Manufacturing and Distribution Strategies, Distribution Channels, and Transaction Costs: The Case of Parallel Imported Automobiles

Godfrey Yeung\textsuperscript{a} and Vincent Mok\textsuperscript{b,}\textsuperscript{*}

\textsuperscript{aDepartment of Geography, National University of Singapore, Singapore}
\textsuperscript{bSchool of Accounting and Finance, Hong Kong Polytechnic University, Hung Hom, Hong Kong}

We examine how constraints on transnational corporations’ official distribution channels, asset specificity, and bounded rationality of franchise dealers and parallel traders contribute to the sustainability of the parallel importation of automobiles. The manufacturing and distribution strategies employed by transnational corporations considerably add to the regional differences in the pricing and availability of specific models, as well as vehicle specifications. These necessary conditions enable opportunistic parallel traders to engage in arbitrage. The asset specificity of franchise dealers, bounded rationality, and opportunism of dealers and arbitrageurs sustain the parallel importation of automobiles. Copyright © 2012 John Wiley & Sons, Ltd.

1. INTRODUCTION

The parallel distribution of genuine branded products by unauthorized distributors is a well-known phenomenon in today’s globalized world. In 2010 and 2011, for instance, iPhone 4 and iPad 2 units designated for the USA and European Union (EU) were resold in other markets where the devices are yet to be officially launched by Apple Inc. Parallel imports exist when an unauthorized distributor procures genuine branded products from an authorized distributor and then resells them to customers in a second market without the permission of the owner of their intellectual property rights (copyright, patent, or trademark) for that market. That is, these traders engage in ‘parallel importation’ or ‘parallel distribution channels’ and compete directly with authorized distribution channels in the second market (Duhan and Sheffet, 1988:76; Weigand, 1991:53; Yang \textit{et al.}, 1998:433).\textsuperscript{1}

The parallel importation of automobiles accounts for a significant market share in the Hong Kong Special Administrative Region (Hong Kong, hereafter) and Singapore, at 15–25%, and in the US and the UK, at 15–17%; thus, global automobile giants and their franchise dealers are certainly aware of the prevalence of parallel imports (Bucklin, 1990; \textit{The Strait Times}, May 18, 2007).\textsuperscript{2} Regional differences in taxes and import duties facilitate parallel trade within the EU, but manufacturers have several tools at their disposal (e.g., imposing fines on recalcitrant dealers) to end this practice. Why then do parallel imports persist? Previous studies on the parallel importation of automobiles are limited despite the importance of the automobile industry in an economy. In 2010, for example, the UK automobile industry provided 737,000 direct jobs and accounted for 11% of total UK exports (SMMT, 2012).

\textsuperscript{*Correspondence to: School of Accounting and Finance, Hong Kong Polytechnic University, Hung Hom, Hong Kong. Email: afvmok@polyu.edu.hk

Copyright © 2012 John Wiley & Sons, Ltd.
In contrast to existing literature, which has largely focused on regional price differentiation as the necessary condition for parallel importation, the current paper aims to investigate the roles of transnational corporations’ (TNCs) manufacturing and marketing strategies in the parallel importation of passenger vehicles. We also examine how constraints on official distribution channels, asset specificity, and bounded rational behavior of franchise dealers and parallel traders contribute to the sustainability of the parallel importation of automobiles. Passenger vehicles include cars, sport utility vehicles, multipurpose vehicles, and minivans. Hong Kong and Singapore are two regions with the most liberal laws for regulating the parallel importation of automobiles. In addition to the primary and secondary evidence collected on these regions, data from major automobile markets in North America and Europe are also used. Issues such as the legality of parallel importation and the warranties of parallel imported products are not the focus of this study and will therefore not be examined in detail.

Regional price differentiation is commonly used by economists to explain the existence of parallel imports (Dutta et al., 1994; Malueg and Schwartz, 1994; Gallini and Hollis, 1999; Ahmadi and Yang, 2000; Maskus, 2000; Richardson, 2002; Maskus and Chen, 2004; Hur and Riyanto, 2006). Arbitrage can occur when the differences in prices among various markets (including differences due to volume discounts and market ‘presence’ policies implemented by manufacturers and substantial fluctuations in exchange rates) are greater than the transaction costs when engaging in parallel importation of the same product or when efforts are made to offset supply shortages in regions below the prevailing market price (Cavusgil and Sikora, 1988:75–77). This phenomenon also explains why most, if not all, of the studies on parallel imports focus on homogeneous products, such as pharmaceuticals. Typical examples include studies by Ganslandt and Maskus (2004), Kanavos and Costa-Font (2005), Szymanski and Valletti (2005), and recently, Kanavos and Vandoros (2010). This simplistic assumption is certainly inapplicable to heterogeneous products, including automobiles. Given that the same vehicle model can have different specifications in various markets; this reality demands further explanation of the parallel importation of automobiles. This paper contributes to literature by unraveling how the manufacturing and marketing strategies of TNCs and the constraints on official distribution channels contribute to the sustainability of the parallel importation of heterogeneous products such as automobiles.

To cover the high costs of product development and set up of production facilities that cater to local demands, many global automobile giants assemble vehicles at scale economies and offload them to their franchise dealers. To control agency problems with their franchise dealers, manufacturers implement the market division strategy and the associated penalty system. TNCs’ manufacturing and distribution strategies partly contribute to the regional differences in the pricing and availability of specific models, as well as to variances in vehicle specifications. These necessary conditions enable opportunistic parallel traders to engage in arbitrage. The asset specificity of franchise dealers, bounded rationality, and opportunism of dealers and arbitrageurs also contribute to the existence and sustainability of parallel importation. Franchise dealers are unable to respond to dynamic market demands because they are ‘locked in’ with specific manufacturers (because of the non-deployable nature of their assets) and are compelled to implement the official distribution strategies of manufacturers by maintaining an inventory of certain models at pre-determined volumes every year. Instead of allowing their capital to be tied up in stocks, profit-oriented dealers with bounded rationality are willing to risk the (legitimate and sometimes illegitimate; Section 2) sanctions imposed by manufacturers for directly or indirectly offloading surplus stocks to opportunistic parallel traders. In addition to the high transaction costs for regulating manufacturers’ market division policies and the infeasibility of engaging in sustained price wars against parallel traders, the official manufacturing and distribution strategies of TNCs play important roles in sustaining the parallel importation of passenger vehicles.

The parallel importation of automobiles involves proprietary information that is well guarded by manufacturers, their franchise dealers, and other parallel importers. Data on parallel trade are rarely accessible because trade statistics does not distinguish between authorized and unauthorized intermediaries. In-depth interviews with veteran practitioners involved in parallel importation can be a reliable way to collect the valuable first-hand information necessary to realize the current study’s objectives. Through personal networks, we conducted four rounds of field surveys in Hong Kong and Germany on 12 firms that engaged in car dealing in March 2006, December 2008, January 2009, and May 2012. The surveys enabled us to ascertain how parallel importation is sustained and the potential policy implications of market division and other distribution policies for TNCs, franchise dealers, and parallel traders. One firm was involved in the first round of pilot
interviews, followed by six firms in the second round and another six (including one repeated interview with an experienced parallel trader) in the third and fourth rounds (Table 1). All interviewees have decade(s) of work experience as parallel importers and franchise dealers in Hong Kong. These interviewees include the founder of the most established parallel importer in Asia and dealers of major Japanese cars and German limousines. Besides, we interviewed three German experts on automobiles, including an experienced automobile consultant, a professional researcher, and a well-known German professor specializing in automobile research (especially on the pricing strategies used by automobile manufacturers) in Germany in May 2012. All the interviews were conducted in a semi-structured manner to facilitate conversational flow, with each interview lasting for at least an hour.

The rest of the paper is organized as follows. In Section 2, we review the mechanisms of and debates on parallel imports. We then examine how the interaction between the manufacturing and distribution strategies of automobile manufacturers and price factors facilitates the existence of parallel imports. A detailed diagnosis of agency costs and their effects on the sustainability of unofficial distribution networks in automobiles is then provided. The concluding section discusses the theoretical and policy implications of the research.

2. PARALLEL IMPORTS: MECHANISMS AND DEBATES

Before we review the theoretical debates on parallel imports, it is essential to have an overview of the relevant regulations of parallel imports. According to the doctrine of national exhaustion, the right (trademark protections) of an intellectual property’s owner to control distribution ends only upon the first sale within a country; therefore, the owner of such a right is allowed to exclude parallel imports from other countries.4 Countries with national exhaustion are segmented markets because original manufacturers have complete authority to directly or indirectly distribute goods and services through authorized dealers. This situation does not apply to international exhaustion, in which the right of the owner of the intellectual property to control distribution is exhausted upon the first sale anywhere; thus, parallel imports are allowed.5 As there is no specific regulation on parallel imports under The Agreement on Trade-Related Aspects of Intellectual Property Rights of the World Trade Organization, the specific regulation of parallel imports is at the discretion of each member country (Hoekman and Mavroidis, 2003:15). In regional exhaustion, the right of the owner of the intellectual property to control distribution ends upon the original sale within a group of countries, such as the EU (but not the first sale

<p>| Table 1. Profile of field interviewees |</p>
<table>
<thead>
<tr>
<th>Date</th>
<th>Interviewees</th>
<th>Main issues investigated</th>
</tr>
</thead>
<tbody>
<tr>
<td>First round of interview in March 2006</td>
<td>One preliminary interview with an experienced sales officer of a firm engaging in parallel importation of cars and second-hand cars in Hong Kong</td>
<td>Reasons for the existence of parallel imports</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Implications of TNCs’ distribution policies</td>
</tr>
<tr>
<td>Second round of interviews in December 2008</td>
<td>Six firms involved: two are authorized dealers of German and Japanese cars and four parallel car retailers in Hong Kong</td>
<td>Reasons for the existence and sustainability of parallel imports</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Implications of TNCs’ market division and other distribution policies</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Roles of franchise dealers and their relationships with parallel traders</td>
</tr>
<tr>
<td>Third round of interviews in January 2009</td>
<td>Three firms engaging in parallel importation of cars and second-hand cars in Hong Kong</td>
<td>Reasons for TNCs’ market division and pricing strategies in their distribution networks</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Reasons for authorized dealers’ lack of involvement in price wars against parallel traders</td>
</tr>
<tr>
<td>Fourth round of interviews in May 2012</td>
<td>Three firms (authorized dealers of German and Japanese cars and another parallel car retailer) in Hong Kong and three German experts on automobiles (including an experienced consultant and two experts specializing in automobile research) in Germany</td>
<td>Reasons for authorized dealers’ involvement in parallel trade</td>
</tr>
</tbody>
</table>

Source: authors’ compilation.
outside the region; hence, parallel imports outside the region are prohibited). Under such a scheme, parallel trade in the region is allowed (Maskus, 2000; Maskus and Chen, 2004:551). The settlement of a legal dispute between Mitsubishi and 11 UK parallel importers regarding the importation of vehicles to the UK from outside the European Economic Area is an example of regional exhaustion (Industry News, April 3, 2007).

2.1. Regional Price Differentiation and Its Potential Limitations

Two major strands of research on parallel imports exist. The first strand focuses on theoretical discussions of parallel imports; this strand includes the works of Barfield and Groombridge (1998), Gallini and Hollis (1999), Hur and Riyanto (2006), Li and Maskus (2006), Malueg and Schwartz (1994), and Maskus (2000). The game-theory-based models developed by Ahmadi and Yang (2000), Dutta et al. (1994), Maskus and Chen (2004), Richardson (2002), and Yang et al. (1998) are the most important theoretical works on parallel imports. Dutta et al. (1994:91) concluded that the optimal enforcement policy for manufacturers is to tolerate some level of parallel imports because this reduces the transaction costs of self-enforcing contracts with distributors. Ahmadi and Yang (2000) argued that some manufacturers knowingly use parallel imports to increase their global market share in terms of volume.

Other studies highlighted the effects of parallel imports on TNCs and their authorized dealers, particularly a number of negative effects. TNCs’ authorized dealers may end up competing with parallel traders, thereby diminishing a brand’s prestige (Cavusgil and Sikora, 1988:76). Moreover, parallel imports may strain the relationship between manufacturers and authorized dealers partly because of the decline in market share and profit margins, as well as the disruption of marketing strategies (Cespedes et al., 1988:75–77; Palia and Keown, 1991). Another thread of argument asserts that the existence of parallel imports facilitates market penetration by manufacturers because parallel imports help improve competitiveness in pricing (Maskulka and Gulas, 1987; Weigand, 1989, 1991; Michael, 1998). Similar arguments are also outlined by Bucklin (1990, 1993) and Yeung and Mok (2006). Bucklin (1993:401) argued that parallel imports can increase manufacturers’ market share and profits. Instead of unraveling TNCs’ distribution systems, Yeung and Mok (2006:104–105) explained that the existence of parallel trade promotes inter-regional competition between regional monopolies, which increases rather than decreases the total market share of TNCs because of the lower retail prices of parallel imports.

Regional price differentiation is used by scholars to explain the existence of parallel imports. This prevailing assumption holds that homogenous products and geographical variations in the price elasticity of demand result in consumer surplus appropriation. Szymanski and Valletti (2005), Kanavos and Costa-Font (2005), Ganslandt and Maskus (2004), Kanavos and Vandoros (2010) used pharmaceuticals to illustrate the various effects of parallel trade. Yang et al. (1998:434) discussed that a coherent pricing policy in different regions is vital to the existence of parallel imports. Regional price differentiation also occurs when an authorized distributor sells excess stock to parallel marketers outside their designated territories to become eligible for a volume-discount pricing scheme or to satisfy sales quotas that are assigned by a manufacturer (Maskulka and Gulas, 1987; Cavusgil and Sikora, 1988:75–77; Cespedes et al., 1988:75–77).

The aforementioned studies provide valuable insights into the mechanism of parallel imports in general, but these nonetheless fail to satisfactorily explain the existence of the parallel importation of heterogeneous products. Such deficiency in literature stems from the fact that the analytical framework of regional price differentiation may not explain the effect of other factors that contribute to the existence of parallel imports. The recommended retail price (RRP) is a factor commonly focused on in such studies. Automobiles may have differences in terms of models and specifications in the same market or such differences among different markets. This phenomenon suggests that the inclusion of automobiles in homogenized ‘global products’ by some scholars, including Mullen et al. (2003:78), is an oversimplification of reality. Consumer demand is a function of RRP and non-RRP factors, including the specifications and availability of certain product models. The behavior of customers can be partially reflected in the price elasticity of different regional markets, a case particularly evident in the automobile industry because car purchasing can be an emotion-based decision for customers (field survey, May 2012).9

2.2. Transaction Cost Economics and Agency Costs

Transaction cost economics (Williamson, 1979, 1989; North, 1990) can provide insights into the causes of the
parallel importation of automobiles. This school of thought analyzes the contractual issues of a transaction that arise from bounded rationality and opportunism (opportunistic or self-interested behavior) of agents and asset specificity, or the unique characteristic of a durable asset that may not be redeployed to alternative uses (Williamson 1979, 1989). According to Simon (1957, 1982), the rational choice of a decision maker is subject to cognitive limits because human beings never have perfect information, only limited knowledge and ability to forecast the future.

Fama and Jensen (1983:302) explained that a firm is the nexus of written and unwritten contracts between property rights owners and production factors. These contracts specify the rights and obligations, appraisal criteria, and payoff (remuneration) functions of each agent in the organization, in terms of either fixed payoffs or incentive payoffs that are tied to specific performance benchmarks. Agency problems often arise because the preparation and enforcement of contracts involve agency costs, the costs of protection against opportunistic agent behavior under information asymmetry and incompleteness (Jensen and Meckling, 1976:308–310). On the behavioral assumptions of human beings, Williamson (1989:138–140) asserted that agency problems are part of human nature given that employees are prone to opportunism under a mixture of stewardship and agencyship. In the context of the theory of incentives, employees can be motivated by their own commitment to be loyal stewards of the firm and by the promise of rewards (through remunerations) or the threat of bearing the financial consequences of their decisions. Therefore, the imperfect enforceability of contractual agreements is a natural consequence of the opportunistic behavior of agents and the bounded rationality of decision makers (Williamson, 1989). Aside from the enforceability of contractual agreement, the high transaction costs associated with certain economic activities (representing as much as 35–40% of the costs of activities; North, 1990) explain the existence of parallel trade; that is, parallel imports will not exist if the enforcement of contracts carries little or no cost.

Agency problems occur in the manufacturer–franchise dealer relationship because their agenda may not always be accordant. In the succeeding sections, we examine how the interactions among manufacturing and distribution strategies, asset specificity, bounded rationality, and opportunism of authorized dealers and parallel traders sustain parallel imports.

3. INTEGRATED MANUFACTURING AND DISTRIBUTION STRATEGIES OF GLOBAL AUTOMOBILE GIANTS

This section examines how global automobile giants attempt to integrate official manufacturing and distribution strategies, which consequently contribute to the parallel importation of their products.

3.1. Modular System Manufacturing and Product Localization

The global automobile industry faces two major challenges: thin profit margins and product localization. China and India are still building new assembly lines, whereas some major volume brand automobile manufacturers are losing money in the European market because of excessive production capacity. Those that earn profits can only enjoy profit margins that are mostly of low, single-digit levels; for example, most volume manufacturers make an average profit margin of 4–5% (field survey, May 2012; also see Parment, 2008:255–256).

To keep per-unit production costs down and cover the high costs of product development, automobile assemblers maximize economies of scale, thereby enabling them to produce cars at a volume close to manufacturing capacity of their existing production lines. Manufacturers are compelled to shift as much stock as possible to maintain plant operations because closing them down is politically and economically costly (field survey, May 2012). Mass production is intrinsically incompatible with a market where customers demand heterogeneous vehicles.

To fulfill the market demand for heterogeneous vehicles in terms of models and specifications, global automobile giants are increasingly tailoring their products to local markets. They accomplish customization by applying modular systems in vehicle assembly technologies (Figure 1). This strategy is best demonstrated by the production of various vehicle models of the Volkswagen Group, in which the same platform is shared by models with different brands, such as Audi, Volkswagen, Seat, and Skoda. Product localization is illustrated by the passenger vehicles assembled for the Japanese domestic market (JDM). These JDM models differ from other mass-produced Japanese vehicles in two respects. First, JDM models are specially designed for a domestic (niche) market where Japanese automobile giants do not expect a mass market overseas. Typical examples include the first production of
petrol–electric hybrids that were originally designed for the stop–go traffic in Tokyo before having been exported to target the trendy North American and European ‘green’ markets. Second, JDM models are used to test consumer response in the ultracompetitive Japanese markets before these are launched worldwide. Thus, they normally have higher specification levels and luxury features, with state-of-the-art automated gadgets as standard equipment. Being right-hand drive is another reason JDM vehicles account for a significant proportion of the parallel importation markets in Hong Kong, Singapore, Thailand, and the UK; as this reduces the transaction costs incurred by parallel traders in sourcing (field survey, March 2006, December 2008, and January 2009).

3.2. Manufacturing and ‘Market Division’ Distribution Strategies

To recover their substantial investment in product localization, manufacturers normally implement certain forms of distribution strategies in various regional markets. The dealers in franchise networks can price vehicles (in consultation with manufacturers) according to a local market’s price elasticity. However, dealers are typically required to keep an inventory of certain models with vehicle specifications determined by manufacturers. For instance, Asian dealers of Japanese brands are allowed to sell vehicle assembly only in Asia, thereby minimizing the investment risks from manufacturer assembly plants in the region (field survey, December 2008).
To address agency problems (especially free-rider services provided by franchise dealers) and to maintain an organized distribution system, automobile manufacturers usually implement the ‘market division’ marketing strategy by dividing the global market into different regional markets, with each monopolized by a corresponding exclusive franchise dealer (de facto regional monopoly) (also Antia and Frazier, 2001; Bergen et al., 1998; Dutta et al., 1994). Dealers sign contracts with manufacturers that forbid the reselling of allocated cars in other countries (field survey, December 2008 and May 2012). General Motors imposes a fine on its Canadian dealers that sell cars in the non-designated US market, a fine that is equivalent to the difference between Canadian and US dealers’ invoice prices. Mercedes-Benz imposes a token fine of 1% of commissions on Asian dealers that violate the market division policy (field survey, December 2008).

Manufacturers also use other punitive measures, such as withholding (a part of) bonuses, delaying the delivery of newly launched models, cancelling volume-discount pricing, and withholding the supply of certain models (such as right-hand drive models), to regulate market division (field survey, December 2008; also Antia et al., 2004; Raff and Schmitt, 2007). This approach prevents competition between different regional monopolies and maximizes the profits of each franchise dealer within its own designated market. For instance, Peugeot Netherlands used to implement an illegal compensation system to restrict its franchise dealers from selling passenger vehicles to consumers in other EU countries by withholding bonus payments and limiting the supply of Peugeot cars (Financial Times, October 6, 2005:28).

Despite these restrictions, the parallel importation of automobiles accounts for double-digit shares in a number of major markets (Antia et al., 2004:68; Raff and Schmitt, 2007:435–436). The market division distribution strategy is fundamentally ineffective because of its intrinsic contradiction of other official production systems implemented by manufacturers.

3.3. Volume Discount, Market ‘Presence’, and Regional Price Discrimination

The official manufacturing strategy of automobile giants forces them to sell as many cars as possible to recoup high development costs. The resultant volume-discount pricing and regional price discrimination cause arbitrage and, therefore, the existence of parallel imports (Figure 1).

To sell as many assembled cars as possible, manufacturers have pre-determined volume-discount (per model) agreements with their franchise dealers worldwide; that is, dealers receive bonuses or special discounts by ordering certain units per model per year. Some volume brand manufacturers also provide special volume-discount deals with vehicle fleet management companies (including car rental companies) partly to maintain their market ‘presence’ (see the next paragraph). For example, vehicle fleet management companies account for almost half of all new car registrations in the UK (SMMT, 2008). A mismatch between the demand and supply of a particular car model in certain markets occurs. A gray market for a product exists when a franchise dealer sells excess stock to parallel traders outside their designated territories in an effort to become eligible for a volume-discount pricing scheme or to satisfy the sales quotas assigned by a manufacturer (field survey, December 2008 and January 2009; also Maskulka and Gulas, 1987; Antia et al., 2004). In Italy, parallel traders (e.g., DR Distribuzione) offer a discount of 26% on the RRP (€7950) of the Kia 1.0-l Picanto Spirit and still earn 1% more of pre-tax profits than do franchise dealers (Ciferri, 2007:10).

An oversupply of vehicles due to the ‘market presence’ distribution strategy employed by some manufacturers gives rise to opportunities of arbitrage by parallel importers. Commonly, manufacturers deliberately oversupply to certain regional markets to maintain presence. For example, Mercedes-Benz is known to systematically ship excess stocks to Barbados, so that its presence in the market is recognized. A number of these unsold cars are subsequently re-exported to the UK (Raff and Schmitt, 2007:435).

Regional price discrimination can result from price reduction by manufacturers or differentiated pricing by manufacturers or dealers. For products with short life cycles or those that require sale economies, sales teams are under constant pressure to sell excess stocks to distributors (including parallel traders) before the cost of the product is written off in the company balance sheets. This price reduction by manufacturers and the subsequent fire sale by parallel importers further reduce product price. These may even lead to a vicious cycle, in which the accumulation of excess stocks prompts price discounts by the manufacturers, thereby entailing further fire sales by parallel importers (field survey, December 2008 and May 2012).

Regional price discrimination reflects the price elasticity of demand; dealers charge lower prices in price elastic markets and vice versa. The RRPs of automobiles are normally lower in Vancouver, Canada, than in the USA, which contributes to the importation of
200,000 vehicles to the USA (Automobile News, March 4, 2002:12). Parallel importation remains a common practice in the EU despite the comparable after-tax RRP. For instance, parallel traders export more than 25,000 automobiles a year from Belgium to other European countries despite the absence of a local automobile assembler (Weigand, 1991; Yang et al., 1998). According to the latest report by the EC on car prices, certain models of passenger vehicles within the Euro zone still have a significant difference in pre-tax prices. For example, the pre-tax price of the Ford Focus was about 24% higher in Belgium (16% higher in the UK) than in Finland (EC, 2011).

4. AGENCY PROBLEMS AND PARALLEL IMPORTS

After the examination of the roles of integrated manufacturing and distribution strategies on the existence of parallel imports, investigation of the importance of agency problems to franchise dealers and parallel importers and the manner by which these issues contribute to the sustainability of parallel imports is crucial.

4.1. Asset Specificity of Franchise Dealers and Regional Differentiation in Vehicle Availability

To resolve agency problems, manufacturers regulate the activities of their franchise dealers through certain transaction-specific investments. To qualify as franchise dealers, franchisees have to invest in certain transaction-specific, non-redeployable physical and human assets that are specialized and unique to a task (Figure 1). Exchange partners use this system as a private ordering mechanism to reduce opportunism. An automobile manufacturer usually requires a franchisee to invest its own money in branding the franchise location to fulfill certain pre-determined standards; for example, a showroom should match brand image, and a workshop is equipped with specialized diagnostic computers (field survey, December 2008). These transaction-specific investments make offering an alternative brand or switching to a different brand without significant new investment in changing the asset-specific equipment costly for franchisees. For example, Ital Auto (Komoco), the newly appointed dealer for Ferrari in Singapore, had invested US$7m to establish a new franchise (The Strait Times, July 19, 2009:18). In other words, dealers are locked in with specific manufacturers, although manufacturers cannot legally forbid their dealers in the EU to sell other marques, according to the EU Block Exemption Regulation implemented since 2002.

As previously mentioned, dealers can sell only certain models of particular vehicle specifications in pre-arranged quantities assigned by manufacturers when the volume-discount agreements are signed every fiscal year. The determination of such quotas is based largely on the life cycle of a manufacturer’s local plants (field survey, December 2008 and January 2009). This approach creates spatial differentiation in vehicle availability, especially of newly launched models with different vehicle specifications, which is the major non-RRP factor that contributes to the parallel importation of automobiles (Figure 1).

Despite the hype surrounding globalization and the power of TNCs, bottlenecks in manufacturing and distribution systems are common. The parallel importation of automobiles exists if the launch of certain models or regional quotas in some markets has a significant time lag. This market for parallel imported vehicles is highly dynamic because (strong) demand usually lasts only for as long as the bottleneck in the distribution channel exists. Hong Kong customers, for example, can buy newly launched Toyota models (such as the GT86 coupé in 2012 and Alphard MPV) through parallel importers within 2 weeks after the first launch of such models in Japan. This rate is even faster than some dealers in Japan can acquire their stocks. Once the official dealer in Hong Kong distributes the same model, the price premium demanded by parallel importers disappears. For newly launched premium brand models, for instance, Ferrari customers in Hong Kong are willing to pay up to €50,000 premium over the RRP to beat the 2-year waiting list at the franchise dealer and import their favored cars directly from Europe where the allocated quotas are larger than those in Hong Kong (field survey, December 2008, January 2009, and May 2012). Parallel imports are a means for customers to overcome the constraints in distribution networks, specifically, the time lag in the launch of certain models in different markets. Under these circumstances, price-inelastic customers are willing to pay a premium to purchase coveted vehicles (especially premium brands) earlier than general customers. This phenomenon creates a niche market for specialized parallel traders.

A significant proportion of consumers in Asia (particularly Hong Kong, Singapore, and Thailand) are dissatisfied with the ordinary models available from franchise dealers partly because of their perception that vehicles assembled in Thailand and Indonesia are of lower quality than those assembled in Japan or
Europe. This is another non-RRP factor that influences parallel importation. In Singapore, about one in three Toyotas is sold by parallel importers partly because the franchise dealer supplies only several mass market models (Vios, Corolla Altis, and Camry) assembled in Thailand and Indonesia. The same is observed in other major manufactures; for example, General Motors restricts the Zafira and Astra assembled in Opel's Bochum plant in Germany for the West European market, whereas Honda targets its Thailand-assembled Accord for Asia–Oceania markets. Such restrictions are particularly imposed on manufacturers with multiple brands; ‘market division’ distribution strategies are crucial for avoiding competition between the different brands of the same company in the same market segment. As succinctly described by a German automobile consultant: ‘You are cannibalizing yourself by having different brands with the same product segments in the same market!’ (field survey, December 2008, January 2009, and May 2012).14

The non-redeployable nature of asset specificity and the corresponding high investment required to provide complete dealer services can resolve the unavailability of certain vehicle models from official dealers. A recent example is the Nissan GT-R, which one parallel importer in Hong Kong managed to secure in one of the earliest rolled-out models right after its initial launch in Japan in December 2007. This high-performance coupé is available in Hong Kong only from parallel traders because providing a 5-year warranty for a model with expected sales figures below 1000 is unprofitable for a local dealer. A franchise dealer is estimated to sell the car at HK$1.4m each (versus HK$0.87–0.92m charged by parallel importers) to cover all overhead costs and dealership support (field survey, March 2006 and December 2008).

Under the abovementioned circumstances, franchise dealers are not as efficient as parallel traders in terms of responding to changes in market demand. For instance, the more than 10-fold increase in vehicle ownership tax (Certificates of Entitlement) imposed by the Singaporean government in 2010 resulted in dramatic changes in automobile market shares in Singapore. Along with these changes, the relative appreciation of the Japanese yen (compared with the Euro) against Singaporean dollars demonstrated the critical effects of asset specificity on the (lack of) competitiveness of franchise dealers for Japanese and Korean brands. The Certificates of Entitlement per se are worth (much) more than the RRP of some mass market models offered by dealers of Japanese and Korean brands. Thus, customers are either priced out of the new vehicle market or ‘upgraded’ to European models. Subsequently, Mercedes-Benz and BMW have dethroned Toyota and Honda as the top two brands in a rapidly diminishing new vehicle market in Singapore since 2011. This situation also partially accounted for the more than 10-fold increase in sales volume by Porsche between 2002 and 2011. Porsche ranked 10th in Singapore’s automobile market during the first quarter of 2012. In stark contrast, Toyota and Honda’s sales collapsed by more than 90% within 4–5 years to 3562 and 942 in 2011, respectively. Chinese and Malaysian manufacturers Geely, Chery, and Proton subsequently exited the Singapore market (LTA, 2012).

Without the constraints of asset specificity, parallel importers can more efficiently respond to the changes in market demand than can franchise dealers and supply their customers with ‘non-mainstream’ vehicles. In response to changing market demands, parallel traders in Singapore have simply shifted from Japanese and Korean brands to German vehicles; for example, BMW, Mercedes-Benz, Audi, Porsche, and Volkswagen were among the top 10 parallel imported vehicles in 2011 (Business Times, November 4, 2011).

4.2. Bounded Rationality and Opportunism of Dealers and Traders

The interests of manufacturers and dealers may not always be compatible with one another (Figure 1). This discordance is demonstrated by the reluctance of dealers to invest in their facilities to cater to the market demand for niche models and other proactive market distribution strategies of manufacturers. After all, franchise dealers earn most of their profits through after-sales services (with an average gross profit margin of 63.7% in the UK) rather than on a thin gross profit margin of 4.6% from vehicle sales (AIGT, 2002:3). The lower the investment in the training of mechanics and inventory (including components), the higher are the profit margins earned by dealers from vehicle maintenance and other after-sales services.

In addition to niche models, franchise dealers are reluctant or refuse to stock ‘bare bones specification’ models in certain markets because of the asset specificity that stems from providing full dealer support for such models and the bounded rationality of minimizing the capital tied up in inventory maintenance. These models are normally entry models that may not command a mass market but have exactly the same physical appearance as higher-end models. These vehicles are targeted for customers who are on relatively tight budgets but prefer to purchase European

TO MAXIMIZE THEIR MARKET SHARES IN HIGHLY COMPETITIVE MARKETS, PREMIUM BRAND MANUFACTURERS USUALLY PRESSURIZE THEIR FRANCHISE DEALERS TO IMPLEMENT PROACTIVE PRICING AND MARKETING STRATEGIES. FOR INSTANCE, BMW DEALERS IN JAPAN HAVE REDUCED THEIR RRPs SEVEN TIMES IN 2 YEARS UNTIL THEIR RATES HAVE REACHED NEARLY THE SAME VALUE AS THOSE IN GERMANY (WEIGAND, 1989). SOME MANUFACTURERS, SUCH AS MERCEDES-BENZ, PEUGEOT, AND RENAULT, HAVE IMPLEMENTED THE ‘MARKET AREA’ DISTRIBUTION STRATEGY BY TAKING OVER DEALERSHIPS IN SELECTED MAJOR CITIES IN EUROPE. IN ADDITION TO COMPETING WITH THEIR RIVALS FOR MARKET SHARE, THIS APPROACH FACILITATES MORE DIRECT MANUFACTURER CONTROL OVER THE DISTRIBUTION OF ITS PRODUCTS AND LOWERS THE AGENCY COSTS IN DEALING WITH DEALERS.

DESPITE THESE APPROACHES, MANUFACTURERS AND THEIR DEALERS HAVE NO INCENTIVE TO DEPLOY AGGRESSIVE PRICING STRATEGIES (SUCH AS OPENLY DECLARING A PROLONGED PRICE WAR AGAINST PARALLEL IMPORTERS) THAT ELIMINATE THE OPPORTUNITY OF ARBITRAGE. PRICE WARS ARE FINANCIALLY COSTLY FOR MANUFACTURERS AND THEIR FRANCHISE DEALERS BECAUSE SUCH A STRATEGY IS INCONSISTENT WITH THEIR AIDS FOR PROFIT MAXIMIZATION AND BRAND OR IMAGE BUILDING. AS POINTED OUT BY AN AUTHORIZED DEALER OF A MAJOR JAPANESE AUTOMOBILE BRAND, ‘CUTTING PRICES TO COMBAT PARALLEL TRADERS WOULD RESULT IN WAFER-THIN PROFIT MARGINS FOR [US]’ BECAUSE CUSTOMERS ARE MORE RECEPTIVE TO PRICE REDUCTION THAN PRICE INCREASE; THAT IS, DEALERS CANNOT ADJUST THEIR RRP DOWNWARD AND UPWARD TOO FREQUENTLY (FIELD SURVEY, MAY 2012). MOREOVER, PRICE WARS AND THE CONSEQUENT PRICE VOLATILITY ARE HIGHLY DISRUPTIVE TO ESTABLISHED DISTRIBUTION NETWORKS BECAUSE THESE PHENOMENA IMPOSE AN IMMEDIATE FINANCIAL EFFECT ON THE EXISTING STOCKS OF DEALERS. FURTHERMORE, ALMOST ALL FRANCHISE DEALERS ARE DIRECTLY OR INDIRECTLY INVOLVED IN USED-CAR MARKETS (I.E., BY ACCEPTING USED VEHICLES THAT ARE TRADED IN BY THEIR CUSTOMERS). A PRICE WAR, ESPECIALLY A PROLONGED ONE, WILL AT THE LEAST REDUCE THE VALUE OF USED-CAR STOCKS, DELAY THE PURCHASING DECISIONS OF POTENTIAL CONSUMERS, AND DIMINISH BRAND VALUE AND IMAGE. FOR EXAMPLE, VEHICLES FOR NICHET MARKET COMMAND A PRICE PREMIUM PARTLY BECAUSE OF THEIR BRANDS AND ASSOCIATED PRESTIGE, INCLUDING THE ABILITY TO HOLD A LOWER RATE OF DEPRECIATION THAN CAN MASS MARKET CONTEMPERARIES (FIELD SURVEY, MAY 2012). THIS IMPORTANT POINT IS ILLUSTRATED BY THE SHORT-TERM AGGRESSIVE PRICING STRATEGY IMPLEMENTED BY MERCEDES-BENZ. TO EFFECTIVELY COMPETE FOR MARKET SHARE WITH RIVAL BMW IN ASIA, MERCEDES-BENZ TOOK BACK PRICING RIGHTS FROM THEIR FRANCHISE DEALERS IN SINGAPORE AND HONG KONG AND CONVERTED DEALERSHIPS TO EXCLUSIVE RETAILERSHIPS IN 2001 AND 2004, RESPECTIVELY (SEE LEE AND LIM, 2002, FOR SINGAPORE). MERCEDES-BENZ’S SUBSEQUENT AGGRESSIVE PRICING POLICIES, INCLUDING A REDUCTION IN THE RRP OF ITS MAINSTREAM E-CLASS VEHICLES BY 32%, ENLARGED ITS MARKET SHARE IN HONG KONG BUT REDUCED THE GROSS PROFIT MARGIN OF ITS EXCLUSIVE RETAILERS FROM A ‘HIGH’ DOUBLE-DIGIT LEVEL TO 8% (FIELD SURVEY, DECEMBER 2008). SIMILAR MARKETING STRATEGIES WERE ALSO IMPLEMENTED BY TOYOTA AND HONDA FRANCHISE DEALERS IN SINGAPORE FOR A BRIEF PERIOD (THE STRAIT TIMES, DECEMBER 31, 2008). PARALLEL TRADERS, ESPECIALLY IN RELATIVELY SMALL MARKETS SUCH AS HONG KONG AND SINGAPORE, HAVE GOOD ACCESS TO PRICING INFORMATION, AND THEY CAN EFFECTIVELY RESPOND TO PRICE WARS GIVEN THEIR LOW OVERHEAD COSTS (BECAUSE OF THEIR LIMITED EXPOSURE TO NON-REDEPLOYABLE ASSETS) AND GLOBAL SOURCING. THAT IS, THEY CAN SOURCE THEIR VEHICLES IN COUNTRIES WITH FAVORABLE EXCHANGE RATES. IN SPITE OF THESE (SHORT-TERM) AGGRESSIVE PRICING STRATEGIES, PARALLEL IMPORTS STILL ACCOUNT FOR UP TO 25% OF THE AUTOMOBILE MARKETS IN HONG KONG AND SINGAPORE. THIS SHARE EXPLAINS WHY MANUFACTURERS ARE GENERALLY RELUCTANT TO ENGAGE IN A (PROLONGED) ‘LOSE–LOSE’ UNSUSTAINABLE PRICE WAR AGAINST PARALLEL IMPORTERS (FIELD SURVEY, MAY 2012).

THOUGH AUTHORIZED DEALERS DO NOT COMMONLY RELY ON PRICE WAR STRATEGIES TO DRIVE PARALLEL TRADE OUT OF THE MARKET, SOME TAKE ADMINISTRATIVE MEASURES TO HANDLE COMPETITION AGAINST PARALLEL TRADERS. WE ELABORATE ON THIS POINT BY DISCUSSING THE CASE OF VOLKSWAGEN IN HONG KONG (FIELD SURVEY, MAY 2012). BEGINNING IN 2009, VOLKSWAGEN’S DEALER IN HONG KONG HAS IMPOSED AN ADMINISTRATIVE MEASURE, IN WHICH NEW VEHICLE REGISTRATION DOCUMENTS ARE WITHHELD FROM THEIR CLIENTS FOR 95 DAYS. FOR INSTANCE, SHOULD THE CUSTOMERS EXPORT THEIR CARS TO SINGAPORE AS PARALLEL IMPORTS WITHIN 95 DAYS (AT WHICH THEY CAN CLAIM THE VEHICLE TAX REBATES FROM THE HONG KONG GOVERNMENT), VOLKSWAGEN (HK) WOULD IMPOSE A FINE OF UP TO HK$100,000.

of parallel imports by allowing their dealers to serve as manufacturers may indirectly facilitate the persistence of unviable, circumstantial evidence suggests that some costs of eliminating such activities are economically unsold stocks before phase out and the transaction for exchange for compliance with the non-export declaration. Because Volkswagen (HK) does not directly compete with Japanese/Korean brands or higher-end German brands, the company can afford to implement such relatively effective administrative measures. For example, the proportion of brand new Volkswagen cars re-exported as parallel goods from Hong Kong to other areas (mostly to Singapore) has decreased by half to about 5% in 2012.16

In reality, franchise dealers and parallel traders may not always have a direct conflict of interests, as usually stated in literature, such as in the works of Cavusgil and Sikora (1988), Cespedes et al. (1988), and Palia and Kehm (1991). Franchise dealers are under pressure to place large orders from manufacturers so that they can avail of their annual bonuses for achieving sales quotas or secure volume discounts per model. These dealers place such orders even under the possibility that not all stocks at RRPs may be sold. Franchise dealers with bounded rationality have their cash flows tied with their inventories of unsold stocks in warehouses or forecourts. Given the short product life cycle of (volume brand) automobiles, some of these unsold stocks can be ‘un-sellable’ at RRP when a model is about to be phased out by manufacturers. Under these circumstances, it is in the mutual interests of franchise dealers and parallel traders to cooperate in the distribution of excess stocks before the window of opportunism for arbitrage is closed. Opportunistic franchise dealers may not earn much profit from the fire sale, but they can knowingly or unknowingly offload their excess stocks to parallel traders, thereby improving their cash flow. Meanwhile, parallel traders can engage in arbitrage on price differentiation in regional markets; for example, at least 50 Mercedes-Benz cars designated for the Hong Kong market are sold to parallel traders in Singapore or Malaysia every year (field survey, December 2008).

Given that the incentive for dealers to offload unsold stocks before phase out and the transaction costs of eliminating such activities are economically unvierviable, circumstantial evidence suggests that some manufacturers may indirectly facilitate the persistence of parallel imports by allowing their dealers to serve as ‘resellers’ of parts, including those for models that they are not officially selling in the market. By directly supplying parts to non-franchised garages, some opportunistic franchise dealers maximize their profits and increase their potential market share. The dealers of two German limousines in Hong Kong act as ‘unofficial importers’ of parts for non-franchised workshops, including those operated by parallel traders and suppliers of specialized parts with a special volume discount for bulk purchases (field survey, March 2006 and December 2008). This strategy has several interesting features.

First, the approach is part of a highly effective marketing strategy in conjunction with RRP reduction. Potential customers, especially ‘marginal’ consumers who can barely afford luxury limousines, will not be put off by the high maintenance costs of owning such a premium brand of vehicles (field survey, March 2006 and December 2008).

Using the unofficial suppliers of genuine parts and a network of non-franchised garages, franchise dealers can minimize operating costs when they provide after-sales warranty and post-warranty maintenance services. Franchise dealers are able to provide such services by keeping a smaller team of mechanics and keeping significantly less inventory of parts. The cost savings for these two German limousine dealers can be relatively substantial because of high land costs and the shortage in well-trained mechanics in Hong Kong. Given that plenty of service specialists are available at other independent garages, dealers can charge higher prices for their maintenance services, thereby protecting their profit margin and brand premium without worrying about complaints from disgruntled customers (field survey, March 2006 and December 2008).

Third, dealers can earn decent profits by being the ‘unofficial importers’ of the genuine parts for non-franchised garages at minimal marginal costs and high cash flow. The widespread use of genuine parts by independent specialist garages also reduces the possibility of complaints from disgruntled customers who may suffer from embarrassing breakdowns. Any mechanical breakdowns are more likely due to poor fitments rather than fitting poor-quality pattern parts. This cost-effective marketing strategy of dealers will not ruin the reputation of these two brands as reliable and luxury limousines (field survey, March 2006 and December 2008).

5. Conclusions and implications

This paper aims to examine how constraints on TNCs’ official manufacturing and distribution strategies contribute to the existence and sustainability of the parallel
importation of automobiles. Transaction cost economics is useful in analyzing the existence of parallel imports. The opportunism (for arbitrage) and bounded rationality (protecting one’s self-interest) of franchise dealers and parallel importers, as well as asset specificity rather than pre-tax price differences between regional markets per se, explain why the parallel importation of automobiles persists.

To cover the high costs of product development and setup of production facilities that cater to local demands, one of TNCs’ manufacturing strategies is to assemble vehicles at scale economies and offload them to their franchise dealers. The market division strategy and the associated penalty system implemented by TNCs are theoretically cost-effective ways of resolving agency problems that stem from franchise dealers. The market division policy in product distribution systems.

Instead of heavily attributing the existence of the parallel importation of homogenized products to regional price differentiation, as suggested by traditional literature (Cavusgil and Sikora, 1988; Malleg and Schwartz, 1994; Barfield and Groombridge, 1998; Bergen et al., 1998; Maskus, 2000; Antia et al., 2006; Hur and Riyanto, 2006; Li and Maskus, 2006), we argue that the official manufacturing and distribution strategies of TNCs in the form of regional market quotas, localized models, and specifications are important non-RRP factors that contribute to the existence of the parallel importation of heterogeneous products.

In the automobile sector, we have argued that the integrated manufacturing and distribution strategies of manufacturers partly contribute to the regional differences in pricing, availability of specific models, and vehicle specifications. These necessary conditions enable opportunistic parallel traders to engage in arbitrage (because of regional differences in RRP and non-RRP). In addition, all agency problems such as the asset specificity of franchise dealers, bounded rationality, and opportunism of dealers and arbitrageurs contribute to the existence and sustainability of parallel imports. Franchise dealers are unable to respond to changing market demands because they are locked in with specific manufacturers (because of the non-deployable nature of their assets) and are compelled to implement the official distribution strategies of manufacturers by placing an order for models with certain vehicle specifications in agreed volumes at the beginning of every fiscal year. Instead of allowing their capital to be tied up in stocks, recalcitrant profit-oriented dealers with bounded rationality are willing to risk (legitimate and sometimes illegitimate) manufacturer-imposed sanctions as a result of direct or indirect surplus stock offloading to opportunistic parallel traders. This practice is especially prevalent when stocks approach the end of their life cycles. Parallel imports compete in price and availability in terms of earlier delivery of newly launched models or supply of certain non-mass-manufactured specifications/models. Such competition can explain why some parallel imported automobiles are more expensive than those from authorized distribution channels. As long as price premiums (determined by price (in)elasticity of vehicles) offset transaction costs, the parallel importation of automobiles among different regional markets can be sustained.

Theoretically, manufacturers can engage in aggressive pricing strategies (including prolonged price wars) to eliminate the price gaps for opportunistic parallel traders to engage in arbitrage. In reality, a prolonged price war is an unsustainable ‘lose–lose’ game because the manufacturers suffer from diminished profit margins, as well as diminished brand image and value. Such decline occurs through the depreciation of the value of used cars, thereby potentially straining relationships with franchise dealers. Some attempt to suppress or eliminate parallel imports at prohibitive high transaction costs, especially in countries where liberal laws allow parallel importation. Examples of such laws are The Trade Marks Acts 1998 and 2004, which specifically state that parallel importation is allowed in Singapore. Instead of adopting this approach and losing potential customers and market share to other car makers, tolerance of such practice to a certain extent may be a more favorable measure for manufacturers and franchise dealers.

This policy suggestion is consistent with the conjecture that parallel imports may be compatible with the marketing strategy of TNCs. These findings contradict those of Cavusgil and Sikora (1988:76), Cespedes et al. (1988:75–77), and Palia and Keown (1991) but are supported by the theoretical parallel importation models proposed by Dutta et al. (1994), Bucklin (1993), and Ahmadi and Yang (2000). Manufacturers typically gather valuable market intelligence in terms of the effectiveness of distribution networks, including the comparative efficiency of each dealer in a network and customer demands at minimal additional marketing.
costs (Michael, 1998:28–30); but they can also use parallel imports as a supplemental channels for exploring untapped markets that authorized dealers are unable to or find too costly to access. Manufacturers can increase their global market share at relatively low costs because manufacturers and parallel importers have no agreement; therefore, traders have to use their own resources to develop market presence. Parallel imports can attract new customers who are unwilling to buy manufacturers’ products through the high-priced channel managed by franchise dealers. The use of parallel imports to penetrate previously untapped markets by TNCs is also observed for products other than automobiles. An estimated 25% of parallel imported health and beauty products do not directly compete with those of franchised distributors (Antia et al., 2004:66–67). To provide more choices to consumers, authorized dealers should cater to service-sensitive customers, and parallel traders should cater to bargain hunters; in this way, the state would benefit from high sales and profit taxes through high turnovers in manufacturers and/or dealers/traders.

Acknowledgements

The authors would like to express their gratitude to the anonymous traders and people who facilitated and participated in their surveys. The Hong Kong Polytechnic University financed the authors’ field surveys between 2006 and 2009 (Research Project Reference: GYG24).

NOTES

1. Some authors, including Li and Maskus (2006:443) and Maskus (2000:1269), have not made explicit distinctions between parallel imports and gray-market imports. However, Duhan and Sheffet (1988:76), Michael (1998:26–27), and Weigand (1989:20; 1991:53–55) have argued that ‘gray market’ is a broader term, which includes parallel imports and ‘re-imports’ (products intended for foreign markets that are diverted back into home markets by unauthorized distributors). The re-importation of genuine products, in which the products may not physically leave the country of production, are gray imports rather than ‘true’ parallel imports because these imports compete with the products from authorized distribution channels rather than other authorized imports in home markets. Refer to Michael (1998:26–27) and Weigand (1991:53–55) for further explanation of the various distribution channels in a gray market.


3. Previous research by Yeung and Mok (2006) also suggests that in-depth interviews with involved players can provide reliable and valuable information necessary to examine parallel imports in the beverage industry.

4. Three specific theories in trademark laws are used to explain the legality of gray markets. Under the theory of universality (trade identity), a trademark is an indication of a product’s origin; thus, gray marketing is allowed. Under the theory of exhaustion, a trademark owner surrenders all rights after a product’s first sale so that no illegality exists in gray-marketing activities. Under the theory of territoriality, a trademark is effective only in the registered country, so that the gray marketing of this trademarked product is considered legal in non-registered countries (Duhan and Sheffet, 1988:78; Clarke and Owens, 2000).

5. No trademark infringement occurs if the parallel traded goods are not ‘materially different’ from authentic goods authorized for sale in the country. In May 1988, the US Supreme Court upheld the legality of gray-market imports under Section 526 of the Tariff Act of 1930 (after the K-Mart vs. Cartier case). This specific law allows the importation of trademarked products as long as the trademarks are owned by the same entity or the foreign trademark is applied under the authorization of the US owner (Cavusgil and Sikora, 1988:83–84. Also see Clarke and Owens, 2000:277–278; Duhan and Sheffet, 1988; NERA, 1999; Palia and Keown, 1991:48; Palmeter, 1988).

6. However, the profitability of manufacturers may not increase because profitability depends on the sizes and profit margins of the market segment of parallel imports. Knox and Richardson (2002:137) argued that parallel imports are welfare enhancing for free-trading countries.

7. For cross-referencing in the pharmaceutical industry, Szymanski and Valleriti (2005) argued that parallel trade in R&D-intensive pharmaceuticals is less desirable in terms of social welfare than are branded consumer products. Kanavos and Costa-Font (2005) further contended that parallel trade in pharmaceuticals benefits the distribution chain rather than the consumers given that the parallel traded drugs are priced marginally lower than those sourced from authorized channels. On the basis of 1994–1999 data on Sweden, Ganslandt and Maskus (2004) found that the emergence of parallel imports reduced the prices of pharmaceuticals by 12–19%. However, using 1997–2002 data on EU members as bases, Kanavos and Vandoros (2010:336) argued that the regulations and structure of wholesaling business in destination countries, rather than parallel imports, determine the relative prices in prescription medicines sourced from parallel traders and local wholesalers in Europe. They further argued that parallel imports led to an upward rather than downward price convergence in prescription medicines.

8. Another conventional explanation for parallel imports is based on free-rider theory. It examines the issue from three perspectives: the availability of trademarked products in markets, the profit incentives attributed to price differences, and the low legal barriers to shipping products from one place to another (Duhan and Sheffet, 1988).
9. This is the case when the manufacturing plant is closely embedded with the local community for decades. For instance, local residents may be less likely to purchase Opel should General Motors decide to close the aging assembly plant in Bochum, Germany, in 2015 (field survey, May 2012).

10. The 1980 Interband Competition Act in the USA allows American automobile assemblers to grant exclusive franchise rights to dealers in given locations. However, this law may not be enforceable outside of the USA considering that no such law exists elsewhere (The New York Times, January 26, 2000).

11. Subsequently, the European Commission (EC) fined PSA Peugeot Citroën €49.5m (US$59.2m) for violating EU competition rules, BMW, Audi, Volkswagen, and then DaimlerChrysler have all been investigated by the EC (Financial Times, October 6, 2005:28).

12. The average pre-tax profit margin of revenue among franchise dealers is about 2% in Italy (e.g., Kia dealers earn 13% of the gross profit margin by buying directly from Kia). Because parallel traders source their vehicles at larger discounts (30–35%) from dealers who have unsold stocks, this practice allows them to offload their cars at 24–29% below the RRP and still earn 3% of the profit margin after taking out 3% for logistics and other operating costs (Ciferri, 2007:10). Directly comparing RRP and parallel trade price should be approached with caution given that discounts are normally available from franchise dealers, especially before the end of each fiscal year when dealers have to satisfy their sales targets for volume discounts from manufacturers.

13. However, the recent appreciation of the Canadian dollar against the US dollar has reduced such price differentiation (International Herald Tribune, January 6, 2012).

14. See Luo (2005:84) on the cooperating and competing relationships among the different regional subsidiaries of Honda.

15. In 2007, Ferrari also took back and internalized its import and distribution rights from authorized dealers in Japan.

16. Except for China and the Philippines, American and other European brands have (very) limited market access in Asia.

17. Parallel traders can more easily offset additional distribution costs with much lower administrative and marketing expenses than can authorized dealers (Michael, 1998:28).

REFERENCES


Automotive News. 2002. Kiss or Kill it. 4 March, 76(5973), 12.


