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## ***THEORY AND PRACTICE OF PARALLEL IMPORTS***

### ***1 Introduction***

Few commercial events in recent years have generated as much controversy as parallel importation. Parallel trading has emerged as one of the major issues of ongoing discussion in the theory of international trade and practice. It contains a variety of pragmatic issues, including economic, legal, and marketing matters. On the one hand, it is desirable to shield the public from possible confusion or deception regarding the origin of a branded good. On the other hand, there are considered to be good reasons for preventing copyright and trademarks from being used to divide markets and to create artificial barriers to free trade. Therefore, there is no consensus about the current policy relating to parallel imports.

Every year billions of dollars worth of products in the world market are imported outside (in parallel to) manufacturers' (or copyright owners') authorised distribution channels. The term parallel imports is used to emphasise the fact that unauthorised products are *imported* across country borders and a *parallel* channel is created to rival authorised ones.

Since the mid-1980s there has been a growing interest in the international business literature in so-called "grey market", or what is referred to, in this study, as parallel imports. Imported parallel goods are products that entered a market in ways not intended by the original manufacturer. In fact, the term "parallel import" is a loosely used

expression intended to explain any goods sold outside “normal”, authorised distribution channels. Taking about the topic Rothnie (1994) wrote: *‘Taking advantage of the lower price, some enterprising middleman buys stocks in the cheaper foreign country and imports them into the dearer, domestic country. Hence, the imports may be described as being imported in “parallel” to the authorised distribution network.’* In addition, Rothnie (1994, p. 193) extended the legal meaning of parallel imports noting that under most current parallel import provisions the plaintiff is also required to prove that the defendant has:

- *imported copyrighted goods into the domestic jurisdiction (for selling, letting for hire or by way of trade exhibiting, exposing or offering for sale or hire after such importation),*
- *imported without the license of the copyright owner: an article the making of which (a) infringed copyright or (b) would have infringed copyright if it had been made in the domestic jurisdiction, and*
- *with knowledge that the article so infringed, or would have infringed, the copyright subsisting in the domestic jurisdiction.*

The crucial point made here by Rothnie (1994) is that parallel imports have, by definition, been made lawfully. Therefore, the actual making of the imported articles did not infringe copyright. The articles imported in parallel are not “pirate” copies. In effect, a parallel import channel exists alongside the authorised one set up by a manufacturer resulting in intrabrand competition.

## ***2.2 The theory of parallel imports***

Parallel imports affect a wide range of industries, spreading from traditional luxury and brand-name consumer products (wines, cameras, and watches) to industrial products. Industry sources estimate that parallel imports account for 10% of IBM's PC sales, 20% of Sharp's copier sales, and 20% to 30% of the world cosmetics and fragrances sales (Ahmadi and Yang, 1995). Belgium, for example, despite the fact that it has no automobile industry is a major car exporter in Europe—more than 25,000 cars some years. This export success story is because cars are cheaper in Belgium than in nearby countries, due to tax differences (Weigand 1991).

Another trend relating to parallel imports, is that this has evolved from basically a U.S. problem in the 1980's into a world-wide phenomenon in the 90's (Ahmadi and Yang, 1995). When the U.S. dollar was strong, during the 1981-1986 period, the number of cars purchased in Europe by U.S. tourists grew 2,000%. In 1986 the total value of products distributed through unauthorised channels in the U.S. reached a peak of \$10 billion (Palia and Keown, 1991). This direction was reversed in subsequent years as other parts of the world, especially Asia and Europe, experienced rapid appreciation in their currencies and a corresponding surge of parallel imports (Ahmadi and Yang, 1995). A 1991 survey of U.S. exporters to Asia showed that 41% of 141 respondents reported having problems with parallel imports in the past five years (Palia and Keown 1991). In 1990 pharmaceutical parallel imports in the European Community stood at \$500 million (Lynn 1991, quoted in Ahmadi and Yang, 1995, p. 3). In an increasingly integrated world, the annual growth rate of parallel imports has been estimated to be 22%, and this is expected to rise as new trade agreements, like NAFTA and GATT, further lower trade barriers across nations.

There are essentially two reasons why parallel imports occur in international markets. The parallel import or “grey market” exists because foreign manufacturers practice price discrimination among countries and grey market sellers arbitrage these price differences. Second, parallel importers are more efficient than authorised sellers because parallel imports compete with the goods of authorised sellers, in turn leading to lower prices that are beneficial to consumers.

Those favouring parallel imports argue that international price discrimination restrict competition to the disadvantage of consumers in countries having higher prices. They say that parallel imports foster competition and efficiency, thus benefiting consumers in importing countries.

Some researchers argue that, while it is clear that active parallel imports cannot exist without price differentials between countries, the source of these differentials is not quite so apparent (Weigand, 1991). Depending on the type of goods involved and the character of the market for the product, price differentials can be the result of a variety of factors, ranging from honest enterprise, such as a diverter who takes advantage of favourable foreign currency exchange rates and engages in a sort of product arbitrage, to a manufacturer who attempts to discriminate by price in different (usually foreign) markets.

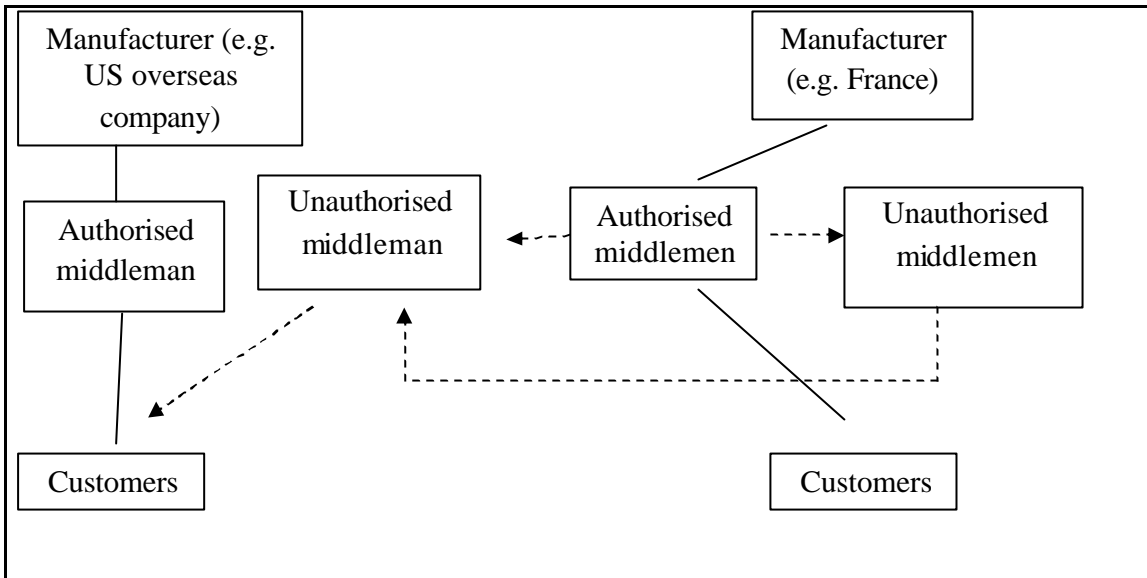
A more questionable strategy in regard to parallel imports, is free riding or the practice of selling goods identical to those sold by full-service dealers without incurring the expenses of promoting and servicing the product. Such free riding falls into two categories: advertising free riding and point-of-sale free riding. An advertising free rider takes

advantage of the advertising and marketing efforts of authorised sellers, reaping consumer recognition and other benefits that flow from this advertising without incurring the attendant expense.

The second but distinct form of free riding, point-of-sale free riding refers to the failure of an importer to provide various ancillary services that consumers desire. Such services range from product instruction, to the maintenance of an inventory of spare and auxiliary parts, or the provision of warranty or repair services. Another type of free rider may also sell trademarked goods without taking sufficient safeguards to ensure product integrity. For example, by compromising on packing, transportation, storage, or inspection costs in order to keep the price of goods lower.

Therefore, in regard of the process of parallel imports, there is no end to the imaginative ways used to bring parallel imports to market. Four methods, however, represent the bulk of market imports and are focus of much of the economic and legal attention. First, are those products made overseas by for example American firms (see Figure 1). These foreign units may be subsidiaries, joint venture companies, or some other entity which have a commonality of interests with the American company. This foreign affiliate may sell to nearby authorised distributors, for example, a French firm. Somewhere in the authorised channel, however, distribution control is lost and the product gets into an unauthorised channel and some of it is exported back to the United States. Here it competes with identical domestically produced products.

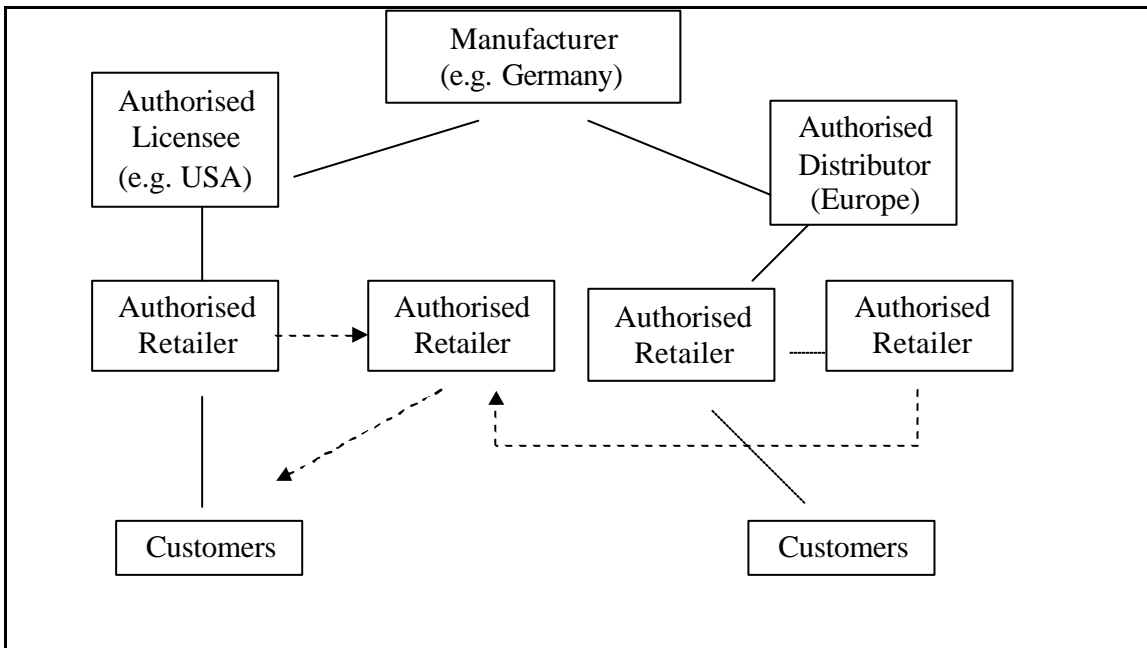
**Figure 1. First case of the parallel imports process**



Source: Weigand, E. R. (1991) p. 54.

A second method (depicted by Figure 2) of parallel importing is when a foreign manufacturer (e.g. German) licenses a company to be the exclusive importer of a product bearing a foreign name or trademark.

**Figure 2. Second case of the parallel imports process**



Source: Weigand, E. R. (1991) p. 55.

That company registers the foreigner's name and becomes the legal trademark owner in their own market and agrees to pay royalties. Now, suppose that a third party trader purchases this same product which was intended for a third market. They then ship the product to the licensee's market as parallel imports.

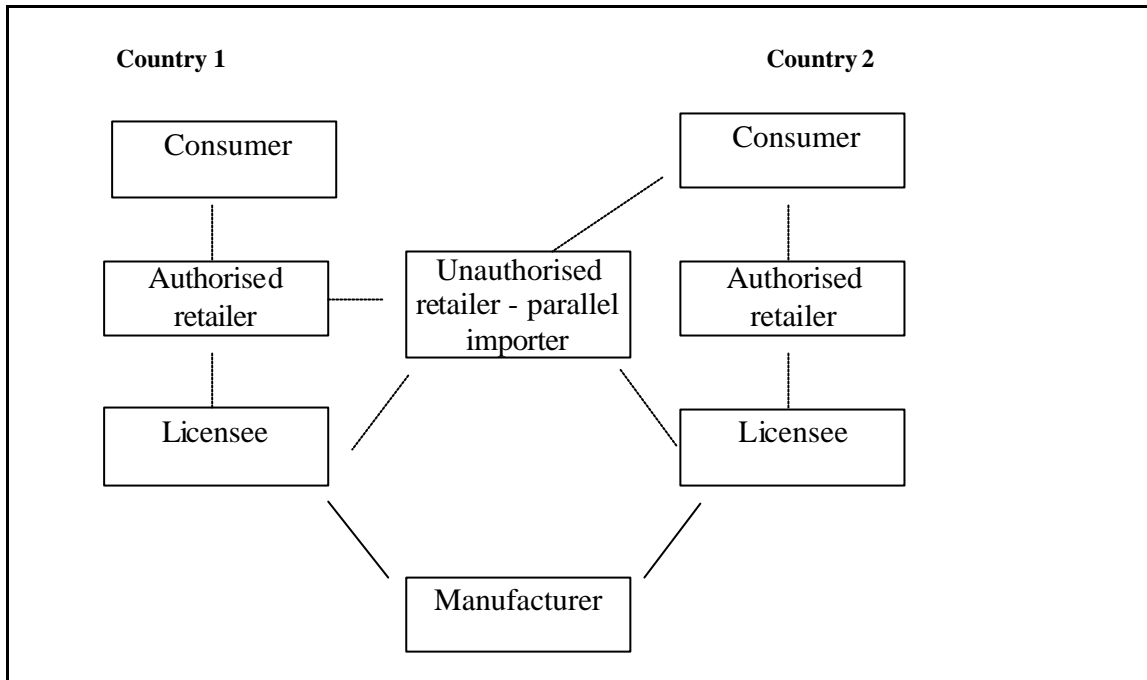
A third possibility of parallel importing arises when a manufacturer exports from its producing plant, only later to have the exports diverted back to the home market. This parallel importing strategy is known in official import statistics as re-importing.

Re-importing is particularly attractive when:

- the manufacturer's strategy is to sell into the foreign market at a substantially lower price than in the home market, due either to the market being poorer or there being dramatic exchange rate differences, and
- the foreign market is geographically close to the home market, thus minimising return transport costs.

This way of importing in parallel may also be developed on premises that an active parallel import cannot exist without price differentials between international markets. Figure 3 illustrates this. It shows a two-country representation of product flows along a manufacturer-distributor-retailer-consumer channel. When parallel importing occurs, products are leaked from every possible level of the supply chain, and an unplanned distribution flow is formed. Sales revenue and profits may therefore be re-allocated across supply chains in different countries, creating tension between the manufacturer and different distributors, which affects the manufacturer's overall profitability.

Figure 3. Third case of the parallel imports process



Adapted from Ahmadi, R. (1995) p. 3.  
 Note for Fig. 1-3: Authorised trade \_\_\_\_\_  
 Unauthorised trade - - - - -.

The ability to exploit price differentials appears likely to result in the creation of parallel imports. However, price differentials inevitably invite arbitrage behaviour, if transportation costs, duties and tariffs between the countries are modest or negligible, as is the case in the software industry. Because of a favourable price differential, a parallel importer can enter the market and compete with authorised products. In contrast, if parallel imports are not allowed, buyers have no other choice than to purchase products priced well above the marginal cost in non-segmented markets.

A fourth way of parallel imports is the use of mail orders. This type of unauthorised channel is emerging with Internet development and is a very important source of parallel trade. Retailers and consumers can currently purchase products either from catalogues from large, local retailers or going directly to mail order houses in different market.

Anyone with a credit card and access to an Internet-linked computer can order CDs, software, books and whatever from overseas suppliers.

After identifying the variety of parallel importing strategies, the next section discusses the effects of these unauthorised channels.

### *2.2.1 The effects of parallel channels*

There are a number of effects of all of this parallel importing activity. Here, the predicaments and opportunities created by these parallel distribution channels are discussed in more detail.

First, consumers may be prejudiced against buying products which have been parallel imported because sometimes they cannot be properly serviced or maintained. They also may be worried that the so-called technical requirements for certain products may not met by grey importers.

It needs to be made clear that parallel imports are not counterfeits but genuine products that are often sold at a lower price to consumers than these distributed by regular channels (Ahmadi and Yang, 1995). However, these may not necessarily have a lower profit margin because they can free ride on the promotional efforts of authorised dealers. Consequently parallel imports may undermine authorised dealers' selling efforts. For example, by discouraging their investment in a sales-force or shelf-space.

In other words, parallel imports may have financial consequences for licensed distributors, if they do not derive sufficient revenue from the sale of these branded goods. In such instances they may not be able to continue with their advertising and promotional efforts.

Parallel importing of trademarked goods may also create confusion for consumers. However, some authors argue that because parallel importers sell genuine trademarked goods there is no possibility of confusion about the origin or source of the goods. Although, modern trademark law does not support this view, involving an unauthorised channel or outlet increases the likelihood of consumer confusion about product source and quality.

The “source function” of a trademark encompasses more than the geographic origin of goods. As a result of modern marketing and distribution techniques, consumers perceive a “genuine” article to be those from the wholesaler, retailer or servicing company they have been able to rely on in the past. The authorised distributor is in effect the “sponsor” of the trademarked good, providing many ancillary services. Consumer confusion is possible if the parallel importer does not disclose that they are not the authorised distributors or they do not offer the same warranty protection or services, which the consumer has come to expect.

The “quality function” of the trademark does not replace the “source function” but stands alongside it as a “guarantee” of consistent quality. In the grey market, genuine

trademarked goods possess identical product quality when shipped from the factory. Product quality, however, is not simply measured at the factory; it is also determined at the time of retail sale. Many trademark owners thus invest in their product by careful shipping, storage, inventory control, and quality management. This investment is a natural adjunct of their desire to build and protect the reputation of their product. In contrast, grey marketers may unknowingly or unknowingly sell inferior products because they provide less quality control and have less incentive to make these expenditures. Inferior products however, confuse and deceive consumers and may negatively impact genuine products and their image.

Manufacturer-distributor relations can also be strained by the appearance of parallel imports. Distributors feel frustrated by having them in their markets and look to the manufacturer to reduce or eliminate this unforeseen competition. Manufacturers profits also may decrease because of parallel imports. Sometimes they may be forced to buy back old stock from authorised distributors because parallel importers create an over-supply in the market.

Despite the problems caused by parallel imports, there are also opportunities for consumers and for manufacturers as well.

- *“There is some evidence to indicate that parallel import channels from the United States have been used to penetrate foreign markets.*

- *Some United States' manufacturers recognised that parallel channels could be used to increase overall foreign sales and market share"* (Michael, 1998).
- Furthermore, when a final decision on an exclusive distributorship was pending, a parallel channel gives the manufacturer an opportunity to evaluate one distributor against another.
- Parallel channels may help overcome a weak distributor's performance at no additional costs to the manufacturer.
- Sales that go through parallel channels may expand a manufacturer's market coverage if the authorised distributor lacks the capacity for covering the whole market. This situation may be very common in developing markets where distributors often lack the financial and marketing resources to effectively push and pull products through the distribution chain.
- *"Parallel channels may also help to identify consumers in foreign markets whom the manufacturer may not be aware of"* (Ibid, p. 30).
- However, by far the most interesting opportunity created by parallel imports is when manufacturers use it to circumvent trade restrictions. In other words *"non-tariff trade barriers exist in the form of quotas or import licences, the authorised importer has limited sales opportunities. The parallel exporter, who sells to a different importer under separate quota or license, provides the manufacturer with additional sales* (Ibid, p. 30).

### ***2.3 Future of parallel imports***

The trend towards the globalisation of markets, which is being facilitated by the development of a global communication system, envisages the end to domestic territoriality because of global competition. Because of the speed of new technologies and communication developments, parallel importation may be a short-term phenomenon.

The impacts of globalisation on parallel importation are two folds. First, as trade barriers between nations decrease, it will become more difficult to implement price discrimination policies based on country boundaries. Implicitly, parallel traders are therefore likely to gradually disappear, as there will be fewer opportunities for arbitrage. The issue of parallel importation may therefore become less significant as globalisation continues.

Secondly, traditionally, under international law, nations have asserted sovereignty based upon the territory that they legally control. Advances in electronic communications, including the Internet, however, have begun to change this. This development suggests that, rather than sovereignty based on territory, sovereignty will be based on information flows or economic spheres of influence will become the norm in cyberspace. This hypothesised shift will however, require a re-evaluation of present legal doctrines, which in turn may “re-establish parallel imports legality”.

Nevertheless, when the world economy becomes far more globally integrated, which is likely in a digitally based economy, it becomes necessary to harmonise the different

transactional rules between nations. This means policy co-ordination among different governments will be a critical step in achieving this.

## ***2.5 Conclusion***

This study analysed the process of parallel importing to aid understanding of the wider parallel import issue.

In this study the process of parallel importing, what create this and the opportunities it provides, as well as the future of parallel importing was analysed, in the light of the emerging digital age and electronic commerce. It was concluded that, due to rapid advances in communications, networks, multimedia technologies, interoperable distributed technologies, and interactivity, parallel imports may eventually become obsolete. What is particularly important to keep in mind is that all these technological advances create new business models, such as these that were suggested without political or trade barriers.

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