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Comments of the Bureaus of
Competition, Consumer Protection and Economics
of the Federal Trade Commission*

on

Gray Market Policy Options Facing
The United States Customs Service

October 17, 1986

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* These comments represent the views of the Bureaus of Competition, Consumer Protection, and Economics of the Federal Trade Commission and do not necessarily represent the views of the Commission or of any individual Commissioner. The Commission, however, has authorized the submission of these comments.

I. INTRODUCTION

Under a long standing Customs Service policy, known as the "related parties" exception, products bearing genuine trademarks may be imported into the U.S. without the permission of the U.S. trademark holder, provided that the U.S. trademark holder is related to the foreign trademark holder. Such imported items are known as gray market imports. The Customs Service has proposed requiring that these imports be labeled as unauthorized imports or that all trademarks they bear be removed (demarking).

The staff of the Federal Trade Commission ("FTC" or "Commission") strongly recommends that the proposal be rejected. Even if it were established that gray market imports could cause some sort of damage in the market place, the Customs Service proposals are not the appropriate method of solving the problem. If the problem is considered to be "free riding" by unauthorized importers on the promotional efforts of authorized U.S. distributors, the dispute is about contractual obligations of the foreign manufacturers and should be resolved privately between the firms involved. If, for example, the problem is that consumers are deceived about the services associated with gray market goods, the FTC itself has jurisdiction to act under Section 5 of the FTC Act.

II. SUMMARY OF THE FTC STAFF'S COMMENTS

According to the Customs Service request for comments,[1] proponents of changing the current policy contend that these new trade restrictions would increase consumer welfare because the related party exception "discourages U.S. trademark owners from investing in marketing or servicing of

[1] Federal Register, Vol. 51, No. 116, June 17, 1986.

trademarked products by permitting others to 'free ride' on these investments." Proponents of the proposed regulations also "argue that the influx of gray market goods may deceive or confuse consumers about the source of the trademarked products and therefore about the quality or availability of warranties on those products."

The FTC staff recommends against adopting either of the proposed restrictions for two reasons.

First, there are alternative private and public remedies for potential free rider or deception problems, if they exist. Even if international free rider problems do exist, firms can deal with them privately, just as they do domestically, where the government does not intervene to stop free rider problems of this sort. If gray market imports pose consumer deception problems, these problems already fall within the jurisdiction of the Commission under Section 5 of the FTC Act.[2] The Customs Service proposals are a far more intrusive solution than are more carefully targeted remedies aimed at particular consumer deception problems.

Second, there are several equally plausible theories for gray market imports. In addition to the free rider and consumer deception theories, there are other theories that imply that gray market imports involve significant consumer benefits. The available data on gray market imports are much too sketchy and anecdotal to determine reliably which theory or theories are valid. Without such information, there is insufficient reason to

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[2] The FTC also has regulations requiring that retailers make any warranty available for consumer inspection before purchase. (See 16 CFR 702.) If no warranty is applicable on a gray market purchase, the FTC regulations could help prevent deception concerning warranty coverage. It should also be noted that the large price differences themselves might be expected to alert consumers to potential differences between authorized imports and gray market imports.

consider adopting government trade restrictions on gray market goods. Blanket government restrictions on gray market imports, such as those proposed by the Customs Service, are inappropriate where so many private remedies are available, where conflicting explanatory theories abound, and where there are such great uncertainties about the reliability of the empirical evidence about potential costs and benefits to consumers.

These conclusions are discussed below. The free rider and consumer deception hypotheses are treated in Section III, parts A and B. Alternative explanations are discussed in Section IV. Available empirical data are analyzed in Section V. A summary of our conclusions is presented in Section VI.

III. THE FREE RIDER AND CONSUMER DECEPTION EXPLANATIONS

A. Free Rider

While there are potential free rider problems at both the domestic and international levels in product distribution, they can best be addressed through private contractual agreements between manufacturers and distributors. Because distributors benefit from promotional activities and services provided by other distributors even if they do not contribute to them, manufacturers often seek to develop vertical restraints on distributors, including exclusive territories. Without such restraints, distributors may lack sufficient incentives to provide high-quality services and promotional programs and to build a brand's reputation. Because a brand's reputation is an important aid to consumer choice, inadequate investment in reputations will injure consumers. In addition, inability to establish a reputation may undermine incentives to produce high quality goods. Free rider problems

may also occur if the identity of the distributor acts as a signal of product quality when consumers cannot readily ascertain quality in other ways.[3]

Because manufacturers can be expected to recognize potential free rider problems and because they are free to contract with distributors, most free rider problems could be addressed by the manufacturers' own private initiatives.[4] This applies to gray market imports as well as to domestic transshipments.[5] Consequently there is reason to doubt that gray market

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[3] T. R. Overstreet, Jr., Resale Price Maintenance: Economic Theories and Empirical Evidence, Washington, D.C.: The Federal Trade Commission, 1983, page 60.

[4] Of course, manufacturers' vertical restraints have to be consistent with U.S. antitrust laws before they can be implemented.

Even if vertical restraints eliminate all intrabrand free riding, there may still be interbrand spillover effects from one brand's promotional efforts to other brand's promotional efforts. Thus, the problem of free riding in intrabrand competition is not unique.

Even if aoo private remedies were ineffective, the benefits of the Customs Service proposals would still have to be traded off against potential market power or other costs to consumers of government restrictions on gray market imports.

The manufacturer may also have alternative public remedies available. Recent legal research (B. Coggio, J. Gordon, and L. Coruzzi, "The History and Present Status of Gray Goods," The Trademark Reporter, Vol. 75, September/October 1985, pages 433-496.) suggests that free rider issues in gray markets could be pursued in U.S. courts under legal theories of unjust enrichment, third-party beneficiary, and/or interference with contractual relations. The Court of International Trade could also be approached on a usurpation or infringement theory.

[5] In an international context, some private remedies may be available that are not available in domestic markets. For example, the manufacturer might be able to alter its trademark, labeling, product specifications, promotions, pricing, or distribution contracts in different countries to reduce or eliminate free riding. The manufacturer could use a different trademark in each country to discourage gray market trade. The manufacturer could also discourage gray marketing by producing goods with distinguishing features for different countries.

Some additional remedies may be more effective in the international context, although they are available domestically as well. For example, the manufacturer could promote the effectiveness of its authorized distribution system in maintaining quality over long shipping distances. The manufacturer could find that its efforts to identify the distributors that sell to gray market importers and to terminate these distributors or limit

imports stem largely from free rider problems. Of course, there might be unexpected circumstances that result in loopholes in private enforcement efforts, but these should disappear as new private methods of addressing these loopholes are developed.

Even if free riding might persist despite private enforcement efforts, it does not automatically follow that government should step in and enforce these private contracts as the Customs Service proposals would do. In general, private contractual relationships that benefit the contractual parties should be enforced through private efforts. In addition, the benefits of solving any residual free rider problems through government action have to be weighed against the costs of the government intervention.

B. Consumer Deception

If authorized imports and gray market goods were identical, then it seems unlikely that any risk of consumer deception would exist. Similarly, if differences between gray market and authorized imports are obvious, well known, or easily discoverable, little risk of deception exists. A risk of consumer deception may arise, however, if consumers are not aware of material differences between gray market goods and authorized imports. Such differences could conceivably arise from differences in services provided with the product, other products included in the transaction, or the principal product itself.[6] However, the FTC already has authority to deal

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shipments to them are more effective when the goods have to cross national boundaries.

[6] One potential problem with gray market goods is incompatibility for use in the U.S. In some cases, such as automobiles, these problems are addressed by changing the product once it has arrived in the U.S. In other cases, where the value of the product is not high enough to warrant such

with consumer deception problems, including deception problems involving gray market imports, and to date has not determined that there is any need to take action in this area.

Consumer confusion about the actual characteristics of gray market goods could potentially cause both immediate and longer term injury to consumers. Immediate injury would result if consumers pay for a characteristic that is not actually included in the product. Longer term injury would occur if consumers dissatisfied with gray market goods could not differentiate higher quality authorized imports. In such circumstances, consumers eventually might be unwilling to pay a price premium sufficient to cover incremental costs associated with producing or distributing the higher quality authorized import, and the higher quality product might disappear from the market.[7]

As noted in the appendix, Commission staff investigations of consumer deception in connection with gray market goods have not produced evidence of substantial systematic deception to date.

C. Relabeling and Demarking Remedies

Neither the relabeling proposal nor the demarking proposal is consistent with both the free rider and consumer deception theories for gray

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modifications, gray markets have not generally emerged. An example is cellular phones where frequency differences have discouraged gray market imports despite reportedly attractive price differences between countries. "Conversation with a Gray Marketeer," Consumer Electronics, July 1985, pages 49-50.

[7] See G. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," Quarterly Journal of Economics, August 1970, pages 488-500.

market imports. Relabeling is more relevant to consumer deception while demarking is more relevant to free riding.

If authorized imports and gray market goods have different characteristics, including services and warranties, that are the source of consumer confusion, a label that specifies the distribution channel would directly reduce this problem. Demarking would also accomplish this by alerting consumers to the likelihood of differences, but this solution could remove too much information. Trademarks serve an important function in identifying superior quality manufacturers even if they are also identified with particular distribution channels. Demarking would eliminate consumers' ability to identify superior manufacturer quality and could cause consumers to undervalue the demarked product.[8] Moreover, if deception of the type allegedly posed by gray markets is a problem, the generally preferred solution is to make sure that consumers have access to information about material differences. This is a less intrusive remedy that addresses the problem directly and does not destroy potentially valuable consumer information in the process, as disparaging relabeling or demarking might.

There are private remedies available if there are consumer deception problems. Any measure that enables consumers to distinguish between gray market and authorized imports would effectively eliminate whatever consumer deception problems might exist. Authorized distributors could affix additional trademarks indicating that their items are authorized for U.S. distribution and have been distributed in the authorized manner. Similarly,

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[8] Similarly, relabeling might cause consumers to perceive greater quality risk than in fact exists and to undervalue the gray market product. This might occur, for example, if the label disparaged the quality of the gray market product.

authorized distributors could inform customers of the advantages of their products, e.g., warranty terms.[9]

Although either relabeling or demarking would have the effect of slowing or disrupting imports of gray market goods and would therefore serve to shelter the U.S. trademark holder's investments in promotion or services, only demarking directly addresses possible free rider problems. Free riding on promotion requires that consumers perceive the gray market imports to be the same as the authorized goods. This perception would be eliminated by demarking if demarking really disguised the brand. Relabeling would not remove free riding on promotions conducted by manufacturers or authorized distributors because the advertised trademark would still be apparent.

IV. ALTERNATIVE EXPLANATIONS

A number of alternative explanations for gray market imports apart from free rider or consumer deception have been developed in conjunction with the debate over retail price maintenance. The recent Federal Trade Commission staff report, cited earlier,[10] reviewed several of these in addition to variations of the free rider hypothesis. Although the theoretical foundations and empirical support for these alternative explanations for gray market imports are often as extensive as those of the free rider and consumer deception explanations, the Customs Service proposals mention only

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[9] Since authorized dealers will reap the benefits, there is some logic in having them bear the burden of distinguishing their product. In contrast, the Customs Service proposals put the burden on gray market suppliers and on the tax payers. An alternative arrangement would be to have authorized importers reimburse the Customs Service.

[10] T. R. Overstreet, Jr., cited at footnote 3.

the price discrimination explanation. The explanation based on lags in adjusting to exchange rate changes, in particular, has not received any attention.

A. Exchange Rate Adjustment Lags

Manufacturers' output constraints,[11] strategic output and pricing considerations,[12] barriers to entry,[13] and long-run marketing

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[11] If a foreign producer faces contractual (or political) obligations in its home market with respect to price or price and quantity, is producing at capacity, and faces a lag in adding new capacity, it may be forced to price discriminate against U.S. consumers. These are the conditions necessary to preclude diversion of the type envisioned by R. Landes and R. Posner, "Market Power in Antitrust Cases," Harvard Law Review, Vol. 94, March 1981, pages 937-996.

[12] A foreign supplier cooperating in a cartel with U.S. producers might price discriminate against U.S. consumers to avoid disrupting the cartel. The same could be true for a territorial division of markets between foreign producers and U.S. firms. Foreign producers might similarly price discriminate against U.S. consumers to avoid political action by U.S. producers directed at increasing tariffs or other trade restrictions. (The fact that trade restraints can be imposed on a country-by-country basis may remove much of the free rider problem in organizing voluntary export restraints of this type.)

Other strategic considerations might also be important. For example, efforts to establish first mover advantages in a particular geographic area may encourage geographic price discrimination. For an example of such first mover advantages, see M. T. Flaherty, "Market Share Determination in International Semiconductor Markets," Cambridge, Mass.: Harvard Business School Working Paper 1-782-04, April 1984.

[13] Barriers to entry or exit may give importing firms an incentive to dampen exchange rate changes in their pricing. When the importing county's currency is appreciating, such barriers may make importers reluctant to expand their distribution networks or to build additional capacity to meet increases in demand that may be temporary, especially when these expansion efforts involve sunk costs. When the importing country's currency is depreciating, barriers to entry or exit may make the importers reluctant to effectively abandon their home market by allowing their prices to fully reflect the exchange rate changes. The reason is that they realize that the decline in demand may be temporary and that the firm's expected present value may be higher by staying in the market during the low demand period because it allows them to avoid exit costs or later reentry costs. For a discussion of the role of sunk costs in determining responses to demand

considerations[14] may make foreign suppliers reluctant to change their U.S. prices in lock step with changes in exchange rates. To the extent that foreign suppliers base their decisions on these longer run considerations, their pricing decisions may differ from those of independent middlemen. The available evidence on trade reactions to changes in exchange rates suggests that lags are extremely common.[15] Some degree of lag may also arise from differences in the inventory positions of potential arbitragers[16]

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changes, see, for example, W. Baumol, "Contestable Markets: An Uprising in the Theory of Industry Structures," American Economic Review, Vol. 72, May 1982, pages 1-15.

[14] Some retailers of imports may be risk averse with respect to price variations. A seller facing such customers may find it attractive to offer long term supply contracts in which the seller insures the buyer against changes in exchange rates. The premium on this type of contract takes the form of higher than short run competitive prices when the buyer's currency is appreciating and lower than competitive prices when the buyer's currency is depreciating. Alternatively, there may be substantial costs associated with frequently changing prices. For instance, if retailers have printed catalogues or have customers, such as the U.S. government, that demand long term supply contracts, frequent price changes may be quite costly. Consistent with this hypothesis, D. Carlton reports that price stability is positively related to the length of association between buyers and sellers in his article "The Rigidity of Prices," American Economic Review, Vol. 26, No. 2, September 1986, pages 637-658.

Two respondents to the Commerce Department survey indicated that dampening exchange rate fluctuations was necessary to stabilize their distribution system. See question A.6.e. Gray market importers apparently cannot offer this type of price stability. Gray market importers do not participate in bids to supply GSA for this reason, for example.

[15] See, for example, R. Dornbusch, "Exchange Rate Dynamics," Journal of Political Economy, Vol 84, 1976, pages 1161-1176; F. Giavazzi and C. Wyplosz, "The Real Exchange Rate, The Current Account and the Speed of Adjustment," Essex Economics Paper #194, 1984; C. Wilson, "Anticipated Shocks and Exchange Rate Dynamics," Journal of Political Economy, Vol. 87, 1979, pages 639-647.

[16] Because of transactions costs associated with switching accounting systems (or associated with operating a second accounting system with more economically meaningful figures) or because of legal constraints, different suppliers may be operating with different inventory systems or with similar systems but with different inventory levels. These differences in accounting systems may cause different suppliers to adjust to changes in exchange rates

or from differences in the speed with which firms recognize demand and cost shifts.[17]

Where suppliers either individually or collectively do not respond to exchange rate changes with prompt price adjustments, sufficient price differences may emerge to encourage gray market goods. Whether the emergence of a gray market is good, bad, or indifferent for consumers in these situations depends on the cause of the lag in the supplier's response to exchange rate changes. In many cases, however, gray markets improve consumer welfare by internationalizing markets.[18]

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at different speeds. For example, if the authorized distributor in the U.S. is operating under a LIFO inventory system, while gray market importers are buying from foreign dealers with FIFO inventory systems, the U.S. authorized distributor would perceive higher marginal costs than the gray market importers, even though their economic opportunity costs might be identical, as long as the U.S. currency was appreciating. See J. Hilke, Firm Size and Regulatory Compliance Costs: The Case of LIFO Regulations, FTC Staff Report, 1984, for a discussion of the costs of switching accounting systems and of the cash flow implications of different accounting systems.

[17] Some gray market suppliers are professional arbitragers who focus their entire attention on responding quickly to exchange rate adjustment imperfections. Firms that are concerned with manufacturing and distribution arrangements might not be as proficient in detecting and responding to exchange rate adjustment situations. Arbitragers generally perform the role of identifying adjustment problems by executing trades that take advantage of the problem. In accord with this explanation, many gray market goods reportedly are bought and sold in several currencies before reaching the U.S. See "Camera Prices in a Shambles," New York Times, December 11, 1982, pages 41, 43. Lags in adjusting to exchange rate changes apparently occur with airline tickets, where failure of the airlines to adjust ticket prices to reflect exchange rate changes prompts the emergence of travel agencies that specialize in arbitraging these differences. ("Travel Agents Woo Clients by Offering Rebates and Other Money-Saving Deals," Wall Street Journal, September 3, 1986, page 29.)

[18] In a macroeconomic context, gray markets increase the rate of response to exchange rate changes. To the extent that such trade changes are necessary to balance financial flows, rapid trade changes help to dampen exchange rate fluctuations.

B. Distributor Collusion

Imposition of geographic restrictions by manufacturers might conceivably stem from the insistence of colluding retailers or wholesalers who are seeking to raise their margins.[19] By limiting intrabrand competition from gray market goods, across-the-board restrictions on gray market goods might therefore allow retailers or wholesalers to raise their margins for all brands in an industry. Since excessive retail or wholesale margins would reduce the demand experienced by manufacturers, manufacturers might be expected to resist retailer or wholesaler collusion. Facilitating gray market imports might be a way in which manufacturers resist distributor collusion of this type. If so, gray market imports benefit consumers by helping manufacturers to limit distributors' markups. Use of the Customs Service to police collusive agreements imposed by distributors would harm consumers and not be an appropriate use of government funds.

C. Disciplining Exclusive Distributors[20]

A potential source of conflict between manufacturers (or their vertically integrated wholesalers) and distributors is the size of the distributor margin. A distributor with exclusive distribution rights for a brand may seek to widen its margin, e.g. in response to an unanticipated increase in market power when the dollar is appreciating. In this case,

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[19] To do this, distributors must be able to threaten the manufacturer into adopting policies that would be against its best interests absent the threat. See Overstreet, op. cit.

[20] For discussions of this argument, see Overstreet, op. cit., pages 25-32, and R. Steiner, "Basic Relationships in Consumer Goods Industries," Research in Marketing, Vol. 7, 1984, pages 165-208.

manufacturers may have incentives to discipline their distributors.[21] In some cases, manufacturing firms may find that gray markets are an efficient way to discipline their retailers.

Since the purpose of gray market imports in this context may be to reduce market power, Customs Service restrictions on gray market imports could harm consumers by disrupting manufacturers' efforts to discipline retailers.

D. Price Discrimination

Another potential explanation for gray market goods is price discrimination against American consumers practiced by foreign manufacturers. In considering the price discrimination explanation, it is important to note that price discrimination can produce greater harm to consumers in the international context than in the domestic context. When price discrimination takes place domestically, the profits remain in the U.S. In contrast, when the price discriminating firm is foreign, the profits from the price discrimination are transferred out of the U.S. economy entirely.

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[21] Some evidence consistent with this argument has been reported in camera sales. Hasselblad camera company decided to meet gray marketing in the U.S. by offering direct consumer rebates for authorized imported cameras. See "'Gray Market' Hits Camera, Watch Sales," Advertising Age, pages 3 and 62. The use of direct rebates to consumers rather than wholesale discounts may indicate uncertainty that wholesale discounts would be fully passed along to consumers.

Porsche, another company with significant gray market imports, announced plans to abolish its traditional franchise system, although it later reconsidered its plans after being sued by the Porsche dealer association. See "Lower Price Porsche Due for U.S. in 1986," Automotive News, May 20, 1985, pages 1 and 62.

Several respondents to the Commerce Department survey noted strained relationships with retailers as a result of gray market imports. See question B.5.

Rather than charging the same prices relative to costs in all locations,[22] some firms might find it feasible to charge higher prices to U.S. consumers. For an individual firm to practice geographic price discrimination of this sort, it must be able to exercise some market power with its particular brand(s).[23] To exercise such market power, the seller would have to differentiate its brand from other brands and restrict arbitrage, including gray market imports. Even then market power would be short lived unless barriers to entry were high or entry lags were long due either to inherent industry characteristics or to government intervention (such as patents).

Geographic price discrimination also might originate through collusion among manufacturers. Collusion would limit the threat of interbrand competition to geographic price discrimination. Success would still depend, however, on entry barriers and on limiting arbitrage from gray market imports.

Another potential source of price discrimination that might give rise to gray market goods is cartelization imposed by foreign governments. Foreign governments may assist cartelization simply to transfer wealth from the importing nation to the exporting nation. Political pressure on the exporting nation to limit the volume of exports may also lead the foreign

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[22] See W. Landes and R. Posner, "Market Power in Antitrust Cases," Harvard Law Review, Vol 94, March 1981, pages 937-996. For a critique, see R. Schmalensee, "Another Look at Market Power in Antitrust," Cambridge, Mass.: MIT Sloan School Working Paper 1238-81, July 1981.

[23] Evidence of price discrimination in the sale of premium priced automobiles within Europe is presented in Y. Martens and V. Ginsburgh, "Product Differentiation and Price Discrimination in the European Community: The Case of Automobiles," Journal of Industrial Economics, Vol. 34, No. 2, December 1985, pages 151-166.

government to limit exports to the U.S. Ironically, the discrimination and emergence of the gray market in this case would stem from U.S. pressure to limit imports.[24]

Whatever the source of the price discrimination, gray markets develop as independent importing firms, retailers, or even individuals purchase at lower prices abroad and sell at higher prices in the U.S. Since price discrimination may harm U.S. consumers and impose efficiency losses on the U.S. economy,[25] gray markets benefit consumers under this explanation.

Perhaps more important than the actual competition effects of gray market goods are the potential competition effects. Manufacturers are not likely to even attempt to price discriminate or collude against U.S. consumers if gray markets can rapidly undercut the discrimination or collusion. Any effort by the Customs Service to make gray marketing more difficult in the future might therefore harm consumers of goods whose prices are now constrained by the threat of gray market imports.

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[24] Japanese construction equipment manufacturers were reportedly reluctant to lower their U.S. prices for this reason while the dollar was rising. "Gray Market: Boon or Bane for Equipment Users?" Construction Equipment, September 15, 1985, pages 55-60, especially page 58.

[25] Price discrimination has a variety of potential welfare effects. The maximum loss of efficiency would occur if price discrimination is perfect, but all of the transfer to producers is consumed in enforcing the discrimination. No efficiency loss would occur if price discrimination were perfect and no resources were consumed in enforcing the discrimination. If these resources were transferred out of the country, however, U.S. consumers would be harmed without any compensating gain by U.S. producers. In this case, although there would be no efficiency loss, there would be a loss in U.S. welfare. Other varieties of price discrimination and other levels of enforcement costs or international transfers would produce intermediate levels of social loss or inefficiency in the U.S.

E. Inefficiencies Induced by Regulation

Some retailers might be more efficient in carrying out some distribution functions that are usually provided by the manufacturers. If this is the case, distribution costs could be reduced if manufacturers were able to offer their products at a lower price to retailers who would undertake such distribution functions. Such cost-related discounts, however, may be discouraged by perceptions of U.S. pricing regulations,[26] which may make the process of justifying a price difference of this type both costly and problematical.

The gray market might provide an avenue through which manufacturers with foreign operations can offer lower prices to retailers who assume more of the distribution costs.[27] If so, retailers taking advantage of gray market opportunities would be substituting some of their own services for the manufacturers' services that are not provided for gray market goods. This arrangement would not be economically attractive to gray market importers unless they could provide these services at a lower cost than the authorized distributor.[28]

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[26] The Robinson-Patman Act bars price discrimination between retailers that is not cost-justified. Several commentators have suggested that the burden of proving that price differences are cost-justified has been quite onerous. See, for example, R. Posner, The Robinson-Patman Act: Federal Regulation of Price Differences, Washington, D.C.: American Enterprise Institute, 1970; U.S. Department of Justice, Report on the Robinson-Patman Act, 1977; and F. Scherer, Industrial Market Structure and Economic Performance, 2nd ed., Chicago: Rand McNally, 1980, page 578.

[27] To the extent this scenario is true, one would not expect foreign manufacturers to be enthusiastic about Customs Service restrictions on gray markets.

[28] It is possible that a whole class of retailers will fit into this category and that this class of retailers will be in competition with another class of retailers that require the higher cost services provided by the manufacturer. During the evolution of retailing from one type of retailer to

Where gray markets facilitate efficient wholesale pricing, Customs Service efforts to restrict gray market imports would impose efficiency losses on the U.S. economy and higher prices on U.S. consumers.

V. EMPIRICAL EVALUATION OF ALTERNATIVE EXPLANATIONS

In the previous sections, several alternative theoretical explanations for gray market imports were identified. Apart from the free rider and consumer deception theories, these theories generally suggest that consumers are likely to benefit from gray market imports. In this section, we examine the empirical support for the various theories. We find that there is insufficient basis to conclude that gray market imports are caused by free rider or consumer deception problems.

We focus on four charaacteristics of gray market import that shed some light on the alternative explanations:[29] gray market imports were not observed in most industries before 1981; manufacturers' wholesale prices and profits often have differed across countries when gray market imports have been prominent; manufacturers' efforts to curtail gray market imports have sometimes been contradictory or less complete than one might expect if free riding were the main cause of gray market imports; and systematic and

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another, manufacturers might be under pressure from the older form of retailer not to offer the cost-justified discount to the newer form of retailer. (This sort of conflict over retail innovations in the grocery business contributed significantly to passage of the Robinson-Patman Act. See M. Adelman's well known analysis, A&P: A Study in Price-Cost Behavior and Public Policy, Cambridge, Mass.: Harvard University Press, 1959.) See also Overstreet, op. cit. and pages 25-32 and the case studies described on pages 106-160. Consistent with this interpretation, many retailers of gray market goods are discount or mail order firms including large retail chains that provide their own warranties and other services. See the Commerce Department survey results, page 6.

[29] See the appendix for details.

material consumer deception has not been found in the Commission's investigations of gray markets. These characteristics are discussed below.

A. Lack of Gray Markets before 1981

If gray market goods were largely a free rider or consumer deception phenomenon, appreciable levels of gray market imports would probably have been observed for many years, in particular before the rapid appreciation of the dollar that began in 1980.[30] For example, at the purely domestic level, secret sales by authorized dealers to unauthorized dealers in other geographic areas have been repeatedly reported within the U.S. where no exchange rate issues exist.[31] In addition, gray market flows not only to but from the U.S. most likely would have occurred regularly, since manufacturers and distributors would find it profitable to free ride on promotion and services offered by distributors abroad or to deceive consumers abroad as well as in the U.S. Instead, in several industries, we find no mention of gray market imports prior to 1980-81, and only limited amounts of reverse gray market flows have been observed, and these have occurred only when the dollar has declined in value.[32]

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[30] What is not expected is the virtual absence of reports of gray market activity before 1980. For free riding to be the dominant cause of gray market imports, but for gray marketing to be dormant until 1981, all of the gray market industries must have had free rider incentives that were just shy of the shipping and related transaction costs of establishing channels of gray market distribution.

[31] See Overstreet, op. cit., for discussion of cases. Also see, D. Coursey, "Compaq's Canion: Micro Gray Mart Is IBM's Fault," Management Information Systems Week, April 7, 1986, pages 21, 46.

[32] A small volume of reverse gray market trade has been reported to the FTC staff by camera distributors, but it has occurred only over the last few months as the dollar has declined.

The reported lack of gray market imports before the 1980s suggests that free riding or consumer deception are unlikely to be the sole incentives underlying gray market imports in the 1980s. However, there could be an interaction between free rider incentives and lags in exchange rate adjustments. For example, a product sold in both Europe and the U.S. might be promoted with extensive national advertising only in the U.S. with costs per unit of 20 cents. If transactions costs were 25 cents per unit through gray market channels, no gray market activity would be observed. However, if a currency revaluation took place and prices in the U.S. were ten cents higher as a result, extensive gray market imports might occur. While it would be true that the revaluation triggered the gray market imports, most of the reason would be incentives to free ride. There is insufficient data to evaluate this possibility empirically.

B. Wholesale Price Differences

Wholesale price differences between countries (even after adjusting for cost differences including transportation) were apparently common in several industries when the dollar was rising. In the Commerce Department survey, several respondents acknowledged this. This may be due to adjustment lags. Neither the free rider nor the consumer deception theories predict these wholesale price and profit differences.

C. Modest Manufacturer Efforts to Curtail Gray Markets

Although some foreign manufacturers whose products are gray marketed have evidenced substantial interest in curtailing gray markets, many manufacturers have failed to take seemingly low-cost actions (for example,

labeling products distributed through authorized channels) that might solve their problem.[33] Other manufacturers have taken actions that seem inconsistent with full opposition to gray market imports. Under a free rider hypothesis, manufacturers should oppose gray market imports, and ambiguous manufacturer behavior toward gray market imports should be rare. This observed ambiguous behavior is consistent with the retail discipline and distributor collusion hypotheses.

D. Lack of Substantial Systematic Consumer Deception

In the Commission staff's investigations of complaints about deception from gray market imports, insufficient evidence has been found to recommend Commission intervention under Section 5 of the F.T.C. Act. We conclude that consumer deception is not widespread enough to justify government intervention of the type contemplated by the Customs Service.

VI. SUMMARY

The Customs Service proposal to relabel or demark gray market goods is based on two conclusions: (1) government restrictions are appropriate if sellers are free riding or deceiving consumers and (2) free riding and/or deception are the reasons for gray market imports. Our analysis leads us to reject both of these conclusions. First, there are less intrusive remedies to free riding and consumer deception are available. Second, the empirical evidence is insufficient to conclude that gray market imports are caused by free riding or consumer deception.

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[33] Failure to take more costly actions does not necessarily imply a lack of interest in stopping gray market imports, just a recognition that such efforts are too costly relative to the expected benefits.

Alternative Remedies: Even if free riding or consumer deception were found, several factors argue against the type of governmental restrictions on international trade the Customs Service has proposed. Most importantly, private remedies such as additional labeling efforts by manufacturers, changes in promotional strategies, additional private enforcement of vertical contractual agreements, or new forms of product differentiation might be expected to develop to alleviate any substantial remaining consumer confusion and free riding. This is the approach that has been taken with domestic free riding problems. In addition, alternative public remedies are also available. In particular, Section 5 of the F.T.C. Act already invests the Commission with authority to intervene where gray market imports deceive consumers.

Inconclusive Empirical Evidence: The analysis in this comment identifies a number of alternative reasons why gray market imports might occur. Some of these theories suggest that gray market goods benefit consumers. The available empirical evidence is not systematic or complete enough to enable us to accept or reject any of the theories for gray market imports. The possibility that gray markets arise because of lags in manufacturers' adjustments to exchange rate changes appears to be consistent with many of the reported characteristics of gray market imports, but some of the evidence is inconsistent even with this explanation. Therefore, although fuller empirical information might conceivably allow the Customs Service to conclude that free riding or consumer deception underlie some gray market imports, the current information is inadequate to reach such a conclusion. Given the extensive array of private remedies available,

it is also questionable whether residual free rider problems could account for a substantial level of gray market activity.

In addition to these two principal reasons for rejecting the Customs Service proposals, there may be two additional potential costs of the Customs Service proposal which require consideration and which weigh against the proposals. First, if the Customs Service were to restrict gray market goods, it could result in higher cost for consumers who would increasingly import gray market goods directly under Section 1526(d) of the Tariff Act of 1930. This section explicitly allows importation of gray market goods for personal use.[34] Forcing consumers to do the importing directly themselves rather than allowing a firm to act as their agent is likely to raise consumers' costs if there are economies of scale in searching for gray market goods and importing them.[35] Second, U.S. trade relationships with other countries are not necessarily robust and rational, especially in the area of import restrictions. U.S. consumers, as well as consumers around the world, have a great deal to lose from disruption of free trade relationships. For this reason, government-imposed blanket trade restrictions that may invite retaliatory trade restrictions in other countries pose a risk of substantially harming consumers generally.

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[34] For a discussion, see A. Parten, "Olympus Corp. v. United States: A Study in Imperfect Parallels," unpublished, University of Virginia Law School, 1986.

[35] See, for example, "Auto 'Gray Market' Takes Off," L. A. Times, December 30, 1984, Section V, pages 2-3.

The existence of the personal exemption from gray market restrictions also raises the possibility that restrictions on gray market imports could result in efforts to circumvent the restrictions through cooperative buying arrangements. This could make the new restriction difficult to enforce without violating the intent of the personal exemption section of the statute.

Given the contrasting implications of the alternative explanations for gray market goods, the inconclusive empirical information, and the additional potential costs of the Customs Service proposals noted above, the FTC staff concludes that the proposals could pose a significant risk of harming consumers rather than helping them in both the short run and the long run. The FTC staff therefore advises against changing the Customs Service gray market rules.

APPENDIX A. THE NATURE AND EXTENT OF THE GRAY MARKET

Empirical information on the nature and extent of the gray market is quite limited. The most widely cited source of data on gray markets is the Department of Commerce survey of 1984.[1] Scattered news reports and public releases by firms involved in importing gray market goods or in opposing gray market imports make up the rest of the publicly available information. On the basis of these largely anecdotal sources and the Commission's own investigations of alleged consumer deception in gray markets, the following are characteristics reported about gray market imports:

1. The volume of gray market imports into the United States has increased and decreased with the relative value of the dollar[2]. Few gray market goods were imported into the United States prior to 1981, except for photographic equipment which appeared in substantial quantities beginning in

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[1] "Economic Effects of Parallel Imports: A Preliminary Analysis," U.S. Department of Commerce, Patent and Trademark Office, 1985.

[2] The Commerce Department survey, op. cit., asked for the time path of gray market imports. Respondents indicated that gray market goods increased after 1981 while the value of the dollar was increasing. This pattern has also been noted in numerous press accounts. For example, "The $7 Billion Gray Market: Where It Stops, Nobody Knows," Business Week, April 15, 1985, pages 86-87; "'Gray Market' Fight Isn't Black and White," The National Law Journal, October 28, 1985, pages 1,22-23; "'Gray Market' in Camera Imports Starts to Undercut Official Dealers," Wall Street Journal, April 1, 1982, page 29; "Importers See Red Over Gray Market," Advertising Age, July 21, 1980, page 57; and "Gray Market: Boon or Bane for Equipment Users?" Construction Equipment, September 15, 1985, pages 55-60. Active gray markets for construction and other industrial equipment did not appear until fairly late in the rise of the dollar in the 1980s. See "Gray Market Expands to Industrial Goods," Inc., July 1985, page 22.

Some firms involved in gray market imports of construction equipment into the U.S. were active in 1970s in gray market exports from the U.S. to Japan. See "Gray Market: Boon or Bane for Equipment Users?" Construction Equipment, September 15, 1985, pages 55-60.

the mid 1970s.[3] Since the value of the dollar began falling against other major currencies in 1985, gray market imports have declined significantly.[4]

2. The brands involved in gray markets are usually premium brands that are among the most highly differentiated in their category in the United States[5]. Part of this differentiation has been accomplished through media

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[3] Several respondents to the Commerce Department survey indicated that no gray market activity was know to them prior to the increase in the value of the dollar in the 1980s. For cameras, Pentax and Hasselblad found no gray market activity until after 1980. Nikon experienced gray market activity earlier. The earlier advent of gray markets in cameras may have stemmed from a tactical shift in the distribution policies of Canon, a Japanese manufacturer. In the mid-1970s, Canon discontinued using Bell and Howell as its U.S. distributor and simultaneously undertook a major expansion of output in Japan. This apparently resulted in expanded output by several Japanese manufacturers (because of their concern about maintaining their market shares) and substantial pressure on Japanese distributors to increase Japanese sales. This may have reduced prices in Japan generally and led to gray market exports before the currency revaluations of the 1980s. See "'Gray Market' in Camera Imports Starts to Undercut Official Dealers," New York Times, December 11, 1982, pages L41 and L43.

[4] See, for example, "Dollar's Drop Drubs Gray Marketeers," Washington Post, May 4, 1986, page F3, and "Is the Gray Market Dead or Alive?," Modern Tire Dealer, July 1985, pages 17-18. In fact, many gray market automobile importers have reportedly exited. See "Dollar Dulls Auto Gray Market," Journal of Commerce and Commercial, March 4, 1986, page 1A(2).

[5] That is, the brands have no very close substitutes. For a recent discussion, see R. Caves and P. Williamson, "What Is Product Differentiation, Really?," Journal of Industrial Economics, 24:2, December, 1985, pages 113-132. Reported gray market activity has been particularly intense in brands that have the highest prices. See generally, "A Cheaper Way to Get the Goods," Insight, October 21, 1985, pages 56-58. The respondents to the Commerce Department survey emphasized these products too. See question A.1. for a listing.

Although gray market goods have predominantly been highly differentiated premium products, gray markets have also arisen in some industrial products where an unexpected supply situation in one country has developed. This reportedly occurred for computer chips and construction equipment in 1985. In both cases, unanticipated declines in world demand were followed by growth in U.S. demand relative to foreign demand. See "The $7 Billion Gray Market: Where It Stops, Nobody Knows," Business Week, April 15, 1985, pages 86-87, and "Gray Market: Boon or Bane for Equipment Users?" Construction Equipment, September 15, 1985, pages 55-60.

advertising by the manufacturers.[6] The value of gray market imports has apparently been greatest in the premium-priced automobile, watch, and camera equipment businesses. Gray market imports are also commonly reported in premium tires, perfumes, ski equipment, wines, and consumer electronics.

3. U.S. wholesale prices for products with significant gray market activity were commonly substantially higher than comparable foreign wholesale prices when the dollar was appreciating[7]. Cost differences do not appear sufficient to explain all these wholesale price differences.[8] However,

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[6] See the Commerce Department survey results, question B.3. Camera, perfume, and ski boot respondents reported advertising and promotion costs as 15% to 30% of sales. Consumer electronics respondents reported advertising costs of 5% of sales.

[7] Several firms replying to the Commerce Department survey confirmed charging different prices in different countries. None of the respondents denied following this practice. See question 6.d. for these responses. Nikon, Nordica, Minolta, and Evinrude each noted wide differences in the prices that they charge at the wholesale level at least partly based on demand differences. K-Mart responded that price differences were the primary incentive for its gray market imports.

At the request of F.T.C. staff, buyers for the U.S. Army and Air Force Exchange Service reported data on the wholesale prices paid by their buyers in different countries for products that have been subject to gray marketing. Although the number of observations is limited, the data confirm that wholesale prices did differ across countries in several instances. The data are listed in Appendix A.

Numerous press accounts note large wholesale price differences across national boundaries. See, for example, "The Gray Market: Where a $200 Watch Can Be Bought for $140," Washington Post, December 16, 1985, pages L1-L2; "The $7 Billion Gray Market: Where It Stops, Nobody Knows," Business Week, April 15, 1986, pages 86-87; "What Price Mercedes?" Forbes, August 27, 1984, pages 134, 136, 139.

When some foreign manufacturers have equalized prices across areas, gray markets have largely disappeared. For example, Michelin tires were gray marketed until it recently equalized prices across areas. Since this pricing action, gray markets have been nearly eliminated. See "Is the Gray Market Alive or Dead?" Modern Tire Dealer, July 1986, pages 17-18.

[8] Consistent with this interpretation, foreign manufacturers were reported to have earned unusually high profits by not lowering their U.S. wholesale prices as the dollar rose in value. See "Watching From Abroad with Mixed Emotions," Fortune, August 19, 1985, page 32. Wholesale prices have also reportedly differed by enough to make it profitable to buy at retail in Europe for export to the U.S. See "The $7 Billion Gray Market: Where It Stops, Nobody Knows," Business Week, April 15, 1986, pages 86-87.

With the recent drop in the value of the dollar, Japanese firms, in particular, are reportedly taking much lower profit margins, transferring production to other countries, or making extra cost cutting efforts in order

sometimes wholesale prices were similar, but U.S. retail margins were higher.[9]

4. Manufacturers have engaged in varying degrees of private efforts to curtail gray market imports[10] under the current Customs Service policy. While some manufacturers have made efforts to discourage gray market trade, several available private remedies, such as labeling authorized imports

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to protect their market shares in the U.S. The stature of U.S. competitors appears to play a role in these decisions. For example, Fuji has apparently raised its prices for film across the world except in the U.S. where Kodak has its most dominant position. See "As the Japanese Yen Grows Stronger, Why Aren't Import Prices Soaring?" Wall Street Journal, July 30, 1986, page 21.

[9] Some veteran gray market importers attribute gray marketing to higher distributor profits for authorized dealers as well as to currency fluctuations. See "Conversation with a Gray Marketeer," Consumer Electronics, July 1985, pages 49-50. Some of the data supplied for the Commerce Department survey showed both higher wholesale and higher retail margins in the U.S. See question A.6.b.

[10] Some manufacturers present a somewhat split policy on gray market goods. For example, although Mercedes makes efforts to discourage gray market goods through publicity and contacts with financial and insurance institutions, it provides a delivery center, factory tours, and dining facilities for U.S. citizens buying their cars at the factory. See "A Cheaper Way to Get the Goods," Insight, October 21, 1983, pages 56-58. Camera manufacturers reportedly undertook substantial enforcement efforts to find and dismiss dealers in Hong Kong who sold to the U.S. gray market during the mid-1970s. Since then, supply sources have shifted to Europe. See "The $7 Billion Gray Market: Where It Stops, Nobody Knows." Business Week, April 15, 1986, pages 86-87. At the same time, the presence of various export licensing requirements in Japan suggests that Japanese manufacturers who were intent on monitoring gray market exports from Japan could do so. See "Conversation with a Gray Marketeer," Consumer Electronics, July 1985, pages 49-50.

Few efforts by authorized importers or manufacturers to use labels to distinguish authorized imports from gray market imports were reported in the Commerce Department survey of gray market practices. (See responses to question B.13 in the survey.) However, some camera manufacturers do require that retailer advertisements affirmatively state that the product is guaranteed by the manufacturer in order to be eligible for cooperative advertising incentives. See Vivitar Corp. vs United States, 593 F. Supp. 420, 435 (C.I.T. 1984); "'Gray Market' Fight Isn't Black and White," National Law Journal, October 28, 1985, pages 1, 22 and 23; and "'Gray Market in Camera Imports Starts to Undercut Official Dealers," Wall Street Journal, April 1, 1982, page 29. Pirelli tire company also reportedly decided to delete all of the DOT Codes from tires not designated for distribution in the U.S. See "Pirelli Ends DOT Code on Future non-USA Tires," Tire Review, November 1985, page 19.

or using different trademarks in different countries have not been widely utilized.

5. Imported gray market products are usually physically close substitutes for the authorized imported products.[11] The principal differences involve services sold with the product[12], particularly warranties,[13] although slight model differences are common.[14]

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[11] An exception is European automobiles. The automobiles available in Europe lack emission control devices required in the U.S. as well as several required safety features. All automobiles imported into the U.S. have to be refitted to include these items. Even with these adjustments, which usually cost several thousand dollars, European wholesale prices were considerably lower than U.S. wholesale prices during the early to middle 1980s. See "What Price Mercedes?" Forbes, August 27, 1984, pages 134, 136, and 139.

Claims concerning deterioration of quality in unauthorized distribution channels have been made for several gray market products including wines, ski equipment, batteries, records, perfumes, and photographic equipment. See the Department of Commerce survey, question B.5.

[12] The most common bundling is with warranty or repair work. Submissions to the Commerce Department survey included a number of consumer complaints indicating that some consumers apparently assumed that warranty service was included when it was not. Consumer complaints received by the Better Business Bureau of Metropolitan New York, the center of U.S. gray market activity, have also focused on repair problems. Complaints of this type have involved calculators, typewriters, cameras, electronic keyboards, and electronic toys. See "No Guarantees for Guarantees in Gray Market," Wall Street Journal, February 5, 1985, page 33.

Consumer Reports recently reported that retailers stocking gray market photography goods now routinely offer products both with and without manufacturer warranties at different prices. See the May 1985 issue, pages 300-301. In this way consumers have greater choice with gray market goods in the market. The same article also reported that a convention has emerged in advertising under which authorized imports are advertised as "U.S. warranty included" while gray market goods do not carry this message. Gray market retailers commonly offer their own warranties to replace the manufacturer warranty. See also "The $7 Billion Gray Market: Where It Stops, Nobody Knows," Business Week, April 15, 1985, pages 85-86.

[13] Retail chains that participate substantially in the gray market supply their own services and warranties to substitute for those of the manufacturers that are not available on gray market goods. See the Commerce Department survey, op. cit.

[14] Some automobile gray markets, in particular, are attributed to manufacturers' decisions not to sell a particular configuration in the U.S. See "Warranty War Next for Automobile Marketers?" Advertising Age, November 11, 1985, page 40.

6. Sufficient evidence of systematic nondisclosure of material facts, which might justify Commission intervention under its Section 5 authority, has not been found by the Commission staff in any of the investigations of gray market goods initiated by the Commission in the 1980s. Although authorized importers have shared with us anecdotal evidence of consumer injury allegedly resulting from various practices associated with the sale of gray market goods, there was insufficient evidence of a systematic problem to warrant Commission action. In addition, investigations of importers of gray market products conducted by the FTC's Division of Marketing Practices in 1983 and 1984 failed to yield sufficient evidcence to substantiate claims of consumer injury resulting from the warranty practices of gray market importers.

Appendix A
Figure 1
Consistency of Facts* and Explanations

industry characteristics	explanations: free ride	cons. decept.	price discr.	col-lusion	discip. retl.	reg. inef.	exch. lags
positive correl. with exch. rates	Yes	Yes	Yes	Yes	Yes	?	Yes
no gray market prior to 1981	No	No	?	?	Yes	No	Yes
primarily highly differentiated products	Yes	?	Yes	?	Yes	?	Yes
extensive promo-tional activities at the national distr. level	Yes	Yes	Yes	?	Yes	Yes	?
wholesale prices different	No	No	Yes	Yes	No	?	Yes
higher U.S. retail margins	Yes	No	?	?	Yes	Yes	Yes
low manufacturer enforcement in some industries	No	?	?	?	Yes	Yes	Yes
no systematic cons. deception	NPR	No	NPR	NPR	NPR	NPR	NPR

The individual cells in this matrix indicate whether the particular fact about gray market imports is generally consistent with the matching explanation. A question mark is used when the fact is not uniformly consistent or inconsistent with the explanation.

* As noted in Section III, the available information on gray market goods is neither complete nor particularly systematic. Hence, the empirical analysis is subject to error. Although the exact distribution of gray market goods among various potential characteristics is unknown, the available information is sufficient to conclude that there is diversity in the characteristics of gray market goods. A question mark appears in the table where the fact has mixed association with the explanation. "NPR" appears where the fact does not have a predictable relationship to the explanation.

Appendix B
Wholesale** and Retail* Prices of Some Gray Market Goods

				Prices Paid by Post Exchange**		
Product	Date	Authorized Retailer Price*	Gray Market Price*	U.S. Wholesale	Japan Wholesale	W. Germany Wholesale
Gucci Watch (9000)	9/86			167.88	167.88	167.88
	9/85	295.00	145.00			
Opium Perfume (1/4 oz.)	9/86			37.30		21.00
	9/85	32.50	30.00	36.00		21.00
	9/83			30.00		
Minolta Rangefin. (Frdm.II)	9/86			discont.	99.13	
	9/85	169.99	69.99	94.95	66.09	
Nikon FE-2 (body)	9/86			discont.	274.99	
	9/85	239.00	209.00	discont.	179.59	
	9/83			276.84	172.55	
Seiko Wt. (522118)	9/86			121.00		
(522048)	9/85			121.00		
(xux06)	9/83			110.00	110.00	110.00
Olympus OM4 (body)	9/86				385.88	
	9/85	315.00	289.00		294.00	

* Retail prices reported for the Washington area by Insight magazine, "A Cheaper Way to Get the Goods," October 21, 1985, pages 56-58.

** Price paid by buyers for the Army and Air Force Exchange Service. These buyers purchase goods in each country for use in the exchange posts at U.S. military bases in each country. They report the prices that they have paid to the Dallas headquarters of the exchange service. Buyers are instructed not to purchase any goods that they have reason to believe are gray market goods. They purchase exclusively from local authorized distributors in each country. The exchange service undertakes no international trading of its own. Data were made available by G.L. Haynie, Deputy Chief, Public Affairs, Headquarters Army and Air Force Exchange Service, Dallas, Texas.