Global Marketing Management
Prof. Zillur Rahman
Department of Management Studies
Indian Institute of Technology- Roorkee

Lecture-25

Global Pricing Part II

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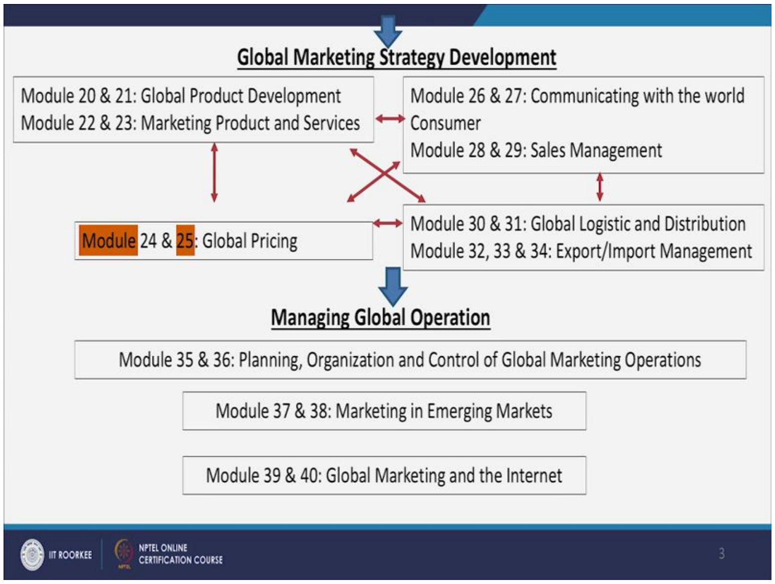

Welcome to this course on, Global Marketing Management, and we were talking about one another element of marketing mix, that is pricing.

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So in module 24 we started talking about pricing and we had talked about things like drivers of foreign market pricing, here in we have discussed the various factors that determine the the prices in foreign market then we have seen how to manage price escalations and how to do pricing in, in inflationary environment. In module 25 we will talk about Global pricing and Currency Movements. So because currency is the key point change, keep on moving against one another, so how does it affect movable pricing, then we will talk about Transfer pricing that is the pricing that is charged by from within the family, from the parent to the subsidiary of one subsidiary to another subsidiary.

And that sometimes this leads to charges of anti-dumping. So we will also see how the how does Global price affect anti dumping, and then as we have talked about earlier if the prices across countries are not coordinated then this will lead to to parallel trade, so we will also talk about how to go about avoiding parallel trade and do the price coordination across countries. Now you see that they are all the countries they have their own currency, exchange rates, they reflect how much one currency is worth in terms of another currency.

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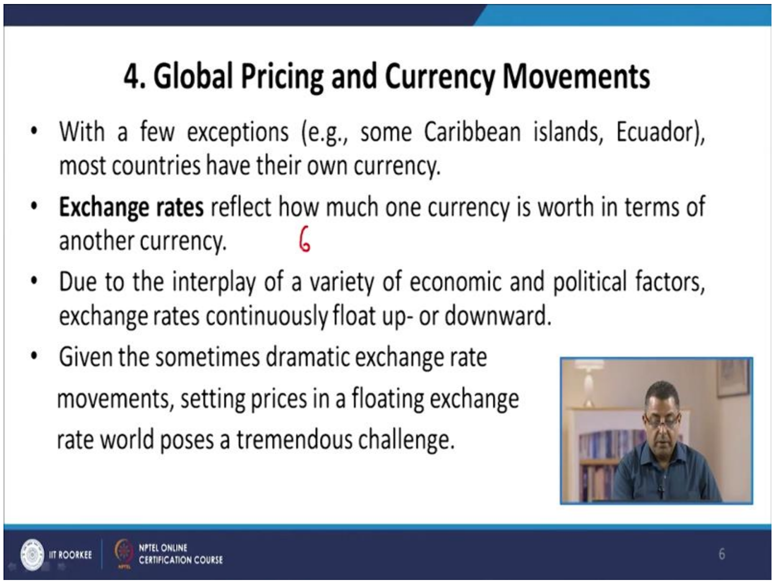

So we are talking of things like 67 rupees, 1 dollar, so this is what, we are talking about. So exchange rate reflects how much one currency is worth in terms of another currency. Due to the interplay of various external factors like, economic and political factors, exchange rates, they continue continuously keep on changing they may either float up or float down, given that sometimes dramatic exchange rate movements, sometimes the exchange rate they move too erratically. In that case, setting prices in a floating currency, floating exchange rate, would pose a tremendous challenge. How to go about pricing in those currencies? With those currencies which are more volatile.

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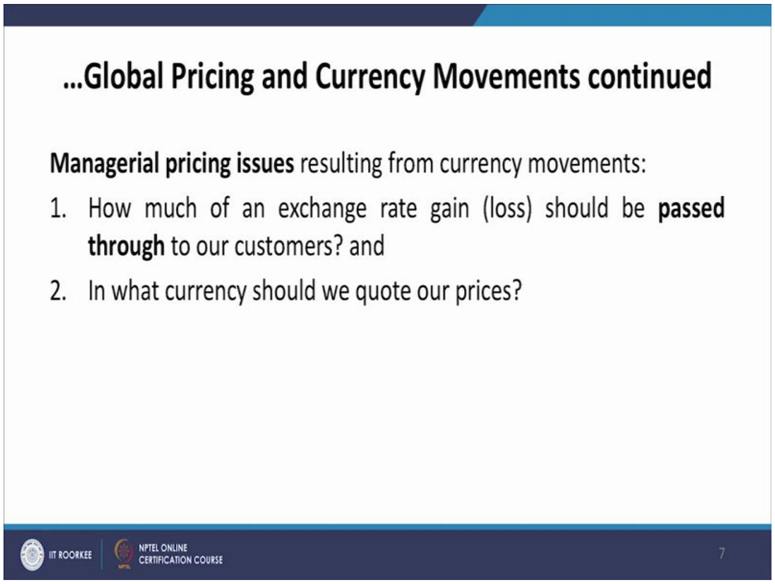

And the managerial pricing issues relating from currency movements, is that, how much of an exchange rate gain or loss should be passed through to our customers? So if we are gaining when should we pass on this game in terms of reduced cost to the customers and if we are losing when should we start charging more money from the customers? In what currency should we quote our, prices so that they are so that the prices of these currencies are relatively stable and they do not keep on changing vis-a viz be another currency several times a day?

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Let us look at the exchange, pass through issues, that is, exchange rate pass through issues. Consider the predicament of American companies exporting to Japan. So there is an American company that exports to us to Japan. In principle, a weakening of US dollar versus the Japanese yen will strengthen the competitive, competitive position of US based exporters in Japan. A weak dollar allows US based firms to lower the yen price of American goods exported to Japan. So those goods now become cheaper, cheaper in Japan. This enables American exporters to steal market share, away from the local Japanese competitors, without sacrificing the profits.

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In contrast a strong US dollar will undermined its position, the position of American exporters in Japan. When the dollar appreciates versus the yen, we have the mirror picture of a previous situation. The retail price in yen of American exports goes up. So they become uncompetitor. As a result American exporter might lose market share if they leave their ex factory prices unchanged.

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Therefore to maintain their competitive edge they may be forced to lower their ex-factory dollar price and that will that will reduce their profits. So the ultimate impact of the exporters competitive position will also depend, on the impact of currency movement, on the exporter's cost and the nature of competition in the Japanese market. The benefit of a weaker dollar could be washed out when many parts are imported from Japan, since the weak dollar will make these parts more expensive. When most of the competitors are US based manufacturers, changes in the dollar's exchange rate might not matter, because everyone will get affected similarly.

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So everyone gets affected equally. Now look at what are the strategies available to exporters under varying currency regime. So when domestic currency is weak, so, stress the price benefits. The benefits of low price costly features expand product line and add more. Shift Sourcing and manufacturing to domestic market. Exploit export opportunities in all markets. Conduct conventional cash for goods trade, and not credit for goods, good trade use costing approach but use marginal costing pricing to penetrate new competitive markets. Minimize expenditure in local host country currency.

Buy needed services, for example, advertising, insurance, transfer and transportation in domestic markets. Minimize local borrowing. But see, let us see what happens when domestic currency is strong, Engage in non price competition by improving quality, delivery, and after sale service. So now we are talking of non price competition earlier we are talking of the benefits of low price, now we are talking of differentiation.

So here we are talking of low prices, and here we are talking of differentiation. Improve productivity and engage in rigorous cost reduction. Shift sourcing and manufacturing to foreign markets. Give priority to exports to relatively strong currency countries. Deal in counter trade with weak currency countries. Trim profit margins and use marginal cost pricing. So here we are reducing cost and here we are trimming profit margin, so we are reducing profit margins also.

Keep the foreign earned income in host countries, slow down the collection process. Maximize expenditure in local and host country currencies. Buy needed service abroad and pay for them in local currencies. Borrow money needed for expansion in local market and not in the home market bill foreign customers in their own currency.

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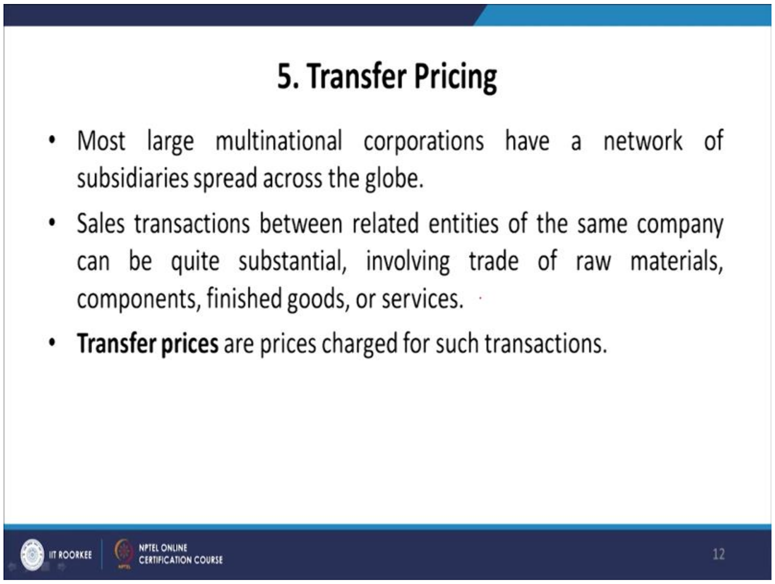

Now this is another important concept, that is, Transfer pricing, because this is important because it has several implications on the profits of the company, and reputation of the company. So most large multinational corporations have a network of subsidiary, spread across the globe. So they have subsidiary in 10 different countries while the parent maybe in US or in Japan.

Now what happens is that, the sales transaction between related entities of the same company that is within the subsidiaries, can be quite, substantial. So as we have seen in the first module also, most of the international trade happens within the company. So parent maybe selling something to the subsidiary, one subsidiary selling something to another subsidiary, and so on. So that involves trade of raw materials, components, finished goods or services. Now transfer pricing are pricing, prices charged from such transaction that are happening within the company. That is for example from the parent to the subsidiary or from subsidiary one to subsidiary two.

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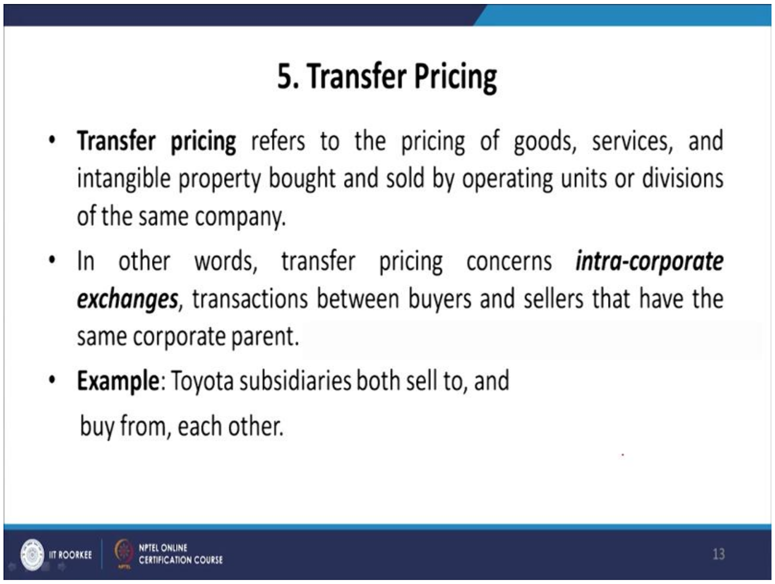

So this is what is called as transfer pricing. So transfer pricing refers to the pricing of goods and services and intangible property, bought and sold by operating units or divisions of the same company. So keep in mind that we are talking of within this company, the same company. In other words, Transfer pricing concerns intra corporate exchange within the company exchanges and we are not talking of intercompany exchange, we are talking of intra company exchange.

Transactions between buyer and seller, that have the same corporate parent for example Toyota subsidiaries sell both sell to and buy from each other so they may sell some component to another subsidiary and they are buying some components from that subsidiary.

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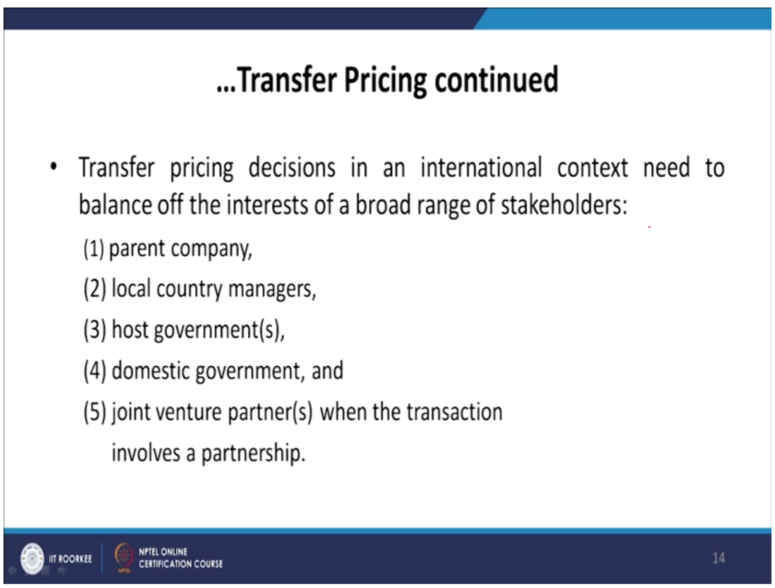

So, what is the price charged during this transaction. So transfer pricing decisions are based on the interest, should look after the interest of a broad range of stakeholders and who are the stakeholders involved? The first is the parent company, because this company is the administrator of the whole network. Then local country manages, the managers, managers based out of each country. Host government, the political in the legal requirement of the host country in which the company operates.

Then the domestic government also, where the parent, where is the headquarters are located. Joint venture partners when the transaction involves partnerships. So these are the various stakeholders whose interest are to be taken care of, and protected by way of transfer pricing.

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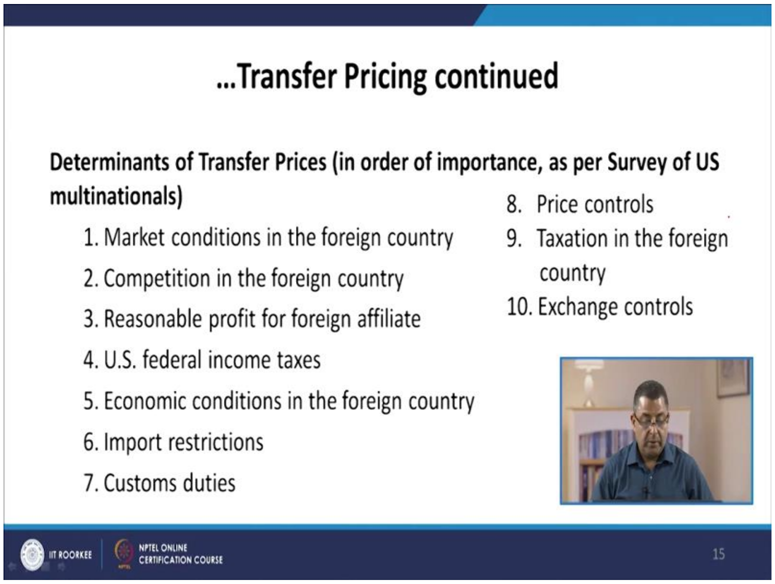

So, let us look at what are the determinants of transfer pricing and they are in order of importance as per the survey of US multinationals. The first is Market conditions in the foreign country. What are the types of market conditions in the foreign country, for example, what is the demand and what is a what are the tax laws, and what are the What are the purchasing power of the customers, competition in foreign country foreign markets, how much the competition is, so higher the competition, the prices have to be lower down in that case, then what are the what is the reasonable profit for the foreign affiliate.

Depending upon the company companies objective overall, the headquarters or the parents objective, what are the, what are the profits that the parents want from the subsidiary, then the, not only US Federal income tax rate, that is for the multinational headquarter in US, but we have, we will talk about the income tax rates. Economic conditions in the foreign country. What are the various kind of economic and what do the various economic indicators say for a particular country.

Import restrictions, so if there are more import restrictions for what kind of restrictions are there are there because of the custom duties, or are there are some non tariff barriers? for example quotas, or there are tariff barriers, for example custom duties then comes price control. Are that product under price control from the government. Taxation in the foreign country, so here we are talking of taxation in the home country. And here we are talking of taxation in the foreign country and then what are the exchange controls. Can, a subsidiary that earns profit can repatriate or send back all the profits that they earn in a foreign country back to their parent.

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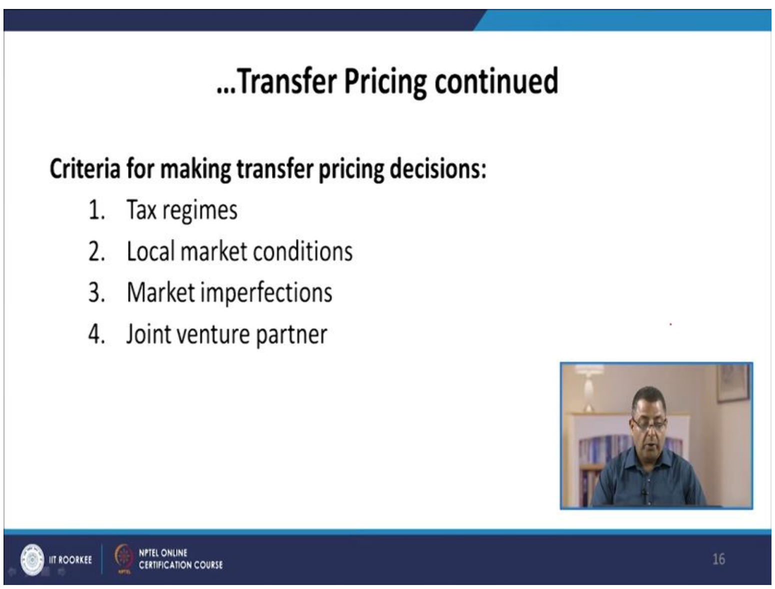

And the criteria for making Transfer pricing decisions include, so broadly we can we can say that the criteria for making Transfer pricing decisions, they are these four. We will talk about each of them in greater detail. So one is Tax Regime then there are local market conditions, market imperfections, and joint venture partners.

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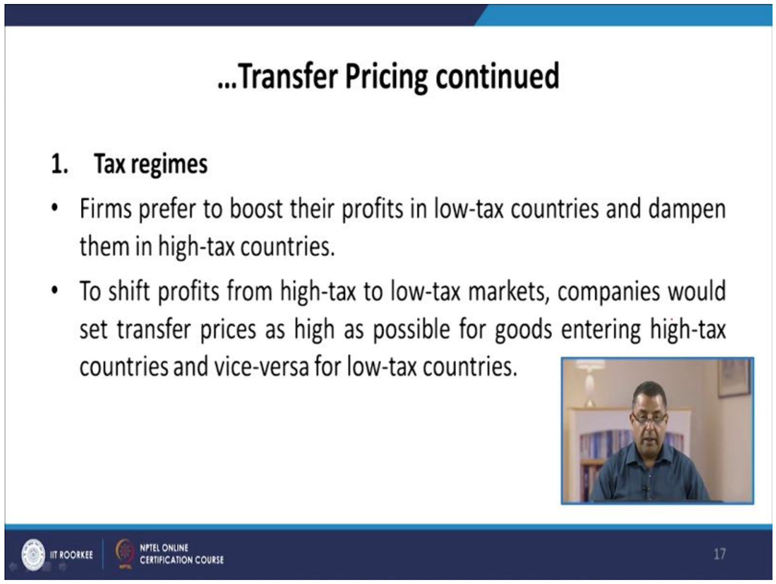

Tax regimes, Firms preferred to boost their profits in low tax countries because that there were they will be paying lesser of taxes and dampen them and reduce them in high tax countries, where profits are taxed higher. So in those countries companies will not book higher profits because they will be paying more in taxes. Therefore to shift profit from high tax to low tax countries, company should set transfer prices, as high as possible for goods entering high tech countries, high tax countries and vice versa for low tax countries.

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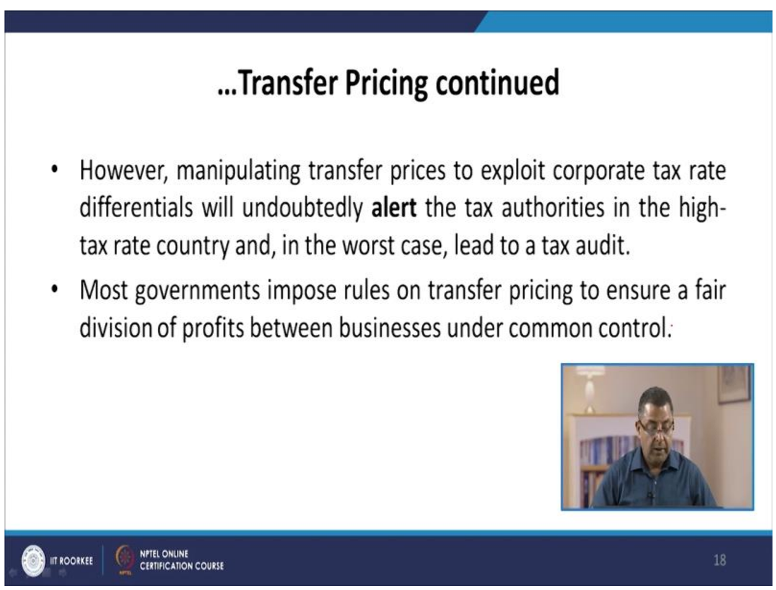

So where the taxes are high, the company will charge higher rate, so that the profits come down and they have to pay lesser tax. However manipulating transfer prices to exploit corporate tax rate differential will undoubtedly alert the tax authorities in the high tax rate country and, in the worst case, can lead to tax audit. So, most government impose rules on transfer pricing to ensure a fair division of profits between businesses under their common control.

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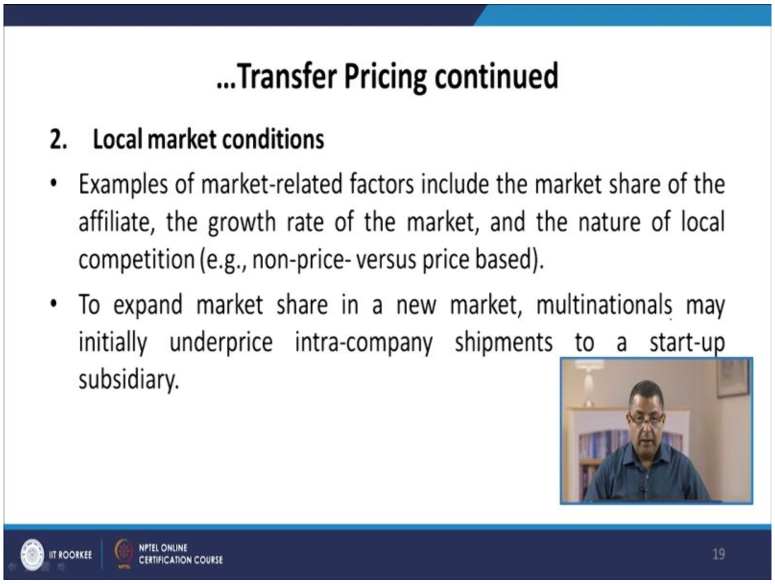

The next thing that determines the transfer pricing are the Local market conditions. Examples of market related factors include the market share of the affiliate, whether it is a big it has a larger market share or a smaller market share, the growth rate of the market, where how far, what is the what is the rate of growth of this market in percentages and the nature of local competition, is it price based competition or non price based competition?. To expand market share in a new market, multinationals may initially under price intra-company shipments to a startup subsidiary.

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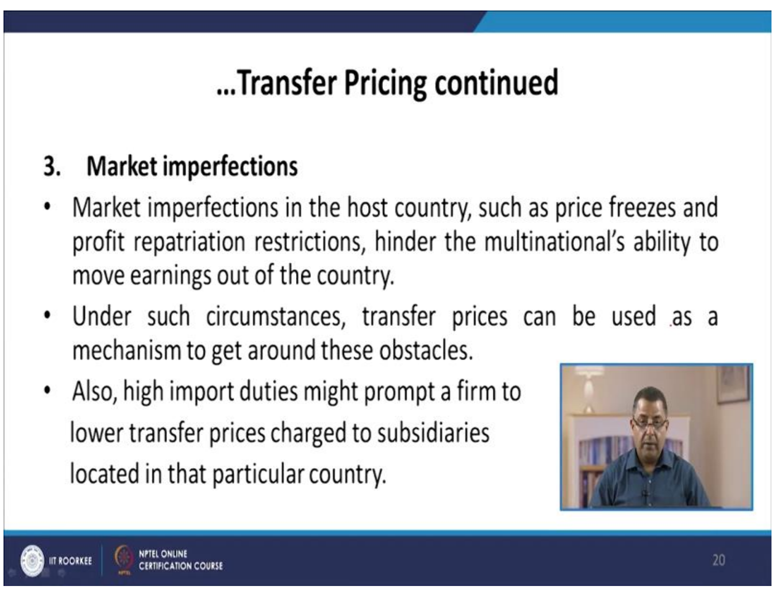

So now they will charge lesser from that subsidiary, so that it becomes large enough, it gains market share and then they will start charging more. The third thing, that is to be taken into consideration, while determining the transfer pricing are the market imperfections. In the host country such as price freezes and profit repatriation restrictions. So what are the government, government controls on, on prices and profits that hinders the multinational ability to move earnings out of the country.

Under such conditions transfer pricing can be used as a mechanism to get around these obstacles. Also high import duties may prompt a firm to lower transfer pricing charged to subsidiaries located in that particular country. So if the import duties are higher, they will charge lower prices so that the total cost remains the same.

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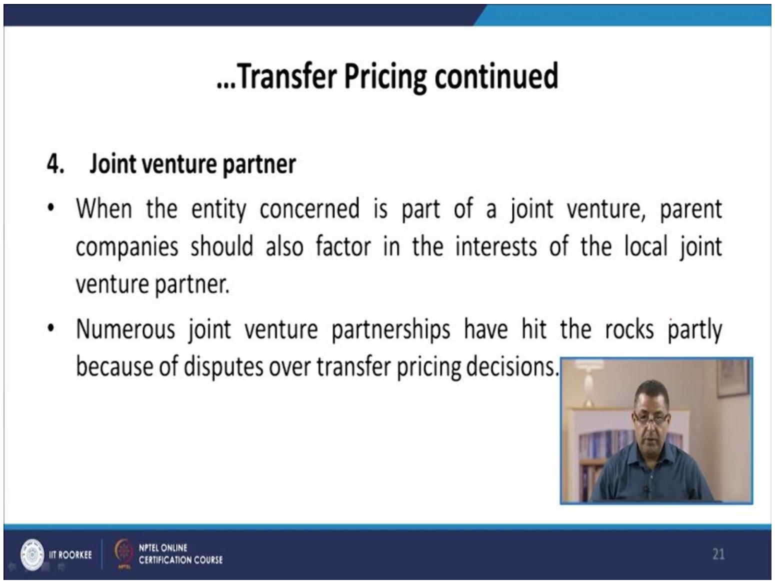

Also they also have to take the objectives of joint venture partners. So when the entity concerned is part of a joint venture, parent companies should also factor in the interest of the local joint venture partner. Numerous joint venture partners partnership have hit the rocks partly because of disputes over transfer pricing decisions, because what happens is that the local joint venture partner maybe looking at more profits but the parent is looking at office because of the reasons that we have discussed earlier, so that creates a problem between the joint venture partners.

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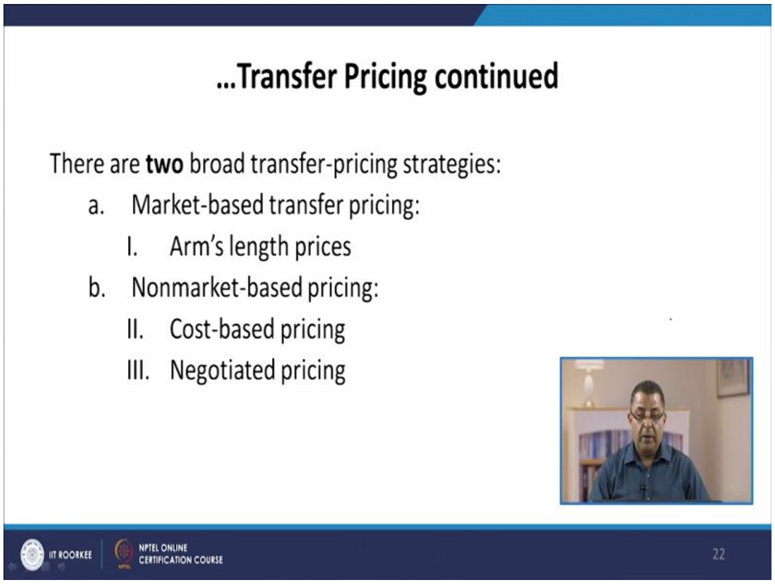

There are two broad transfer pricing strategies, the first is Market based transfer pricing that include Arm's length prices. The second are, the second is Non market based price. So one is Market based price that improves Arm's length price and the second is Non market based price that include Cost based pricing and negotiated pricing.

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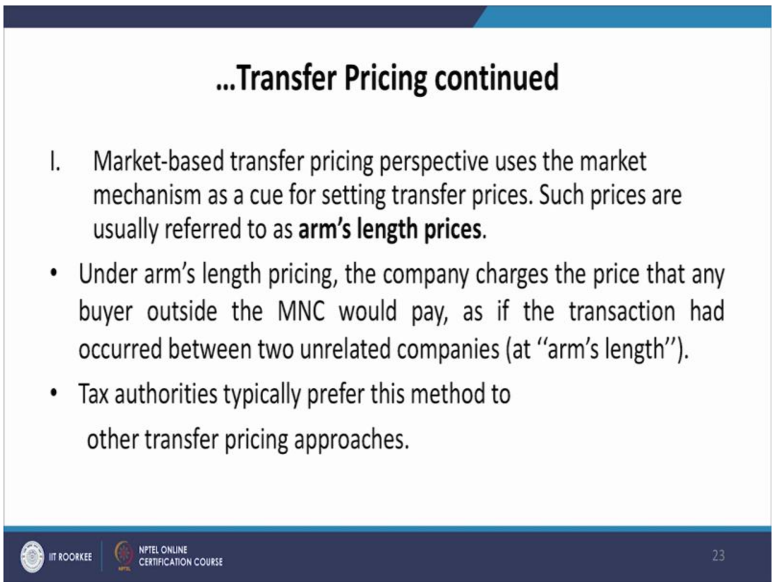

Market based transfer pricing perspective uses the market mechanism as a cue for setting transfer pricing. Such prices are usually referred to as arm's length price. Arm's length price, is the price that is charged between two unrelated entities. So under arm's length pricing, the company charges the price that any buyer outside the mne, MNC would pay, as if the transaction has occurred between two unrelated companies, that is, at the, they are at the arm's length.

So they are two different companies and what would one company charge from another company, that is the, arm's length price. So tax authorities typically prefer this method, to other transfer pricing approaches. So the tax authorities, when they ordered this kind of pricing, they look at arm's length price, in order to determine, whether they have charged good enough prices, from within the company and therefore otherwise that will attract the dumping duty.

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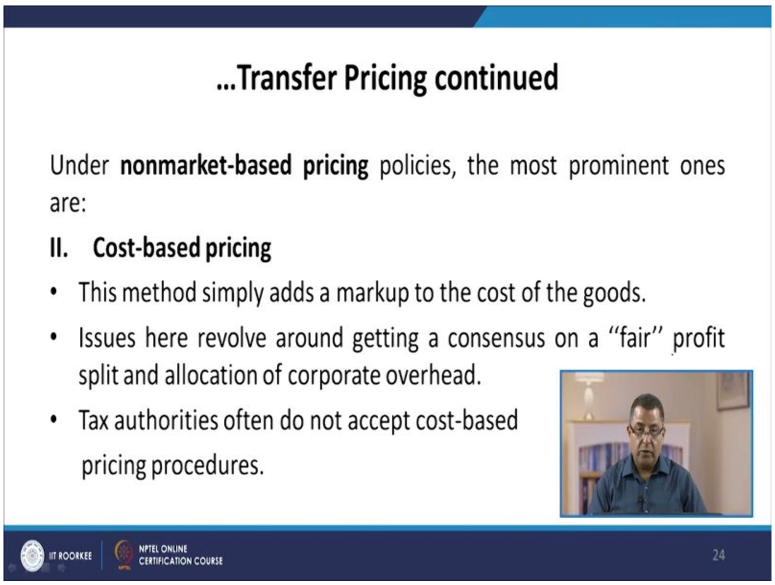

Under non market based pricing policy the most prominent ones are the first is the cost based pricing. This method simply add a markup to the cost of the goods. So the total cost plus a percentage margin, that that becomes the price issues here revolve around getting a consensus on a fair profit split and allocation of corporate overheads. So what should what, what is, what should be this and how are we going to take into account the fixed cost. So tax authorities often do not accept cost based pricing procedures.

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The second type is negotiated pricing. Here conflicts between country affiliates are resolved through negotiation of transfer prices. This process may lead to better cooperation among corporate divisions.

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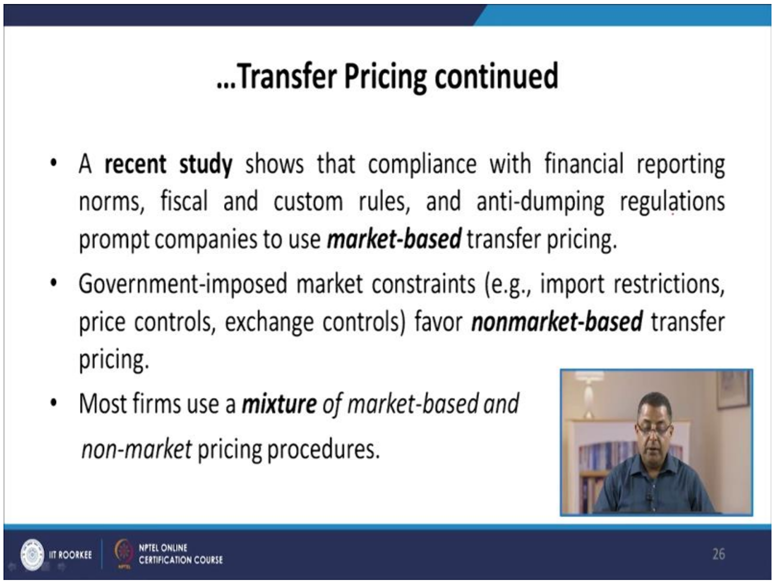

A recent study shows that compliance with financial reporting norms, fiscal and custom rules, and antidumping regulations prompts companies to use market based transfer pricing, that is, and you see that the market based transfer pricing is the Arm's length price. So Government imposed market constraints, that for example the import restrictions, price controls, exchange controls favor, non market based transfer pricing. So there are two different, different situations in which,

which kind of transfer pricing should be used. So most firms used a mixture of market based and non market based pricing procedures.

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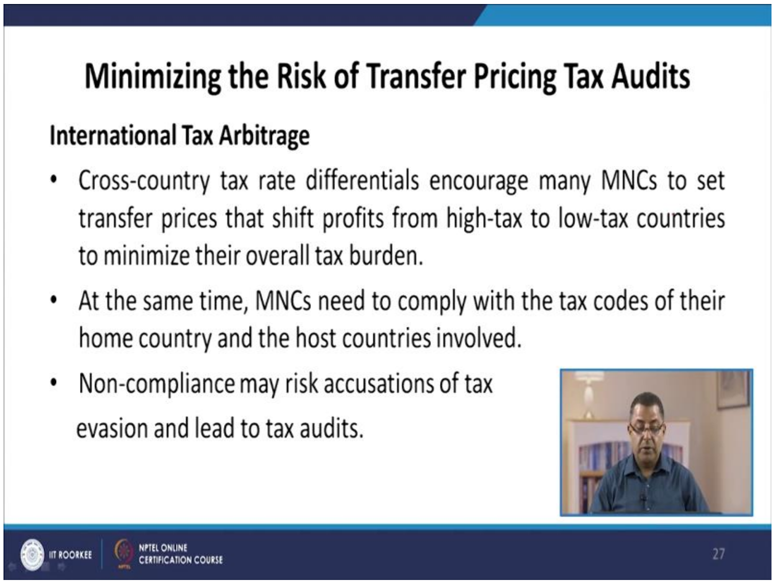

Now how to go about minimizing the risk of transfer pricing tax audit, the first is international tax arbitrage. Cross country track tax rate differentials, they encourage many multinational to set transfer pricing that shift profits from high tax countries to low tax countries to minimize their overall tax burden. At the same time multinationals need to comply with the tax code of their home country and the host countries also. Non compliance may risk accusations of tax evasion and that can lead to lots of lots of problem for the company.

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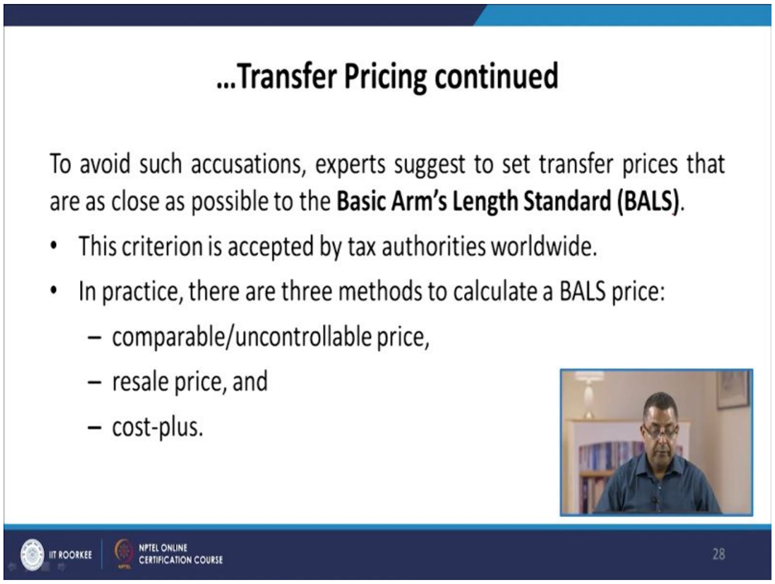

To avoid such accusations experts suggest to set transfer pricing that are, as close as possible to the Basic Arm's Length Standard, so this is, BALS, that is it stands for Basic Arm's Length Standard. This criteria accepted by tax authorities worldwide. In practice, there are three methods to calculate this, the first is, comparable/uncontrollable price, resale price and cost plus.

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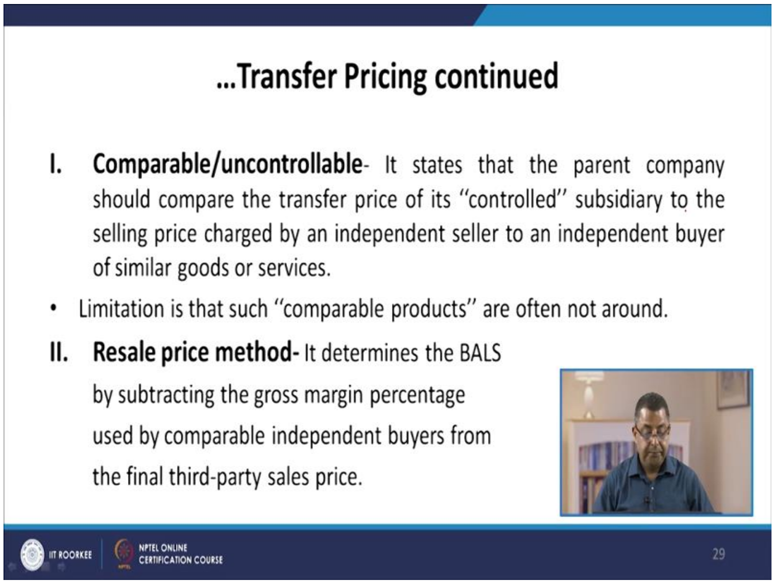

Now let us look at each one of them, what is comparable, or uncontrollable price? It states said that the parent company should compare the transfer price of its controlled subsidiary to the selling price charged by an independent seller to an independent buyer of similar goods and services. So that is comparable. To compare, the price is compares across, across companies. So limitation is that such comparable products are often not around. Resale price method, it determines the Basic Arm's Length Standard, by subtracting the gross margin percentage used by comparable independent buyers from the final third party sales price.

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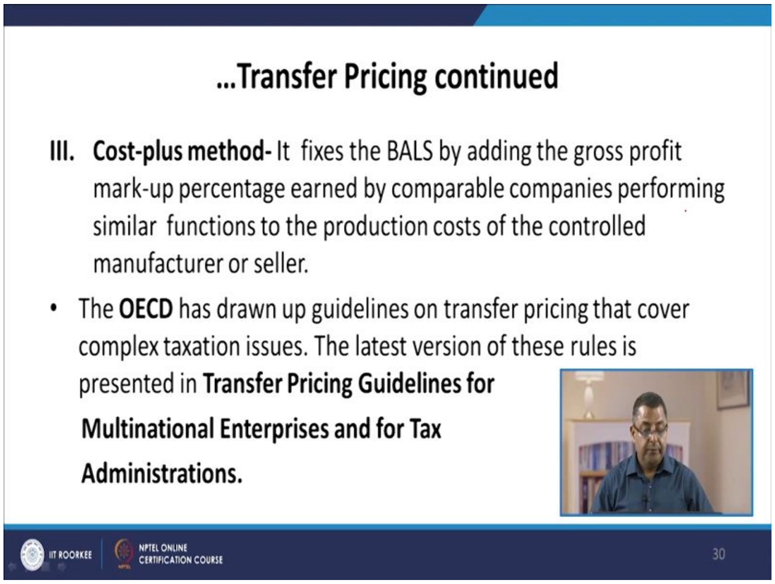

The third is the cost plus method. It fixes the basics arm's length standard by adding the gross profit markup percentage earned by comparable companies performing similar functions to the produce to the production costs of the controlled manufacturer or seller. The OECD has drawn up guidelines to transfer pricing that cover complex taxation issues. The latest version of these rules is presented in Transfer Pricing Guidelines for Multinational Enterprises and for Tax Administrator.

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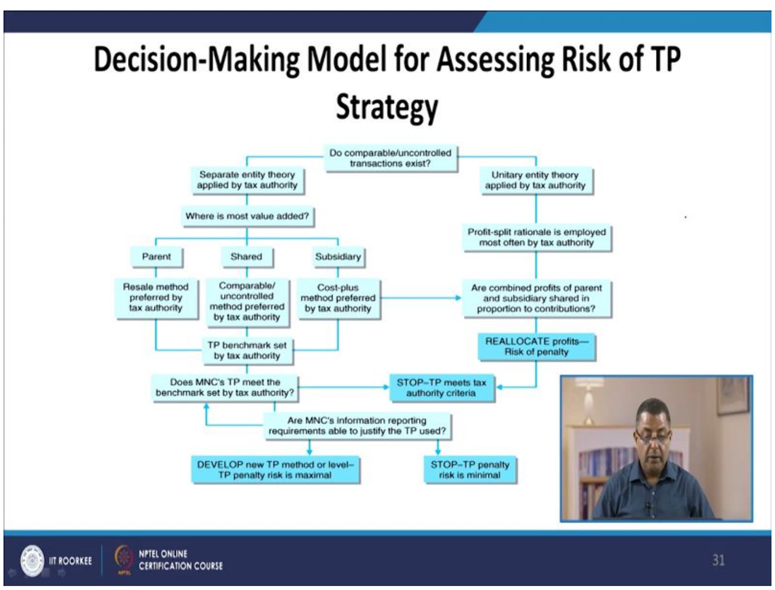

Now let us look at the Decision Making Model for Assessing Risk of Transfer Pricing Strategy. We start from this place, do comparable or uncontrollable transactions exist? So, Unitary entity theory applied by tax authorities it means profit split, rationale is employed most often by the tax authority. Are combined profits of parent and subsidiary shared in proportion to the contribution? Separate and in this case separate entity theory applied by the tax authorities where is most value added? At the parent or under subsidiary or shared and therefore at the outcome we get stop transfer price penalty risk is minimal. And here develop a new transfer pricing method or level- transfer pricing risk is maximal.

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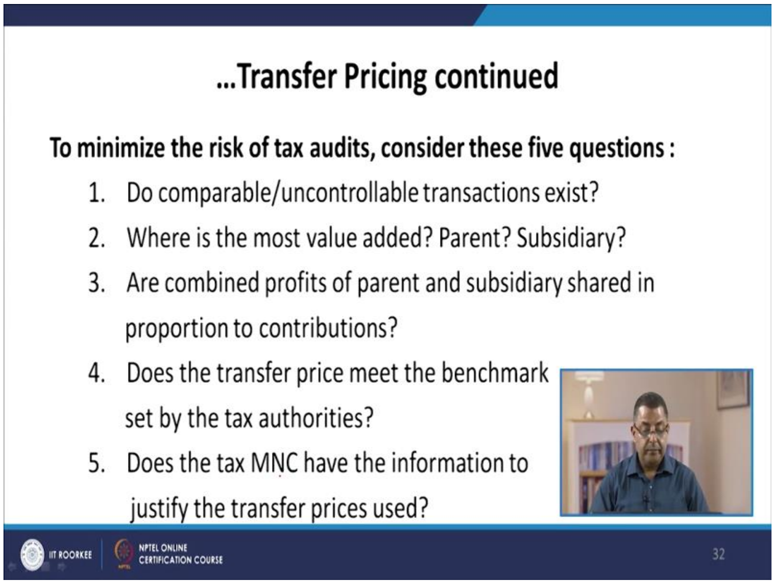

Now in order to minimize the risk of attracting tax authorities, consider five questions: The first is do, comparable/uncontrollable transactions exist? So we are at this stage. So second question is where is the most value added? Is it at the parent level or at the subsidiary level? Are combined profits of parent and subsidiary shared in proportion to this contributions? So the profit should be more, where the value added is more.

So if it at the parent level, then obviously more profit should go to the parent if the value is more at the subsidiary level then obviously more profit should go to the subsidiary. Does the transfer price meet the benchmark set by the tax authorities? Does the tax MNC have the information to justify the transfer pricing used?

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Now another important concept here is, whether this Transfer pricing leads to Anti-dumping? So we will talk about how the globe, globe, Global pricing and antidumping regulations. How the Global pricing are affected by anti dumping regulation. Now dumping is defined as the sale of an imported product, at a price, lower than that normally charged in the domestic market or the country of origin. So if it is so, then it is called as dumping.

To protect local produces against the encroachment of low priced imports, government may levy anti-dumping duties or fines, because if someone is exporting a product, at a very low price, then what happens in the host in the host country, the local competition will be wiped out, because there because this particular product is being imported at a very low price. So that will lead to the loss of employee, employment in the local country and loss of employment and lead to lots of trouble for the government. So, Economists often refer to this trend of anti dumping actions as a rise in protectionism.

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One major possible reason for growing popularity of anti-dumping litigation is the removal of traditional trade barriers that is tariffs and quotas. Antidumping action is often utilized as a tactical tool to foster voluntary export restraints. Foreign competitors, faced with the prospect of anti-dumping action, may decide to fall back on VERs as a lesser of the two evils.

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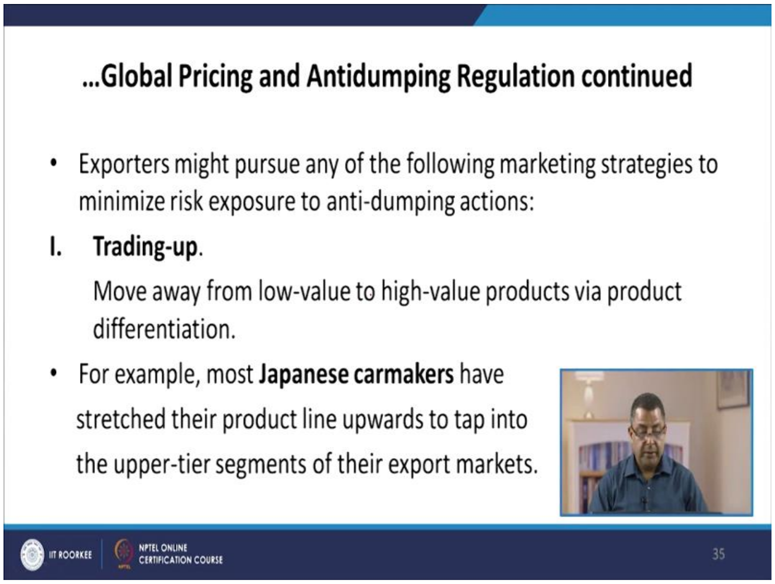

Exporters might pursue any of the following marketing strategies to minimize risk exposure to anti-dumping actions: The first is trading up. Move away from low value to high value products via product differentiation. So now you are adding high value to the product by way of differentiation. So we are not talking of just the cost differentiation. For example, most Japanese car makers have stretched their product line upwards to tap into the upper tier segments of their export makers.

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Another is service enhancement. So one is that you trade up you are you are you move from low value to high value product or you look at service enhancements. Exporters can also differentiate their product we are still talking of differentiation but by way of service enhancement. Exporter can also differentiate their product by adding support services to the core product. Both moves-trading up and service enhancement- are basically attempts to move away from price competition, thereby making the exporter less vulnerable to dumping accusations.

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The third is distribution and communication. Other initiative on the distribution and communication front in the marketing mix include establishment of communication channel with the local competitors, entering into cooperative arrangements with them for example strategic alliances or reallocation of the firm's marketing efforts from vulnerable products, that is, those most likely to be subjected to subjected to dumping scrutiny to less sensitive products. Now let us look at what to do in order to reduce the parallel trade in order to do away with the gray market or the parallel trade.

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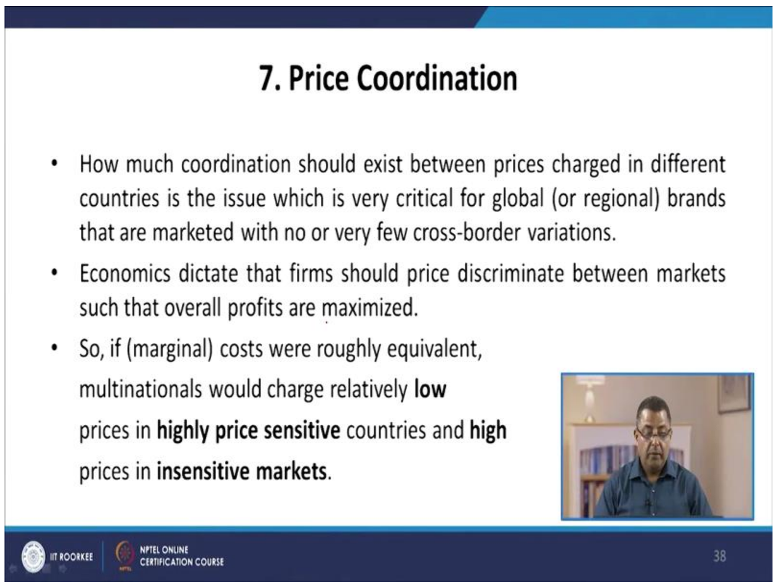

So how much coordination should exist between prices charged in different countries is the issue which is very critical for global pricing, global brands that are marketed with no or very few cross border variations. So when the product is the same then what amount how much change in the prices can you charge for the same product in different markets. Economics dictate that firm should price discriminate between markets such as, such that overall profits are maximized.

So, economics says that you should charge different prices, so that in each market you are able to maximize the profit. So, if marginal cost were roughly equivalent, multinationals would charge relatively low prices in high price sensitive countries and high prices in insensitive markets. So, that is a plain simple logic.

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So, where the people are more price sensitive, they charge low prices in those countries where they are not you charge high prices. Unfortunately, this will lead to the parallel trade. Huge cross country price differentials will encourage gray markets where goods are shipped from low price to high price countries by unauthorized distributors. Thus, some coordination will usually be necessary. In deciding how much coordination, should be, how much coordination should be there and there are several considerations.

So now you see that prices in one country will be affected by the pricing and prices in other country. So you cannot price independently in each country they should there has to be a certain amount of coordination, and what are the several considerations that that should be kept in mind.

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One is the nature of customers and amount of product differentiation so if the amount, we will talk about them later on. If the amount of product differentiation is more then you can charge more prices. If it is the same product is the same then the price differential cannot be huge. Then nature of the channels, what kind of big distributor and retailers or not, nature of competition whether they are huge competitors, local competitors, global competitors.

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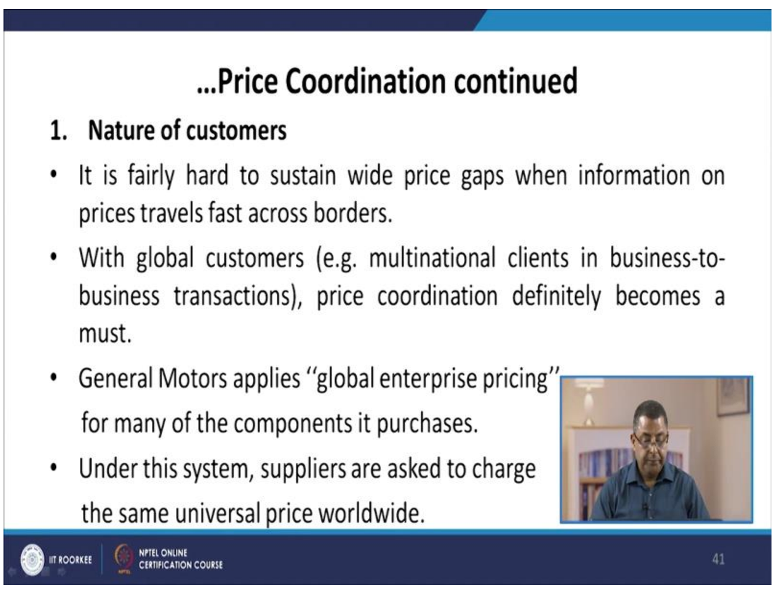

And then market integration. Now look at the nature of customers. It is fairly hard to sustain wide price gaps when information on price travels fast across borders. When global customers that is, multinational clients in business to business situations, price coordination definitely becomes a must because they know the price that is being charged for a particular component across the world. So they in that case you cannot charge a huge price differential. General Motors applies, global enterprise pricing for many of its components that is purchases. Under this system suppliers are asked to charge the same universal price worldwide.

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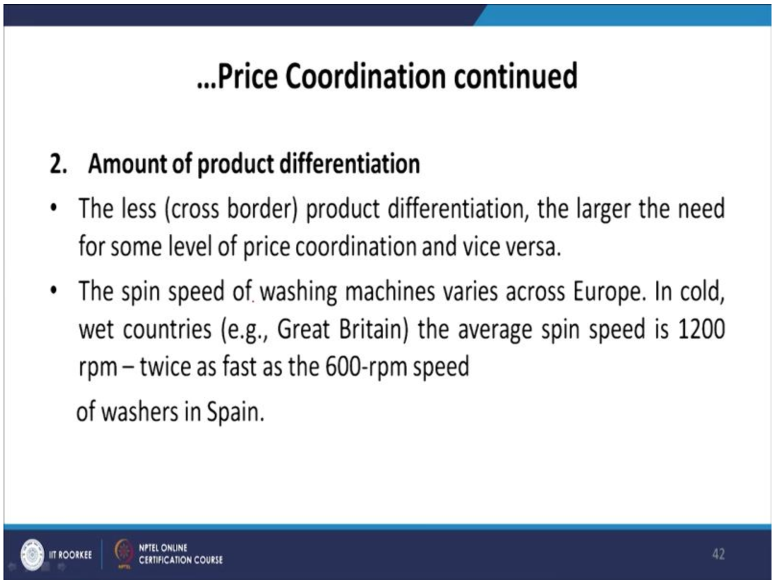

The next thing to keep in mind is the amount of product differentiation. The less cross border differentiation, the higher the need for some level of price coordination and vice versa. The spin speed of washing machines varies across Europe. In cold, wet countries like Great Britain, the average spin speed is 12000 RPM twice as fast as 600 RPM speed of washers in Spain. So now this can be used to charge a differential price.

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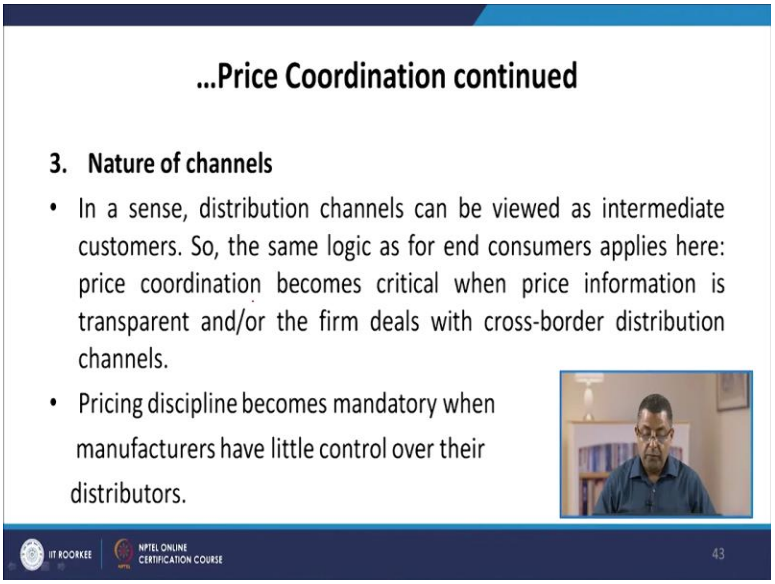

The nature of channel, In a sense, distribution channels can be viewed as intermediate customers, because they stand between the company and the customer, and they are they also buy the product of the company. So the same logic so far as end consumers applies here: price coordination becomes critical when price information is transparent or the firm deals with cross border distribution channels, because then the channel member's know, what is the price charged by this company for the same product across different countries. Price discipline becomes mandatory when manufacturers have little control over their distributors.

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Another factor is the nature of competition. In many industries, firms compete with the same rivals in the given region, if not worldwide. Global competition demands a cohesive strategic approach for the entire marking marketing mix strategy, including pricing.

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And the degree of market integration: When markets integrate, barriers to cross-border movement movements of goods comes down. Given the freedom to move goods from one member state to another member state, for example, the pan European market offers little latitude for perfect price discrimination. Because the goods can move anywhere so therefore there is no point in charging different prices for the same product in different countries. Many of the transaction costs plaguing parallel imports that once existed have now disappeared.

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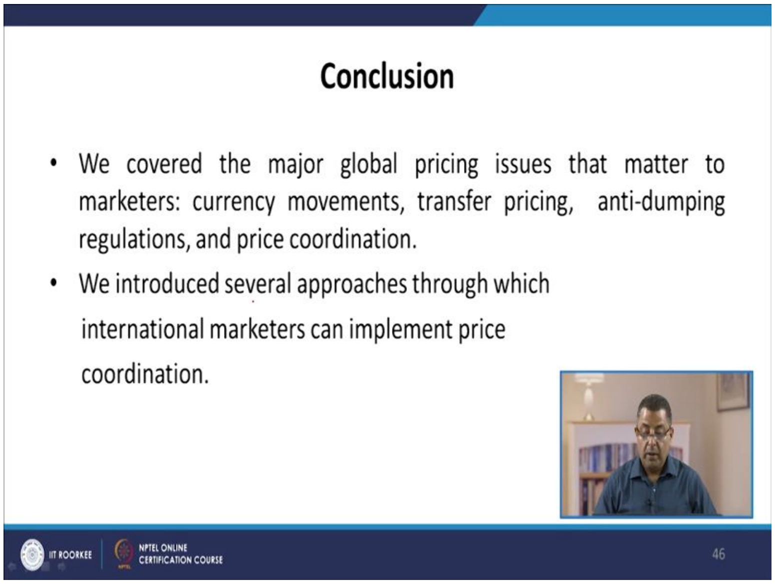

So let us conclude so we have seen that what are the major global pricing issues, that matters to the, to the marketers, for example, movement of currency, whether they are trading up or trading down, what is the transfer pricing, how much price should be charged within the same network, anti-dumping regulations, what, what kind of, what kind of prices, will lead to anti dumping duty attraction, and what amount of price coordination should be there across the country.

So we have introduced several approaches through which international market marketers can implement price coordination across the across the country so they can either get into the cost competition or they can add various kind of services to the core product or they can bring about differentiation in the core protect itself.

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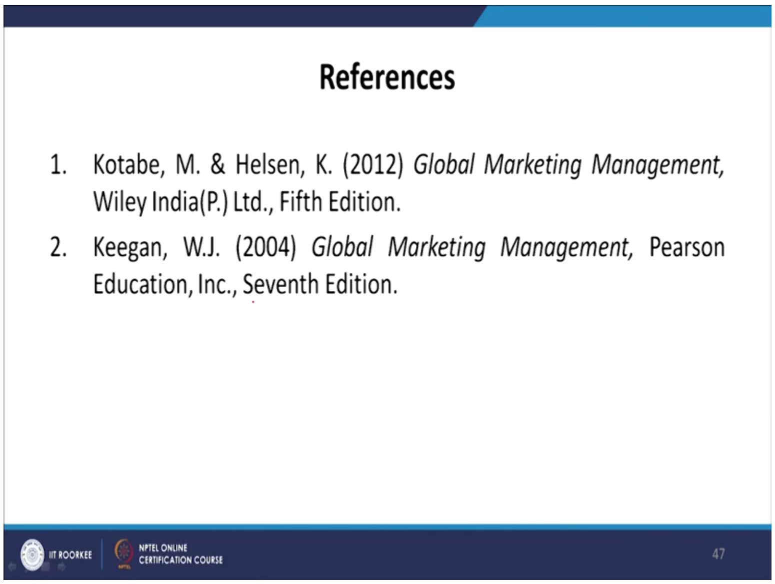

And these two books have been used for this particular module. Thank you.