

CHAPTER SIX: PRICING AND TERMS OF PAYMENT IN THE INTERNATIONAL CONTEXT

6.1. The nature of price

Price is the amount of money charged for a product or service. It is the sum of the values that customers exchange for the benefits of having or using the product or service. Price is the only element in the marketing mix that produces revenue; all other elements represent costs. Price is also one of the most flexible marketing mix elements. Unlike product features and channel commitments, prices can be changed quickly.

6.2 Factors That Affect International Pricing

There are several factors which influence price determination. Pricing is complex in international business, due to multiple factors. The following are factors that will affect pricing in the international markets.

- 1. Cost**-The cost is the prime factor of determining price. Since cost varies from country to country, especially production costs and distribution costs in overseas markets are concerned, the prices have wide variations.
- 2. Taxes and tariffs**-The prices are also influenced by taxes and tariffs. The manufacturer will add the tax rate to the prices to recoup them from the customers. If it is not added to price, the exporter's profit will decline. If the exporter charges higher prices because of tariffs, the price will increase and he could not compete in international market. So exporters have to manage the prices depending on tariffs.
- 4. Inflation**-The international marketers face different rates of changes in different countries. The prices may change in values of money. They have to protect themselves against the inflation.
- 5. Exchange rate**-The exporters face fluctuations in exchange rates of several countries' currencies. If the rate is fixed, the payment would be easy. The fluctuating atmosphere makes it difficult to decide how much money at what time it would be received by the exporters.
- 7. Demand and supply**-The demand and supply are instrumental to the determination of the prices. The marketer has to evaluate the demand in every country. The supply can be regulated by the exporter himself. The prices can be influenced by the supply positions.
- 8. Competition**-The behavior of competitors put severe constraints on the operating margins and price adjustments and it had become the critical element affecting the prices in free market.
- 9. Government control**-The government control limits the profits and price. The marketer has to fix prices in the customer countries at a given level. The government can impose selective control on the prices of the imported commodities.

6.3 PRICING STRATEGIES

In international marketing the strategies that are to be followed are different. This is because of the difference in environments. What is applicable fails in most of the time to meet the international requirements is due to the heterogeneity of market. The manufacturer employs several strategies to counteract the price problems. The different pricing strategies are;

1. New product pricing Strategies

Pricing strategies usually change as the product passes through its life cycle. The introductory stage is especially challenging. Companies bringing out a new product face the challenge of setting prices for the first time. They can choose between two broad strategies: market-skimming pricing and market-penetration pricing.

A. Market Penetration Pricing

Penetration pricing uses deliberate low prices to stimulate market growth and capture market share. Once this is achieved, the price is increased. The objective of this strategy is market share or market penetration. Here, the firm prices its product lower than the others do in competition. It can be useful when there is a mass market and price sensitive customers. Japanese companies increasingly resort to penetrative pricing due to intense local competition. This approach was used by France Telecom and Sky TV.

This strategy suitable in the following situations:

- When the size of the market is large and it is a growing market.
- When customer loyalty is not high; customers have been buying the existing brands more because of habit rather than any specific preferences for it.
- When the market is characterized by intensive competition
- When the firm uses it as an entry strategy
- Where price-quality association is weak.

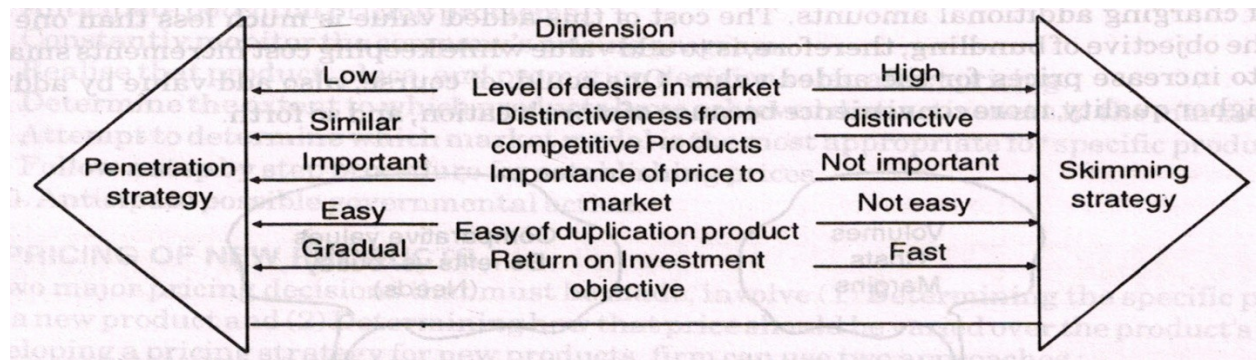
B. Market Skimming pricing

Market skimming involves charging a higher price. Skimming refers to the objective of achieving highest possible profit in a short time. Many companies that invent new products set high initial prices to "skim" revenues layer by layer from the market. Sony frequently uses this strategy, called market-skimming pricing. To use this approach, the product has to be unique and the target market should be willing to pay the high price. Success of this strategy depends on the ability and speed of competitive reaction. A firm with a small market share can face aggressive local competition when using skimming. Maintenance of high quality requires lot of resources.

This strategy delivers results in the following situations:

- ◆ When the target market associates quality of the product with its price, and high price is perceived to mean high quality of the product.
- ◆ When the customer is aware and is willing to buy the product at a higher price just to be an opinion leader.
- ◆ When the product is perceived as enhancing the customer's status in society.

- ◆ When the product represents significant technological breakthroughs and is perceived as a 'high technology' product.



2. PRODUCT MIX PRICING STRATEGIES

The strategy for setting a product's price is often changed when the product is part of a product mix. In this case, the firm looks for a set of prices that maximizes the profits on the total product mix. Pricing is difficult because the various products have related demand and costs and face different degrees of competition. Product mix pricing strategies involves the following.

A. Product Line Pricing

Firms usually develop product lines rather than single product. Where there is a range of products or services the pricing reflects the benefits of parts of the range. Product line pricing takes into account the cost difference between products in the line, customer evaluation of their features, and competitors' prices. While designing the price structure of different product items the firm should take into consideration the factors like

- Cost difference between (among) the items,
- Customer evaluation of the different features and
- The competitor's prices.

B. Optional Product Pricing

Optional 'extras' feature increase the overall price of the product or service. For example airlines will charge for optional extras such as guaranteeing a window seat or reserving a row of seats next to each other. Again budget airlines are prime users of this approach when they charge you extra for additional luggage or extra legroom.

C. Captive Product Pricing

Where products have complements, companies will charge a premium price since the consumer has no choice. For example a razor manufacturer will charge a low price for the first plastic razor and recoup its margin (and more) from the sale of the blades that fit the razor. Another example is where printer manufacturers will sell you an inkjet printer at a low price. In this instance the inkjet company knows that once you run out of the consumable ink you need to buy more, and this tends to be relatively expensive. Again the cartridges are not interchangeable and you have no choice.

D. Product Bundle Pricing

In a bundle pricing, companies sell a package or set of goods or services for a lower price than they would charge if the customer bought all of them separately. It calls for setting the prices of a bundle. Bundle pricing is less than the individual item pricing. Price bundling can promote the sales of the products. Consumers might not otherwise buy, but the combined price must be low enough to get them to buy the bundle.

E. By product pricing

In pricing of some products there are some residue products which are called as by-products. If the by-products have little value and are in fact costly to dispose off, the manufacturer should accept any price that covers more than the cost of disposing them. If the byproducts have values to the customer groups, then they will give price on value. The revenue earned on the by-products will make it easier for the company to charge a lower price of the main product if the competition is intense. For example, while processing of crude oil we get Petrol as the main product and some by-products also come out as Diesel, kerosene oil, coal tar etc. The prices of by products are kept on the lower side.

3. PRICE ADJUSTMENT STRATEGY

Companies usually adjust their basic prices to account for various customer difference and changing situation. The following are some of price adjustment pricing strategy.

A. Psychological Pricing

This approach is used when the marketer wants the consumer to respond on an emotional rather than rational basis. Psychological pricing uses the customer's emotional response to encourage sales. By pricing products strategically, a company may increase sales without significantly reducing prices. In some cases, a higher price is actually more likely to increase sales. For example Price Point Perspective (PPP) 0.99 Cents not 1 US Dollar.

B. Promotional Pricing.

With promotional pricing, companies will temporarily price their products below list price and sometimes even below cost to create buying excitement and urgency. Pricing to promote a product is a very common application. There are many examples of promotional pricing including approaches such as BOGOF (Buy One Get One Free), money off vouchers and discounts. Promotional pricing takes several forms. Supermarkets and department stores will price a few products as loss leaders to attract customers to the store in the hope that they will buy other items at normal markups.

C. Geographical Pricing

Geographical pricing sees variations in price in different parts of the world. For example rarity value, or where shipping costs increase price. In some countries there is more tax on certain types of product which makes them more or less expensive, or legislation which limits how many products might be imported again raising price. Some countries tax inelastic goods such as alcohol or petrol in order to increase revenue, and it is noticeable when you do travel overseas that sometimes goods are much cheaper, or expensive of course.

D. Dynamic pricing

Throughout most of history, prices were set by negotiation between buyers and sellers. Fixed price policies-setting one price for all buyers-is a relatively modern idea that arose with the development of large-scale retailing at the end of the nineteenth century. Today, most prices are set this way. However, some companies are now reversing the fixed pricing trend. They are using dynamic pricing-adjusting prices continually to meet the characteristics and needs of individual customers and situations.

6.4 International pricing strategies versus domestic pricing strategies

International pricing and domestic pricing are different: different overseas market conditions, different costs, different quoting formats and different currencies all affect what you charge your customers for your products or services. Pricing for any market requires an understanding of the relative costs, demand and competition of that market. Many overseas contacts you meet will want to know your price, so it is essential to have your pricing determined before you approach an overseas market.

While dealing with international marketing activities, a marketer may face various challenges in setting price for his products. There are a lot of differences between domestic pricing and international pricing strategies. Among the situations that made international pricing strategy different from the domestic one are discussed as follows.

- 1. Currency Fluctuations:** Fluctuating currency values are a fact of life in international business. The marketer must decide what to do about this fact. Are price adjustments appropriate when currencies strengthen or weaken? There are two extreme positions; one is to fix the price of products in the currency of target country. If this is done, any appreciation or depreciation of the value of the currency in the country of production will lead to gains or losses for the seller. The other extreme position is to fix the price of products in home country currency. If this is done, any appreciation or depreciation of the home-country currency will result in price increases or decreases for customers with no immediate consequences for the seller.
- 2. Inflation:** Inflation, or a persistent upward change in price levels, is a worldwide phenomenon. Inflation requires periodic price adjustment. These adjustments are necessitated by rising costs that must be covered by increased selling prices. An essential requirement when pricing in an inflationary environment is the maintenance of operating profit margins. Regardless of cost accounting practices, if a company maintains its margins, it has effectively protected itself from the effects of inflation.
- 3. Government Controls and Subsidies:** If government action limits the freedom of management to adjust prices, the maintenance of margins is definitely compromised. Under certain conditions, government action is a real 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 (e.g., a foreign exchange shortage caused in part by runaway inflation), government officials are under pressure to take some type of action.

Government control can also take the form of prior cash deposit requirements imposed on importers. This is a requirement that a company has to tie up funds in the form of a non-interest-bearing deposit for a specified period of time if it wishes to import products. Such requirements clearly create an incentive for a company to minimize the price of the imported product; 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. Government subsidies can also force a company to make strategic use of sourcing to be price competitive.

6.5 Price standardization vs. adaptation

The company has to choose between price standardization and adaptation in the international market. The company has to be careful about these factors to be able to decide which approach is the most effective.

Price standardization means that the head office decide a fixed price that is applied in all international markets. When companies use this strategy, they take less risk, since as no attempt is made to respond to local conditions, no effort is made to maximize the profit neither.

The other alternative is to adapt the price to local conditions and is a way for the company to have a greater success. Managers have to establish price depending on the foreign market and foreign consumer's revenues. Adapting the price is sensitive to local conditions; but on the other hand; it gives the company the opportunity to take advantages of price differences that can occur when a company for example buys for lower prices and sells for a higher one.

Table 6.1 factors driving to price standardization or adaptation

Factors driving to price differentiation	Factors driving to price standardization
Customer preference	Reduction of trade barrier
Competitive situation	Decreasing transportation cost
Cost situation	Improved communication and information flow
Inflation/exchange rates	Increasing brand globalization
Regulation/tariff and duties	Active retailer / global sourcing

6.6 Methods of payment

The rapid growth and expansion in global trade cannot be sustained without efficient and timely payment arrangements. There are several payment methods. We will try to see them as follows.

1. Consignment sales

This is a method in which the exporter sends the product to an importer on a deferred payment basis; that is, the importer does not pay for the merchandise until it is sold to a third party. Title to the merchandise passes to the importer only when payment is made to the exporter. Consignment is rarely used between unrelated parties, for example, independent exporters and importers. It is best used in cases involving an increasing demand for a product for which a proportioned stock is required to meet such need. It is also used when sellers want to test-market new products, or test the market in a new country. For the exporter, consignment is the least desirable form of selling and receiving payment. The problems associated with this method include the following:

Delays in payment: Buyer bears little or no risk, and payment to seller is delayed until the goods are sold to a third party. This ties up limited credit facilities and often creates liquidity problems for many exporting firms.

Risk of nonpayment: Even though title to the goods does not pass until payment is made, the seller has to acquire possession of merchandise (to sell in the importer's country or ship back to the home country) in the event of nonpayment. This involves litigation in the importer's country, which often is time-consuming and expensive.

Cost of returning merchandise: If there is limited success in selling the product, there is a need to ship it back to the exporter. It is costly to arrange for the return of merchandise that is unsold.

Limited sales effort by importers: Importers may not be highly motivated to sell merchandise on consignment because their money is not tied up in inventory. They are likely to give priority to products in which they have some financial involvement.

2. Cash in advance

This method of payment requires the buyer to pay before shipment is done. The seller assumes no risk of bad debt and/or delays in payment because advance payment is a precondition to shipment. Sellers often require advance payment in cases in which the credit worthiness of the overseas customer is poor or unknown and/or the political/ economic conditions of the buyer's country are unstable. Cash in advance is sometimes used between related companies. It is also common to require money in advance for samples.

3. Open account

Open account: from the importer's perspective, it is the safest form of payment; whereby goods are shipped by the exporter and received by the importer prior to payment. The exporter then bills the importer for the goods, stipulating the amount, form, and time at which payment is expected.

The opposite of prepayment is the **open account transaction** in which the exporter ships the merchandise and expects the buyer to remit payment according to the agreed-upon terms.

The exporter is relying fully upon the financial creditworthiness, integrity, and reputation of the buyer. As might be expected, this method is used when the seller and buyer have mutual trust and a great deal of experience with each other. Despite the risks, open account transactions are widely utilized, particularly among the industrialized countries in North America and Europe.

A major weakness of this method is that the importer could delay payment until merchandise is received, even when the importer is expected to pay within a specified period after shipment. There is also a greater risk of default or nonpayment by the buyer.

4. Bill of exchange (documentary draft)

The documentary collection or documentary draft is one of the most customary methods of making payments in international trade. To facilitate the transaction, two banks are usually involved, one in the exporter's country and one in the buyer's country. The banks may be independent banks or branches of the same bank. A typical documentary collection procedure includes the following steps:

- After the exporter (drawer) and overseas customer (drawee) agree on the terms of sale, the exporter arranges for shipment and prepares the necessary documents such as invoice, bill of lading, certificate of origin, and draft.
- The exporter forwards the documents to its bank (remitting bank) with instructions.
- The remitting bank then forwards the documents to its overseas correspondent bank (collecting bank) in the importer's country.
- The collecting bank contacts the importer to effect or accept payment.

5. letter of credit

If the buyer pays in advance, he risks that the goods may not be sent. Similarly, if the seller ships the goods before he receives full payment from the buyer, he risks not being paid. To cover these risks, buyers, sellers, and banks use documentary letters of credit in international trade transactions. Under this method, the supplier requires these documents to be presented before payment is made. It is a document that is issued by a bank and contains its **promise to pay the exporter** up on receiving proof that the exporter has fulfilled all the requirements specified in the document.

Letters of credit (LCs) are among the most secure instruments available to international traders. A LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter provided that the terms and conditions have been met, as verified through the presentation of all required documents.

The exporter bears less risk; exporter benefits from the bank's knowledge of the importer's credit worthiness, the requirements of the importer's home country customers service, and any restrictions the importer's home country government imposes on currency movements.

The buyer pays its bank to render this service. A LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but you are satisfied with the creditworthiness of your buyer's foreign bank. A LC also protects the buyer since no payment obligation arises until the goods have been shipped or delivered as promise.

6.8 Transfer pricing

Transfer pricing is a term used to describe aspects of intercompany pricing arrangements between related business entities and commonly applies to intercompany transfers tangible property, intangible property services and finance transfers. Intercompany transactions across borders are growing rapidly and becoming more complex

The creation of foreign subsidiaries and bases of operation for cross border flow of products, services, trademarks, funding and technology is having a significant impact on the issue of transfer pricing in today's international business scenario. The transfer pricing problem for multinationals is of great significance. There are different income tax rates in different countries. So, it becomes desirable from the view point of overall corporate strategy to show higher profits in low-tax countries and lower profits in high-tax countries. One way to do so is through transfer prices. There are two basic issues relating to transfer prices in case of multinational companies having divisions in different countries:

1. Income Tax Rates

Multinational companies always consider domestic and foreign income tax rates while setting transfer prices. For instance, suppose an Indian company based in India has a division in Australia. The Indian division manufactures a component which is transferred to Australian division for assembly and sale of the final product. Assume, the income tax rate in India is higher than the income tax rate in Australia. The different income tax rates will influence the transfer price for the component.

Suppose, the management of the company sets a lower transfer price for the component, this will result in lower profits for the Indian division and lower tax. However, the lower transfer prices will produce high income for the Australian. Since the tax rate is lower in Australia, the overall company will save on income tax. The company, by setting a low transfer price, tends to shift a portion of its income to a country having lower tax rate. In some countries, there are regulations and laws prohibiting such transfer pricing practices.

2. Import Duties:

Transfer pricing policies followed by multinational companies are affected by import duties or tariffs. These are the fees charged to an importer generally on the basis of the reported value of the goods being imported. Consider the above example again of a multinational firm with divisions in India and Australia. If Australia imposes an import duty on goods transferred in from the Indian division, the company has an incentive to set a relatively low transfer price on the

transferred goods. This will reduce the duty to be paid and maximize the overall profit for the company as a whole. Like income taxes, countries sometimes make laws to restrict multinational firms' flexibility in setting transfer prices to minimize import duties payable by them.

6.8.1. Objectives of Transfer Pricing

- Competitiveness in the international marketplace
- Reduction of taxes and tariffs
- Management of cash flows Minimization of foreign exchange risks
- Avoidance of conflicts with home and host governments over tax issues
- internal concerns - goal congruence or subsidiary manager motivation

6.8. Counter trading (reciprocal trade)

Countertrade is transactions in which purchases are tied to sales and sales to purchases. Counter trade, one of the oldest forms of trade, is a government mandate to pay for goods and services with something other than cash. It is a practice, which requires a seller as a condition of sale, to commit contractually to reciprocate and undertake certain business initiatives that compensate and benefit the buyer.

Unlike monetary trade, suppliers are required to take customers' products for their use or for resale. In most cases, there are multiple deals that are separate yet related, and a contract links these separable transactions. Counter trade may involve several products, and such products may move at different points in time while involving several countries. Monetary payments' may or may not be part of the deal.

6.8.1. Types of Counter trade

There are several types of counter trade, including barter, counter purchase, compensation trade, and offsets

1. Barter- Barter, possibly the simplest of the many types of counter trade, is a onetime direct and simultaneous exchange of products of equal value (i.e., one product for another). By removing money as a medium of exchange barter makes it possible for cash-tight countries to buy and sell. Although price must be considered in any counter trade, price is only implicit at best in the case of barter. For example, Chinese coal was exchanged for the construction of a seaport by the Dutch, and Polish coal was exchanged for concerts given by a Swedish band in Poland. In these cases, the agreement dealt with how many tons of coal was to be given by China and Poland rather than the actual monetary value of the construction project or concerts.

2. Counter purchase “An agreement whereby the primary supplier accepts parallel obligations to purchase products and/or services from the buyer's country.” This form is also known as counter exports. Example: As a condition for the purchase of communication equipment by the buyer, the seller commits to buy goods and services from the buyer's country.

3. Offsets -- An agreement whereby the primary supplier commits, as a condition of sale, to undertake or to introduce a wide-range of industrial and commercial activities for the benefit of the buyer or the buyer's country such as:

- Investments
- Technology transfer
- Training and skills upgrade
- Research and development
- Donations

1. Buyback - An agreement whereby the seller/supplier of a turnkey production facility, machinery or equipment agrees to be paid, partially or fully, by the resultant products manufactured from the operation of the said facility or equipment. Example: The seller of a tomato-processing machine agrees to be paid partially through the export of canned tomato paste produced by the machine. The buyer of the processing machine ensures that sufficient quantities of canned tomato paste are exported to the seller as partial payment for the machine.

2. Debt for goods -- A transaction whereby a debtor country offers its goods or services for export to cover full or partial payment for an outstanding debt. Example: Creditor country agrees to accept coconut oil and other commodities from the debtor country as full payment of an outstanding debt. No foreign currency is paid/used to pay the debt. Local commodity suppliers are paid in local currency by the debtor agency.