple Corp.'s international marketing strategy of 3G iPhone attempts to extract different prices from different countries—the situation is more attractive as iPhones become a better value to Asian gray-market entrepreneurs<sup>55</sup> (see **Global Perspective 16-3**).
- **Legal differences.** Different prices across different markets due to different legal systems similarly motivate gray marketing activities. For example, as explained in Chapter 5, copyright protection lasts only 50 years in the European Union and Japan compared with 95 years in the United States. In other words, even if the music recordings were originally made and released in the United States, the recordings made in the early- to mid-1950s by such figures as Elvis Presley and Ella Fitzgerald are entering the public domain in Europe, opening the way for any European recording company to release albums that had been owned exclusively by particular labels. Although the distribution of such albums would be usually limited to Europe, CD-store chains and specialty outlets in the United States routinely stock cheaper foreign imports via gray markets.<sup>56</sup>
- **Opportunistic behavior.** Opportunistic behavior by distributors tends to occur when the distributor's gross margin is disproportionately large relative to the marketing task performed and is particularly attractive if the transaction occurs outside the distributor's assigned territory. For example, if the sale takes place in a neighboring foreign country (i.e., outside the territory), the opportunistic distributor could lower the selling price in that market because the sale is not made at the expense of the distributor's own full markup sales in its domestic market. In other words, this opportunistic behavior typifies the attitude, "somebody else's problem is not my problem."
- **Segmentation strategy.** Although currency exchange rates and differences in market demand could be beyond the control of international marketing managers, segmentation strategy can result in 1) planned price discrimination and 2) planned product differentiation among various markets. Even for an identical product, different

<sup>55</sup>Mark Ritson, "iPhone Strategy: No Longer a Grey Area," *Marketing*, June 11, 2008, p. 21.

<sup>56</sup>"Companies in U.S. Sing Blues As Europe Reprises 50's Hits," *New York Times*, January 3, 2003, Late Edition, p. A1.





## GLOBAL PERSPECTIVE 16-3

### ACCOUNTING FOR IPHONE GRAY MARKETS

Apple created a fad for iPhone from the very beginning. However, unfortunately, a large part of the handsets sales come from gray markets. Why?

When it was launched in the United States in 2007, the iPhone was locked into the AT&T network. The only way to own one was by signing a contract with the carrier. The deal gave AT&T exclusive rights to the handset, and ensured that Apple could maintain premium prices and receive an unprecedented 15 percent of the operator's revenues from each user. Apple repeated the arrangement with O2 in the UK and Orange in France. But this groundbreaking strategy also created the perfect conditions for a gray market. This middle ground, between a brand's official "white" sales channels and the clearly illegal black market in counterfeit or stolen goods, offers genuine products through non-official channels.

Within hours of launch, the internet was awash with offers of unlocked iPhones that would work with any SIM. Apple had a goal of selling 10 million iPhones by the end of 2008. While gray-market sales count in the tally, the loss of subsequent share of sales from network usage on the approved mobile network could cost Apple up to \$500 million in lost revenues. If only taking sales into consideration, it is estimated that a quarter of the 5 million iPhones sold to date have been through the gray market—more than four times the number officially sold in Europe. But it is not surprising when you review the factors that turned the iPhone into the perfect gray-market product.

First, there was Apple's attempt to maintain exclusivity. Using a single operator in each market ensured maximum

control of the offer to the consumer, but it also increased the potential for gray-market activity. The more control a company tries to exert over the way its brand is retailed, the more likely gray markets are to emerge.

Second, the product's international rollout was also a factor. The company wanted to stagger the launch, partly because of the limited number of handsets that were initially made available to consumers and partly to maximize the impact in each country. With today's global markets, however, it is almost impossible to prevent consumers in one market from accessing a product in another.

Third, Apple's international marketing strategy also attempted to extract different prices from different countries. Again, this makes sense in theory, but gray markets flourish in the spaces between different prices. The currency fluctuations of the past 12 months made this situation even more attractive as iPhones became a better value to Asian gray-market entrepreneurs, who were buying them in U.S. dollars but selling them on in Chinese Yuan.

Fourth, Apple also encouraged the gray market by using multiple retail channels. If it had allowed consumers to buy the phone only through operator channels, where a fixed 18-month contract would have been a stipulation for purchase, the gray market would have been restricted.

So why did Apple insist that its stores would also sell the iPhone, thus enabling consumers to get the handset without an operator contract? The straightforward answer is that Apple wanted to showcase the sexy new phone in its own stores to drive sales and ensure brand consistency. The more suspicious marketer might also suggest that it wanted a bit of gray-market action to boost sales and spread its super-cool, premium status around the world.

*Source:* Mark Ritson, "iPhone Strategy: No Longer A Grey Area," *Marketing*, June 11, 2008, p. 21.

pricing strategy can be adopted for various reasons, including differences in product life cycle stage, customer purchase behavior, and price elasticity across different markets. Different prices across different markets motivate gray marketers to exploit the price differences among the markets.

- **The World Wide Web.** As an information medium, the World Wide Web raises a customer's awareness of special offers that were initially designed to be limited to specific regions, countries, or classes of customers. Gray-market sales are growing with the popularity of the internet. Web-based gray marketers can also advertise merely by using the product's brand name or model number on their web sites and waiting for search engines to direct consumers there. The internet greatly stimulates gray market activity by presenting different price quotations from multiple merchants. Gray marketers can pay for presence on shopping bots, such as mysimon.com, cnet.com, shopping.yahoo.com, or bottomdollar.com, as well as amazon.com and eBay.com. If you look closely at Amazon's website, you will see that the site sells Seiko (not authorized Seiko retailers) at or below dealer cost. If you click the SAS (Southern Audio Services) name on eBay (not authorized SAS retailers), it will come up thousands of times and sell SAS at 30 percent

discounts or more. The explosion of unauthorized e-commerce has hit many sectors, including pharmaceuticals, electronics, and software.<sup>57</sup>

Alternatively, the product can be modified to address the specific needs of different markets. Contradictory to common sense, adaptation of individual products for a specific market also leads to substantially more gray marketing. This occurs for two reasons. First, when, for example, a stripped version of the product is marketed in Europe and an enhanced version is marketed in the United States, some U.S. consumers, who may not be willing to pay for the enhanced model with too many refinements, import the simpler, less expensive version from an unauthorized distributor through a gray marketing channel. Second, some consumers simply want to purchase the product models that are not available in their domestic markets to differentiate themselves from the rest of the consumers. This is increasingly likely as markets around the world become more homogeneous.<sup>58</sup>

Gray marketing activity can also bring about some beneficial effect to manufacturers. Parallel channels foster intrabrand competition that can force authorized channels to do a better job serving their local customers and lead to improved customer satisfaction. It is conceivable that manufacturers can add gray marketers to the authorized channel or even acquire them, provided that such actions do not lead to increased conflict with existing authorized distributors. In industries with high fixed costs where capacity utilization and economies of scale are important, manufacturers may require the incremental sales generated by parallel channels to sustain high production volumes.<sup>59</sup>

A key question for the manufacturer of branded products is whether a gray market will cause a global strategy to become less desirable. Closer control and monitoring of international marketing efforts can certainly reduce the threat of gray market goods to negligible levels. As rule of thumb, firms using independent distributors (e.g., commission agents and merchant distributors) tend to suffer most from gray-market activity while firms with ownership-based control over distribution channels (e.g., joint venture partners, wholly owned subsidiaries, and direct sale of exports to end users) offer more control over the final sale of the product.<sup>60</sup> As presented in **Exhibit 16-7**, international marketers not only try to confront existing gray markets reactively but also are increasingly developing more proactive approaches to gray market problems before they arise.

Cisco decided to offer discounts to combat gray market providers, in an effort to win back sales from small and medium-sized businesses. Although gray market products have been on sale for some time, the networking company's popularity among smaller businesses was starting to affect its revenues. To appeal to smaller businesses, Cisco launched products targeted at companies with fewer than 100 users, and it would be working with its official Select resellers to offer discounts. The company also plans to push its Cisco Certified Refurbished Equipment mark to help differentiate products.<sup>61</sup> In a similar vein, Hyundai dealers in Germany created a trading company. The company would help Hyundai's German dealers buy the brand's cars in low-cost European Union (EU) countries for resale in Germany. The move aims to beat re-importers, who exploit price differences within the EU by purchasing vehicles in low-price countries and reselling them in high-price countries.<sup>62</sup>

<sup>57</sup>Steven Sagri, "Don't Give Press Play to Amazon's 'Gray Market' Watch Sales," *National Jeweler*, June 2007, p. 18; and Mina Kimes, "How Middlemen Can Discredit Your Goods," *FSB: Fortune Small Business*, May 2008, pp. 75–78.

<sup>58</sup>Matthew B. Myers, "Incidents of Gray Market Activity among U.S. Exporters: Occurrences, Characteristics, and Consequences," *Journal of International Business Studies*, 30 (First Quarter 1999), pp. 10–126.

<sup>59</sup>Michael R. Mullen, C. M. Sashi, and Patricia M. Doney, "Gray Markets: Threats or Opportunity? The Case of Herman Miler vs. Asal GMBH," in Tiger Li & Tamer S. Cavusgil, ed., *Advances in International Marketing*, Greenwich, CT: JAI Press, 2003, pp. 77–105.

<sup>60</sup>Ibid.

<sup>61</sup>John-Paul Kamath, "Cisco Plans Discounts to Win Back SME Users," *Computer Weekly*, April 17, 2007, p. 40.

<sup>62</sup>Bettina John, "Hyundai's German Dealers Aim to Stop Gray-Market Sales," *Automotive News Europe*, April 16, 2007, p. 8.

**EXHIBIT 16-7**

**HOW TO COMBAT GRAY MARKET ACTIVITY**

*A. Reactive Strategies to Combat Gray Market Activity*

<i>Type of Strategy</i>	<i>Implemented by</i>	<i>Cost of Implementation</i>	<i>Difficulty of Implementation</i>	<i>Does It Curtail Gray Market Activity at Source?</i>	<i>What Relief Does It Provide Authorized Dealers?</i>	<i>Long-Term Effectiveness</i>	<i>Legal Risks to Manufacturers or Dealers</i>	<i>Company Examples</i>
Strategic confrontation	Dealer with manufacturer support	Moderate	Requires planning	No	Relief in the medium term	Effective	Low	Creative merchandising by Caterpillar and auto dealers
Participation	Dealer	Low	Not difficult	No	Immediate relief	Potentially damaging reputation of manufacturer	Low	Dealers wishing to remain anonymous
Price cutting	Manufacturer and dealer jointly	Costly	Not difficult	No, if price cutting is temporary	Immediate relief	Effective	Moderate to high	Dealers and manufacturers remain anonymous
Supply interference	Either party	Moderate at the wholesale level; high at the retail level	Moderately difficult	No	Immediate relief or slightly delayed	Somewhat effective if at wholesale level; not effective at retail level	Moderate at wholesale level; low at retail	IBM; Hewlett-Packard; Lotus Corp.; Swatch Watch USA; Charles of the Ritz Group, Ltd.; Leitz, Inc.; NEC Electronics
Promotion of gray market product limitations	Jointly, with manufacturer leadership	Moderate	Not difficult	No	Slightly delayed	Somewhat effective	Low	Komatsu, Seiko, Rolex, Mercedes-Benz IBM
Collaboration	Dealer	Low	Requires careful negotiations	No	Immediate relief	Somewhat effective	Very high	Dealers wishing to remain anonymous
Acquisition	Dealer	Very costly	Difficult	No	Immediate relief	Effective if other gray market brokers don't creep in	Moderate to high	No publicized cases

*(continued)*

**EXHIBIT 16-7** (CONTINUED)*B. Proactive Strategies to Combat Gray Market Activity*

<i>Type of Strategy</i>	<i>Implemented by</i>	<i>Cost of Implementation</i>	<i>Difficulty of Implementation</i>	<i>Does It Curtail Gray Market Activity at Source?</i>	<i>What Relief Does It Provide Authorized Dealers?</i>	<i>Long-Term Effectiveness</i>	<i>Legal Risks to Manufacturers or Dealers</i>	<i>Company Examples</i>
Product/service differentiation and availability	Jointly with manufacturer leadership Manufacturer	Moderate to high	Not difficult	Yes	Medium to long term	Very effective	Very low	General Motors, Ford, Porsche, Kodak
Strategic pricing	Manufacturer	Moderate to high	Complex; impact on overall profitability needs monitoring	Yes	Slightly delayed	Very effective	Low	Porsche
Dealer development	Jointly, with manufacturer leadership	Moderate to high	Not difficult; requires close dealer participation	No	Long term	Very effective	None	Caterpillar, Canon
Marketing information systems	Jointly, with manufacturer leadership	Moderate to high	Not difficult; requires dealer participation	No	After implementation	Effective	None	IBM, Caterpillar, Yamaha, Hitachi, Komatsu, Lotus Development, Insurance companies
Long-term image reinforcement	Jointly	Moderate	Not difficult	No	Long term	Effective	None	Most manufacturers with strong dealer networks
Establishing legal precedence	Manufacturer	High	Difficult	Yes, if fruitful	No	Uncertain	Low	COPIAT, Coleco, Charles of the Ritz Group, Ltd.
Lobbying	Jointly	Moderate	Difficult	Yes, if fruitful	No	Uncertain	Low	COPIAT, Duracell, Porsche

*Note:* Company strategies include, but are not limited to, those mentioned here.

*Source:* S. Tamer Cavusgil and Ed Sikora, "How Multinationals Can Counter Gray Market Imports," *Columbia Journal of World Business*, 23 (Winter 1988), pp. 75–85.



## GLOBAL PERSPECTIVE 16-4

### SMUGGLING AND BLACK MARKETS: AN ETHICAL DILEMMA FOR MULTINATIONAL COMPANIES SELLING LAWFUL PRODUCTS

Conventional wisdom has it that trade liberalization (i.e., adopting freer trade policy) in many emerging markets would reduce smuggling and black market phenomena because it reduces unnecessary and artificial price differences across countries. Economists call this tendency the “Law of One Price.” However, in a seminal work on smuggling in 1996, Kate Gillespie and Brad McBride found quite the opposite: These countries are likely to see the resurgence of organized smuggling and black-market distribution as a result of trade liberalization. A number of reasons may be considered. First, liberalization is rarely complete, and smugglers could still take advantage of evading income, sales, and other taxes as well as tariffs. Second, as the reduced price differences (thanks indeed to trade liberalization) make it difficult for casual smugglers to make enough money, smugglers need to be larger and better organized in pursuit of “economies of scale” in their operations. As a result, smuggling shifted to organized crime and takes on a more sinister aspect. Third, evidence indicates that both the evolution of smuggling into organized crime and the use of smuggling as a way to launder money for international drug cartels and possibly terrorist organizations are increasing.

Smuggling is an illegal importation of either legal products (e.g., TVs, computers, music CDs) or illegal products (e.g., narcotics and child pornographic material). We focus only on smuggling of legal products here. What does smuggling have to do with multinational companies that engage in the business of selling legal products internationally? Nothing directly.

In June 2000, U.S. Customs estimated the global volume of money laundering, much of which is related to the illicit trade in narcotics, to total more than \$600 billion a year or between 2 and 5 percent of the world’s GDP. The problem is that money is *fungible* (simply stated, money is money wherever it comes from). U.S. exports are often purchased with narcotics dollars. Those exports include otherwise lawful goods, including household appliances, consumer electronics, liquor, cigarettes,

*Sources:* Kate Gillespie and J. Brad McBride, “Smuggling in Emerging Markets: Global Implications,” *Columbia Journal of World Business*, 31 (Winter 1996), pp. 40–54; and Kate Gillespie, “Smuggling and the Global Firm,” *Journal of International Management*, 9 (3) (2003), pp. 317–33.

used auto parts, and footwear. The connection between money laundering and smuggled consumer products has been a major concern of U.S. Customs for several years particularly after the government cracked down on money laundering through U.S. banks.

This is how the system works. A drug cartel in a Latin American country exports narcotics to the United States where they are sold for U.S. dollars. The cartel in this Latin American country contacts a third party—a peso broker—who agrees to exchange pesos in the country for the U.S. dollars that the cartel controls in the United States. The peso broker uses contacts in the United States to place the drug dollars purchased from the cartel into the U.S. banking system. Latin American importers then place orders for items and make payments through the peso broker who uses contacts in the U.S. to purchase the requested items from U.S. manufacturers and distributors. The peso broker pays for these goods with cash or drafts drawn on U.S. bank accounts. The purchased goods are shipped to some Caribbean or South American destinations, sometimes via Europe or Asia, and are then smuggled into this Latin American country. The Latin American importer avoids paying high tariffs, and the peso broker profits by charging both the cartel and the importers for services rendered.

The U.S. multinational companies that sell these products have routinely denied having any idea that they were involved in money laundering. Beginning in June 2000, however, a group of corporate executives began a series of meetings at the Justice Department. The companies included Hewlett-Packard, Ford Motor, Whirlpool, General Motors, Sony, Westinghouse, and General Electric (GE). With the exception of GE, the companies called to participate had products appearing in the black market in a Latin American country. GE was invited as the example of a good corporate citizen that was successfully cleaning up the smuggling of its goods into South America. However, GE’s shutting down smuggling came at a fairly steep price to the company and to the benefit of those competitors that kept their eyes closed on the fact. Between 1995 and 2000, General Electric estimated that its good corporate citizenship policy cost the company about 20 percent of its sales to South America.

Gray marketing is a legal trading transaction. On the other hand, smuggling and black market refer to the illegal importation and sales of either otherwise legal goods or illegal products. Although such illegal transactions are outside the scope of this book, we address these issues in **Global Perspective 16-4** to introduce you to some ethical dilemma that multinational companies can face concerning the smuggling and black market activities by independent distributors of what would otherwise be legal products.

## SUMMARY

The national government has a variety of programs to support exports, although many government policies—which are sometimes dictated by political compulsions—also hinder exports. Export markets provide a unique opportunity for growth, but competition in these markets is usually fierce. With the rise of the big emerging markets (Brazil, China, and India), competition is likely to intensify even more.

Procedurally, exporting requires locating customers, obtaining an export license from the federal government (a general or validated license); collecting export documents (such as the bill of lading, commercial invoice, export packing list, insurance certificate); packing and marketing; shipping abroad; and receiving payment—most of the time through a bank. Conversely, importing requires locating a seller, obtaining an import license, usually establishing a letter of credit, turning over import documents (the bill of lading, etc.) to indicate receipt of goods, and making payment through the banking system. Methods of payment include advance payment, open account, consignment sale, documents against payment (D/P), documents against acceptance (D/A), and letter of credit. Of these, the last two are the most popular. Depending on the nature of the payment terms and the

currency of payment, the exporter could need to make foreign exchange hedging transactions. The U.S. government is now taking a more active role in promoting the exports of U.S. firms as they bid for big-ticket items in the emerging markets.

Imports are the obverse of exports. A U.S. importer can make payments in U.S. dollars unlike an importer in many other countries. Any good coming in through a U.S. port must pass through customs and pay the appropriate duty and be authorized by customs at the port of entry or the port of destination for entry. Unlike an exporter who faces a payment risk, the importer's risks are associated with delivery schedules and product quality. Foreign exchange risk is common to both imports and exports. Entry of some goods into a country is restricted by bilateral and multilateral quotas as well as by political considerations.

Finally, globalization of markets has spawned gray marketing activities by unauthorized distributors taking advantage of price differences that exist among various countries due to currency exchange rate fluctuations, different market demand conditions, and price discrimination, among other factors. For companies marketing well-known branded products, gray markets have become a serious issue to be confronted proactively as well as reactively.

## KEY TERMS

Ad valorem duty	Customs receipt	Export Enhancement Act of 1992	Import duty
American Export Trading Company of 1982	Direct exporting	Export license	Indirect exporting
Automated Export System	Documents against acceptance (D/A)	Export merchant	Letter of credit
Bill of lading	Documents against payment (D/P)	Export sales subsidiary	Open account
Bond	Ex-Im Bank (Export-Import Bank)	Foreign exchange risk	Piggyback exporting
Combination export manager (CEM)	Export broker	Foreign sales branch	Political risk
Commercial invoice	Export commission house	Foreign Trade Zone	Specific duty
Compound duty	Export department	Freight forwarder	Trading company
Credit risk		Gray market (Parallel imports)	Transfer risk

## REVIEW QUESTIONS

- How does a prospective exporter choose an export market?
- What are the factors that influence the decision of the exporter to use a standardized product strategy across countries and regions?
- What are the direct and indirect channels of distribution available to exporters? Under what conditions would the use of each be the most appropriate?
- Terms of payment represent an extremely important facet of export transactions. Describe the various terms of payments in increasing order of risk.
- Describe the various terms of shipment and sale.
- What is the role of government (home country) in export activities? Explain in the context of U.S. exporters.
- Managing imports in the United States is by and large easier and less risky than managing export? Give reasons why this is true.
- What are gray markets? What factors led to the development of gray markets?

## DISCUSSION QUESTIONS

1. A friend of yours who owns a small firm manufacturing and selling CD-ROM-based computer games would like to market the company's products abroad. Your friend seeks information from you on the following:
  - a. Which markets should the firm target (what sources of information to tap)?
  - b. How should it tap these markets (what are the steps you would advise)?
  - c. What are the direct and indirect costs involved in exporting?
  - d. What kind of assistance can your friend get from governmental and nongovernmental agencies at any of the stages involved? What would your advice be?
2. General trading companies have played and continue to play a leading role in the exports and imports of products from and to Japan. The effectiveness of these companies is evident from the fact that in the recent Fortune 500 list of the world's largest corporations, 5 of the top 10 corporations (including the top three) are Japanese trading firms. Although there is little question about the effectiveness of these firms, various business executives, especially outside Japan, interpret the directing of exports and imports through such firms as adding to significant inefficiencies in terms of higher costs and lost opportunities. Do you agree with this contention? Why or why not? The top three trading houses, Mitsubishi, Mitsui, and Itochu, had profitability ratios (profits after taxes/total revenues) of 0.18 percent, 0.17 percent, and 0.07 percent, respectively. Would this information have any bearing on your answer?
3. You are the manager for international operations of a manufacturer of steel in the United States. You have received an offer to purchase at a very attractive price 5,000 metric tons of wire rods (used to draw wires for the manufacture of nails) from a large nail manufacturer located in a developing country X. What would you deem to be the most appropriate choice of export terms of payment and terms of shipment, given the following information? (Include any precautions that you would take to ensure the successful execution of the order):
  - a. The prospective importer has its account at a local bank. Local government rules stipulate making payments only through this bank.
  - b. The local bank does not have any international operations/branches.
  - c. The currency of country X has been extremely unstable, with its value having depreciated by more than 20 percent recently.
  - d. The interest rates are extremely high in this country.
  - e. The legal system in this country is weak, but the firm that is willing to place the order has a good reputation based on past experience with other international manufacturers.
4. Non-tariff barriers to international trade have significant implications, for both exporters and importers. One of the most prevalent non-tariff barriers used is antidumping duties or the threat of initiating antidumping investigations. The use of antidumping duties has recently received some criticisms as affecting certain high-growth industries adversely while protecting some smaller inefficient (as claimed) industries. One typical example quoted is the manufacture of laptop computers. Antidumping duties were levied against Japanese manufacturers of flat-panel screens (used in the manufacture of laptop computers) at the behest of would-be flat-panel manufacturers in the United States. It was the contention of these U.S. producers that if the flat panels were not dumped by Japanese manufacturers, the U.S. producers would be able to raise capital to initiate production of this product. As a result of the duties levied, which would have added significant costs to the computers manufactured in the United States, most U.S. manufacturers (many of whom had plans to manufacture laptop computers within the United States) shifted to sites abroad. According to the computer manufacturers, the antidumping decision sacrificed the fastest-growing segment of the computer industry to a nonexistent domestic flat-panel industry. The proponents of antidumping legislation, however, contend that the threat of predatory practices is real and antidumping procedures take care of this threat. Whom would you side with, the proponents or the critics of antidumping actions?
5. The internet has become a powerful place for products, information, and everything you can think of today, and internet retailing has become increasingly accepted by most consumers. While consumers are surfing for the best prices, it is difficult for them to tell a legitimate, authorized dealer from a gray marketer. Assuming that you are a consultant of a famous computer company, what are your recommendations for the firm to be able to combat gray market activities? Could the company continuously attract bargain-seeking consumers by informing consumers of the dark side of gray market retailing?
6. As presented in Global Perspective 16-3, the rampant gray market of iPhone largely resulted from Apple's international strategy. In order to reduce and control gray market, what strategies should Apple use?
  - f. Rain and summer heat can cause the product to deteriorate if kept unused for a time longer than necessary.
  - g. This country exports a larger amount by the sea route than it imports. Hence, many ships have to go empty to get cargo from this country to the United States.

## SHORT CASES



### ASE 16-1

#### AN UPSET MERCK

Purchasing medicines through internet pharmacies is the latest trend to hit the drug industry. This channel of distribution has existed for years now but it drew attention to itself when Pfizer's popular drug for erectile dysfunction was released and consumers who were too embarrassed to buy this drug offline, resorted to buying it online. At the time, drug companies were not too distressed at this trend, given that it added one more channel of distribution of their products and drug companies willingly supplied pharmacies with drugs for sale over the internet.

However, the past couple of years have seen major U.S. pharmaceutical companies cutting off drug supplies to some Canadian pharmacies and now second largest U.S. drug company Merck, with sales of over \$20 billion worldwide, is the most recent one to join the bandwagon. The reason for this move: Canadian pharmacies that operate through the mail order or online channel, provide drugs not only to Canadian consumers but also indulge in cross-border exports to patients in the United States who demand drugs at lower prices than those offered in the U.S. The Canadian government controls prices of pharmaceuticals in Canada unlike the U.S. government and therefore prices of drugs tend to be cheaper in Canada than the same drugs that are available in the U.S.

According to U.S. pharmaceuticals companies, this export-import practice affects Canadian consumers on one hand because drug exports to the U.S. results in a shortage of medicines for Canadian patients. On the other hand, firms such as Merck argue that such drug exports to patients are essentially risky due to the lack of stringent controls. Furthermore, the emergence of internet pharmacies that sell counterfeit medicines has increased the possibility of health hazards to patients who expect to get genuine products but do not. Also, Merck argued that some of its drugs provided under the U.S.'s Medicaid program are affordably priced and should preclude drug exports by Canadian pharmacies.

Source: "Pain of the Pill Market," *Maclean's*, February 21, 2005, pp. 28–29.

In January 2005, Merck's Canadian subsidiary Merck Frosst sent a letter to Canadian pharmacies that export drugs to the U.S., stating that it would no longer supply products to these companies unless they proved that they had discontinued such activities. According to the firm, drug exports violate their sales agreements with these retailers. The result of this dispute between Canadian pharmacies and U.S. drug makers like Merck is that the pharmacies are left struggling to fill orders from consumers in the U.S.

But, this business has proved to be extremely attractive for the pharmacies. Sale of prescription and other drugs over the internet started off on a small scale but over the years, due to the high demand for this method of sale, these firms have grown so much that drug companies are becoming more vigilant and defensive against such activities. Nevertheless such moves by Merck and others have managed to curb drug exports to a certain extent. Since Merck's decision to boycott these pharmacies, internet pharmacies have reduced their workforce. There are some, however, that are still going strong by obtaining drugs from wholesalers and retailers behind closed doors. Still others are now looking toward other foreign countries, mainly in Europe, to supply drugs.

It is interesting to see whether or not drug exports will cease in the future but that might need some strict regulation and governmental interference. Amidst complaints by pharmaceuticals giants, the Canadian government has considered passing a law to shut down internet pharmacies. But, the talks are still on.

#### DISCUSSION QUESTIONS

1. What else can Merck do to reduce the exports of drugs back into the U.S. by Canadian pharmacies?
2. Should the U.S. and Canadian governments step in to solve this problem? If so, what can the governments do in this matter?
3. Will Merck's recent move prevent further exports by Canadian pharmacies?
4. What does the future likely hold for this retail method for drugs in particular?

### ASE 16-2

#### SONY—COMBATING GRAY MARKETS FOR PSPs

Sony Corporation, the famous Japanese consumer electronics company, recently launched its (PlayStation Portable) PSP product, a handheld media system, amidst much hype and

publicity. The product is the latest addition to its popular PS (PlayStation) line of products. The company has plans to introduce the product in major markets in the world. However,





even before its launch everywhere, the much awaited PSP gadgets are already available in some target markets via the gray market channel and Sony, along with its subsidiary Sony Computer Entertainment Europe is fighting tooth and nail to prevent retailers worldwide from biting into its revenues when the product is officially released for sale.

In the recent past, multinational firms have introduced their innovations in the Triad markets almost simultaneously. But, the PSP system was launched in Japan late 2004 and in the United States in March 2005. Sony planned to launch PSP in the UK market and the rest of Europe months later in September 2005. The reasons for this delay were multifold but it was partly due to the multicultural requirements for software for European consumers and also Europe's stringent safety and standard compliances. Another reason for the deferred European launch was that Sony wanted to ensure that there was sufficient supply to meet demand in the U.S. The company, however, did not offer any apologies for the late launch, stating that Europeans would eventually benefit from a better version of the product, having corrected the bugs well in advance.

However, even before the launch, retailers in the UK were importing PSPs from Japan and the United States and selling them in Europe. In order to keep retailers from selling PSPs, Sony finally brought legal action against these parties in the UK in June 2005. Sony wrote over 500 letters to importers who were selling gray market PSPs in Europe, including some who sold their products on popular online auctioneer eBay. Sony claimed that it wanted confiscation of PSPs and also sought compensation for damages. Pushed to the edge by these sales, Sony also demanded that it be given the identities of retailers and consumers who had indulged in these transactions.

One of the main adversaries in this legal battle in the UK was online retail firm ElectricBirdLand or EBL, which decided to stand up against Sony and fight the charges. Moreover, EBL argued that Sony did not have appropriate trademarks for its PSP product and related technologies in Europe. EBL also claimed that Sony was pursuing action against smaller firms while ignoring larger firms such as music company HMV, which sold PSP add-ons to parties who were importing Sony PSPs. However, HMV was only advertising the products pre-sales but was to make them available to consumers only after

the formal launch in September. This controversy surrounding the PSP's launch gave rise to doubts as to whether Sony would in fact be able to stick to its schedule to present the PSP to Europeans on time. End June 2005, Sony won the case against EBL but there were other similar ongoing cases against retailers such as Nuplayer. Nevertheless, some retailers have responded by pulling the products off their real and virtual shelves. There are still others who are pushing Sony's buttons by continuing to sell PSPs because the lucrative margins of over 60 percent make it worthwhile. Sony's headaches were not restricted to the UK only. Gray markets for PSPs exist all over Europe.

Even before the unveiling of the PSP in Europe, it has created a buzz but it is not just Sony that is benefiting from its popularity. In fact, it is gray market sellers who are bringing in the dough right now. Meanwhile, hackers all over the world have busied themselves trying to run unauthorized games and other software on Sony's PSPs. Sony meanwhile is working hard to continuously develop new versions of the PSP to keep hackers at bay. And as Sony awaits the UK High Court's decision, gray marketers are continuing to sell PSPs through their websites.

Technology geeks are the happiest as end consumers. Even though they pay a higher price for the gray market product that comes with no warranties, they get to keep abreast of the latest advances in electronics. There are some who believe there is a difference in the PSPs sold in Japan and the rest of the world because the products sold in Japan are superior in terms of their hardware and software.

## DISCUSSION QUESTIONS

1. What can firms like Sony do to prevent sale of new products in gray markets?
2. Do you think Sony launched the PSP too early and should instead have waited to launch it in the Triad simultaneously? Why did the company then rush to introduce its product?
3. How was the sale of PSPs in Europe through gray markets a threat to Sony?
4. How does the sale of PSPs in Europe through gray markets affect the future of the product itself?

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