



11 Pricing Decisions

Twentieth Century Fox, the film entertainment unit of Rupert Murdoch's News Corporation, has a problem: Video pirates are siphoning off profits from the studio's hit movies. In many parts of the world, lax enforcement of intellectual property laws creates an opportunity for unscrupulous merchants to sell counterfeit DVDs at rock-bottom prices. In emerging markets, such as Mexico, Russia, and China, piracy costs Fox and rival movie studios hundreds of millions of dollars each year. These losses reflect both decreased ticket sales at movie theaters and decreased sales of legitimate DVD releases. It is not uncommon for counterfeit copies of Hollywood's latest blockbuster to hit the streets before the movie has even opened in local cinemas. The Motion Picture Association of America estimates that, in China alone, losses totaled \$244 billion in 2005. In China and elsewhere, the movie studios take legal action against the counterfeiters. Despite such efforts, Chinese merchants do a brisk trade in DVDs that sell for as little as RMB10—the equivalent of about \$1.20. Now Fox is adopting a new approach in China: charging less than RMB30 for new DVD releases. The studio is hoping that, at this price, Chinese movie lovers will be motivated to buy an official version rather than a counterfeit.

In general, two basic factors determine the boundaries within which prices should be set. The first is product cost, which establishes a *price floor*, or minimum price. Although pricing a product below the cost boundary is certainly possible, few firms can afford to do this over the long run. Moreover, as we saw in Chapter 8, low prices in export markets can invite dumping investigations. Second, prices for comparable substitute products create a *price ceiling*, or maximum price. In many instances, global competition puts pressure on the pricing policies and related cost structures of domestic companies. The imperative to cut costs—especially fixed costs—is one of the reasons for the growth of outsourcing. In some cases, local market conditions such as piracy force companies such as Fox to adopt innovative pricing tactics. Between the lower and upper boundary for every product there is an *optimum price*, which is a function of the demand for the product as determined by the willingness and ability of customers to buy. In this chapter, we will review basic pricing concepts and then discuss several pricing topics that pertain to global marketing. These include target costing, price escalation, and environmental considerations such as currency fluctuations and inflation. In the second half of the chapter, we will discuss gray market goods, dumping, price fixing, transfer pricing, and countertrade.



Home video piracy—including DVDs and VHS tapes—is rampant in many parts of the world. The Motion Picture Association of America claims that Hollywood loses \$3.5 billion each year due to piracy; according to another estimate, the figure could exceed \$6 billion.

BASIC PRICING CONCEPTS

Generally speaking, international trade results in lower prices for goods. Lower prices, in turn, help keep a country's rate of inflation in check. In a true global market, the **law of one price** would prevail: All customers in the market could get the best product available for the best price. As Lowell Bryan and his collaborators note in *Race for the World*, a global market exists for certain products such as integrated circuits, crude oil, and commercial aircraft: All other things being equal, a Boeing 777 costs the same worldwide. By contrast, beer, compact discs, and many other products that are available around the world are actually being offered in markets that are national rather than global in nature. That is, these are markets where national competition reflects differences in factors such as costs, regulation, and the intensity of the rivalry among industry members.¹ The beer market is extremely fragmented; for example, even though Budweiser is the leading global brand, it commands less than 4 percent of the total market. The nature of the beer market explains why; for example, a six-pack of Heineken varies in price by as much as 50 percent (adjusted for purchasing power parity, transportation, and other transaction costs) depending on where it is sold. In Japan, for example, the price is a function of the competition between Heineken, other imports, and five national producers—Kirin, Asahi, Sapporo, Suntory, and Orion—that collectively command 60 percent of the market.

Because of these differences in national markets, the global marketer must develop pricing systems and pricing policies that take into account price floors, price ceilings, and optimum prices. A firm's pricing system and policies must also be consistent with other uniquely global opportunities and constraints. For example, many companies that are active in the 13 nations of the euro zone are adjusting to the new cross-border transparency of prices. Similarly, the Internet has made price information for many products available around the globe. Companies must carefully consider how customers in one country or region will react if they discover they are paying significantly higher prices for the same product as customers in other parts of the world.

¹ Lowell Bryan, *Race for the World: Strategies to Build a Great Global Firm* (Boston: Harvard Business School Press, 1999), pp. 40–41.

There is another important internal organizational consideration besides cost. Within the typical corporation, there are many interest groups and, frequently, conflicting price objectives. Divisional vice presidents, regional executives, and country managers are each concerned about profitability at their respective organizational levels. Similarly, the director of global marketing seeks competitive prices in world markets. The controller and financial vice president are concerned about profits. The manufacturing vice president seeks long production runs for maximum manufacturing efficiency. The tax manager is concerned about compliance with government transfer pricing legislation. Finally, company counsel is concerned about the antitrust implications of global pricing practices. Ultimately, price generally reflects the goals set by members or the sales staff, product managers, corporate division chiefs, and/or the company's chief executive.

GLOBAL PRICING OBJECTIVES AND STRATEGIES

Whether dealing with a single home country market or multiple country markets, marketing managers must develop pricing objectives as well as strategies for achieving those objectives. However, a number of pricing issues are unique to global marketing. The pricing strategy for a particular product may vary from country to country; a product may be positioned as a low-priced, mass-market product in some countries and a premium-priced, niche product in others. Stella Artois beer is a case in point. Pricing objectives may also vary depending on a product's life-cycle stage and the country-specific competitive situation. In making global pricing decisions, it is also necessary to factor in external considerations such as the added cost associated with shipping goods long distances across national boundaries. The issue of global pricing can also be fully integrated in the product-design process, an approach widely used by Japanese companies.

Market Skimming and Financial Objectives

Price can be used as a strategic variable to achieve specific financial goals, including return on investment, profit, and rapid recovery of product development costs. When financial criteria such as profit and maintenance of margins are the objectives, the product must be part of a superior value proposition for buyers; price is integral to the total positioning strategy. The **market skimming** pricing strategy is often part of a deliberate attempt to reach a market segment that is willing to pay a premium price for a particular brand or for a specialized or unique product. Companies that seek competitive advantage by pursuing differentiation strategies or positioning their products in the premium segment frequently use market skimming. LVMH and other luxury goods marketers that target the global elite market segment use skimming strategies. For years, Mercedes-Benz utilized a skimming strategy; however, this created an opportunity for Toyota to introduce its luxury Lexus line and undercut Mercedes.

The skimming pricing strategy is also appropriate in the introductory phase of the product life cycle when both production capacity and competition are limited. By setting a deliberately high price, demand is limited to innovators and early adopters who are willing and able to pay the price. When the product enters the growth stage of the life cycle and competition increases, manufacturers start to cut prices. This strategy has been used consistently in the consumer electronics

industry; for example, when Sony introduced the first consumer VCRs in the 1970s, the retail price exceeded \$1,000. The same was true when compact disc players were launched in the early 1980s. Within a few years, prices for these products dropped well below \$500. Today, both products are considered commodities.

A similar pattern is evident with HDTVs; in the fall of 1998, HDTV sets went on sale in the United States with prices starting at about \$7,000. This price maximized revenue on limited volume and matched demand to available supply. Already, prices for HDTV sets are dropping significantly as consumers become more familiar with HDTV and its advantages and as next-generation factories in Asia bring lower costs and increased production capacity. In 2005, Sony surprised the industry by launching a 40-inch HDTV for \$3,500; by the end of 2006, comparable HDTVs were selling for about \$2,000. The challenge facing manufacturers now is to hold the line on prices; if they do not succeed, HDTVs may also become commoditized.

Penetration Pricing and Nonfinancial Objectives

Some companies are pursuing nonfinancial objectives with their pricing strategy. Price can be used as a competitive weapon to gain or maintain market position. Market share or other sales-based objectives are frequently set by companies that enjoy cost-leadership positions in their industry. A **market penetration pricing strategy** calls for setting price levels that are low enough to quickly build market share. Historically, many companies that used this type of pricing were located in the Pacific Rim. Scale-efficient plants and low-cost labor allowed these companies to blitz the market.

It should be noted that a first-time exporter is unlikely to use penetration pricing. The reason is simple: Penetration pricing often means that the product may be sold at a loss for a certain length of time. Unlike Sony, many companies that are new to exporting cannot absorb such losses, nor are they likely to have the marketing

the rest of the story

Using Price to Combat Video Piracy

Pirated movies are found in other emerging country markets as well. In Russia, for example, customs duties and tariffs contribute to retail prices equivalent to \$20 or \$30 for an authentic DVD; pirated versions sell for about \$4. Columbia TriStar has responded to the situation in Russia by cutting prices to the equivalent of \$10; as Vyacheslav Dobychn, director of Columbia TriStar's licensee in Russia, explained, "The idea is to get Russian consumers used to buying licensed material, but at a price that most of the population can afford. We're changing distribution from the 'exclusive model' to the 'mass model' in Russia."

A similar situation exists in Mexico, where a movie ticket costs a day's pay and pirated DVDs sell for about \$5.50. Videomax, Quality Films, and other Mexican distributors have responded by cutting retail prices for DVDs to about \$4.50. As Carlos Cayon, vice president of Videomax, noted, "If we don't do something drastic, our business is finished." Another tactic is to bundle several older movie titles on individual DVDs that sell for \$23 at Blockbuster, Sam's Club, and Wal-Mart stores in Mexico. Videomax is also experimenting with innovative

distribution channels such as street vendors, many of whom previously sold pirated movies. These vendors set up stands in high-traffic areas such as public plazas and subway station entrances.

The video piracy problem isn't confined to emerging markets: In the United States, losses from piracy exceed \$1 billion each year for the movie industry as a whole. In the United States, Europe, and Japan, DVDs of hit movies such as *X-Men: The Last Stand* sell for \$20 to \$24. For years, Hollywood studios have relied on a business model that calls for DVDs to be released several months after a movie's theatrical run; DVD sales generate substantial profits for the studios and can equal or exceed a movie's take at the box office.

Sources: Mure Dickie, "Fox in DVD Distribution Deal with China Partner," *Financial Times* (November 13, 2006), p. 23; Ross Johnson, "Good News in Hollywood. Shhh." *The New York Times* (January 31, 2005), pp. C1, C8; Erin Arvedlund, "To Combat Rampant DVD Piracy, U.S. Film Companies Cut Prices," *The New York Times* (April 7, 2004), p. E1; Ken Bensinger, "Film Companies Take to Mexico's Streets to Fight Piracy," *The Wall Street Journal* (December 17, 2003), p. B1.

STRATEGIC DECISION-MAKING *in global marketing*

Sony

When Sony was developing the Walkman in 1979, initial plans called for a retail price of ¥50,000 (\$249) to achieve breakeven. However, it was felt that a price of ¥35,000 (\$170) was necessary to attract the all-important youth market segment. After the engineering team conceded that they could trim costs to achieve breakeven volume at a price of ¥40,000, Chairman Akio Morita pushed them further and insisted on a retail price of ¥33,000 (\$165) to commemorate Sony's thirty-third anniversary. At that price, even if the initial production run of 60,000 units sold out, the company would lose \$35 per unit. The marketing department was convinced the product would fail: Who would want a tape recorder that couldn't record? Even Yasuo Kuroki, the project manager, hedged his bets: He ordered enough parts for 60,000 units but had only 30,000 actually produced. Although sales were slow immediately following the Walkman's launch in July 1979, they exploded in late summer. The rest, as the saying goes, is history.

Sony has used penetration strategies with numerous other product introductions. When the portable CD player was in development in the mid-1980s, the cost per unit at initial sales volumes was estimated to exceed \$600. Realizing that this was a "no-go" price in the United States and other target markets, Chairman Morita instructed management to price the unit in the

\$300 range to achieve penetration. Because Sony was a global marketer, the sales volume it expected to achieve in these markets led to scale economies and lower costs.

It is not unusual for a company to change its objectives as a product proceeds through its life cycle and as competitive conditions change. For example, in 2000, Sony rolled out its next-generation game console, the PlayStation 2 (PS2), for \$299; competing systems from Microsoft (Xbox) and Nintendo (GameCube) were launched one year later. By March 2001, Sony had shipped 10 million units to Asia, Europe, and the United States. As of today, Sony has sold more than 100 million PS2 units worldwide; according to industry estimates, one out of three American households owns a PlayStation.

As noted in Case 10-1, Sony launched the PlayStation 3 (PS3) in November 2006; it is equipped with a chip that is capable of performing more than 200 billion calculations per second. The development cost of the chip alone was nearly \$2 billion. Two different models are available, priced at \$499 and at \$599. Industry observers estimate that Sony will lose \$100 on each PS3 unit sold.

Sources: P. Ranganath Nayak and John M. Kettingham, Breakthroughs! How Leadership and Drive Create Commercial Innovations That Sweep the World (San Diego, CA: Pfeiffer, 1994), pp. 124-127; Lauren J. Flynn, "Deep Price Cuts Help Nintendo Climb to No. 2 in Game Sales," The New York Times (January 26, 2004), p. C3.

system in place (including transportation, distribution, and sales organizations) that allows global companies like Sony to make effective use of a penetration strategy. Many companies, especially those in the food industry, launch new products that are not innovative enough to qualify for patent protection. When this occurs, penetration pricing is recommended as a means of achieving market saturation before competitors copy the product.

Companion Products: "Razors and Blades" Pricing

One crucial element is missing from the discussion of video game console pricing in the previous section: the video games themselves. The biggest profits in the video industry come from sales of game software; even though Sony and Microsoft may actually lose money on each console, sales of hit video titles generate substantial revenues and profits. Sony, Microsoft, and Nintendo receive licensing fees from the companies that create the games. This illustrates the notion of *companion products*: a video game console has no value without software, a DVD player has no value without movies, a razor handle has no value without blades, a cellular phone has no value without a calling plan, and so on. As the saying goes, "If you make money on the blades, you can give away the razors." Thus, cellular phone companies heavily discount (or even give away) handsets to subscribers who sign long-term service contracts. Likewise, Gillette can sell a single Mach3 razor for less than \$5; over a period of years, the company will make significant profits from selling packages of replacement blades. Moreover, a given household might own one or two consoles but dozens of games. Since launching the first

"Nobody buys a piece of hardware because they like hardware. They buy it to play movies or music content."²

Howard Stringer, CEO, Sony Corporation

² Phred Dvorak and Merissa Marr, "Shock Treatment: Sony, Lagging Behind Rivals, Hands Reins to a Foreigner," *The Wall Street Journal* (March 7, 2005), p. A8.

PlayStation in 1994, Sony has sold more than 200 million game consoles worldwide. During the same time period, however, sales of PlayStation games have exceeded 880 million units.

Target Costing³

Japanese companies have traditionally approached cost issues in a way that results in substantial production savings and products that are competitively priced in the global marketplace. Toyota, Sony, Olympus, and Komatsu are some of the well-known Japanese companies that use target costing. The process, sometimes known as *design to cost*, can be described as follows:

Target costing ensures that development teams will bring profitable products to market not only with the right level of quality and functionality but also with appropriate prices for the target customer segments. It is a discipline that harmonizes the labor of disparate participants in the development effort, from designers and manufacturing engineers to market researchers and suppliers . . . In effect, the company reasons backward from customers' needs and willingness to pay instead of following the flawed but common practice of cost-plus pricing.⁴

Western companies are beginning to adopt some of these money-saving ideas. For example, target costing was used in the development of Renault's Logan, a car that retails for less than \$10,000 in Europe. According to Luc-Alexandre Ménard, chief of Renault's Dacia unit, the design approach prevented technical personnel from adding features that customers did not consider absolutely necessary. For example, the Logan's side windows have relatively flat glass; curved glass is more attractive but it adds to the cost. The Logan was originally targeted at consumers in Eastern Europe; to the company's surprise, it has also proven to be popular in Germany and France.⁵

As shown in Figure 11-1, the process begins with market mapping and product definition and positioning; this requires using concepts and techniques discussed in Chapters 6 and 7. The marketing team must do the following:

- Determine the segment(s) to be targeted, as well as the prices that customers in the segment will be willing to pay. Using market research techniques such as conjoint analysis, the team seeks to better understand how customers will perceive product features and functionalities.

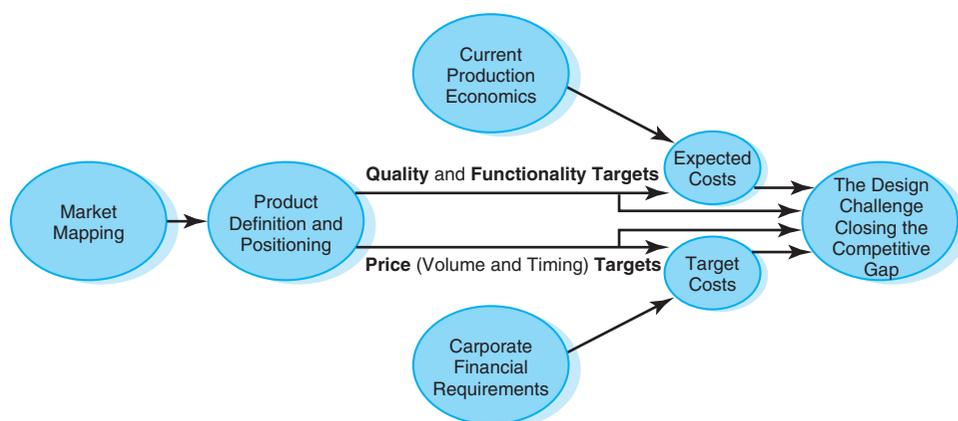


Figure 11-1

The Target Costing Process

Source: Robin Cooper and W. Bruce Chew, "Control Tomorrow's Costs Through Today's Designs," *Harvard Business Review* 74, no. 1 (January–February 1996), p. 95.

³ This section is adapted from Robin Cooper and W. Bruce Chew, "Control Tomorrow's Costs Through Today's Designs," *Harvard Business Review* 74, no. 1 (January–February 1996), pp. 88–97. See also Robin Cooper and Regine Slagmulder, "Develop Profitable New Products with Target Costing," *Sloan Management Review* 40, no. 4 (Summer 1999), pp. 23–33.

⁴ Robin Cooper and W. Bruce Chew, "Control Tomorrow's Costs Through Today's Designs," *Harvard Business Review* 74, no. 1 (January–February 1996), pp. 88–97.

⁵ Norihiko Shirouzu and Stephen Power, "Unthrilling but Inexpensive, the Logan Boosts Renault in Emerging Markets," *The Wall Street Journal* (October 14, 2006), pp. B1, B18.

- Compute overall target costs with the aim of ensuring the company's future profitability.
- Allocate the target costs to the product's various functions. Calculate the gap between the target cost and the estimated actual production cost. Think of debits and credits in accounting: Because the target cost is fixed, additional funds allocated to one subassembly team for improving a particular function must come from another subassembly team.
- Obey the cardinal rule: If the design team can't meet the targets, the product should not be launched.

Only at this point are design, engineering, and supplier pricing issues dealt with; extensive consultation between all value chain members is used to meet the target. Once the necessary negotiations and trade-offs have been settled, manufacturing begins, followed by continuous cost reduction. In the U.S. process, cost is typically determined after design, engineering, and marketing decisions have been made in sequential fashion; if the cost is too high, the process cycles back to square one—the design stage.

Calculating Prices: Cost-Plus Pricing and Export Price Escalation

The laptop computer exemplifies many characteristics of today's global marketplace: No matter what the brand—Acer, Apple, Dell, or Hewlett-Packard, for example—components are typically sourced in several different countries, and the computers themselves are assembled in China, Taiwan, or Japan (see Table 11-1). Within two days, the computers are sent via airfreight to the countries where they will be sold. As anyone who has studied managerial accounting knows, finished goods have a cost associated with the actual production. In global marketing, however, the total cost will depend on the ultimate market destination, the mode of transport, tariffs, and various fees, handling charges, and documentations costs. **Export price escalation** is the increase in the final selling price of goods traded across borders that reflects these factors. The following is a list of eight basic considerations for persons whose responsibility includes setting prices on goods that cross borders.⁶

1. Does the price reflect the product's quality?
2. Is the price competitive given local market conditions?
3. Should the firm pursue market penetration, market skimming, or some other pricing objective?
4. What type of discount (trade, cash, quantity) and allowance (advertising, trade-off) should the firm offer its international customers?
5. Should prices differ with market segment?
6. What pricing options are available if the firm's costs increase or decrease? Is demand in the international market elastic or inelastic?

Table 11-1

Sourcing a Laptop Computer

Component	Country of Manufacture
Hard-disk drive	Japan, China, Singapore, United States
Power supplies	China
Magnesium casings	China
Memory chips	South Korea, Taiwan, United States, Germany
Liquid-crystal displays	South Korea, Taiwan, Japan, China
Microprocessors	United States
Graphics processors	Designed in the United States, Canada; made in Taiwan

Source: Jason Dean and Pui-Wing Tam, "The Laptop Trail," *The Wall Street Journal* (June 9, 2005), p. B1.

⁶ Adapted from "Price, Quotations, and Terms of Sale are Key to Successful Exporting," *Business America* (October 4, 1993), p. 12.

USA Today: "The economy has become bifurcated. Some people will pay any price, while others want bargains. Do you think that will continue?"

Rich Gelfond: "I really do. We're seeing how much of an international trend it is. We have a theater in Moscow that's charging \$11 for tickets, and on several movies, it's been among the top performers in the world. In India, people are paying triple the ticket price. In China, people are paying the equivalent of \$10. So there's no question that as the demographic increases and you get an expanded upper-middle and wealthy class, there is more disposable income for entertainment."

Source: Adapted from Ron Insana, "Imax Chief Sees a Big Future in Big Screens," USA Today (December 5, 2005), p. 4B. Courtesy of NPN.

7. Are the firm's prices likely to be viewed by the host-country government as reasonable or exploitative?
8. Do the foreign country's dumping laws pose a problem?

Companies frequently use a method known as cost-plus pricing when selling goods outside their home-country markets. **Cost-based pricing** is based on an analysis of internal (e.g., materials, labor, testing) and external costs. As a starting point, firms that comply with Western cost accounting principles typically use the *full absorption cost method*; this defines per-unit product cost as the sum of all past or current direct and indirect manufacturing and overhead costs. However, when goods cross national borders, additional costs and expenses such as transportation, duties, and insurance are incurred. If the manufacturer is responsible for them, they too must be included. By adding the desired profit margin, managers can arrive at a final selling price; this process is known as *cost-plus pricing*. It is important to note that, in China and some other developing countries, many manufacturing enterprises are state run and state subsidized. This makes it difficult to calculate accurate cost figures and opens a country's exporters to charges that they are selling products for less than the "true" cost of producing them.



Canada's Imax Corporation is the world's premier provider of large-format motion picture projection technology. The company has identified nine hundred potential markets for new Imax theaters; two-thirds of those are global. Imax has developed a lower-cost projection system called Imax MPX that fits in existing movie theaters; by improving the economics for movie exhibitors, this innovation will expand the number of available market opportunities. In China, for example, 25 Imax theaters will be operating by 2008.

Companies using *rigid cost-plus pricing* set prices without regard to the eight considerations listed previously. They make no adjustments to reflect market conditions outside the home country. The obvious advantage of rigid cost-based pricing is its simplicity: Assuming that both internal and external cost figures are readily available, it is relatively easy to arrive at a quote. The disadvantage is that this approach ignores demand and competitive conditions in target markets; the risk is that prices will either be set too high or too low. If the rigid cost-based approach results in market success, it is only by chance. Rigid cost-plus pricing is attractive to inexperienced exporters, who are frequently less concerned with financial goals than with assessing market potential. Such exporters are typically responding to global market opportunities in a reactive manner, not proactively seeking them.

An alternative method, *flexible cost-plus pricing*, is used to ensure that prices are competitive in the context of the particular market environment. This approach is frequently used by experienced exporters and global marketers. They realize that the rigid cost-plus approach can result in severe price escalation, with the unintended result that exports are priced at levels above what customers can pay. Managers who utilize flexible cost-plus pricing are acknowledging the importance of the eight criteria listed earlier. Flexible cost plus sometimes incorporates the *estimated future cost method* to establish the future cost for all component elements. For example, the automobile industry uses palladium in catalytic converters. Because the market price of heavy metals is volatile and varies with supply and demand, component manufacturers might use the estimated future cost method to ensure that the selling price they set enables them to cover their costs.

Terms of the Sale

Every commercial transaction is based on a contract of sale, and the trade terms in that contract specify the exact point at which the ownership of merchandise is transferred from the seller to the buyer and which party in the transaction pays which costs. The following activities must be performed when goods cross international boundaries:

1. Obtaining an export license if required (in the United States, nonstrategic goods are exported under a general license that requires no specific permit)
2. Obtaining a currency permit if required
3. Packing the goods for export
4. Transporting the goods to the place of departure (this would normally involve transport by truck or rail to a seaport or airport)
5. Preparing a land bill of lading
6. Completing necessary customs export papers
7. Preparing customs or consular invoices as required by the country of destination
8. Arranging for ocean freight and preparation
9. Obtaining marine insurance and certificate of the policy

Who is responsible for performing these tasks? It depends on the terms of the sale. The internationally accepted terms of trade are known as **International Commercial Terms (Incoterms)**. Incoterms are classified into four categories. **Ex-works (EXW)**, the sole “E-Term” or “origin” term among Incoterms, refers to a transaction in which the buyer takes delivery at the premises of the seller; the buyer bears all risks and expenses from that point on. In principle, ex-works affords the buyer maximum control over the cost of transporting the goods. Ex-works can be contrasted with several “D-Terms” (“post-main-carriage” or “arrival” terms). For example, under **delivered duty paid (DDP)**, the seller has agreed to deliver the goods to the buyer at

the place he or she names in the country of import, with all costs, including duties, paid. Under this contract, the seller is also responsible for obtaining the import license if one is required.

Another category of Incoterms is known as “F-Terms” or “pre-main-carriage terms.” Because it is suited for all modes of transport, **free carrier (FCA)** is widely used in global sales. Under FCA, transfer from seller to buyer is effected when the goods are delivered to a specified carrier at a specified destination. Two additional F-terms apply to sea and inland waterway transportation only. **Free alongside ship (FAS) named port** is the Incoterm for a transaction in which the seller places the shipment alongside, or available to, the vessel upon which the goods will be transported out of the country. The seller pays all charges up to that point. The seller’s legal responsibility ends once the goods have been cleared for export; the buyer pays the cost of actually loading the shipment. FAS is often used with *break bulk cargo*, which is noncontainerized, general cargo, such as iron, steel, or machinery (often stowed in the hold of a vessel rather than in containers on the deck). With **free on board (FOB) named port**, the responsibility and liability of the seller do not end until the goods—typically in containers—have cleared the ship’s rail. As a practical matter, access to the terminal and harbor areas in many modern ports may be restricted; in such an instance, FCA should be used instead.

Several Incoterms are known as “C-Terms” or “main-carriage” terms. When goods are shipped **cost, insurance, freight (CIF) named port**, the risk of loss or damage to goods is transferred to the buyer once the goods have passed the ship’s rail. In this sense, CIF is similar to FOB. However, with CIF, the seller has to pay the expense of transportation for the goods up to the port of destination, including the expense of insurance. If the terms of the sale are **cost and freight (CFR)**, the seller is not responsible for risk or loss at any point outside the factory.

Table 11-2 is a typical example of the kind of export price escalation that can occur when some of these costs are added to the per-unit cost of the product itself. In this example, a Kansas City-based distributor of agricultural equipment is shipping a container load of farm implements to Yokohama, Japan, through the port of Seattle. A shipment of product that costs ex-works \$30,000 in Kansas City ends up with a

behind the scenes

Choosing the Terms of the Sale

Students of global marketing may feel a little overwhelmed by the various Incoterms discussed in this section. Mastering the nomenclature and understanding which term to choose takes a great deal of study and experience. As a practical matter, Beth Dorrell, an export coordinator at a U.S.-based company that markets industrial ink products, offers the following explanation:

We actually use different Incoterms as incentives for larger orders. Instead of offering a “price break” price, we offer a better Incoterm based upon the size of a customer’s order. We adhere to some general guidelines: Any order less than 1 ton is sold on an ex-works basis. Anything 1 ton or more is sold CIF port. All air freight is ex-factory. We will, of course, go to great lengths to ensure that our customers are happy. So, even though a product is sold ex-works, we’ll often arrange shipping to destination port (CIF) or airport (CIP), or to the domestic port (FOB) and simply tag the freight cost onto the invoice. We end up with an ex-factory price, but a CIF or FOB invoice total. Sounds complicated, doesn’t it? It keeps me busy arranging shipping.

We also ship FCL (full container load). We usually do these “door-to-port.” This means that we have the shipping line deliver the empty container to our warehouse dock where we load it. The shipping line then pulls away with the container and delivers it as far as the foreign port where the consignee (customer) must then arrange for local clearance and inland trucking. It’s actually a ton of fun—as long as you load and secure the container properly!

When choosing among the various Incoterm options, remember that it all depends on how much work you want to do and how much responsibility you want to accept. From the seller’s point of view, ex-works is easy, and FOB domestic port is fairly easy. The seller’s responsibility increases with other Incoterms. For example, if I’m shipping CIF and the container ends up in a ditch on the way to the port because the truck driver fell asleep (it happened to us last week—what a mess!), then it’s my responsibility and my problem. That’s because we still own the freight, we have to deal with the insurance company, we have to replace the freight, and somehow we still have to get the freight there on time—which is almost impossible.

Table 11-2

Price Escalation: A 20-Foot Container of Agricultural Equipment Shipped from Kansas City to Yokohama*

Item		Percentage of Ex-works Price
Ex-Works Kansas City	\$30,000	100%
Container freight charges from Kansas City to Seattle	\$1,475.00	
Terminal handling fee	350.00	
Ocean freight for 20-foot container	2,280.00	
Currency Adjustment Factor (CAF) (51% of ocean freight)	1,162.80	
Insurance (110% of CIF value)	35.27	
Forwarding fee	150.00	
Total shipping charges	<u>5,453.07</u>	18
Total CIF Yokohama value	35,453.07	
VAT (3% of CIF value)	<u>1,063.69</u>	3
	36,516.76	
Distributor markup (10%)	<u>3,651.67</u>	12
	40,168.43	
Dealer markup (25%)	<u>10,042.10</u>	33
Total retail price	\$50,210.53	166%

*This was loaded at the manufacturer's door, shipped by stack train to Seattle, and then transferred via ocean freight to Yokohama. Total transit time from factory door to foreign port is about 28 days.

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total retail price in excess of \$50,000 in Yokohama. A line-by-line analysis of this shipment shows how price escalation occurs. First, there is the total shipping charge of \$5,453.07, which is 18 percent of the ex-works Kansas City price. The principal component of this shipping charge is a combination of land and ocean freight totaling \$5,267.80. A currency adjustment factor (CAF) is assessed to protect the seller from possible losses from disadvantageous shifts in the dollar-yen exchange rate. This figure will vary depending on the perceived volatility of exchange rates.

All import charges are assessed against the landed price of the shipment (CIF value). Note that there is no line item for duty in this example; no duties are charged on agricultural equipment sent to Japan.⁷ Duties may be charged in other

Chrysler began exporting right-hand drive Jeeps to Japan in 1996. However, the country was in a deep recession at the time, forcing many American marketers—including Coca-Cola, J. Crew, Microsoft, and Jeep—to cut prices. Ten years later, Japan's economy has rebounded, and consumers are buying. Jeep is enjoying double-digit sales growth at the sixty-plus dealerships that sell Chrysler and Jeep vehicles.



⁷ Since the Uruguay Round of GATT negotiations, Japan has lowered or eliminated duties on thousands of categories of imports. Japan's simple average duty rate for 2003 was 2.5 percent; approximately 60 percent of tariff lines (including most industrial products) were rated 5 percent or lower.

Item	Amount of Price Escalation	Total
Ex-works price	0	\$30,000
Exchange rate adjustment	\$2,100	\$32,100
Shipping	\$300	\$32,400
Customs fees	\$1,000	\$33,400
Distributor margin	\$3,700	\$37,100
Inspection, accessories	\$1,700	\$38,800
Added options, prep	\$3,000	\$41,800
Final sticker price	\$8,200	\$50,000

Table 11-3

An American-Built Jeep Grand Cherokee Goes to Japan (Estimates)

countries. A nominal distributor markup of 10 percent (\$3,652) actually represents 12 percent of the CIF Yokohama price because it is a markup not only on the ex-works price but on freight and VAT as well. (It is assumed here that the distributor's markup includes the cost of transportation from the port to Yokohama.) Finally, a dealer markup of 25 percent adds up to \$10,042 (33 percent) of the CIF Yokohama price. Like distributor markups, dealer markup is based on the total landed cost.

The net effect of this add-on accumulating process is a total retail price in Yokohama of \$50,210, or 166 percent of the ex-works Kansas City price. This is price escalation. The example provided here is by no means an extreme case. Longer distribution channels or channels that require a higher operating margin, as are typically found in export marketing, can contribute to price escalation. Because of the layered distribution system in Japan, the markups in Tokyo could easily result in a price that is 200 percent of the CIF value. An example of price escalation for a single product is shown in Table 11-3 A right-hand-drive Jeep Grand Cherokee equipped with a V8 engine ends up costing ¥5 million—roughly \$50,000—by the time it reaches a dealer in Japan. The final price represents a 166 percent increase over the U.S. sticker price of \$30,000.

These examples of cost-plus pricing show an approach that a beginning exporter might use to determine the CIF price. This approach could also be used for differentiated products such as the Jeep Cherokee for which buyers are willing to pay a premium. However, as noted earlier, experienced global marketers are likely to take a more flexible approach and view price as a strategic variable that can help achieve marketing and business objectives.

ENVIRONMENTAL INFLUENCES ON PRICING DECISIONS

Global marketers must deal with a number of environmental considerations when making pricing decisions. Among them are currency fluctuations, inflation, government controls and subsidies, and competitive behavior. Some of these factors work in conjunction with others; for example, inflation may be accompanied by government controls. Each is discussed in detail in the following paragraphs.

Currency Fluctuations

In global marketing, fluctuating exchange rates complicate the task of setting prices. As we noted in Chapter 2, currency fluctuations can create significant challenges and opportunities for any company that exports. Management faces different decision situations, depending on whether currencies in key markets have strengthened or weakened relative to the home-country currency. A weakening of the home country currency swings exchange rates in a favorable direction: A producer in a weak-currency country can choose to cut export prices to increase market share or maintain

Table 11-4

Value of U.S. Dollar Versus
Japanese Yen

	United States	Japan
January 2000	\$1.00	¥101
April 2002	\$1.00	¥130

its prices and reap healthier profit margins. Overseas sales can result in windfall revenues when translated into the home-country currency.

For example, as shown in Table 11-4, over a recent 16-month period the yen weakened approximately 29 percent relative to the dollar. The figures in the table should be interpreted in the following way: If the amount of yen (or other currency) per dollar increases in a given time period, it means the yen's value is decreasing. (Conversely, if the amount of yen per dollar had *decreased*, it would have indicated that the yen had strengthened relative to the dollar.) The currency shift indicated in Table 11-4 was a boon for Japanese companies such as Canon and Olympus Optical because each dollar in U.S. export sales was worth ¥130 in April 2002.

It is a different situation when a company's home currency strengthens; this is an unfavorable turn of events for the typical exporter because overseas revenues are reduced when translated into the home country currency. Fast forward one year from the situation shown in Table 11-4: By early 2003, as the Bush administration prepared for war, the dollar was down 11 percent from its 2002 peak against a weighted portfolio of foreign currencies. This was good news for American companies such as Boeing, Caterpillar, and GE but bad news for Canon and Olympus (and Americans shopping for cameras). Indeed, according to Teruhisa Tokunaka, chief financial officer of Sony, a 1 yen shift in the yen-dollar exchange rate can raise or lower the company's annual operating profit by 8 billion yen.⁸ These examples underscore the point that "roller-coaster" or "yo-yo" style swings in currency values, which may move in a favorable direction for several quarters and then abruptly reverse, characterize today's business environment.

The degree of exposure varies among companies. For example, Harley-Davidson exports all of its motorcycles from the United States. In every export market, the company's pricing decisions must take currency fluctuations into account. Similarly, 100 percent of German automaker Porsche's production takes place at home; Germany serves as its export base. However, for exports within the euro zone, Porsche is insulated from currency fluctuations. The situation is more complicated for a transnational company such as Honda. The company is heavily dependent on the North American market, which accounts for more than half its operating income. How can Honda reduce the potential negative impact of currency fluctuations? About three-fourths of the cars Honda sells in America are produced in the United States. In late 2000, the dollar had fallen to ¥108 compared with ¥113 the previous year; the unfavorable shift had a direct negative impact on corporate profits.

The situation was even more complicated in Europe; Honda serves the entire European market from a single plant in the United Kingdom. The pound's strength relative to the euro in the first years of the decade resulted in a significant decline in Honda's European sales. At the same time, the euro weakened relative to the yen. So, not only did currency fluctuations negatively affect sales on the continent, but, translated into yen, the revenue that Honda realized from those sales was reduced as well!⁹

In responding to currency fluctuations, global marketers can utilize other elements of the marketing mix besides price. Table 11-5 provides several guidelines. In

⁸ Robert A. Guth, Michael M. Phillips, and Charles Hutzler, "On the Decline: As the Yen Keeps Dropping, A New View of Japan Emerges," *The Wall Street Journal* (April 24, 2002), pp. A1, A8.

⁹ Todd Zaun, "Honda Takes Currency Hit in Europe," *The Wall Street Journal* (March 28, 2001), p. A16.

When Domestic Currency Is Weak	When Domestic Currency Is Strong
1. Stress price benefits.	1. Engage in nonprice competition by improving quality, delivery, and after-sale service.
2. Expand product line and add more costly features.	2. Improve productivity and engage in cost reduction.
3. Shift sourcing to domestic market.	3. Shift sourcing outside home country.
4. Exploit market opportunities in all markets.	4. Give priority to exports to countries with stronger currencies.
5. Use full-costing approach, but employ marginal-cost pricing to penetrate new or competitive markets.	5. Trim profit margins and use marginal-cost pricing.
6. Speed repatriation of foreign-earned income and collections.	6. Keep the foreign-earned income in host country; slow down collections.
7. Minimize expenditures in local (host-country) currency.	7. Maximize expenditures in local (host-country) currency.
8. Buy advertising, insurance, transportation, and other services in domestic market.	8. Buy needed services abroad and pay for them in local currencies.
9. Bill foreign customers in their own currency.	9. Bill foreign customers in the domestic currency.

Table 11-5

Global Pricing Strategies

Source: S. Tamer Cavusgil, "Pricing for Global Markets," *Columbia Journal of World Business* 31, no. 4 (Winter 1996), p. 69.

some instances, slight upward price adjustments due to the strengthening of a country's currency have little effect on export performance, especially if demand is relatively inelastic. The first two strategies in the right-hand column of Table 11-5 call for focusing attention on competitive issues besides price as well as productivity and cost reduction efforts. Companies in the strong-currency country can also choose to absorb the cost of maintaining international market prices at previous levels—at least for a while. Companies using the rigid cost-plus pricing method described earlier may be forced to change to the flexible approach. The use of the flexible cost-plus method to reduce prices in response to unfavorable currency swings is an example of a **market holding strategy** and is adopted by companies that do not want to lose market share. If, by contrast, large price increases are deemed unavoidable, managers may find their products can no longer compete.

As noted earlier, price discrepancies across the euro zone should gradually disappear because manufacturers will no longer be able to cite currency fluctuations as a justification for the discrepancies. **Price transparency** means that buyers will be

GLOBAL marketing in action

Pricing U.S. Exports to the Europe

In the three years immediately after the euro zone was established, the euro declined in value more than 25 percent relative to the dollar. This situation forced American companies, in particular small exporters, to choose from among the options associated with strong currencies listed in Table 11-5. The strategy chosen varies according to a company's particular circumstances. For example, Vermeer Manufacturing of Pella, Iowa, with annual sales of \$650 million, prices its products in euros for the European market. As 2000 came to an end, Vermeer had been forced to raise its European prices four times since the euro's introduction. Its subsidiary in the Netherlands pays employees in euros and also buys materials locally, illustrating strategies number 7 and 8.

By contrast, Stern Pinball of Melrose Park, Illinois, prices its machines in dollars in export markets; this represents strong-currency strategy number 9. Company president Gary Stern's product strategy also reflects strong-currency strategy number 1 in Table 11-5: To offset the higher cost to European customers who must convert euros before paying in dollars, the company developed new features such as pinball machines that "speak" several European languages. It has also produced new products such as a soccer game themed to European interests as well as an Austin Powers game targeted at the United Kingdom. As Stern commented, "If I were bright enough to know which way the euro was going, I sure wouldn't be making pinball machines. I'd be trading currency."

Source: Christopher Cooper, "Euro's Drop Is Hardest for the Smallest," *The Wall Street Journal* (October 2, 2000), p. A21.

Table 11-6

Automobile Price Differences in the EU, 1998/2003

Small Segment		Medium Segment		Large Segment	
Opel Corsa	24.0%/13.6%	VW Golf	43.5%/28.0%	BMW 318I	12.0%/12.7%
Ford Fiesta	44.7%/23.1%	Opel Astra	26.0%/17.6%	Audi A4	13.0%/ 9.1%
Renault Clio	33.8%/17.3%	Ford Escort/Focus	33.8%/22.7%	Ford Mondeo	58.5%/21.0%
Peugeot 106/206	21.1%/24.6%	Renault Mégane	27.9%/19.6%	Opel Vectra	18.2%/16.0%
VW Polo	36.7%/19.3%	Peugeot 306/307	46.2%/16.9%	VW Passat	36.4%/39.0%

Source: Reprinted from the *Columbia Journal of World Business*, Vol. 31, S. Tamer Cavusgil, "Pricing for Global Markets," p. 4, Copyright © 2004, with permission from Elsevier.

"The car industry is going to be hurt. There will be greater price transparency. Prices are higher in northern Europe and once consumers there get wind of this there will be a move down in prices towards the southern countries."¹⁰

Marcie Krempel, AT Kearney

able to comparison shop easily because goods will be priced in euros as opposed to marks, francs, or lira. The European Commission publishes an annual report comparing automobile price differences in the EU. Table 11-6 shows prices from the late 1990s (pre-euro zone) and prices from November 2003. A comparison of the figures shows that, although price discrepancies for some models have narrowed, prices for a Volkswagen Passat are as much as 39 percent higher depending on the country of purchase. Not surprisingly, these differences encourage cross-border shopping.

Some automobile price differences in Europe are due to different standards for safety equipment and different tax levels. For example, Denmark and Sweden have a value-added tax (VAT) of 25 percent, the highest rates in the EU. Moreover, Denmark taxes luxury goods heavily. Taxes are also high in Finland, Belgium, Ireland, Austria, and Italy. Volkswagen has already begun to harmonize its wholesale prices for vehicles distributed in Europe.

Inflationary Environment

Inflation, or a persistent upward change in price levels, is a problem in many country markets. An increase in the money supply can cause inflation; as noted in the previous section, inflation is often reflected in the prices of imported goods for a country whose currency has been devalued. In 1998, for example, the Russian government defaulted on its foreign debt and devalued the ruble; prices for some goods in Russian stores rose as much as 300 percent. Likewise, in the Dominican Republic, the peso lost one-third of its value in 2002; suddenly, shoppers were faced with price increases of 40 percent to 50 percent. The situations in Russia and the Dominican Republic are extreme; overall, in 2000, the average rate of inflation in the world's advanced economies stood at a low 2.3 percent. In developing countries, inflation averaged about 6 percent. By comparison, inflation in 2000 was much higher in the transitional economies in Central and Eastern Europe with Russia experiencing inflation of 20 percent.

An essential requirement for pricing in an inflationary environment is the maintenance of operating profit margins. When present, inflation requires price adjustments, for a simple reason: Increased selling prices must cover rising costs. Regardless of cost accounting practices, if a company maintains its margins, it has effectively protected itself from the effects of inflation. This, in turn, requires manufacturers and retailers of all types to become more technologically adept. In Brazil, where the inflation rate was as high as 2,000 percent during the late 1980s, retailers sometimes changed prices several times each day. Shelf pricing, rather than individual unit pricing, became the norm throughout the retailing sector nearly 15 years before Wal-Mart arrived in the region. Because their warehouses contained goods that had been bought at different prices, local retailers were forced to invest in sophisticated computer and communications systems to help them keep pace with the volatile financial environment. They utilized sophisticated inventory

¹⁰ Graham Bowley, "On the Road to Price Convergence," *Financial Times* (November 12, 1998), p. 29.

Pricing Reeboks in India

When Reebok, the world's number two athletic shoe company, decided to enter India in 1995, it faced several basic marketing challenges. For one thing, Reebok was creating a market from scratch. Upscale sports shoes were virtually unknown, and the most expensive sneakers available at the time cost 1,000 rupees (about \$23). Reebok officials also had to select a market entry mode. The decision was made to subcontract with four local suppliers, one of which, the Phoenix Group, became a joint venture partner. To reinforce Reebok's high-tech brand image, company officials decided to establish their own retail infrastructure. There were two other crucial pieces of the puzzle: product and price. Should Reebok create a line of mass-market shoes specifically for India and priced at Rs1,000? The alternative was to offer the same designs sold in other parts of the world and price them at Rs2,500 (\$58), a figure that represents the equivalent of a month's salary for a junior civil servant.

In the end, Reebok decided to offer Indian consumers about 60 models chosen from the company's global offerings. The decision was based in part on a desire to sustain Reebok's brand image of high quality. Management realized that the decision could very well limit the size of the market; despite estimates that as many as 300 million Indians could be classified as "middle class," the number of people who could afford premium-priced products was estimated to be about 30 million.

Reebok's least expensive shoes were priced at about Rs2,000 per pair; for the same amount of money, a farmer could buy a dairy cow or a homeowner could buy a new refrigerator. Nevertheless, consumer response was very favorable, especially among middle-class youths. As Muktesh Pant, a former regional manager who became the first CEO of Reebok India, noted, "For Rs2,000 to Rs3,000, people feel they can really make a statement. It's cheaper than buying a new watch, for instance, if you want to make a splash at a party. And though our higher-priced shoes put us in competition with things like refrigerators and cows, the upside is that we're now being treated as a prestigious brand."

Sneakers represented just one aspect of the larger marketing of professional sports and sports culture to Indian youth. India's middle class households were spending more time in the living room watching cricket matches on TV, a trend that created an opportunity for sports sponsorships and sports-related ads. In the late 1990s, Reebok spent more than \$1.5 million on event marketing and sponsoring teams such as the East Bengal Football Club.

Reebok quickly discovered that demand was strong outside of key metropolitan markets such as Delhi, Mumbai, and Chennai. The cost of living is lower in small towns so consumers have more disposable income to spend. Reebok appointed distributors in each of India's 26 states to distribute lower-priced shoe models in a network of about 1,500 multibrand footwear and apparel shops. One problem, however, is that knockoff versions of Reebok, Adidas, and Nike shoes were widely available. Reebok conducted several raids on outlets that were selling the counterfeit goods.

Reebok's agreement with the Phoenix Group called for the latter to create a 50-plus chain of stores. However, after the first 10 stores were opened, management at Phoenix decided to concentrate on marketing the company's own brands. Accordingly, Reebok began to identify individual partners to run stores in major cities; there are currently about 90 branded franchise stores in 50 cities. By establishing exclusive stores, promoting Reebok as a lifestyle brand, and offering a unique "sports fashion" shopping experience, Reebok was able to offer a taste of Western-style capitalist consumption for those so inclined. Between 1996 and 1999, Reebok's retail sales in India more than tripled, increasing from Rs250 million to Rs900 million.

Today, Reebok India exports hundreds of thousands of pairs of Indian-made shoes to Europe and the United States. CEO Pant was promoted to vice president of global brand marketing at Reebok International headquarters in Stoughton, Massachusetts. Reflecting on Reebok's Indian launch, he observed, "At first we were embarrassed about our pricing. But it has ended up serving us well."

Sources: Bernard D'Mello, "Reebok and the Global Footwear Sweatshop," *Monthly Review* 54, no. 9 (February 2003), pp. 26–41; Mark Nicholson, "Where a Pair of Trainers Costs as Much as a Cow," *Financial Times* (August 18, 1998), p. 10.

management software to help them maintain financial control. As Wal-Mart came to Brazil in the mid-1990s, it discovered that local competitors had the technological infrastructure that allowed them to match its aggressive pricing policies.¹¹

Low inflation presents pricing challenges of a different type. With inflation in the United States in the low single digits in the late 1990s and strong demand forcing factories to run at or near capacity, companies should have been able to raise prices. However, the domestic economic situation was not the only consideration. In the mid-1990s, excess manufacturing capacity in many industries, high rates of

¹¹ Pete Hisey, "Wal-Mart's Global Vision," *Retail Merchandiser* 41, no. 4 (April 2001), pp. 21–49.

Reebok dominates the footwear market in India, where its cricket shoes are a top seller. In an effort to attract more foreign investment, India's leaders approved legislation in 2006 that will make it easier for Reebok and other global marketers to establish single-brand retail chains.

Previously, market entry and expansion was done primarily through franchisees. Now, Reebok is stepping up its efforts to expand outside of large metropolitan areas such as Mumbai. Some three dozen Indian cities have populations exceeding one million people, including a rapidly growing base of middle class consumers.



unemployment in many European countries, and the lingering recession in Asia made it difficult for companies to increase prices. As John Ballard, CEO of a California-based engineering firm, noted in 1994, "We thought about price increases. But our research of competitors and what the market would bear told us it was not worth pursuing." By the end of the decade, globalization, the Internet, a flood of low-cost exports from China, and a new cost-consciousness among buyers were also significant constraining factors.¹²

Government Controls, Subsidies, and Regulations

Governmental policies and regulations that affect pricing decisions include dumping legislation, resale price maintenance legislation, price ceilings, and general reviews of price levels. Government action that limits management's ability to adjust prices can put pressure on margins. Under certain conditions, government action poses a threat to the profitability of a subsidiary operation. In a country that is undergoing severe financial difficulties and is in the midst of a financial crisis (for example, a foreign exchange shortage caused in part by runaway inflation), government officials are under pressure to take some type of action. This was true in Brazil for many years. In some cases, governments take expedient steps such as selective or broad price controls.

When selective controls are imposed, foreign companies are more vulnerable to control than local ones, particularly if the outsiders lack the political influence over government decision that local managers have. For example, Procter & Gamble encountered strict price controls in Venezuela in the late 1980s. Despite increases in the cost of raw materials, P&G was only granted about 50 percent of the price increases it requested; even then, months passed before permission to raise prices was forthcoming. As a result, by 1988, detergent prices in Venezuela were less than what they were in the United States.¹³

¹² Lucinda Harper and Fred R. Bleakley, "Like Old Times: An Era of Low Inflation Changes the Calculus for Buyers and Sellers," *The Wall Street Journal* (January 14, 1994), p. A1. See also Jacob M. Schlesinger and Yochi J. Dreazen, "Counting the Cost: Firms Start to Raise Prices, Stirring Fear in Inflation Fighters," *The Wall Street Journal* (May 16, 2000), pp. A1, A8.

¹³ Alecia Swasy, "Foreign Formula: Procter & Gamble Fixes Aim on Tough Market: The Latin Americans," *The Wall Street Journal* (June 15, 1990), p. A7.

Government control can also take other forms. As discussed in Chapter 8, companies are sometimes required to deposit funds in a noninterest-bearing escrow account for a specified period of time if they wish to import products. For example, Cintec International, an engineering firm that specializes in restoring historic structures, spent eight years seeking the necessary approval from Egyptian authorities to import special tools to repair a mosque. In addition, the country's port authorities required a deposit of nearly \$25,000 before allowing Cintec to import diamond-tipped drills and other special tools. Why would Cintec's management accept such conditions? Cairo is the largest city in the Muslim world, and there are hundreds of centuries-old historic structures in need of refurbishment. By responding to the Egyptian government's demands with patience and persistence, Cintec is positioning itself as a leading contender for more contract work.¹⁴

Cash deposit requirements such as the one described here clearly create an incentive for a company to minimize the stated value of the imported goods; lower prices mean smaller deposits. Other government requirements that affect the pricing decision are profit transfer rules that restrict the conditions under which profits can be transferred out of a country. Under such rules, a high transfer price paid for imported goods by an affiliated company can be interpreted as a device for transferring profits out of a country.

Also discussed in Chapter 8 were government subsidies. As noted earlier, the topic of agricultural subsidies is a sensitive one in the current round of global trade talks. Brazil and a bloc of more than 20 other nations are pressing Washington to end agricultural subsidies. For example, Washington spends between \$2.5 billion and \$3 billion per year on cotton subsidies (the EU spends about \$700 million), a fact that has contributed to delays in completing the Doha round. Benin, Chad, Burkina Faso, and others complain that the subsidies keep U.S. cotton prices so low that it costs the African nations \$250 to \$300 million each year in lost exports.¹⁵ Brazil recently won its WTO complaint against U.S. cotton subsidies.

Government regulations can affect prices in other ways. In Germany, for example, price competition was historically severely restricted in a number of industries. This was particularly true in the service sector. The German government's recent moves toward deregulation have improved the climate for market entry by foreign firms in a range of industries, including insurance, telecommunications, and air travel. Deregulation is also giving German companies their first experience with price competition in the domestic market. In some instances, deregulation represents a *quid pro quo* that will allow German companies wider access to other country markets. For example, the United States and Germany recently completed an open-skies agreement that will allow Lufthansa to fly more routes within the United States. At the same time, the German air market has been opened to competition. As a result, air travel costs between German cities have fallen significantly. Change is slowly coming to the retail sector as well. The Internet and globalization have forced policy makers to repeal two archaic laws. The first, the *Rabattgesetz* or Discount Law, limited discounts on products to 3 percent of the list price. The second, the *Zugabeverordnung* or Free Gift Act, banned companies from giving away free merchandise, such as shopping bags.¹⁶

¹⁴ Scott Miller, "In Trade Talks, the Gloves Are Off," *The Wall Street Journal* (July 15, 2003), p. A12. See also James Drummond, "The Great Conservation Debate," *Financial Times Special Report—Egypt* (October 22, 2003), p. 6.

¹⁵ Neil King, Jr. and Scott Miller, "Trade Talks Fail amid Big Divide over Farm Issues," *The Wall Street Journal* (September 15, 2003), pp. A1, A18.

¹⁶ Greg Steinmetz, "Mark Down: German Consumers Are Seeing Prices Cut in Deregulation Push," *The Wall Street Journal* (August 15, 1997), pp. A1, A4; David Wessel, "German Shoppers Get Coupons," *The Wall Street Journal* (April 5, 2001), p. A1.

Competitive Behavior

Pricing decisions are bounded not only by cost and the nature of demand but also by competitive action. If competitors do not adjust their prices in response to rising costs, management—even if acutely aware of the effect of rising costs on operating margins—will be severely constrained in its ability to adjust prices accordingly. Conversely, if competitors are manufacturing or sourcing in a lower-cost country, it may be necessary to cut prices to stay competitive.

In the United States, Levi Strauss & Company is under price pressure from several directions. First, Levi faces stiff competition from the Wrangler and Lee brands marketed by VF Corporation. A pair of Wrangler jeans retails for about \$20 at JCPenney's and other department stores, compared with about \$30 for a pair of Levi 501s. Second, Levi's two primary retail customers, JCPenney and Sears, are aggressively marketing their own private label brands. Finally, designer jeans from Calvin Klein, Polo, and Diesel are enjoying renewed popularity. Exclusive fashion brands such as Seven and Lucky retail for more than \$100 per pair. Outside the United States, thanks to the heritage of the Levi brand and less competition, Levi jeans command premium prices—\$80 or more for one pair of 501s. To support the prestige image, Levi's are sold in boutiques. Levi's non-U.S. sales represent about one-third of revenues but more than 50 percent of profits. In an attempt to apply its global experience and enhance the brand in the United States, Levi has opened a number of Original Levi's Stores in select American cities. Despite such efforts, Levi rang up only \$4.1 billion in sales in 2003 compared with \$7.1 billion in 1996. In 2002, officials announced plans to close six plants and move most of the company's North American production offshore in an effort to cut costs.¹⁷

Using Sourcing as a Strategic Pricing Tool

The global marketer has several options for addressing the problem of price escalation or the environmental factors described in the last section. Product and market competition, in part, dictate the marketer's choices. Marketers of domestically manufactured finished products may be forced to switch to offshore sourcing of certain components to keep costs and prices competitive. In particular, China is quickly gaining a reputation as "the world's workshop." U.S. bicycle companies such as Huffy are relying more heavily on production sources in China and Taiwan.

Another option is a thorough audit of the distribution structure in the target markets. A rationalization of the distribution structure can substantially reduce the total markups required to achieve distribution in international markets. Rationalization may include selecting new intermediaries, assigning new responsibilities to old intermediaries, or establishing direct marketing operations. For example, Toys "R" Us successfully targets the Japanese toy market by bypassing layers of distribution and adopting a warehouse style of selling similar to its U.S. approach. Toys "R" Us was viewed as a test case of the ability of Western retailers—discounters in particular—to change the rules of distribution.

GLOBAL PRICING: THREE POLICY ALTERNATIVES

What pricing policy should a global company pursue? Viewed broadly, there are three alternative positions a company can take on worldwide pricing.

¹⁷ Leslie Kaufman, "Levi Strauss to Close 6 U.S. Plants and Lay Off 3,300," *The New York Times* (April 9, 2002), p. C2.

Extension or Ethnocentric

The first can be called an *extension* or *ethnocentric* pricing policy. An **extension or ethnocentric pricing policy** calls for the per-unit price of an item to be the same no matter where in the world the buyer is located. In such instances, the importer must absorb freight and import duties. The extension approach has the advantage of extreme simplicity because it does not require information on competitive or market conditions for implementation. The disadvantage of the ethnocentric approach is that it does not respond to the competitive and market conditions of each national market and, therefore, does not maximize the company's profits in each national market or globally. When toymaker Mattel adapted U.S. products for overseas markets, for example, little consideration was given to price levels that resulted when U.S. prices were converted to local currency prices. As a result, Holiday Barbie and some other toys were overpriced in global markets.¹⁸

Similarly, Mercedes executives recently moved beyond an ethnocentric approach to pricing. As Dieter Zietsche, chairman of Daimler AG, noted, "We used to say that *we* know what the customer wants, and he will have to pay for it . . . we didn't realize the world had changed."¹⁹ Mercedes got its wake-up call when Lexus began offering "Mercedes quality" for \$20,000 less. After assuming the top position in 1993, Mercedes CEO Helmut Werner boosted employee productivity, increased the number of low-cost outside suppliers, and invested in production facilities in the United States and Spain in an effort to move toward more customer- and competition-oriented pricing. The company also rolled out new, lower-priced versions of its E Class and S Class sedans. *Advertising Age* immediately hailed management's new attitude for transforming Mercedes from "a staid and smug purveyor into an aggressive, market-driven company that will go bumper-to-bumper with its luxury car rivals—even on price."²⁰

"In the past, Mercedes vehicles would be priced for the European market, and that price was translated into U.S. dollars. Surprise, surprise: You're 20 percent more expensive than the Lexus LS 400, and you don't sell too many cars."

Joe Eberhardt, Executive Vice President for Global Sales, Marketing and Service, Chrysler Group

Adaptation or Polycentric

The second policy, **adaptation or polycentric pricing**, permits subsidiary or affiliate managers or independent distributors to establish whatever price they feel is most appropriate in their market environment. There is no requirement that prices be coordinated from one country to the next. IKEA takes a polycentric approach to pricing: While it is company policy to have the lowest price on comparable products in every market, managers in each country set their own prices, which depend in part on local factors such as competition, wages, taxes, and advertising rates. Overall, IKEA's prices are lowest in the United States, where the company competes with large retailers. Prices are higher in Italy where local competitors tend to be smaller, more upscale furniture stores than those in the U.S. market. Generally, prices are higher in countries where the IKEA brand is strongest. When IKEA opened its first stores in mainland China, the young professional couples who are the company's primary target segment considered the store's offerings to be too expensive. Prices were promptly lowered; today, the average Chinese customer spends ¥300—about \$36—per visit.²¹

One recent study of European industrial exporters found that companies utilizing independent distributors were the most likely to utilize polycentric pricing. Such an approach is sensitive to local market conditions; however, valuable

¹⁸ Lisa Bannon, "Mattel Plans to Double Sales Abroad," *The Wall Street Journal* (February 11, 1998), pp. A3, A11.

¹⁹ Alex Taylor III, "Speed! Power! Status!" *Fortune* (June 10, 1996), pp. 46–58.

²⁰ Raymond Serafin, "Mercedes-Benz of the '90s Includes Price in Its Pitch," *Advertising Age* (November 1, 1993), p. 1.

²¹ Eric Sylvers, "IKEA Index Indicates the Euro Is Not a Price Equalizer Yet," *The New York Times* (October 23, 2003), p. W1. See also Paula M. Miller, "IKEA with Chinese Characteristics," *China Business Review* (July–August 2004), pp. 36–38.

"The practice of selling U.S. products abroad at prices keyed to the local market is longstanding. It's not unusual, it doesn't violate public policy, and it's certainly not illegal."²²

Allen Adler, American Association of Publishers

knowledge and experience within the corporate system concerning effective pricing strategies are not brought to bear on each local pricing decision. Because the distributors or local managers are free to set prices as they see fit, they may ignore the opportunity to draw upon company experience. Arbitrage is also a potential problem with the polycentric approach; when disparities in prices between different country markets exceed the transportation and duty costs separating the markets, enterprising individuals can purchase goods in the lower-price country market and then transport them for sale in markets where higher prices prevail.

This is precisely what has happened in both the pharmaceutical and textbook publishing industries. Discounted drugs intended for AIDS patients in Africa have been smuggled into the EU and sold at a huge profit. Similarly, Pearson Education (which publishes this text), McGraw-Hill, Thomson, and other publishers typically set lower prices in Europe and Asia than in the United States. The reason is that the publishers use polycentric pricing: They establish prices on a regional or country-by-country basis using per capita income and economic conditions as a guide.

Geocentric

The third approach, geocentric pricing, is more dynamic and proactive than the other two. A company using **geocentric pricing** neither fixes a single price worldwide nor allows subsidiaries or local distributors to make independent pricing decisions. Instead, the geocentric approach represents an intermediate course of action. Geocentric pricing is based on the realization that unique local market factors should be recognized in arriving at pricing decisions. These factors include local costs, income levels, competition, and the local marketing strategy. Price must also be integrated with other elements of the marketing program. The geocentric approach recognizes that price coordination from headquarters is necessary in dealing with international accounts and . The geocentric approach also consciously and systematically seeks to ensure that accumulated national pricing experience is leveraged and applied wherever relevant.

Local costs plus a return on invested capital and personnel fix the price floor for the long term. In the short term, however, headquarters might decide to set a market penetration objective and price at less than the cost-plus return figure by using export sourcing to establish a market. This was the case described earlier with the Sony Walkman launch. Another short-term objective might be to arrive at an estimate of the market potential at a price that would be profitable given local sourcing and a certain scale of output. Instead of immediately investing in local manufacture, a decision might be made to supply the target market initially from existing higher-cost external supply sources. If the market accepts the price and product, the company can then build a local manufacturing facility to further develop the identified market opportunity in a profitable way. If the market opportunity does not materialize, the company can experiment with the product at other prices because it is not committed to a fixed sales volume by existing local manufacturing facilities.

For consumer products, local income levels are critical in the pricing decision. If the product is normally priced well above full manufacturing costs, the global marketer should consider accepting reduced margins and price below prevailing levels in low-income markets. *The important point here is that in global marketing there is no such thing as a "normal" margin.* Of the three methods described, the geocentric approach is best suited to global competitive strategy. A global competitor will take into account global markets and global competitors in establishing prices. Prices will support global strategy objectives rather than the objective of maximizing performance in a single country. Table 11-7 lists some comments by European exporters that provide insights into the real-world process of setting prices.

²² Tamar Lewin, "Students Find \$100 Textbooks Cost \$50, Purchased Overseas," *The New York Times* (October 21, 2003), p. A16.

Statement by Management	Implication/Interpretation
<p>"We have the competitors' price list on our desk. I may speak frankly—who does not? We know exactly what our competitors charge for certain products, and we calculate accordingly."</p> <p>"An interesting way of evaluating whether a product will fit requirements of the market has emerged. You give some machines to an auction house and set a very low price limit. Your products are then auctioned off. That way, you get a feel for the right price level as well as the potential demand for the product. It is a very easy and cost-effective method."</p> <p>"At trade shows, we go directly to our customers and try to find out what prices we can charge. We scan our price limits sensitively. This is how we get to a price list in the end."</p> <p>"We differentiate simply because there are some countries where we can get a better price. Then there are countries where we can't."</p> <p>"I decided not to listen to people who advise me to differentiate prices. Wherever we are active, we want to have the image and the reputation of calculating our prices correctly and honestly."</p>	<p>When calculating prices for foreign markets, managers benchmark competitors' prices.</p> <p>As a practical matter, some companies use innovative, trial-and-error approaches to determine price elasticity.</p> <p>Some companies take a methodical approach to determining price elasticity.</p> <p>Rationale for differentiating prices using either polycentric or geocentric approach.</p> <p>Rationale for using standardized pricing.</p>

Source: Adapted from Barbara Stöttinger, "Strategic Export Pricing: A Long and Winding Road," *Journal of International Marketing* 9, no. 1 (2001), pp. 40–63.

Table 11-7

How Managers Calculate Export Prices for Industrial Products

GRAY MARKET GOODS

Gray market goods are trademarked products that are exported from one country to another where they are sold by unauthorized persons or organizations. Consider the following illustration:

Suppose that a golf equipment manufacturer sells a golf club to its domestic distributors for \$200; it sells the same club to its Thailand distributor for \$100. The lower price may be due to differences in overseas demand or ability to pay. Or, the price difference may reflect the need to compensate the foreign distributor for advertising and marketing the club. The golf club, however, never makes it to Thailand. Instead, the Thailand distributor resells the club to a gray marketer in the United States for \$150. The gray marketer can then undercut the prices charged by domestic distributors who paid \$200 for the club. The manufacturer is forced to lower the domestic price or risk losing sales to gray marketers, driving down the manufacturer's profit margins. Additionally, gray marketers make liberal use of manufacturer's trademarks and often fail to provide warranties and other services that consumers expect from the manufacturer and its authorized distributors.²³

This practice, known as **parallel importing**, occurs when companies employ a polycentric, multinational pricing policy that calls for setting different prices in different country markets. Gray markets can flourish when a product is in short supply, when producers employ skimming strategies in certain markets, or when the goods are subject to substantial markups. For example, in the European pharmaceuticals market, prices vary widely. In the United Kingdom and the Netherlands, for example, parallel imports account for as much as 10 percent of the sales of some pharmaceutical brands. The Internet is emerging as a powerful new tool that allows would-be gray marketers to access pricing information and reach customers.²⁴

²³ Adapted from Perry J. Viscounty, Jeff C. Risher, and Collin G. Smyser, "Cyber Gray Market Is Manufacturers' Headache," *National Law Journal* (August 20, 2001), p. C3.

²⁴ Perry J. Viscounty, Jeff C. Risher, and Collin G. Smyser, "Cyber Gray Market Is Manufacturers' Headache," *National Law Journal* (August 20, 2001), p. C3.

Gray markets impose several costs or consequences on global marketers. These include:²⁵

- *Dilution of exclusivity.* Authorized dealers are no longer the sole distributors. The product is often available from multiple sources, and margins are threatened.
- *Free riding.* If the manufacturer ignores complaints from authorized channel members, those members may engage in *free riding*. That is, they may opt to take various actions to offset downward pressure on margins. These options include cutting back on presale service, customer education, and salesperson training.
- *Damage to channel relationships.* Competition from gray market products can lead to channel conflict as authorized distributors attempt to cut costs, complain to manufacturers, and file lawsuits against the gray marketers.
- *Undermining segmented pricing schemes.* As noted earlier, gray markets can emerge because of price differentials that result from multinational pricing policies. However, a variety of forces—including falling trade barriers, the information explosion on the Internet, and modern distribution capabilities—hamper a company’s ability to pursue local pricing strategies.
- *Reputation and legal liability.* Even though gray market goods carry the same trademarks as goods sold through authorized channels, they may differ in quality, ingredients, or some other way. Gray market products can compromise a manufacturer’s reputation and dilute brand equity, as when prescription drugs are sold past their expiration dates or electronics equipment is sold in markets where they are not approved for use or where manufacturers do not honor warranties.

Sometimes, gray marketers bring a product produced in a single country—French champagne, for example—into export markets in competition with authorized importers. The gray marketers sell at prices that undercut those set by the legitimate importers. In another type of gray marketing, a company manufactures a product in the home-country market as well as in foreign markets. In this case, products manufactured abroad by the company’s foreign affiliate for sales abroad are sometimes sold by a foreign distributor to gray marketers. The latter then bring the products into the producing company’s home-country market, where they compete with domestically produced goods.

As these examples show, the marketing opportunity that presents itself requires gray market goods to be priced lower than goods sold by authorized distributors or domestically produced goods. Clearly, buyers gain from lower prices and increased choice. In the United Kingdom alone, for example, total annual retail sales of gray market goods are estimated to be as high as \$1.6 billion. A recent case in Europe resulted in a ruling that strengthened the rights of brand owners. Silhouette, an Austrian manufacturer of upscale sunglasses, sued the Hartlauer discount chain after the retailer obtained thousands of pairs of sunglasses that Silhouette had intended for sale in Eastern Europe. The European Court of Justice found in favor of Silhouette. In clarifying a 1989 directive, the court ruled that stores cannot import branded goods from outside the EU and then sell them at discounted prices without permission of the brand owner. The *Financial Times* denounced the ruling as “bad for consumers, bad for competition, and bad for European economies.”²⁶

In the United States, gray market goods are subject to the Tariff Act of 1930. Section 526 of the act expressly forbids importation of goods of foreign

“The gray market is the biggest threat we have. You can’t develop this market properly and make investments in retailing, merchandising, after-sales service and distribution without a legal market.”²⁷

Pankaj Mohindroo, President, Indian Cellular Association

²⁵ Kersi D. Antia, Mark Bergen, and Shantanu Dutta, “Competing with Gray Markets,” *MIT Sloan Management Review* 46, no. 1 (Summer 2004), pp. 65–67.

²⁶ Peggy Hollinger and Neil Buckley, “Grey Market Ruling Delights Brand Owners,” *Financial Times* (July 17, 1998), p. 8.

²⁷ Ray Marcelo, “Officials See Red Over Handset Sales,” *Financial Times* (October 3, 2003), p. 16.

challenges of the global marketplace

In the United States, drug makers set prices for that country that are the highest in the world. There is a reason for the high prices: The companies need to recover the high R&D costs associated with bringing a new drug to market. Elsewhere, governments set price ceilings that do not take R&D into account. For example, prices for Allegra, Lipitor, Viagra, Zocor, and other popular prescription drugs are as much as 85 percent lower in Canada than in the United States. High prices are one reason why, overall, the U.S. drug market rings up \$200 billion

in sales each year. High prices have also resulted in a thriving cross-border trade with Canada worth about \$800 million per year. Many persons living near the Canadian border cross over by car or bus to shop. Americans who live farther from the border have several options: They can order drugs from Canadian pharmacies over the Internet or visit storefront operations such as RxDepot that fax prescriptions to Canada. Whichever option they choose, Americans who buy drugs in other countries are breaking the law.

manufacture without the permission of the trademark owner. However, because courts have considerable leeway in interpreting the act, one legal expert has argued that the U.S. Congress should repeal Section 526. In its place, a new law should require gray market goods to bear labels clearly explaining any differences between them and goods that come through authorized channels. Other experts believe that, instead of changing the laws, companies should develop proactive strategic responses to gray markets. One such strategy would be improved market segmentation and product differentiation to make gray market products less attractive; another would be to aggressively identify and terminate distributors that are involved in selling to gray marketers.

DUMPING

Dumping is an important global pricing strategy issue. GATT's 1979 antidumping code defined **dumping** as the sale of an imported product at a price lower than that normally charged in a domestic market or country of origin. In addition, many countries have their own policies and procedures for protecting national companies from dumping. For example, China has retaliated against years of Western antidumping rules by introducing rules of its own. China's State Council passed the Antidumping and Antisubsidy Regulations in March 1997. The Ministry of Foreign Trade and Economic Cooperation and the State Economic and Trade Commission have responsibility for antidumping matters.²⁸

The U.S. Congress has defined *dumping* as an unfair trade practice that results in "injury, destruction, or prevention of the establishment of American industry." Under this definition, dumping occurs when imports sold in the U.S. market are priced either at levels that represent less than the cost of production plus an 8 percent profit margin or at levels below those prevailing in the producing country. The U.S. Commerce Department is responsible for determining whether products are being dumped in the United States; the International Trade Commission (ITC) then determines whether the dumping has resulted in injury to U.S. firms. Many of the dumping cases in the United States involve manufactured goods from Asia and frequently target a single or very narrowly defined group of products. U.S. companies that claim to be materially damaged by the low-priced imports often initiate such cases. In 2000, the U.S. Congress passed the so-called **Byrd Amendment**; this law calls for antidumping revenues to be paid to U.S. companies harmed by imported goods sold at below-market prices.²⁹

²⁸ Lester Ross and Susan Ning, "Modern Protectionism: China's Own Antidumping Regulations," *China Business Review* (May–June 2000), pp. 30–33.

²⁹ Philip Brasher, "Clarinda Plant Takes Hit in Dispute over Imports," *Des Moines Register* (November 16, 2005), p. D1.

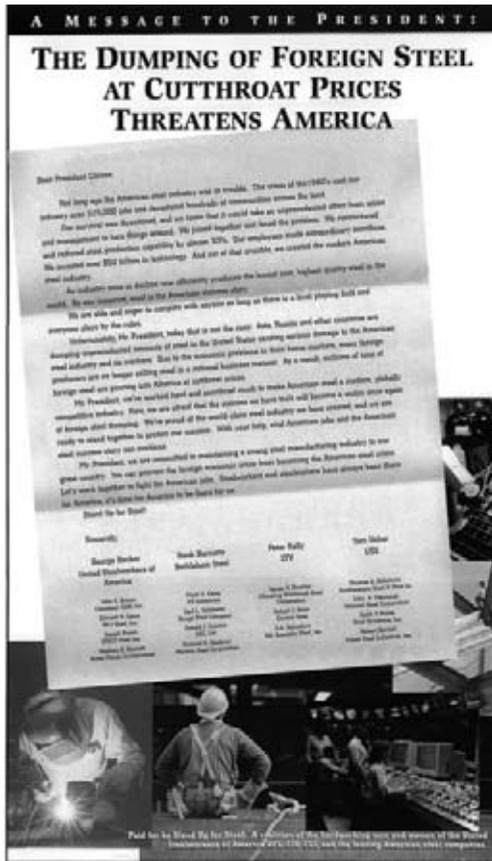
In Europe, the European Commission administers antidumping policy; a simple majority vote by the Council of Ministers is required before duties can be imposed on dumped goods. Six-month provisional duties can be imposed; more stringent measures include definitive, five-year duties. Low-cost imports from Asia have been the subject of dumping disputes in Europe. Another issue concerns \$650 million in annual imports of unbleached cotton from China, Egypt, India, Indonesia, Pakistan, and Turkey. A dispute pitted an alliance of textile importers and wholesalers against Eurocotton, which represents textile weavers in France, Italy, and other EU countries. Eurocotton supports the duties as a means of protecting jobs from low-priced imports; the job issue is particularly sensitive in France. British textile importer Broome & Wellington maintains, however, that imposing duties would drive up prices and cost even more jobs in the textile finishing and garment industries.³⁰ In January 2005, the global system of textile quotas was abolished. Almost overnight, Chinese textile exports to the United States and Europe increased dramatically. Within a few months, the U.S. government had re-imposed quotas on several categories of textiles imports; in the EU, trade minister Peter Mandelson also imposed quotas for a period of two years.

Dumping was a major issue in the Uruguay round of GATT negotiations. Many countries took issue with the U.S. system of antidumping laws, in part because historically the U.S. Commerce Department almost always ruled in favor of the U.S. company that filed the complaint. For their part, U.S. negotiators were concerned that U.S. exporters were often targeted in antidumping investigations in countries with few formal rules for due process. The U.S. side sought to improve the ability of U.S. companies to defend their interests and understand the bases for rulings.

The result of the GATT negotiations was an agreement on interpretation of GATT Article VI. From the U.S. point of view, one of the most significant changes between the agreement and the 1979 code is the addition of a “standard of review” that will make it harder for GATT panels to dispute U.S. antidumping determinations. There are also a number of procedural and methodological changes. In some instances, these have the effect of bringing GATT regulations more in line with U.S. law. For example, in calculating “fair price” for a given product, any sales of the product at below-cost prices in the exporting country are not included in the calculations; inclusion of such sales would have the effect of exerting downward pressure on the fair price. The agreement also brought GATT standards in line with U.S. standards by prohibiting governments from penalizing differences between home market and export market prices of less than 2 percent.

For positive proof that dumping has occurred in the United States, both price discrimination and injury must be demonstrated. *Price discrimination* is the practice of setting different prices when selling the same quantity of “like-quality” goods to different buyers. The existence of either one without the other is an insufficient condition to constitute dumping. Companies concerned with running afoul of antidumping legislation have developed a number of approaches for avoiding the dumping laws. One approach is to differentiate the product sold from that in the home market so it does not represent “like quality.” An example of this is an auto accessory that one company packaged with a wrench and an instruction book, thereby changing the “accessory” to a “tool.” The duty rate in the export market happened to be lower on tools, and the company also acquired immunity from antidumping laws because the package was not comparable to competing goods in the target market. Another approach is to make nonprice competitive adjustments in arrangements with affiliates and distributors. For example, credit can be extended and essentially have the same effect as a price reduction.

³⁰ Neil Buckley, “Commission Faces Fight on Cotton ‘Dumping,’” *Financial Times* (December 2, 1997), p. 5; Emma Tucker, “French Fury at Threat to Cotton Duties,” *Financial Times* (May 19, 1997), p. 3.



'Stand Up for Steel' Ad, sponsored by a coalition of the United Steelworkers of America and the major domestic steel companies: The Dumping of Foreign Steel At Cutthroat Prices Threatens America

Representatives of the U.S. steel industry sponsored this 1998 ad to urge President Clinton to get tough on unfairly-traded, government subsidized steel that was sold in the United States by producers in Western Europe, Asia, and Russia. In 2001, the International Trade Commission launched an investigation under the 'Section 201' provision of the U.S. Foreign Trade Act to determine whether steel imports were hurting American steel producers.

Based on the ITC's recommendation, in March 2002 President George W. Bush imposed sweeping tariffs of up to 30 percent on a wide range of steel imports for a three-year period. The European Union responded by drawing up a list of U.S. product imports that would be taxed in retaliation for the president's action. In 2003, President Bush dropped the tariffs.

PRICE FIXING

In most instances, it is illegal for representatives of two or more companies to secretly set similar prices for their products. This practice, known as **price fixing**, is generally held to be an anticompetitive act. Companies that collude in this manner are generally trying to ensure higher prices for their products than would generally be available if markets were functioning freely. In *horizontal price fixing*, competitors within an industry that make and market the same product conspire to keep prices high. For example, in the 1990s, Archer Daniels Midland (ADM) and several other companies were found guilty of colluding to prop up world prices for an enzyme used in animal feed. The term *horizontal* applies in this instance because ADM and its co-conspirators are all at the same supply-chain "level" (i.e., they are manufacturers). *Vertical price fixing* occurs when a manufacturer conspires with wholesalers or retailers (i.e., channel members at different "levels" from the manufacturer) to ensure certain retail prices are maintained. For example, the European Commission recently fined Nintendo nearly \$150 million after it was determined that the video game company had colluded with European distributors to fix prices. During the 1990s, prices of Nintendo video game consoles varied widely across Europe. They were much more expensive in Spain than in Britain and other countries; however, distributors in countries with lower retail prices agreed not to sell to retailers in countries with high prices.³¹ Another recent case of price fixing pits DeBeers SA, the South African diamond company, against the United States. The price fixing case involves industrial diamonds rather than gemstones; however, DeBeers is a well-known name in the United States thanks to a long-running advertising campaign

³¹ Paul Meller, "Europe Fines Nintendo \$147 Million for Price Fixing," *The Wall Street Journal* (February 24, 2004), p. W1.

keyed to the tagline “A Diamond Is Forever.” Because the company itself has no American retail presence, DeBeers diamonds are marketed in the United States by intermediaries. DeBeers executives have indicated a willingness to plead guilty and pay a fine in exchange for access to the United States. As a spokesperson said, “The U.S. is the biggest market for diamond jewelry—accounting for 50 percent of global retail jewelry sales—and we would really, really like to resolve these issues.”³²

TRANSFER PRICING

Transfer pricing refers to the pricing of goods, services, and intangible property bought and sold by operating units or divisions of the same company. In other words, transfer pricing concerns *intracorporate exchanges*, which are transactions between buyers and sellers that have the same corporate parent. For example, Toyota subsidiaries both sell to, and buy from, each other. Transfer pricing is an important topic in global marketing because goods crossing national borders represent a sale; therefore, their pricing is a matter of interest both to the tax authorities, who want to collect a fair share of income taxes, and to the customs service, which wants to collect an appropriate duty on the goods. Joseph Quinlan, chief marketing strategist at Bank of America, estimates that U.S. companies have 23,000 overseas affiliates; about 25 percent of U.S. exports represent shipments by American companies to affiliates and subsidiaries outside the United States.

In determining transfer prices to subsidiaries, global companies must address a number of issues, including taxes, duties and tariffs, country profit transfer rules, conflicting objectives of joint venture partners, and government regulations. Tax authorities, such as the Internal Revenue Service (IRS) in the United States, Inland Revenue in the United Kingdom, and Japan’s National Tax Administration Agency, take a keen interest in transfer-pricing policies. Transfer pricing is proving to be a corporate key issue in Europe as the euro makes it easier for tax authorities to audit transfer-pricing policies.

Three major alternative approaches can be applied to transfer pricing decisions. The approach used will vary with the nature of the firm, products, markets, and historical circumstances of each case. A *market-based transfer price* is derived from the price required to be competitive in the global marketplace. In other words, it represents an approximation of an arm’s-length transaction. *Cost-based transfer pricing* uses an internal cost as the starting point in determining price. Cost-based transfer pricing can take the same forms as the cost-based pricing methods discussed earlier in the chapter. The way costs are defined may have an impact on tariffs and duties of sales to affiliates and subsidiaries by global companies. A third alternative is to allow the organization’s affiliates to determine *negotiated transfer prices* among themselves. This method may be employed when market prices are subject to frequent changes. Table 11-8 summarizes the results of recent studies comparing transfer-pricing methods by country. As shown in the table, market-based and cost-based transfer pricing are the two preferred methods in the United States, Canada, Japan, and the United Kingdom.

Tax Regulations and Transfer Prices

Because global companies conduct business in a world characterized by different corporate tax rates, there is an incentive to maximize system income in countries with the lowest tax rates and to minimize income in high-tax countries. Governmental regulatory agencies are well aware of this situation. In recent years, many governments have tried to maximize national tax revenues by examining

³² John R. Wilke, “DeBeers Is in Talks to Settle Price-Fixing Charge,” *The Wall Street Journal* (February 24, 2004), pp. A1, A14.

Methods	United States (%)	Canada (%)	Japan (%)	United Kingdom (%)
1. Market-based	35	37	37	31
2. Cost-based	43	33	41	38
3. Negotiated	14	26	22	20
4. Other	8	4	0	11
	100%	100%	100%	100%

Source: Adapted from Charles T. Horngren, Srikant M. Datar, and George Foster, *Cost Accounting: A Managerial Emphasis* (Upper Saddle River, NJ: Prentice Hall, 2003), p. 767.

Table 11-8

Transfer Pricing Methods Used in Selected Countries

company returns and mandating reallocation of income and expenses. Some companies recently involved in transfer-pricing cases include:

- Motorola may owe the IRS as much as \$500 million in taxes from earnings from global operations that were booked incorrectly.
- The U.S. Labor Department filed a complaint against Swatch Group alleging that the Swiss watchmaker improperly used transfer pricing to evade millions of dollars in customs duties and taxes.³³
- The U.S. government spent years attempting to recover \$2.7 billion plus interest from pharmaceutical giant GlaxoSmithKline (GSK). The IRS charged that GSK did not pay enough tax on profits from Zantac, its hugely successful ulcer medication. Between 1989 and 1999, U.S. revenues from Zantac totaled \$16 billion; the IRS charged that GSK's American unit overpaid royalties to the British parent company, thus, reducing taxable U.S. income. The case was scheduled for trial in 2007; however, in September 2006, GSK settled the case by agreeing to pay the IRS approximately \$3.1 billion.³⁴

Sales of Tangible and Intangible Property

Each country has its own set of laws and regulations for dealing with controlled intracompany transfers. Whatever the pricing rationale, executives and managers involved in global pricing policy decisions must familiarize themselves with the laws and regulations in the applicable countries. The pricing rationale must conform with the intention of these laws and regulations. Although the applicable laws and regulations often seem perplexingly inscrutable, ample evidence exists that most governments simply seek to prevent tax avoidance and to ensure fair distribution of income from the operations of companies doing business internationally.

Even companies that make a conscientious effort to comply with the applicable laws and regulations and that document this effort may find themselves in tax court. Should a tax auditor raise questions, executives should be able to make a strong case for their decisions. Fortunately, consulting services are available to help managers deal with the arcane world of transfer pricing. It is not unusual for large global companies to invest hundreds of thousands of dollars and hire international accounting firms to review transfer-pricing policies.

COUNTERTRADE

In recent years, many exporters have been forced to finance international transactions by taking full or partial payment in some form other than money.³⁵ A number of alternative finance methods, known as *countertrade*, are widely used.

³³ Leslie Lopez and John D. McKinnon, "Swatch Faces Complaint over Taxes," *The Wall Street Journal* (August 13, 2004), p. B2.

³⁴ Susannah Rodgers, "GlaxoSmithKline Gets Big Tax Bill," *The Wall Street Journal* (January 8, 2004), p. A8.

³⁵ Many of the examples in the following section are adapted from Matt Schaffer, *Winning the Countertrade War: New Export Strategies for America* (New York: John Wiley & Sons, 1989).

In a **countertrade** transaction, a sale results in product flowing in one direction to a buyer; a separate stream of products and services, often flowing in the opposite direction, is also created. Countertrade generally involves a seller from the West and a buyer in a developing country; for example, the countries in the former Soviet bloc have historically relied heavily on countertrade. This approach, which reached a peak in popularity in the mid-1980s, is now used in some 100 countries. Within the former Soviet Union, countertrade has flourished in the 1990s, following the collapse of the central planning system.

As one expert notes, countertrade flourishes when hard currency is scarce. Exchange controls may prevent a company from expatriating earnings; the company may be forced to spend money in-country for products that are then exported and sold in third-country markets. Historically, the single most important driving force behind the proliferation of countertrade was the decreasing ability of developing countries to finance imports through bank loans. This trend resulted in debt-ridden governments pushing for self-financed deals.³⁶ According to Pompiliu Verzariu, former director of the Financial Services and Countertrade Division of the International Trade Administration:

In the 1990s, countertrade pressures abated in many parts of the world, notably Latin America, as a result of debt reduction induced by the Brady plan initiative, lower international interest rates, policies that liberalized trade regimes, and the emergence of economic blocs such as NAFTA and Mercosur, which integrate regional trade based on free-market principles.³⁷

Today, several conditions affect the probability that importing nations will demand countertrade. First is the priority attached to the Western import. The higher the priority, the less likely it is that countertrade will be required. The second condition is the value of the transaction; the higher the value, the greater the likelihood that countertrade will be involved. Third, the availability of products from other suppliers can also be a factor. If a company is the sole supplier of a differentiated product, it can demand monetary payment. However, if competitors are willing to deal on a countertrade basis, a company may have little choice but to agree or risk losing the sale altogether. Overall, the advantages to nonmarket and developing economies are access to Western marketing expertise and technology in the short term, and creation of hard currency export markets in the long term. The U.S. government officially opposes government-mandated countertrade, which represents the type of bilateral trade agreement that violates the free trading system established by GATT.

Two categories of countertrade are discussed here. Barter falls into one category; the mixed forms of countertrade, including counterpurchase, offset, compensation trading, and switch trading belong in a separate category. They incorporate a real distinction from barter because the transaction involves money or credit.

Barter

The term **barter** describes the least complex and oldest form of bilateral, nonmonetized countertrade. Simple barter is a direct exchange of goods or services between two parties. Although no money is involved, both partners construct an approximate shadow price for products flowing in each direction. One contract formalizes simple barter transactions, which are generally for less than one year to avoid problems in price fluctuations. However, for some transactions, the exchange may span months or years, with contract provisions allowing adjustments in the exchange ratio to handle fluctuations in world prices.

³⁶ Pompiliu Verzariu, "Trends and Developments in International Countertrade," *Business America* (November 2, 1992), p. 2.

³⁷ Janet Aschkenasy, "Give and Take," *International Business* (September 1996), p. 11.

Companies sometimes seek outside help from barter specialists. For example, New York-based Atwood Richards engages in barter in all parts of the world. Generally, however, distribution is direct between trading partners, with no intermediary included. For example, during the Soviet era, General Electric sold a turbine generator to Romania. For payment, GE Trading Company accepted \$150 million in chemicals, metals, nails, and other products that it then sold on the world market. One of the highest-profile companies involved in barter deals is PepsiCo, which has done business in the Soviet and post-Soviet market for decades. In the Soviet era, PepsiCo bartered soft-drink syrup concentrate for Stolichnaya vodka, which was, in turn, exported to the United States by the PepsiCo Wines & Spirits subsidiary and marketed by M. Henri Wines. In the post-Soviet market economy in the Commonwealth of Independent States, barter is not necessarily required. Today, Stolichnaya is imported into the United States and marketed by Carillon Importers, a unit of Diageo PLC.

Counterpurchase

This form of countertrade, also termed *parallel trading* or *parallel barter*, is distinguished from other forms in that each delivery in an exchange is paid for in cash. For example, Rockwell International sold a printing press to Zimbabwe for \$8 million. The deal went through, however, only after Rockwell agreed to purchase \$8 million in ferrochrome and nickel from Zimbabwe, which it subsequently sold on the world market.

The Rockwell-Zimbabwe deal illustrates several aspects of counterpurchase. Generally, products offered by the foreign principal are not related to the Western firm's exports and cannot be used directly by the firm. In most counterpurchase transactions, two separate contracts are signed. In one, the supplier agrees to sell products for a cash settlement (the original sales contract); in the other, the supplier agrees to purchase and market unrelated products from the buyer (a separate, parallel contract). The dollar value of the counterpurchase generally represents a set percentage—and sometimes the full value—of the products sold to the foreign principal. When the Western supplier sells these goods, the trading cycle is complete.

Offset

Offset is a reciprocal arrangement whereby the government in the importing country seeks to recover large sums of hard currency spent on expensive purchases such as military aircraft or telecommunications systems. In effect, the government is saying, "If you want us to spend government money on your exports, you must import products from our country." Offset arrangements may also involve cooperation in manufacturing, some form of technology transfer, placing subcontracts locally, or arranging local assembly or manufacturing equal to a certain percentage of the contract value.³⁸ In one deal involving offsets, Lockheed Martin Corp. sold F-16 fighters to the United Arab Emirates for \$6.4 billion. In return, Lockheed agreed to invest \$160 million in the petroleum-related UAE Offsets Group.³⁹

Offset may be distinguished from counterpurchase because the latter is characterized by smaller deals over shorter periods of time.⁴⁰ Another major distinction between offset and other forms of countertrade is that the agreement is not contractual but reflects a memorandum of understanding that sets out the dollar value of products to be offset and the time period for completing the transaction. In

³⁸ The commitment to local assembly or manufacturing under the supplier's specifications is commonly termed a *coproduction agreement*, which is tied to the offset but does not, in itself, represent a type of countertrade.

³⁹ Daniel Pearl, "Arms Dealers Get Creative with 'Offsets,'" *The Wall Street Journal* (April 20, 2000), p. A18.

⁴⁰ Patricia Daily and S. M. Ghazanfar, "Countertrade: Help or Hindrance to Less-Developed Countries?" *Journal of Social, Political, and Economic Studies* 18, no. 1 (Spring 1993), p. 65.

addition, there is no penalty on the supplier for nonperformance. Typically, requests range from 20 percent to 50 percent of the value of the supplier's product. Some highly competitive sales have required offsets exceeding 100 percent of the valuation of the original sale.

Offsets have become a controversial facet of today's trade environment. To win sales in important markets such as China, global companies can face demands for offsets even when transactions do not involve military procurement. For example, the Chinese government requires Boeing to spend 20 percent to 30 percent of the price of each aircraft on purchases of Chinese goods. As Boeing executive Dean Thornton explained:

"Offset" is a bad word, and it's against GATT and a whole bunch of other stuff, but it's a fact of life. It used to be twenty years ago in places like Canada or the UK, it was totally explicit, down to the decimal point. "You will buy 20 percent offset of your value." Or 21 percent or whatever. It still is that way in military stuff. [With sales of commercial aircraft], it's not legal so it becomes less explicit.⁴¹

Compensation Trading

Compensation trading, also called *buyback*, is a form of countertrade that involves two separate and parallel contracts. In one contract, the supplier agrees to build a plant or provide plant equipment, patents or licenses, or technical, managerial, or distribution expertise for a hard currency down payment at the time of delivery. In the other contract, the supplier company agrees to take payment in the form of the plant's output equal to its investment (minus interest) for a period of as many as 20 years.

Essentially, the success of compensation trading rests on the willingness of each firm to be both a buyer and a seller. The People's Republic of China has used compensation trading extensively. Egypt also used this approach to develop an aluminum plant. A Swiss company, Aluswiss, built the plant and also exports alumina (an oxide of aluminum found in bauxite and clay) to Egypt. Aluswiss takes back a percentage of the finished aluminum produced at the plant as partial payment for building the plant. As this example shows, compensation differs from counterpurchase in that the technology or capital supplied is related to the output produced.⁴² In counterpurchase, as noted before, the goods taken by the supplier typically cannot be used directly in its business activities.

Switch Trading

Also called *triangular trade* and *swap*, **switch trading** is a mechanism that can be applied to barter or countertrade. In this arrangement, a third party steps into a simple barter or other countertrade arrangement when one of the parties is not willing to accept all the goods received in a transaction. The third party may be a professional switch trader, switch trading house, or a bank. The switching mechanism provides a "secondary market" for countertraded or bartered goods and reduces the inflexibility inherent in barter and countertrade. Fees charged by switch traders range from 5 percent of market value for commodities to 30 percent for high-technology items. Switch traders develop their own networks of firms and personal contacts and are generally headquartered in Vienna, Amsterdam, Hamburg, or London. If a party to the original transaction anticipates that the products received in a barter or countertrade deal will be sold eventually at a discount by the switch trader, the common practice is to price the original products higher, build in "special charges" for port storage or consulting, or require shipment by the national carrier.

⁴¹ William Greider, *One World, Ready or Not: The Manic Logic of Global Capitalism* (Upper Saddle River, NJ: Simon & Schuster, 1997), p. 130.

⁴² Patricia Daily and S. M. Ghazanfar, "Countertrade: Help or Hindrance to Less-Developed Countries?" *Journal of Social, Political, and Economic Studies* 18, no. 1 (Spring 1993), p. 66.

Pricing decisions are a critical element of the marketing mix that must reflect costs, competitive factors, and customer perceptions regarding value of the product. In a true global market, the **law of one price** would prevail. Pricing strategies include **market skimming**, **market penetration**, and **market holding**. Novice exporters frequently use **cost-plus pricing**. International terms of a sale such as **ex-works**, **DDP**, **FCA**, **FAS**, **FOB**, **CIF**, and **CFR** are known as **Incoterms** and specify which party to a transaction is responsible for covering various costs. These and other costs lead to **export price escalation**, the accumulation of costs that occurs when products are shipped from one country to another.

Expectations regarding currency fluctuations, inflation, government controls, and the competitive situation must also be factored into pricing decisions. The introduction of the euro has impacted price strategies in the EU because of improved **price transparency**. Global companies can maintain

competitive prices in world markets by shifting production sources as business conditions change. Overall, a company's pricing policies can be categorized as **ethnocentric**, **polycentric**, or **geocentric**.

Several additional pricing issues are related to global marketing. The issue of **gray market goods** arises because price variations between different countries lead to **parallel imports**. **Dumping** is another contentious issue that can result in strained relations between trading partners. **Price fixing** among companies is anticompetitive and illegal. **Transfer pricing** is an issue because of the sheer monetary volume of intracorporate sales and because country governments are anxious to generate as much tax revenue as possible. Various forms of **countertrade** play an important role in today's global environment. **Barter**, **counterpurchase**, **offset**, **compensation trading**, and **switch trading** are the main countertrade options.

1. What are the basic factors that affect price in any market? What considerations enter into the pricing decision?
2. Define the various types of pricing strategies and objectives available to global marketers.
3. Identify some of the environmental constraints on global pricing decisions.
4. Why do price differences in world markets often lead to gray marketing?
5. What is dumping? Why was dumping such an important issue during the Uruguay Round of GATT negotiations?
6. What is a transfer price? Why is it an important issue for companies with foreign affiliates? Why did transfer pricing in Europe take on increased importance in 1999?
7. What is the difference between ethnocentric, polycentric, and geocentric pricing strategies? Which one would you recommend to a company that has global market aspirations?
8. If you were responsible for marketing CAT scanners worldwide (average price, \$1,200,000), and your country of manufacture was experiencing a strong and appreciating currency against almost all other currencies, what options are available to you to maintain your competitive advantage in world markets?
9. Compare and contrast the different forms of countertrade.

Compare and contrast LVMH's pricing strategy (see Case 11-1) with that of Coach (Chapter 7).

Case 11-1

LVMH and Luxury Goods Marketing

Do you know anyone who spends \$1,700 on a suit plus \$600 for a matching handbag? When it comes to champagne and perfume, do your friends spend \$100 or more for a single bottle? Welcome to the rarefied world of luxury goods marketing. In this world, affluent consumers eagerly seek out luxury brands such as Armani, Christian Dior, Gucci, Louis Vuitton, Prada, and Versace. They are willing and able to pay high prices for top-quality merchandise from fashion houses whose names are synonymous with status, good taste, and prestige. In France, *haute couture* traditionally meant that one outfit was meticulously crafted for members of the aristocracy, "old money" socialites, or celebrities. Today, however, the concept and meaning of *haute couture* are being transformed.

Although the *couture* image of the supermodel strutting down the catwalk is still a mainstay of the fashion world, some of the world's best-known fashion houses are redefining the notion of luxury by catering to the needs of a more diverse, *nouveau riche* clientele. Whereas in years past, fashion houses produced only clothing, today numerous licensing deals are generating more cash than the clothing itself. Countless items bearing the names of venerable *couture* houses are now available worldwide. Thanks to the stock market boom of the 1990s and rising prosperity levels in developing nations, a new class of affluent consumers has begun to develop a taste for luxury branded products, ranging from Gucci sunglasses to Dior pantyhose. Apparel goods constitute less than 20 percent of total sales volume by Hermès. As Lord Thurso, chief executive of a luxury health spa in Great Britain, noted, "The trick is not to sell real luxury to very rich people. It's to sell a *perception* of luxury to aspiring people."

One fashion house that is changing with the times is LVMH Moët Hennessy-Louis Vuitton SA, the largest marketer of luxury products and brands in the world. Chairman Bernard Arnault presides over a diverse empire of products and brands, sales of which totaled \$16.5 billion (€15.3 billion) in 2006 (see Figure 1). Arnault, whom some refer to as "the pope of high fashion," recently summed up the luxury business as follows: "We are here to sell dreams. When you see a *couture* show on TV around the world, you dream. When you enter a Dior boutique and buy your lipstick, you buy something affordable, but it has the dream in it." Sales of luggage and leather fashion goods, including the 100-year-old Louis Vuitton brand, account for 30 percent of revenues. The company's specialty group includes Duty Free Shoppers (DFS) and Sephora. DFS operates stores in international airports around the world; Sephora, which LVMH acquired in 1997, is Europe's second-largest chain of perfume and cosmetics stores. Driven by such well-known brands as Christian Dior, Givenchy, and Kenzo, perfumes and body products generate nearly 20 percent of LVMH's revenues. LVMH's wine and spirits

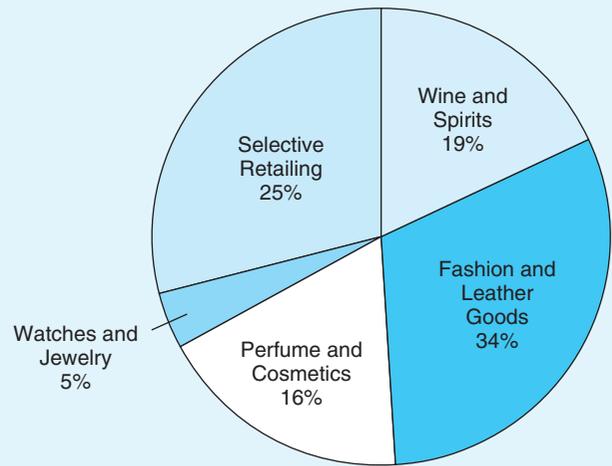


Figure 1

LVMH Operating Units by 2006 Net Sales

unit includes such prestigious such Champagne brands as Dom Perignon, Moët & Chandon, and Veuve Clicquot.

Despite the high expenses associated with operating elegant stores and purchasing advertising space in upscale magazines, the premium retail prices that luxury goods command translate into handsome profits. The Louis Vuitton brand alone accounts for about 60 percent of LVMH's operating profit. Unscrupulous operators have taken note of the high margins associated with Vuitton handbags, gun cases, and luggage displaying the distinctive beige-on-brown latticework LV monogram. Louis Vuitton SA spends \$10 million annually battling counterfeiters in Turkey, Thailand, China, Morocco, South Korea, and Italy. Some of the money is spent on lobbyists who represent the company's interests in meetings with foreign government officials. Yves Carcelle, chairman of Louis Vuitton SA, recently explained, "Almost every month, we get a government somewhere in the world to destroy canvas, or finished products."



Another problem is a flourishing gray market. Givenchy and Christian Dior's Dune fragrance are just two of the luxury perfume brands that are sometimes diverted from authorized channels for sale at mass-market retail outlets. LVMH and other luxury goods marketers recently found a new way to combat gray market imports into the United States. In March 1995, the U.S. Supreme Court let stand an appeals court ruling prohibiting a discount drugstore chain from selling Givenchy perfume without permission. Parfums Givenchy USA had claimed that its distinctive packaging should be protected under U.S. copyright law. The ruling means that Costco, Wal-Mart, and other discounters will no longer be able to sell some imported fragrances without authorization.

Asia—particularly Japan—represents important markets for companies such as LVMH. The financial turmoil that began in July 1997 and the subsequent currency devaluations and weakening of the yen have translated into lower demand for luxury goods. Because price perceptions are a critical component of luxury goods' appeal, LVMH executives are making a number of adjustments in response to changing business conditions. For example, Patrick Choel, president of the perfume and cosmetics division, has raised wholesale prices in individual Asian markets. The goal is to discourage discount retailers from stocking up with designer products and then selling them to down-market consumers. Also, expenditures on perfume and cosmetics advertising have been reduced to maintain profitability in the face of a possible sales decline. Louis Vuitton chairman Yves Carcelle is also making adjustments. He canceled plans for a new store in Indonesia; group managers have raised prices to counteract the effect of currency devaluations. Because the DFS chain depends on Japanese tourists in Asia and Hawaii for 75 percent of sales, Louis Vuitton managers also work with tour operators to predict the flow of Japanese tourists. When tourism is at a peak, price increases from 10 percent to 22 percent help maximize profits on merchandise sales.

Arnault was confident that the Asian crisis would not severely affect his company's performance in the long term. As Arnault explained in the spring of 1998, "One has to distinguish between Japan, where most of our business is, and the rest of Asia. Japan is in a growth slump, but it isn't going to have the same difficulties as Korea or Indonesia. And our business in Japan is doing very well." Because the Louis Vuitton unit controls its own distribution, management has even been able to take advantage of the crisis by renegotiating store leases in key Asian cities. In some instances, the company has secured longer lease terms plus reductions in rates by as much as one-third. Arnault's optimism was well founded; with interest rates at record lows and a gloomy outlook for the stock market, Japanese consumers had few other spending options. In 2001, executives actually raised prices at Louis Vuitton's 45 Japanese stores.

"One friend of mine has 10 Louis Vuitton bags. In Japan, it's a status symbol. It's very important to have European luxury goods."

A 39-year-old flight attendant based in Tokyo

The United States is also a key market for LVMH. One particular marketing program focused on increasing awareness of Hennessy cognac. Thanks to a revival of "cocktail culture" in the United States, sales of hard spirits are up. To promote awareness and consumption among a younger demographic, in the mid-1990s Hennessy marketing managers recruited twentysomethings to go to upscale bars in major metropolitan markets and order drinks such as the "Hennessy martini" and "Hennessy sidecar" made with cognac. Although traditionalists consider the notion of mixing cognac heresy, it was essential to broadening the brand's appeal. If a bartender didn't know how to create a particular drink, the Hennessy agent helpfully explained the recipe while attracting the attention of other patrons. Hennessy also picked up the tab when their "secret agents" would buy rounds of cognac-based drinks for everyone at the bar. The promotion was designed to increase awareness among young adults and to communicate that cognac can be enjoyed by people other than "old fogies." The effort paid off in some unexpected ways: Urban hip-hop culture has embraced cognac, and cognac exports to the United States tripled over the past decade. LVMH's Hennessy is the brand of choice for many rap stars; the brand name has even popped up in more than 100 songs.

Such marketing tactics are a world away from the old days, when the companies that today make up LVMH were family-run enterprises focused more on prestige than on profit. They sold mainly to a small, very rich clientele. Even as he broadens the company's consumer base, Arnault has taken a number of steps to raise the level of professionalism of LVMH's management team. In 1997, Arnault implemented a corporate restructuring that groups the company's subsidiaries into divisions. Previously, the heads of individual subsidiaries reported directly to Arnault; now, division heads meet with him to discuss strategy. Notes Arnault, "It's much more efficient, because it allows us to put into practice all the synergies between the different brands in a coordinated way."

Arnault's choice of American designer Marc Jacobs to create the first-ever Louis Vuitton ready-to-wear line shows that times are changing. The line is priced quite high, and to preserve its exclusivity, it is currently available only through Louis Vuitton boutiques. There will be no markdowns on unsold merchandise. Any stocks that remain at the end of the season will be destroyed. Jacobs's first collection included a plain white cotton poplin raincoat that prompted one observer to ask, "Is this luxury?" Ironically, the signature LV is hard to spot on many pieces in the collection, such as a white-on-white patent leather bag.

In the late 1990s, Arnault sensed that cosmetics-buying habits were changing in key markets. He opened Sephora stores in New York, Chicago, and San Francisco in conjunction with a new Web site, Sephora.com. Today, there are more than 70 Sephora stores in the United States; plans call for expanding into Japan and Latin America as well. Customers who visit Sephora USA stores

are encouraged to wander freely and sample products on an open floor without waiting for sales clerks to assist them. However, high start-up and promotion costs have reduced the financial contribution that Sephora makes to LVMH, and some analysts have asked when Sephora will be profitable.

Profitability is also an issue with another of Arnault's acquisitions, Donna Karan International Inc. In 2001, Arnault paid more than \$600 million for the company and its trademarks. Arnault had tried without success to acquire Giorgio Armani; Donna Karan is LVMH's first American designer label. As Arnault noted, "What appealed to us is the fact that it is one of the best-known brand names in the world." After the deal was completed, however, company executives were surprised to learn that some items from the DKNY line could be found in discount stores such as T.J.Maxx. Arnault appointed Giuseppe Brusone, a former managing director of Armani, as Donna Karan's chief executive and instructed him to reshape the company. Brusone intends to improve quality, close company-owned outlet stores, and reduce shipments to department stores to keep the clothes from being marked down. He also intends to shift manufacturing out of New York; the move will both cut costs and lend the line the added prestige associated with garments that are "made in Italy."

All of these actions are designed to keep LVMH—and Arnault himself—at the forefront of the luxury goods business and one step ahead of an ever-changing business environment. Arnault is widely admired for his business instincts and acumen. However, some in the industry view his bold moves as emblematic of all that is wrong with luxury in the new millennium. An executive at a competitor noted disapprovingly, "They run this thing like Procter & Gamble."

Discussion Questions

1. Bernard Arnault has built LVMH into a luxury goods empire by making numerous acquisitions. What strategy is evident here?
2. How do LVMH executives adjust prices in response to changing economic conditions?
3. Do you think the high retail prices charged for luxury goods are worth paying?

Sources: Lisa Bannon and Alessandra Galloni, "Brand Manager Deluxe," *The Wall Street Journal* (October 10, 2003), p. B1; John Carreyrou and Christopher Lawton, "Napoleon's Nightcap Gets a Good Rap from Hip-Hop Set," *The Wall Street Journal* (July 14, 2003), pp. A1, A7; Teri Agins and Deborah Ball, "Changing Outfits: Did LVMH Commit a Fashion Faux Pas Buying Donna Karan?" *The Wall Street Journal* (March 21, 2002), pp. A1, A8; Deborah Ball, "Despite Downturn, Japanese Are Still Having Fits for Luxury Goods," *The Wall Street Journal* (April 24, 2001), pp. B1, B4; Bonnie Tsui, "Eye of the Beholder: Sephora's Finances," *Advertising Age* (March 19, 2001), p. 20; Lucia van der Post, "Life's Brittle Luxuries," *Financial Times* (July 18–19, 1998), p. 1. Gail Edmondson, "LVMH: Life Isn't All Champagne and Caviar," *Business Week* (November 10, 1997), pp. 108+; Jennifer Steinhauer, "The King of Posh," *The New York Times* (August 17, 1997), sec. 3, pp. 1, 10–11; David Owen, "A Captain Used to Storms," *Financial Times* (June 21–22, 1997); Holly Brubach, "And Luxury for All," *The New York Times Magazine* (July 12, 1998), pp. 24–29+; Amy Barrett, "LVMH's Chairman Remains Calm Despite Turbulence," *The Wall Street Journal* (March 16, 1998), p. B4; Amy Barrett, "Gucci's Big Makeover Is Turning Heads," *The Wall Street Journal* (August 26, 1997), p. 12; Stewart Toy, "100 Years of Louis Vuitton," *Cigar Aficionado* (Autumn 1996), pp. 378–379+.

Appendix

Section 482 of the Internal Revenue Code

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of

any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

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