Pricing Strategies In High-Inflation Markets: Implications For The Multinational Corporation

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Abstract

The pricing decision of multinational firms directly affects their ability to competitively remain in a high-inflation market. Pricing, never an easy task, involves many factors such as competition, market demand, government regulations, and internal factors. However, when the firm must set price within a high-inflation market, these factors become compounded. A framework for formulating pricing strategies in high-inflation markets is proposed.

Introduction

Price is a key element of the marketing mix because it is tied directly to the generation of total revenue. The process of establishing price is similar for domestic and international markets. However, international price setting is more complex, since the company has to take additional factors into account. For example, international pricing is affected by government regulations, differences in costs from country to country, different demand conditions, and an increase in competition (Jain 1990). Price setting is influenced by internal and external factors. Internal factors include pricing objectives and costs. External factors that influence price include demand, competition, government regulations, and exchange rates.

Broadly stated, inflation can be defined as a sustained increase in the general level of prices (Busche and Easton 1984). This means that prices paid for raw materials, labor, and various overhead items increase. For the consumer, the prices of products and services rise. Inflation is a state in which too much money "chases" too few goods. As the amount of money in an economy increases, the supply of goods and services rise leading to a state where there are fewer goods for each dollar (or any other currency for that matter!). This results in an increase in price for the available goods and services. Each dollar now buys less than it did previously (Busche and Easton 1984).

The purpose of this paper is to present a framework for evaluating the relationship between internal and external constraints as they affect the pricing strategies of MNCs in high-inflation markets. This framework is depicted in Figure 1. The rest of the article will be devoted to discussing the components of the framework.

Internal Constraints

The internal constraints facing the MNC can be classified into three major categories: (1) organization pricing objectives, (2) costs, and (3) organizational perceptions of international price setting. The nature of each constraint will affect the pricing decisions of the MNC in high inflation markets.

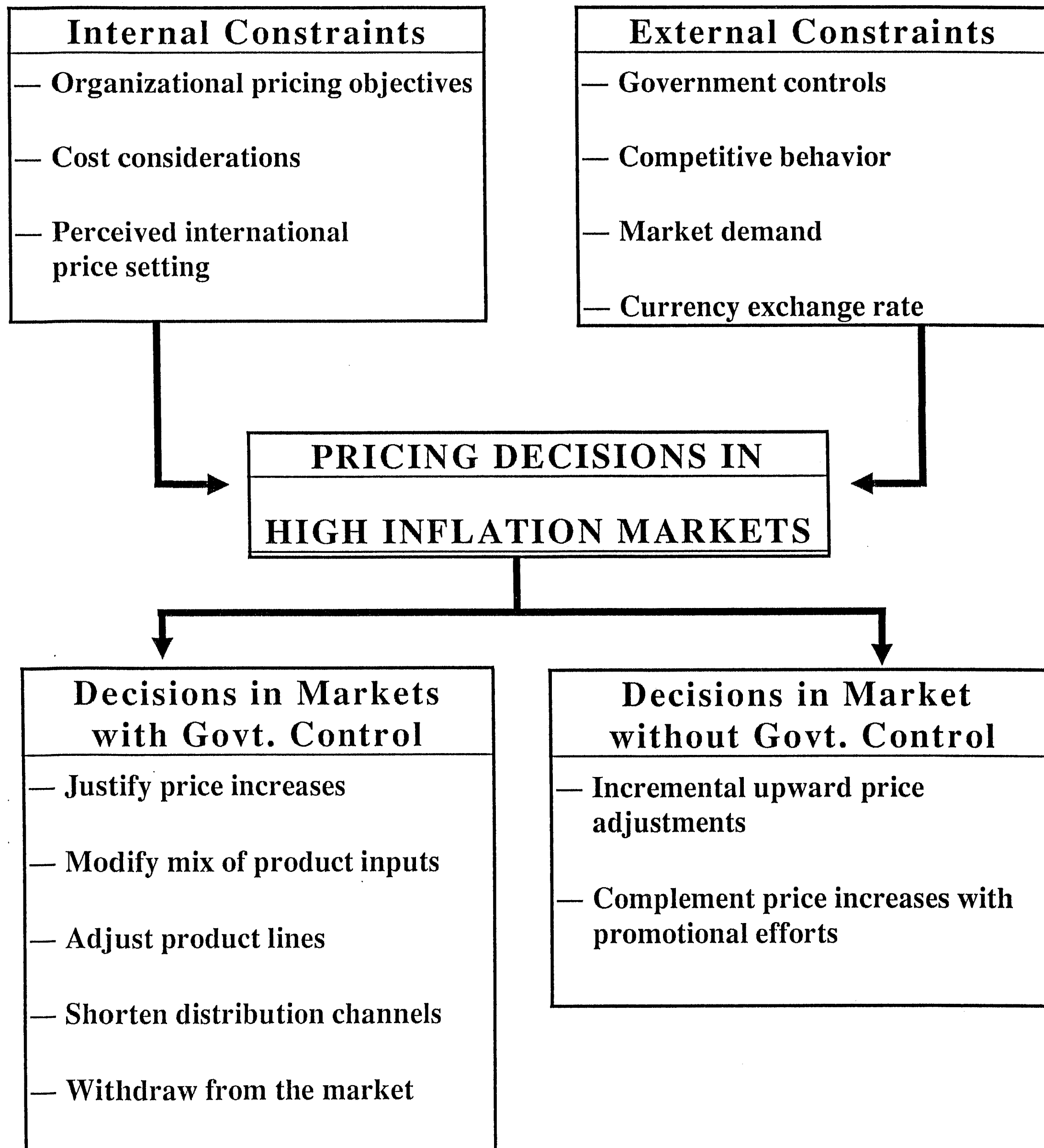
Pricing Objectives

Price setting is influenced by the firm's pricing objectives which in turn reflect overall company objectives. Objectives may be stated in terms of profits, survival, return on investment, market share, and/or cash flow. Ideally, pricing objectives should reflect local conditions and be consistent with overall company objectives (Becker 1980). For example, a pricing objective may call for profit maximization. Under high inflation, there is a pressure to raise prices in order not to erode the desired level of profit margin.

Cost Structure

Costs constitute the price floor and can be classified as either fixed or variable (Becker 1980). Variable costs, such as labor rates and raw materials, are much affected by inflation, thus making an increase in price necessary to remain profitable. Exporters must account for incremental manufacturing costs including labor, raw

FIGURE 1
FRAMEWORK FOR PRICING DECISIONS IN HIGH INFLATION MARKETS:



material, and overhead due to inflation. Since costs increase due to inflation, the company should project the increasing costs so it is able to cover this with an increase in price. One way is to make projections by developing a cost inflation index (Bergfeld 1981). First, direct costs are broken down into various cost elements (labor cost, material cost, energy cost, selling cost, etc.). Once the various cost elements are identified, the company can develop a cost inflation index for each element to make projections of the direct costs. For example, if the cost of an input is projected to increase over a period of time, the company can incorporate the projected increase into its price.

International Price Setting

The tendency for most firms in high-inflation markets is to raise prices to cover costs. Unfortunately, in some markets, this might be impossible due to unpredictable responses by consumers and competitors. Two types of

price setting orientations exist for international marketers, cost orientation and market orientation. Under cost orientation, all relevant costs are added to a derived profit margin to arrive at the price whereas under market orientation the company estimates an acceptable price the target segment is willing to pay for a product while meeting the company's profit objective (Jain 1990). Ultimately, the choice of orientation depends largely on the perceived reactions from competitors and consumers in the marketplace.

External Constraints

The pricing strategy of MNCs operating in high inflation markets is also affected by external constraints. These constraints include government controls, competitor behavior, market demand, and exchange rate fluctuations.

Government Controls

The legal requirements of the home government and the foreign government must be met (Jain 1990). In the U.S., the government is not usually involved in pricing. An exception is the Robinson-Patman Act, where the unjustifiable cost differences of manufacturer price discrimination between wholesalers and/or retailers is prohibited (Terpstra 1988). There is no similar law in other countries; however, foreign governments do play active roles in pricing, especially during inflation.

Price control is manifested when governments deny or allow price increases (Terpstra 1988). Under high inflation, the government may temporarily freeze prices to help suppress inflation. An example of this tactic is in the setting of a price ceiling in Argentina. The government did not remove the freeze, instead it maintained price control and encouraged competition. To help set this price ceiling, tariffs were lowered on some price sensitive products including cigarettes. The goal was to keep domestic prices from increasing by lowering the foreign brand prices (Cateora 1990).

The government may also establish margins for middlemen and manufacturers. This is often achieved by dictating the allowable increase of a product price. When management's freedom is restricted by government margin setting, an operation may disintegrate because of profit loss. Cadbury Schweppes sold its plant in April 1982 because price ceiling imposed by the Kenyan government rendered its operation unprofitable. In Mexico in early 1983, Coca-Cola and PepsiCo withdrew their products from the market until a price increase was allowed, and Glaxo, a pharmaceutical manufacturer, in early 1984, was reported to have canceled its expansion plans in Pakistan because of price controls (Frank 1984).

Competitor Behavior

How existing competitors react to high inflationary prices is also crucial. If the competition is using penetration pricing (low prices), and a competitor is not monitoring such behavior, it is conceivable that profits, sales, and market share may diminish and possibly disappear. Under such circumstance, the competition is aggressively "swaying" customers away from the unmindful company. The competition should be analyzed according to the number of firms, their size, their product differentiation and the ease of market entry (Jain 1990). Actually, under high inflation market entry would be difficult because of high tariffs and overall high prices.

Market Demand

Prices must also reflect market demand. A margin reduction may be a more profitable alternative than maintaining profit margins during inflation (Keegan 1989). At lower prices, which presumably would also lower the profit margin, more of the product would be sold. In this instance, this decrease in profit margin may increase actual profits.

Included in the market demand is the consumer demand. According to Jain (1990), determinants of consumer demand include the buyer's lifestyle, substitute prices, and the unfulfilled or saturated potential market. All of these factors can be affected by inflation. Because of high prices the accustomed lifestyle may be unattainable. The prices of available products and substitutes may be restricted by a price ceiling and the market may change from saturated to unfulfilled because some competitors are not capable of operating profitably with government price ceilings. It is generally accepted that under high inflation, availability of investment capital is low and consumer demand decreases (Jacque and Lorange 1984). Because prices are so high, consumers are unable to purchase the product, spending is reduced and consumer demand falls.

Exchange Rate

High inflation weakens a nation's currency and other countries' demand of the host country's products would tend to increase. However, the product demand within the country decreases because at higher prices more currency is needed to purchase a product.

Given the preceding external and internal constraints, i.e., pricing objectives, costs, government controls,

competitor behavior, market demand, and exchange rates, appropriate pricing strategies under high-inflation must carefully be considered.

Pricing Strategies

Successful pricing is a key element in the profitability of any business operation. Many U.S. firms have had some experience with double digit inflation in recent years as a result of the oil crisis in the early seventies. Nevertheless, inflation in the United States is rather mild compared to many high inflation countries of the world. Countries with high inflation rates pose a different pricing challenge to the marketing manager than do countries with moderate inflation rates.

While inflation poses a large environmental threat, it is not sufficient grounds to exhibit risk paranoia in strategic decision-making. The records show that a number of U.S. MNCs have had very profitable years in triple digit hyperinflationary countries such as Argentina, Mexico and Brazil (Jacque and Lorange 1984). In the discussions to follow, the nature of the pricing strategy will be presented by first discussing the nature of pricing policy in inflationary markets. This is followed by the discussion of pricing strategies in high inflation markets with little or no government control and pricing strategies in high inflation markets with government control.

Pricing Policy In High-Inflation Markets

Several elements of the firm's pricing policy directly impact the firm's ability to remain competitive within inflationary markets. First is the degree of price uniformity desired within the subsidiaries. There is yet no agreement on the setting of uniform prices worldwide. Some international marketers argue for uniform prices. For example, Boeing sells its jetliners for the same price anywhere in the world, including developing countries while other firms seek flexibility in inflationary markets by adopting a differentiated pricing policy (Jain 1990).

A second element of the pricing policy relevant to inflation is the firm's pricing orientation. Companies basically follow either a cost or market pricing orientation. Under the cost approach, the desired markup is added to the relevant costs to arrive at a price. Under a market oriented approach, marketers start with an estimate of the acceptable price for the target segment, and then it is determined if an acceptable profit will result. Jain (1990) recommends the cost approach because in high-inflation markets costs become the firm's major concern. The cost-oriented pricing approach is also favored because the market-oriented pricing approach requires a good deal of marketing research. This may be difficult to generate in LDCs or developing countries, which are often the same countries with high rates of inflation.

The question of which costs to account for is the third element relevant to a pricing policy in high-inflation markets. Costs can be accounted for either by full costing or by incremental costing. Under full costing, there is a charge for all fixed costs such as plant, administration, and R&D. With incremental costing, only variable costs such as production wages, raw materials expense, and components are charged. The assumption is that fixed costs are incurred regardless of sales. Therefore, only variable costs need to be recovered. If the inflationary conditions are not expected to persist indefinitely, then firms should set prices in an attempt to recover only the relevant variable costs (Cavusgil 1988). It should be noted, however, that fixed costs are not forever static because in the long run a firm unable to recover its full cost will have to withdraw from the market.

A final element that must be addressed in a pricing policy is the responsibility for price setting. Headquarters should spell out who is responsible for setting price. There are three general ways to allocate the task: headquarters can set prices, the subsidiaries can set prices and operate independently, or the decision can be made jointly between the parent and the subsidiary. Because of the unique environment in high-inflation markets, it is generally suggested that the local subsidiary should set prices using corporate objectives as a guide. Depending on the level of autonomy allowed foreign subsidiaries, any of the three methods may be employed.

Pricing Strategies In High-Inflation Markets With No Governmental Control

Without price controls, pricing involves essentially raising prices very often (Terpstra 1988). Unfortunately, it is not as simplistic as this. As mentioned earlier, firms can be restrained from raising price in unregulated or uncontrolled markets by the firm's competition and market factors. If the competition, due to lower costs, is able to maintain price, then it is difficult to justify higher consumer prices. Under this condition, the strategy is to lower costs. Because the situation so closely resembles a price ceiling, specific strategies available to the firm will be similar to strategies pursued under price control. Similarly, the firm cannot pass the higher cost on to the consumer if the market will not "bear" it (Leff 1975).

Several strategies, however, may reduce the effects of higher prices and income elasticity (Jacque and Lorange 1984). First, firms should adjust prices frequently since large price increases are potentially traumatic. Second, a high level of promotional effort is needed to ensure a continued stimulation of customer purchasing and to reduce psychological resistance to the price increases. Further, in support of the first two steps, the firm can frequently make minor changes in the physical appearance of the product and its packaging. This should make the customer feel that he/she is indeed getting something new or extra in return for the higher price. Other strategies include delayed quotation pricing and escalator clauses.

Pricing Strategies in High-Inflation Markets With Governmental Control

Inflation and government price controls often go hand-in-hand. Price controls have been used by governments for many centuries (the first is thought to be by the Roman Emperor Diocletian in 301 AD!) and despite their blatant inefficiency, MNCs can expect to deal with them in centuries to come (Paukert 1988). Given this reality, there are several strategies available to multinational firms to help them remain competitive.

Often, price control means that an application to increase price must be filed with the government. One way to keep pace with inflation is to apply for increases often. To receive approval (which may take several months), the firm must show that a price increase is necessary by providing supporting data of cost increases. Consequently, good cost accounting is important to enable the firm to justify the request for the price increase.

A second strategy is to convince the countries' administrators and policy makers not only that price controls will hurt the country in the long run, but also that price control is not the way to solve the country's inflation difficulties (Frank 1984). The firm should demonstrate that it is getting an unacceptable return on investment, and without an acceptable profit opportunity, future investments will not be made and current production may be stopped as was the case of Coca-Cola and PepsiCo who withdrew their products from Mexico in early 1983 until they subsequently received a price hike (Frank 1984). By indicating the consequences of such actions to the local government, such as laid off workers and reduced demand of goods and services from local suppliers, the firm may be able to force a price increase.

A third approach to dealing with the combined problems of inflation and price controls is to change the mix of the inputs used by the firm (Terpstra 1988). The firm may consider moving to a more capital intensive form of production. If the cost of inputs are increasing rapidly, the firm should look for substitute materials that are more price stable.

Adjusting the line of products offered by the firm is a fourth alternative under price control (Terpstra 1988). There are two reasons for this. First, not all products are subject to the same degree of price controls. Whenever possible, firms should move away from price controlled products to those which are not. Prescription pharmaceuticals, for example, are often highly price controlled. With this in mind, the MNC may want to switch to the production of over the counter drugs, which may have more moderate controls. The second reason is that not all products experience the same degree of cost inflation. Some use inputs with more stable costs, so the firm should identify and consider these.

A fifth approach that has been suggested is to shorten the channels of distribution (Cavusgil 1988). Each firm in the channel will tend to increase the price of the product. The key here is to reduce the number of intermediaries. Vertical integration, or company-sponsored distribution, involves a much higher commitment and consequently is more risky than simply shortening the channels. Highly committed firms may consider this an alternative.

Other strategies have received some attention. Firms can charge for "extras" that are not price controlled such as delivery and they can reduce or eliminate cash and quantity discounts that are traditionally offered (Bourne 1988). The multinational firm may separate sales by breaking-up its product into easily assembled components and price each separately. Where formerly delivery and installation were included, they would now be charged separately. Firms may also require customers to purchase a more expensive, unregulated product with the product they want, a practice often referred to as matching sales (Bourne 1988). Finally, for some firms, the choice may be simply to withdraw from the high-inflation market (Terpstra 1988). This is never desirable but may be necessary in extreme cases. Cadbury Schweppes pulled out of Kenya in 1982 because high inflation and rigid price controls in that country made its operations grossly unprofitable (Frank 1984).

Conclusions

The pricing decision of multinational firms directly affects their ability to remain in the market. Pricing,

never an easy task, involves many factors such as competition, market demand, government regulations, and internal factors. However, when the firm must set price in a high-inflation market, these factors become compounded. Multinational firms must identify and understand these factors before attempting to set price. The paper also suggests several strategies for operating with or without the presence of government price controls. Using these recommendations, firms dramatically increase their chances for survival under inflationary conditions.

Finally, some potential caveats should be noted. The pricing strategies suggested here for coping with high inflation markets may work quite well with manufactured goods, yet might not be very applicable with services. For example, determining the uniquely attributable costs associated with a service or attempting to breakdown the "price bundling" of a service are often problematic and may become more difficult as factors affecting pricing practices in high inflation foreign markets. Similarly, the strategies proposed in this paper may not be generalizable to every country with high levels of inflation. Some effort should be made to carefully examine the unique attributes of each high inflation market to determine the specific applicability of the pricing strategies put forward in the present analysis.

Suggestions For Future Research

Much of what we currently know about multinational firms' pricing strategies in high-inflation markets represent attempts to conceptualize responses to high levels of inflation. The time is ripe for empirical studies that focus upon firm pricing responses to high-inflation constraints in markets around the world. Topical suggestions might include: (1) the response differences by firms operating in a particular high-inflation market, and (2) whether there are significant differences in performance levels between firms in high-inflation markets and firms in low-inflation markets, and if so, whether these differences can be attributed to pricing decisions relative to the level of inflation. Case Studies of firms operating in major markets with high-inflation is also suggested if we are to gain further insights on the pricing choices firms make in high-inflation markets. Efforts in the direction of empirical and case research will enhance the validity of current conceptual analyses in this area. ❧

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