**Chapter – Six**

**Pricing and Terms of Payment**

**6.1 Basic International Pricing Concepts**

As the experience of many companies show, the global manager must develop pricing systems and pricing policies that address price floors, price ceilings, and optimum prices in each of the national markets in which his or her company operates.

The task of determining prices in global marketing is complicated by fluctuating exchange rates, which may bear only limited relationship to underlying costs. According to the concept of purchasing power parity, changes in domestic prices will be reflected in the exchange rate of the country's currency. Thus, in theory, fluctuating exchange rates should not present serious problems for the global marketer because a rise or decline in domestic price levels should be offset by an opposite rise or decline in the value of the home-country currency and vice versa. In the real world, however, exchange rates do not move in lockstep fashion with inflation. This means that global marketers are faced with difficult decisions about how to deal with windfalls resulting from favorable exchange rates, as well as losses due to unfavorable exchange rates.

A firm's pricing system and policies must also be consistent with other unique global constraints. Those responsible for global pricing decisions must take into account international transportation costs, middlemen in elongated international channels of distribution, and the demands of global accounts for equal price treatment regardless of location. In addition to the diversity of national markets in all three basic dimensions-cost, competition, and demand-the international executive is also confronted by conflicting governmental tax policies and claims as well as various types of price controls. These include dumping legislation, resale price maintenance legislation, price ceilings, and general reviews of price levels. For example, Procter & Gamble (P&G) encountered strict price controls in Venezuela in the late 1980. Despite increases in the cost of raw materials, P&G was granted only 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 elsewhere.

**6.2 Price Standardization**

One area of pricing that has received some attention is the issue of pricing standardization. A study of the marketing mix by large US-based industrial firms in their Latin American businesses found that the degree of standardization varied across individual elements, with branding and product being least adapted. Perhaps because of government regulations, price and advertising elements were most adapted. In comparison with the same firms’ European and Latin American strategies, price was similarly adapted in both regions. According to one study, most American multinational firms standardize their prices in most world markets because they are probably cost driven. Due to market variations, one has to wonder why these firms are inflexible and whether they have been successful overseas. Perhaps these firms have been able to be rigid due to the fact that they do not rely on foreign sales very much and that they do business primarily with industrialized countries. In contrast, those companies that are more committed to international business localize their prices and are more successful overseas.

Whether price should be uniform worldwide is a subject of much debate. One school of thought holds that, from the management’s viewpoint, there is no reason for an export price to differ from the home price. In addition, economists believe that arbitrage will eliminate any price differential between markets. This is especially the case with the European Union due to the free movement of goods, the elimination of customs barriers, and the harmonization of VAT rates. In addition, the free movement of people will enable them to easily observe prices of the same products in neighboring countries. As a result, internationally recognized consumer goods with wide European distribution are likely to have a more uniform pricing system. A multinational corporation needs to coordinate prices across its multiple markets – without violating national laws. A study of South Korean, Taiwanese, Hong Kong, and Singaporean firms operating in Europe found that they had closer relationships with their parent firms and that they had greater autonomy in strategy and pricing decisions.

***Global Pricing Policies***

1. ***Standard Price Policy****:* An international marketer following a geocentric approach to international marketing will adopt a standard price policy. Under standard price policy the firm charges the same price for its goods and services regardless of where they are sold. Firms that adopt this policy are generally of two types: first, firms whose products or services are highly visible and allow price comparisons to be readily made. Second, a firm that sells commodity goods in competitive markets.
2. ***Two- Tiered Pricing Policy****:* An international firm that follows an ethnocentric approach will use two-tiered pricing policy. Under two-tiered pricing policy, the firm sets one price for all its domestic sales and a second price for all its international sales. A firm that adopts a two-tiered pricing policy commonly allocates to domestic sales all accounting charges associated with research & development, administrative overheads, capital depreciation, and so on. The international marketer can then establish a uniform foreign sales price without having to worry about covering these costs. Domestic marketers that are just beginning to go international often use two-tiered pricing policy. International marketers that adopt a two-tiered pricing policy are also vulnerable to charges of dumping.
3. ***Market Pricing Policy****:* International marketers that follow a polycentric approach to international marketing use market-pricing policy. Market pricing policy is the most complex of the three pricing policies and the one most commonly used. An international marketer utilizing market pricing policy customizes its prices on a market - by - market basis to maximize its profits in each market. Two conditions must be met if an international marketer is to successfully practice market pricing:

* The firm must face different demand and / or cost conditions in which it sells its products.
* The firm must be able to prevent arbitrage. ***( there may be companies that buy at lower price from the producer company and sells at high price)***

Assuming these conditions are met, the advantages of this market pricing are obvious. For example, the firm can set higher prices where markets will tolerate them and lower prices where necessary in order to remain competitive. International marketers most likely to use this approach are those that produce and market their products in many different countries.

A market pricing policy can, however expose a firm to dumping complaints as well as to two other risks: Damage to its brand name and Development of gray market for its products.

Under each of these policies, accompany may follow different pricing strategies which are clarified below one by one.

1. ***Market Skimming****:* The market skimming pricing strategy is a deliberate attempt to reach a market segment that is willing to pay a premium price for a product. In such instances, the product must create high value for buyers. This pricing strategy is often used 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 early adopters who are willing and able to pay the price. One goal of this pricing strategy is to maximize revenue on limited volume and to match demand to available supply. Another goal of market skimming pricing is to reinforce customers' perceptions of high product value. When this is done, the price is part of the total product positioning strategy.
2. ***Penetration Pricing****:* Penetration pricing uses price as a competitive weapon to gain market position. The majority of companies using this type of pricing in international marketing are located in the Pacific Rim. Scale-efficient plants and low-cost labor allow 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. Companies that are new to exporting cannot absorb such losses. They are not likely to have the marketing system in place (including transportation, distribution, and sales organizations) that allows global companies to make effective use of a penetration strategy. However, a company whose product is not penetrable may wish to use penetration pricing to achieve market saturation before the product is copied by competitors.
3. ***Market Holding****:* The market holding strategy is frequently adopted by companies that want to maintain their share of the market. In single-country marketing, this strategy often involves reacting to price adjustments by competitors. For example, when one airline announces special bargain fares, most competing carriers must match the offer or risk losing passengers. In global marketing, currency fluctuations often trigger price adjustments. Market holding strategies dictate that source country currency appreciation will not be automatically passed on in the form of higher prices. If the competitive situation in market countries is price sensitive, manufacturers must absorb the cost of currency appreciation by accepting lower margins in order to maintain competitive prices in country markets.
4. ***Cost Plus****:* Companies new to exporting frequently use a strategy known as cost -plus pricing to gain a toehold in the global marketplace. There are two cost-plus pricing methods: The older is the historical accounting cost method, which defines cost as the sum of all direct and indirect manufacturing and overhead costs. An approach used in recent years is known as the estimated future cost method. Cost-plus pricing requires adding up all the costs required to get the product to where it must go, plus shipping and ancillary charges, and a profit percentage. The obvious advantage of using this method is its low threshold: It is relatively easy to arrive at a selling price, assuming that accounting costs are readily available. The disadvantage of using historical accounting costs to arrive at a price is that this approach completely ignores demand and competitive conditions in target markets. Therefore, historical accounting cost-plus prices will frequently be either too high or too low in the light of market and competitive conditions. If historical accounting cost-plus prices are right, it is only by chance. However, novice exporters do not care-they are reactively responding to global market opportunities, not proactively seeking them. Experienced global marketers realize that nothing in the historical accounting cost-plus formula directly addresses the competitive and customer-value issues that must be considered in a rational pricing strategy.

**Alternative Pricing Strategies**

***Transfer Pricing***

Transfer pricing refers to the pricing of goods and service bought and sold by operating units or divisions of a single company. In other words, transfer pricing concerns intra-corporate exchanges-transactions between buyers and sellers that have the same corporate parent. As companies expand and create decentralized operations, profit centers become an increasingly important component in the overall corporate financial picture. Appropriate intra-corporate transfer pricing systems and policies are required to ensure profitability at each level. There are three major alternative approaches to transfer pricing. The approach used will vary with the nature of the firm, products, markets, and the historical circumstances of each case. The alternatives are:

1. ***Cost-Based Transfer Pricing:*** Because companies define costs differently, some companies using the cost-based approach may arrive at transfer prices that reflect variable and fixed manufacturing costs only. Alternatively, transfer prices may be based-on full costs, including overhead costs from marketing, research and development (R&D), and other functional areas. The way costs are defined may have an impact on tariffs and duties on sales to affiliates and subsidiaries by global companies. Cost-plus pricing is a variation of the cost-based approach. Companies that follow the cost-plus pricing method are taking the position that profit must be shown for any product or service at every stage of movement through the corporate system. While cost-plus pricing may result in a price that is completely unrelated to competitive or demand conditions in international markets, many exporters use this approach successfully.
2. ***Market-Based Transfer Price:*** A market based transfer price is derived from the price required to be competitive in the international market. The constraint on this price is cost. However, as noted previously, there is a considerable degree of variation in how costs are defined. Because costs generally decline with volume, a decision must be made regarding whether to price on the basis of current or planned volume levels. To use market-based transfer prices to enter a new market that is too small to support local manufacturing, third-country sourcing may be required. This enables a company to establish its name or franchise in the market without committing to a major capital investment.
3. ***Negotiated Transfer Prices:*** A third alternative is to allow the organization's affiliates to negotiate transfer prices among themselves. In some instances, the final transfer price may reflect costs and market prices, but this is not a requirement. The gold standard of negotiated transfer prices is known as an arm's-length price: the price that two independent, unrelated entities would negotiate.

***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 nominally 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. There are several types of dumping: sporadic, predatory, persistent, and reverse.

***Sporadic dumping*** occur when a manufacturer with unsold inventories wants to get rid of distressed and excess merchandise. To preserve its competitive position at home, the manufacturer must avoid starting a price war that could harm its home market. One way to find a solution involves destroying excess supplies, as in the example of Asian farmers dumping small chickens in the sea or burning them. Another way to solve the problem is to cut losses by selling for any price that can be realized. The excess supply is dumped abroad in a market where tee product is normally not sold.

***Predatory dumping*** is more permanent than sporadic dumping. This strategy involves selling at a loss to gain access to a market and perhaps to drive out competition. Once the competition is gone or the market established, the company uses its monopoly position to increase price. Some critics question the allegation that predatory dumping is harmful by pointing out that if price is subsequently raised by the firm that does the dumping, former competitors can rejoin the market when it becomes more profitable again.

***Persistent dumping***is the most permanent type of dumping, requiring a consistent selling at lower prices in one market than in others. This practice may be the result of a firm's recognition that markets are different in terms of overhead costs and demand characteristics. For example, a firm may assume that demand abroad is more elastic than it is at home. Based on this perception, the firm may decide to use incremental or marginal-cost pricing abroad while using full-cost pricing to cover fixed costs at home. This practice benefits foreign consumers, but it works to the disadvantage of local consumers.

The three kinds of dumping just discussed have one characteristic in common: each involves charging lower prices abroad than at home. It is possible, however, to have the opposite tactic-reverse dumping. In order to have such a case, the overseas demand must be less elastic, and the market will tolerate a higher price. Any dumping will thus be done in the manufacturer's home market by selling locally at a lower price.

**6.3 Methods of Financing and Means of Payment**

There are several payment methods. It should be noted that how buyers handle payments can vary from one part of the world to another.

**Consignment**

When a consignment is used, goods are shipped but ownership is retained by the seller. This means that the product is furnished on a deferred-payment basis, and once the product is sold the seller is reimbursed by the consignee. In effect, the seller is providing full financing for the consignee. The problem with consignment sales is that a high degree of risk prevails. First of all, it is costly to arrange for the return of merchandise that is unsold.

In addition, due to the distance involved, the seller has difficulty keeping track of the inventory and its condition. Certain safeguards are thus necessary.

Consignment, however, can be a satisfactory arrangement when the sale involves an affiliated firm or the seller’s own sales representative or dealer.

**Open account**

With an open account, goods are shipped without documents calling for payment, other than the invoice. The buyer can pick up goods without having to make payment first. The advantage with the open account is simplicity and assistance to the buyer, who does not have to pay credit charges to banks. In return the seller expects that the invoice will be paid at the agreed time. A major weakness of this method is that there is no safeguard against default, since a tangible payment instrument does not exist. The lack of payment instrument also makes it difficult to sell the account receivable. To compound the problem, the buyer often delays payment until the merchandise is received – a standard practice in many countries. Because of the inherent risks of an open account, precautions should be taken. The seller must determine the integrity of the buyer by relying on prior experience, or through a credit investigation.

**Cash in advance**

The seller may want to demand cash in advance when:

1 The buyer is financially weak or an unknown credit risk.

2 The economic/political conditions in the buyer’s country are unstable.

3 The seller is not interested in assuming credit risk, as in the case of consignment and open account sales.

Because of the immediate uses of money and the maximum protection, sellers naturally prefer cash in advance. The problem, of course, is that the buyer is not eager to tie up its money, especially if the buyer has some doubt about whether it will receive the goods as ordered. By insisting on cash in advance, the seller shifts the risk completely to the buyer, but the seller may end up losing the sale by this insistence.

**Bill of exchange (draft)**

A means of financing international transactions is through a bill of exchange or draft, which is a request for payment. The request is an unconditional order in writing from one person (drawer) requiring the person to whom it is addressed (drawee) to pay the payee or bearer on demand or at a fixed or determinable time. The drawer, usually the exporter, is the maker or originator of the draft requesting payment. The drawee, usually the buyer, is the party responsible for honoring or paying the draft. The payee may be the exporter, the exporter’s bank, the bearer, or any specified person. In short, a draft is a request for payment. It is a negotiable instrument that contains an order to pay a payee. As noted by John Stuart Mill many years ago, the purpose is to save expense and minimize the risk of transporting precious metals from place to place as payment of imports. The bill of exchange simply allows banks to make adjustments by debiting or crediting accounts maintained in buyer or seller names with other banks. The transaction process occurs in this way. The drawee accepts the draft by signing an acceptance on the face of the instrument. If the buyer does not accept (sign) the bill, the buyer is not given the attached documents to obtain goods from the steamship company, since the shipment is made on the negotiable order bill of lading. In practice, banks are responsible for payment collection. The original order bill of lading is endorsed by the shipper and sent to the buyer’s bank along with the bill of exchange, invoices, and other required documents (e.g., consular invoice, insurance certificate, inspection certificate). Once notified by the bank, the buyer pays the amount on the draft and is given the bill of lading, which allows the buyer to obtain the shipment.

There are two principal types of bill of exchange: sight and time.

A **sight draft**, as the name implies, is drawn at sight, meaning that it is paid when it is first seen by the drawee. A sight draft is commonly used for either credit reasons or for the purpose of title retention.

A **time (usance** or **date) draft** is drawn for the purpose of financing the sale or temporary storage of specified goods for a specified number of days after sight (e.g., thirty, sixty, ninety days, or longer). It specifies payment of a stated amount at maturity. As such, it offers less security than a sight draft since the sight draft demands payment prior to the release of shipping documents.

The time draft, on the other hand, allows the buyer to obtain shipping documents to draw up merchandise when accepting the draft, even though the buyer can actually defer payment.

At first sight, it may seem that a time draft is not really different from an open account, since the goods may be obtained or picked up by the buyer before making payment. There is one crucial difference, however. In the case of the time draft, there is a negotiable instrument evidencing the obligation. Since this document may be sold to factors and discounted immediately, the seller can obtain cash before maturity.

**Letter of credit (L/C)**

An alternative to the sight draft is a sight letter of credit (L/C). As a legal instrument, it is a written undertaking by a bank through prior agreement with its client to honor a withdrawal by a third party for goods and services rendered. The document, issued by the bank at the buyer’s request in favor of the seller, is the bank’s promise to pay an agreed amount of money on its receipt of certain documents within the specified time period.

Usually, the required documents are the same as those used with the sight draft. In effect, the bank is being asked to substitute its credit for that of the buyer. The bank agrees to allow one party to the transaction (the seller, creditor, or exporter) to collect payment from that party’s correspondent bank or branch abroad. Drafts presented for payment under the L/C are thus drawn on the bank. The importer can repay the bank by either making an appropriate deposit in cash or borrowing all or part of the money from the bank. The drawee (buyer) is usually responsible for the collection charges by banks at home and overseas. The *issuing bank*, as a rule, issues letters of credit for its current customers only, even if collateral is offered by someone else. In contrast, the *advising bank* is the bank which notifies the exporter that an L/C has been issued. The issuing bank forwards the L/C to the advising bank (its foreign correspondent), which is usually selected for its proximity to the beneficiary. In the case of a *confirming bank* the same services are performed as the advising bank but also the confirming bank becomes liable for payment.