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Is the Exercise of Market Power by Distributors in Newly Liberalized Economies Preventing Trade Gains?

An Empirical Inquiry

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I. INTRODUCTION

The underwhelming performance of the newly adopted trade liberalization programmes throughout Latin America has been attributed, in part, to barriers to entry in distribution services.[1] In this article, we examine this hypothesis.

The distribution barrier to entry theory claims that multinational firms have failed to enter markets in newly reformed or transition economies because prospective entrants have been either unable to contract with domestic third party distributors or they have encountered significant difficulties in establishing their own independent distribution networks.[2] These market entry failures are attributed to multiple causes, including unreasonable commercial terms demanded by established domestic distributors, derived from their ability to control the available supply of distribution services.[3]

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[1] See, Dutz, Mark A. and Sethaput Suthiwart-Narueput (1995): "Competition Issues Beyond Trade Liberalization: Distribution and Domestic Market Access", in Claudio R. Frischtak (ed.) *Regulatory Policies and Reform: A Comparative Perspective* (Washington, D.C.: The World Bank); ProCompetencia, *Informe Anual* 1997 (Caracas, 1998); Curiel, Claudia (1995): "Revision Doctrinal de las Prácticas Horizontales en la Legislacion Venezolana" Draft, ProCompetencia (October); and Scherer, F.M. (1999): *Retail Distribution Channel Barriers to International Trade*, Antitrust Law Journal Vol. 67 Issue 1.

[2] The metric used by commentators to document claims of domestic distributor market power is the differential between domestic and international market prices. See, Dutz and Suthiwart-Narueput, as note 1, above. Specifically, any persistent and non-transitory margin between the international price and the price of a domestically traded good unexplained by freight, customs charges, duties and other transactions costs, is attributed to distributor market power. The theoretical argument underscoring these claims is the law of one price (LOP), a core proposition in economics. The LOP states that within a single geographic market, identical goods must sell at identical prices; put differently, there should be no two prices for any one good. However, without additional simplifying assumptions and data refinements, it would be impossible to test for distributor market power using this approach. In our opinion, these tests rely on unrepresentative data and are, as a result, unreliable.

[3] This is, of course, not a new debate, but a new setting and a bolder conclusion. The extent to which vertical restraints restrict the ability of (competing) manufacturers to reach the customers is a classic antitrust concern. The novelty lies in the fact that customers are in foreign countries and vertical restraints limit the penetration of imports into national markets. The new conclusion is ambitious. Whereas most commentators hypothesize that the anticompetitive effects are likely to result in reduction of consumer welfare, the more bold have concluded that limited market access will result in reduced *economic* growth. As an example of the former, see, Scherer, as note 1, above, discussing Eastman Kodak's 1995 petition seeking s. 301 relief against Fuji of Japan. A key component of Kodak's claim was that its ability to successfully compete in the Japanese market was impaired due to the presence of exclusive dealing by the four primary wholesales used by Fuji in distributing its film. As an example of the latter conclusion, see Curiel, as note 1, above.

As is well known, most recently reformed market economies have avidly sought to attract foreign investment. Foreign investment provides employment, growth and greater price competition, features that ultimately increase consumer welfare. Independent entry, and, under particular circumstances, even the threat of entry alone would bring about price discipline in domestic markets. Price stability and low inflation are visible signals and popular gauges of policy success in many countries.[4] By opening domestic markets to foreign competition, producers of tradeable goods and services are forced to become more efficient in order to protect their market shares.[5] However, with distributors effectively controlling access to markets, the highly anticipated gains from liberalization will continue to be unrealized. These seemingly anticompetitive practices have preoccupied the newly installed competition agencies.[6]

A. Second-best alternatives

Unfortunately, in the view of competition authorities, there are additional complications derived from distributor bottlenecks that worsen competitive conditions in newly liberalized economies. Multinational firms which have been prevented from entering by distributors restricting the available supply of services, have chosen alternative routes to penetrate foreign new markets. In this "second-best" world, entry has occurred via joint-venture agreements with domestic competitors, or via the acquisition of domestic competitors.[7]

In both instances, the multinational firm's intention is to obtain access to established distribution networks. The rationale underscoring competition specialists' apprehension over these forms of entry is identical. Consolidation or control of two firms who would

[4] Entry need not occur in contestable markets for prices to remain competitive. A credible threat of entry would suffice to deter supracompetitive pricing even in contestable markets with only one firm. A market is said to be contestable if it is accessible to potential entrants and has the following two properties: First, the potential entrants can, without restriction, serve the same market demands and use the same productive techniques as those available to the incumbent firms. Second, the potential entrants evaluate the profitability of entry at the incumbent firm's pre-entry prices. Baumol, William J., John C. Panzar and Robert D. Willig (New York: Harcourt Brace Jovanovitch, 1982): *Contestable Markets and the Theory of Industry Structure*, at 5. Operationally, approximations to the concept of a contestable market are markets characterized by relatively small amounts of sunk costs required relative to the size of the market in general. This is the approach used by the US Merger Guidelines; see Coate, Malcolm B. and A.E. Rodriguez, *The Economic Analysis of Mergers* (Moneterey: Monterey Institute of International Studies, Center for Trade & Commercial Diplomacy, 1997).

[5] Levinsohn, James (1993): *Testing the Imports-as-Markets-Discipline Hypothesis*, Journal of International Economics, Vol. 35, No. 1–2, pp. 1–22 ("that international competition might act to curtail domestic market power is an old, theoretically robust, and very simple insight"). Dawar, Niraj and Tony Frost (1999): *Competing with Giants: Survival Strategies for local Companies in Emerging Markets*, Harvard Business Review (March).

[6] Thoughout Eastern Europe, the former Soviet Republics, Latin America and Asia, countries that have opened up previously closed or State-dominated economies to competition have simultaneously adopted legislative measures designed to advance and protect a market economy. Specifically, governments have revised or adopted competition legislation as a complement to the privatization and deregulation policies that typify promarket reforms. See Palim, Mark A.A. (1998): *The Worldwide Growth of Competition Law: An Empirical Analysis*, The Antitrust Bulletin (Spring); Shyam, R. Khemani and Mark A. Dutz (Washington, D.C.: The World Bank, 1995): "The Instruments of Competition Policy and their Relevance for Economic Development", in Claudio Frischtak (ed.) *Regulatory Policies and Reform in Industrializing Countries*.

[7] Entry via joint venture occurs when a multinational firm chooses to distribute its products via a joint distribution agreement with an established local competitor. In entry by acquisition, a multinational acquires an existing competitor.

otherwise be competitors would limit competition, prevent independent price competition in the market and might result in anticompetitive price increases.

The core of the anticompetitive theory proposed by competition policy commentators is as follows. There appears to be distribution problems that multinational firms must overcome to enter domestic markets independently, which is the "preferred" mode of entry for them. These hurdles are created by established distributors whose aim is to preserve their supracompetitive rents. Put differently, there is an observable progression in multinational firm entry-choice decision-making that leads to inferior results. The competition policy prescription that appears to be emerging in response to this articulated causal chain of events is that domestic agencies should rely on any number of statutes available to them in their enabling legislation to challenge distributor business practices, and thereby erode their market power.[8] Vehicles for the challenges could be abuse of dominant position clauses available to a number of competition agencies or they could seek to enjoin several vertical practices under general proscriptions against vertical restrictions and restraint of competition.

Perceived distribution bottlenecks have always been a source of concern for ProCompetencia, the Venezuelan competition agency.[9] Similarly, advancing a potential competition theory based on distribution service considerations, CADE, the Brazilian competition agency, recently enjoined the acquisition of Antarctica by Anheuser-Busch.[10] The acquisition was subsequently approved after Anheuser-Busch agreed to settle. Both competition agencies acted under the belief that antitrust enforcement activity would eliminate or reduce barriers to entry preventing the realization of the anticipated gains from trade.

Any analysis of supracompetitive pricing is complicated because it is not uncommon to find contractual stipulations in the manufacturer–distributor contractual arrangements that confer specific attributes to the transaction. For example, there may be pricing or geographic stipulations in the manufacturer–distributor agreement that confers market power on the distributor. These vertical restraints could be an anticompetitive exercise of manufacturer or distributor market power, or they could be acting as a device for

[8] Other mechanisms designed to curtail these alleged anticompetitive practices have been proposed, ranging from harmonization of competition policy rules to extraterritorial enforcement of antitrust laws. See, for example, Scherer, F.M. (Washington, D.C.: Brookings Institution, 1994): *Competition Policies for an Integrated World Economy*; and Fox, Eleanor and J. Ordover (New York: Routledge, 1997): "The Harmonization of Competition and Trade Law", in Leonard Waverman, William Comanor and Akira Goto (eds) *Competition Policy in the Global Economy: Modalities for Cooperation*.

[9] See Rodriguez, A.E. and Mark D. Williams (1998): *Recent Decisions by the Venezuelan and Peruvian Agencies: Lessons for the Export of Antitrust*, The Antitrust Bulletin (spring), at 147–178.

[10] Despite having been decided only recently, there are already several papers on the *Anheuser-Busch/Antarctica* decision. See, for example, Mattos, Cesar (1998): *The Recent Evolution of Competition Policy in Brazil: An Incomplete Transition*, The Journal of Latin American Competition Policy (August); Page, William H. (1998): *Antitrust Review of Mergers in Transition Economies: A Comment, with Some Lessons from Brazil*, The Journal of Latin American Competition Policy (December); Correa, Paulo (1998): *The Role of Merger Guidelines in the Enforcement of Antitrust Law: The Anheuser-Busch-Antartica Case*, The Journal of Latin American Competition Policy (December); and Rodriguez, A.E. and Malcolm B. Coate (1998): "Pitfalls in Practice: An Application to Three Cases", Draft (December).

correcting market failure in the market for distribution service.[11] In the latter case, the vertical restraints may serve to certify product quality or to induce retailers to carry a greater range of products, or they may be a response to uncertainty.

Another example results from the potential risk of transacting in a foreign currency. By increasing the transfer price to compensate for prospective currency risks, manufacturers often shift risk upstream. This insulates the distributor from fluctuations in foreign currency and other contractual hazards.

The enforcement policy implications vary. If vertical restraints are a way for manufacturers to enhance their own market power, or for distributors to induce a manufacturer to police a dealer cartel, then competition authorities may be justified in seeking redress from distributors. Yet if vertical restraints are necessary to permit manufacturers to purchase dealer services that they cannot otherwise obtain, then impugning existing distributor business practices and organization rests on substantially less tenable grounds.

B. Approach

This article examines the market for distribution services in transition economies. The aim is to scrutinize the claims of *anticompetitive* distributor market power. Based on the results obtained, we can then review the policy recommendations raised by commentators. We also offer some limited policy conclusions.

The problem is addressed as follows. First, we examine import performance to determine whether it is true that imports have fallen short of what was anticipated. Then we test the explicit premise of market power by gathering empirical evidence on rates of return to distribution services in transition economies and in known competitive markets. If the claims of market power were true, we would expect to find supranormal rates of return to distribution services in foreign countries when compared to comparable rates of return to distribution services in competitive markets. We use US market data as the example of a competitive market.

The results are revealing. We find that imports have increased for every country in the selected sample every year during the 1990–1997 period. Not surprisingly, we find that as a group/region, imports have increased significantly throughout this time. Our comparability analysis shows that profitability of distribution services in Latin America was significantly lower than profitability in the United States.

Details, comments and results are organized as follows throughout the article.

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[11] The seminal papers in this literature are Telser, Lester G. (1960): *Why Should Manufacturers Want Fair Trade?*, The Journal of Law and Economics, Vol. 3 No. 1, at 86; and, Klein, Benjamin and Kevin Murphy (1988): *Vertical Restraints as Contract Enforcement Mechanisms*, Journal of Law and Economics, Vol. 31, at 265. An exhaustive survey of the expansive law and economics literature on vertical restraints is beyond the scope of this article, but a recent paper by Butz conveys a state-of-the-art view of current theory. See Butz, David A. (1997): *Vertical Price Controls with Uncertain Demand*, The Journal of Law & Economics, Vol. 40 No. 2 (October), at 433–459; and Katz, Michael (Amsterdam: North Holland, 1989): "Vertical Contractual Relations", in R. Schmalensee and R. Willig (eds) *Handbook of Industrial Organization*.

TABLE 1: ANNUAL GROSS DOMESTIC PRODUCT (GDP) SHARE OF IMPORTS (PERCENT) FOR A GROUP OF LATIN AMERICAN NATIONS

Year	Country					
	Argentina	Brazil	Guatemala	Panama	Peru	Venezuela
1990	4.9	6.5	23.0	78.6	11.1	15.9
1991	6.3	6.8	23.8	92.9	12.9	21.6
1992	8.7	7.1	31.1	96.2	14.8	25.4
1993	8.8	9.2	31.2	92.6	14.2	23.9
1994	9.9	10.4	31.4	95.0	15.4	20.0
1995	8.8	14.3	32.2	98.1	17.8	23.3
1996	9.6	14.3	29.1	91.5	17.6	21.5
1997	11.4	16.3	30.9	99.5	17.5	24.1

Source: International Financial Statistics.

Section II details the methodology and the preliminary results obtained. Section III contains a more thorough discussion on the analysis of comparables. The last section (IV), provides competing interpretations of the data and some concluding comments.

II. METHODOLOGY AND RESULTS

To explore the extent of market power in domestic distribution, we look at two complementary approaches. First, we examine the data on imports. Second, we perform a performance comparability analysis.

Individually, neither method suffices to rebut conclusively the market power hypothesis. Taken together, the evidence suggests that allegations of distributor market power may have to be examined with more care than competition commentators have demonstrated.

A. IMPORT PERFORMANCE

Are imports being unduly restricted? Preliminary examination of import performance of the sample selected for this study indicates that this may not be the case.[12] We examined this claim with import data for randomly selected Latin American countries (see Table 1).

Table 2 presents data showing that imports as a share of gross domestic product (GDP) rose for each one of the countries in the sample over the 1990–1997 period.

The group of countries as a whole experienced a 131 percent increase in the GDP share of imports over the same period.[13]

[12] We recognize that the proper comparison should be against a "theoretical" or alternative anticipated growth rate. Note however, that our statistic suffices for our purposes. To the extent that reduced distribution services reduce the availability of imports, increased imports contradict claims of bottlenecks in distribution.

[13] Calculated as the weighted average of each country's growth rate over the period. The weights consist of share of group GDP.

TABLE 2: GROWTH OF IMPORT SHARE OF GDP

Year	Country					
	Argentina	Brazil	Guatemala	Panama	Peru	Venezuela
1997–1990	135.5	151.1	34.3	26.5	58.2	51.2

Source: International Financial Statistics.

An increase in the volume of imports may be inconsistent with supracompetitive returns in distribution services.

B. ANALYSIS OF COMPARABLES

Economic theory tells us that in the long run the pricing of any product will be set at a level at which price just covers long-term costs including a normal profit *unless* there are barriers to entry or some other type of market imperfection. It follows that under comparable market conditions, profit level indicators will reflect this convergence.

The profit level indicators we use in the comparison are gross margin (GM), return on sales (ROS) and the Berry ratio. GM, which is gross profit (net sales minus cost of goods sold) divided by net sales, measures the profitability of the sales effort. GM measures the mark-up that a company makes on its sales. This ratio is particularly relevant for a distribution company to determine their profitability on the distribution function without taking into account the selling, general and administrative expenses associated with the sales of the product.

ROS is calculated as operating income divided by net sales; operating income is net sales less cost of sales less operating expenses.[14] A post-operating expense measure of profitability, such as ROS, is sometimes considered to be a more reliable economic measure of profitability than gross margin. ROS reveals the operating profits earned per dollar of sales, which is a measure of the efficiency of the operation relative to the competitors. ROS is not sensitive to accounting differences between companies and often between countries, such as classification of costs between cost of goods sold (COGS) and operating expenses, a potential flaw that GM and the Berry ratio are unable to avoid. ROS is particularly relevant when calculating profitability of distribution companies which purchase goods from related parties and resell them to third parties, as net sales is an arm's length indicator of business activity.

The ratio of gross profit divided by operating expense is known as the Berry ratio. It is often the most appropriate profit level indicator for comparing companies involved in distribution and marketing activities. Because a distributor does not manufacture products for resale, its gross profit measures the income attributable to its marketing and distribution functions. The costs of providing these functions are measured by operating

[14] We use operating income after depreciation because depreciation is a legitimate business expense. However, we do not anticipate depreciation to be a significant expense in distribution.

expenses.[15] The Berry ratio measures the extent to which the gross profit earned from distribution and marketing activities provides a return on the costs incurred in performing the marketing and distribution activities.

Profitability comparisons are not an entirely failsafe approach to rebutting claims of market power for at least two reasons. Supracompetitive profits may fail to appear conclusively because they are captured as rents or squandered in inefficiency. The rents can be preserved, the inefficient can remain viable, because the same restraints on actual and potential competition that create the potential monopoly rents also permit their persistent diversion. Previous studies of market performance have confirmed the capture of potential monopoly profits as rents in employee compensation. However, to our knowledge, only Caves has examined the absorption of monopoly rents as inefficiency.[16]

The second potential problem with financial ratios is one of measurement. Implicit in our argument is that the *accounting* rate of return we use is an accurate measure of the economic rate of return. Presumably, it is the *economic* rate of return on capital that equilibrates across firms over time as a result of competition. As the accounting rate of return on capital relies on the *book* value of capital,[17] it is only by coincidence that it will be identical to the economic rate of return. In reality, at any one time, the accounting rate of return on capital is gauging a weighted average in which the weights are the varying depreciation rate. This mismatch is problematic as it impugns the validity of a ratio that would control for the quantifiable effect on profitability of varying asset intensity throughout our samples. Needless to say, it has been the source of much controversy.[18]

This criticism is not binding on our analysis for two reasons. First, we do not attempt to measure returns on capital employed, as distribution is not generally a capital-intensive business (at least in property, plant and equipment). Unfortunately, the ones we use, financial ratios such as the GM, ROS and the Berry ratio, do not directly relate operating profit to the amount of net assets they must finance above or below those of the comparable group. Neither do they reflect the level of investment and risk in a trade or business.

Accordingly, we adjust our financial ratios for material differences in operating assets between the two groups of firms and for financial and business risk. The measured

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[15] Operating expenses are all expenses not included in the cost of goods sold except for interest expense, foreign income taxes, domestic income taxes and any other expenses not related to the relevant business activity. Operating expenses ordinarily include expenses associated with advertising, promotion, sales, marketing, warehousing and distribution, administration, and a reasonable allowance for depreciation and amortization.

[16] Caves, Richard E. (1992): "Technical Efficiency, Rent-seeking, and Excess Profits in US Manufacturing Industries, 1977", in D.B. Audrestsch and J.J. Sigfried (eds) *Empirical Studies in Industrial Organization* (Dordrecht: Kluwer).

[17] The asset values in the balance sheet are neither an assessment of the realizable value nor the replacement cost of the asset. Depreciation or amortization figures in the balance sheet are not an assessment of the declining value of an aging asset, but the residual value of an expense not yet written off. An accurate estimation of depreciation or an asset would require estimates of its useful life and terminal value which depend on future demand for outputs and future supply of more efficient technology. Invariably, firms prefer simple depreciation rules, rather than a more complicated and accurate estimation of depreciation. Inflationary tendencies pose additional limitations on the usefulness of capital-based ratios. Profits would be overstated and capital would be understated in a profitability ratio.

[18] See Fisher, F.M and J.J. McGowan (1983): *On the Misuse of Accounting Rates of Return to Infer Monopoly Profits*, American Economic Review, 73, No. 1 (March), and the comments and responses published in subsequent numbers.

operating income level of the relevant group is adjusted upward or downward by an amount that represents a market return to the level of net assets they must finance above or below those of the comparable group. The risk adjustment methodology is explained below.

The second, and perhaps more important, reason is that our use of financial ratios in this article is not to infer anticompetitive profits. Rather, it is merely to establish the *similarity* between distributors in transition economies and those in competitive economies. A close match between the two groups would indicate that they operate in comparable competitive conditions and *would fail to support* the hypothesis that distributors in transition economies exercise market power.

III. Comparables Data and Results

The dataset analysed was developed from Disclosure's Worldscope. We also relied on the Robert Morris Associates (RMA's) financial ratios, Disclosure's business descriptions and those available through Edgar and Hoover's financial reports to determine whether the firm qualified as a pure distributor.[19] The distribution companies selected for this analysis are all drawn from Standard Industrial Classification (SIC) digit code 50, *Wholesale Trade—Durable Goods*, and SIC 51, *Wholesale Trade-Non-Durable Goods*.[20] While it is impossible to guarantee close functional comparability at this level of aggregation,[21] a finer screen produced few firms for Latin America.[22] We limit our inquiry to Central and South America.

We interpret the results by comparing whether the profitability measures for the grouped foreign distribution companies are within the interquartile range of similar measures obtained for the US group of companies. This is done in two ways:

- by dropping the top and bottom 25 percent of the sample population; and
- by obtaining a range such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling at the lower end of the range.

[19] Data sources follow. Imports: Organization of American States, SICE; GDP: Organization of American States, SICE; *International Financial Statistics*, various years. Financial ratios: Worldscope, Hoover's Online, Edgar, RMA. Prices: *International Financial Statistics*, various years; Sovereign Debt Ratings: Moody's. T-Bill yields: Board of Governors, US Federal Reserve.

[20] SIC 50 and 51 group establishments or places of business primarily engaged in selling merchandise to retailers; to industrial, commercial, institutional, farm, construction contractors, or professional business users; or to other wholesalers; or acting as agents or brokers in buying merchandise for or selling merchandise to such persons or companies: Office of Management and Budget, *Standard Industrial Classification Manual 1987* (Washington, D.C.).

[21] The chief functions of establishments included in wholesale trade are selling goods to establishments, or to industrial, commercial, institutional, farm, construction contractors, or professional business users; and bringing the buyer and seller together. In addition to selling, functions frequently performed by wholesale establishments include maintaining inventories of goods; extending credit; physically assembling, sorting and grading goods in large lots; breaking bulk and redistribution in smaller lost; delivery; refrigeration; and various types of promotion, such as advertising and label designing.

[22] We searched for wholesale distributors in all regions for the following SIC codes: 5013–5015, 5033, 5063 and 5065 (durables); and 5162, 5169, 5171–5172, 5182 and 5198 (non-durables). Although there were some companies available, there was an insufficient number to achieve any meaningful inferences.

Adjustments

US and foreign firms match closely only to the extent that the 2-digit SIC accurately reflects a similar functional capability. However, there are other issues that must be considered to enhance the comparability. For example, differences in risk conditions translate into differences in expected profitability.

We made adjustments to the financial data of the US group to reflect the higher risk of operating in Central and South American economies relative to the United States. First, to adjust for country/region risk, we obtained the difference between the Latin American group weighted average yield on sovereign debt[23] and the average yield on US average ten-year T-bond yields over the relevant period.

This procedure required the following steps. We obtained the risk premium based on Moody's ratings of the riskiness of sovereign debt. Based on the results obtained by Cantor & Packer,[24] we obtained a spread between US Treasury bill yields and yields on foreign bonds of similar maturity for each country.[25]

To obtain the average risk premium over the three-year period, we calculated the weighted sum of each country's annual risk spread weighted by the appropriate percentage of total assets collected from the balance sheet.

The calculated spread between Latin American and the United States was 19.2 percent over the three-year period.

We added this change to the average operating income total for the US firms. We assumed the change in operating income to be the difference in operating income between a company operating in the Latin America and a company operating in the United States.

The results were as follows. The calculated interquartile ranges for gross margins and returns on sales, shown in Table 3, show no noticeable difference between the US and Latin America's distribution services sector even prior to applying the country risk adjustment.

Somewhat surprisingly, the results suggest that the Latin American distribution sector performed more poorly than the US one. If one applies the risk premium, Latin American performance indicators worsen. There does not appear to be substantive evidence of distributor supracompetitive rates of return.

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[23] Sovereign debt ratings are assessments of the creditworthiness of sovereign obligors. The ratings are assigned by credit ratings agencies at the country's request. The assessment is based on relevant public and non-public information acquired in the due diligence process. Conceptually, the sovereign debt rating reflects the government's ability to meet its international borrowing obligations based on its management of monetary, taxation and exchange rate policy.

[24] Cantor, Richard and Frank Packer (1996): *Determinants and Impact of Sovereign Credit Ratings*, FRBNY Economic Policy Review (October), at 37–53 ("finding that sovereign ratings effectively summarize and supplement the information contained in macroeconomic indicators and are therefore strongly correlated with market-determined credit spreads"), at 49.

[25] Not all countries for which we obtained firm financial data had issued sovereign bonds prior to 1997. Of the group, Moody's only listed Argentina, Brazil, Chile, Colombia, Mexico and Venezuela. For the purposes of the comparability analysis, we rely on this group of countries as "representative" of Latin America. This assumption translates into a conservative spread estimate, as it is unlikely that other countries reflect lower country risk than those listed.

TABLE 3: FINANCIAL RATIOS WITH NO RISK PREMIUM ADJUSTMENTS

Region	Gross margin	Return on sales	Berry ratio
United States	18.5–36.7	8.1–14.2	138.8–218.9
Latin America	16.30–44.52	6.2–12.7	117–136

Source: International Financial Statistics.
Note: Calculated risk premium: 19.2 percent.

IV. CONCLUSION

A. ALTERNATIVE EXPLANATIONS

There are several other equally plausible non-market power based alternative explanations that provide comparable qualitative conclusions. The perceived lack of entry may be due to reasons other that the alleged distributor exercise of anticompetitive market power. Clearly, any thorough investigation of distribution channels should examine alternative explanations.

The slower rate of entry than that which is deemed pareto-optimal could be due to the unavailability of satisfactory redress procedures in instances of default or contractual non-compliance by the domestic partner.[26] Lack of confidence in the judiciary, procedural unfamiliarity with the legal system, or both, could be key constraints, preventing welfare-enhancing transactions between potential entrants and distributors.[27] Firms may fear the loss of value or the misuse of trademarks, copyrights and other intellectual property assets due to poor protections. Similarly, the unavailability of institutional mechanisms designed to minimize the potential for opportunistic behaviour could be equally inhibiting for firms wary of potential hold-up problems.

Entry difficulties can be due to (albeit important) banalities, such as the inability to adapt the foreign firm's product to local tastes and preferences; or to selecting the inappropriate distribution strategy. Foreign firms may lack the familiarity with local customs and markets that would facilitate the selection of the optimal product and distribution mix. Frost offers interesting and insightful examples of these failures in a recent paper.[28] Similarly, Scherer analyses the automotive and photographic film market,

[26] Gordon, Roger H. (1994): "Fiscal Policy During the Transition in Eastern Europe", in Olivier J. Blanchard *et al.* (eds) *The Transition in Eastern Europe*, Vol. II (Washington, D.C.: National Bureau of Economic Research) (noting that capital flows from abroad have been limited, possibly because of little confidence in the legal system).

[27] Rodriguez, A.E. and Malcolm B. Coate (1996): *Limits to Antitrust Policy for Reforming Economies*, Houston Journal of International Law (winter), at 311–358.

[28] Dawar and Frost, as note 5, above. For example, Shanghai Jahwa, China's oldest cosmetics company, has successfully fended off aggressive and well-endowed foreign competitors by developing customer-care products around beliefs about traditional ingredients. Asian Paints has managed to retain its 40 percent share of the Indian market for house paints, despite vigorous moves by ICI, Kansai Paints and Sherwin Williams. The mangers of Asian Paints are used to dealing with the Indian marketing environment—thousands of scattered retailers, illiterate customers and customers who want only small quantities of paint that can be diluted to save money. Luckily for Asian Paints, the market penetration strategy chosen by its foreign rivals was based on the demand of affluent customers looking for a wide choice of colours and finishes. Vist, a Russian computer-maker, emphasized Russian shoppers' comparatively large demand for more information and reassurance before they will purchase a computer. Vist's customers evidently appreciate a local presence and information manuals in Russian.

contrasting and comparing the relative success of competitors' strategies in penetrating the US and Japanese markets.[29]

Another underlying problem may be sizable adjustment costs in expanding capital, or in reallocating capital from the old sectors from which exit is now optimal, to those where expansion of capital is now more profitable under the new regime.[30] Foreign investors could be apprehensive of capital market imperfections. For example, investors could face prohibitive financing costs because of financial considerations or inexperience in approaching emerging markets.[31] Finally, there could be structural uncertainty, a condition that arises when a firm is uncertain about its profit function and can only discover it through a process of search via experience gained only by entering the market.[32] Structural uncertainty could be especially severe during periods of reform which require major sectoral reallocation of capital.

Of key importance is a policymaker's credibility and investor's expectations on the government's commitment to continuity of reforms,[33] especially whether the liberalization initiatives are sustainable within the socio-political environment of the country. When the credibility of the government or the sustainability of policies makes significant the risk of policy reversal, investors may wait for greater assurances before committing themselves to entering. The durability and irreversibility of much capital investment often renders such a wait-and-see strategy optimal.[34]

B. Concluding comments

Antitrust challenges to distributor market power may not necessarily eliminate the perceived market entry bottleneck which commentators view as the key problem underscoring both the lack of independent entry and the fundamental cause of the derivative second-best choice of entry via acquisition or joint venture agreements. Our examination of import performance, price performance and a comparison of rates of return to distribution services between recently liberalized economies and the United States, does not support an inference of supracompetitive returns.

Certainly, the methodology relies on aggregated information and various simplifying assumptions. But at the very least, we are confident that our analysis accomplished at least two objectives. First, we may have effectively raised the burden of proof on commentators and policymakers advocating pro-active antitrust policies. Second, we believe that antitrust

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[29] Scherer, as note 1, above.

[30] Dixit, A.K. (1989): *Intersectoral Capital Reallocation Under Price Uncertainty*, Journal of International Economics (May), at 309–325.

[31] Stiglitz, Joseph and A. Weiss (1981): *Credit Rationing in Markets with Imperfect Information*, American Economic Review (June), at 393–410.

[32] Zeira, Joseph (1987): *Investment as a Process of Search*, Journal of Political Economy (February), at 204–210.

[33] Rodrik, Dani (1989): *Policy Uncertainty and Private Investment in Developing Countries*, NBER WP No. 2999 (June) (presenting a model linking policy uncertainty to private investment response and showing that even moderate amounts of policy uncertainty can act as a hefty tax on investment).

[34] Pindyck, Robert (1982): *Adjustment Costs, Uncertainty and the Behaviour of the Firm*, American Economic Review (June), at 415–427.

cannot accomplish its intended procompetitive results unless it admits into its analysis the broad influence of macroeconomic and political conditions. Specifically, to recognize that because of macroeconomic or political uncertainty seemingly anticompetitive practices may not necessarily reflect distributor market power once examined under a rule of reason approach. Finally, antitrust practitioners should allow empirical work to be a key component of their analysis. Although empirical work will not provide any answers, it will certainly focus the scope of analysis.

Why (if this is the case) have entry rates into Latin American countries been much less than anticipated? Any seeming paucity of entry may be simply a rational business decision, given the absence of reliable formal or informal contractual assurance mechanisms, heightened political risk and other factors present in recently liberalized transition economies that contribute to business uncertainty.

Competition laws that restrict independent firm's choice set in entering arm's length contractual agreements may have the identical effect of encouraging vertical and horizontal integration even in cases in which these forms of organization are not the most efficient ones. A competition policy that impedes firms from selecting their preferred contractual arrangement may actually be worse than a policy that allows these practices. To the extent that vertical integration is possible, these practices may take place anyway, and the costs of production and distribution under these arrangements may be higher due to the use of an inefficient organizational form.

The general policy recommendation of this article is that in analysing arrangements between firms in reforming economies the competition agencies should presume innocence. Truly effective market reforms may demand a recognition of institutional situations particular to reforming economies. Overlooking the special conditions prevalent in transition economies reduces the benefits of reform. Antitrust enforcement, faced with a modest burden of proof, reveals a predisposition to allege anticompetitive behaviour and may be unable to discern legitimate efficiency gains. We continue to believe that only extremely narrow antitrust policies may be optimal for the early stages of a country's development.