

THE ECONOMICS OF PARALLEL TRADE
–
ICONOCLAST VIEWS ON A DOGMA OF EU COMPETITION LAW

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Introduction

Under European Union (“EU”) competition law, firms’ concerted or unilateral attempts to block parallel trade from “*low price countries*” to “*high price countries*” are akin to “*hardcore*” restrictions of competition infringing Articles 101 and 102 of the Treaty on the Functioning of the European Union (“TFEU”). This is because parallel trade is deemed to improve consumer welfare, through downward price equalization.

In the past decades, the Court of Justice (“CJ”) has repeatedly upheld European Commission (“the Commission”) decisions against firms that had sought to limit parallel trade within the EU. The leading cases involve sectors where goods and services are subject to price differentials across countries and/or IP rights, such as pharmaceuticals, cars, luxury goods and branded products, etc. In *GlaxoSmithKline*, for instance, the Court of Justice held that an agreement intended to limit parallel trade must in principle be considered to have as its object the restriction of competition.¹ In *Sot. Lélos kai Sia*, it explained clearly that “*parallel trade is liable to exert pressure on prices and, consequently, to create financial benefits*” for consumers.² Finally, in sectors involving Intellectual Property Rights (“IPR”), the Court have repeatedly judged that once a particular product/service is sold into a low price country, the IPR holder can no longer prevent imports of this particular product/service into the high price country. His rights are exhausted.³

This strong prohibition of restrictions to parallel trade is firmly anchored in EU competition law. To date, most – if not all – attempts to soothe this principle have failed,⁴ or been left unanswered by the EU institutions.⁵

From a public policy perspective, legal standards ought ideally to be based on robust economic evidence. Against this background, this paper seeks to demonstrate that whilst parallel trade (also referred to as “*grey market trade*” in the United States, or as “*arbitrage*” in economic theory) in the EU is subject to a remarkably sympathetic and protective legal regime, the economic case supporting this approach remains to be made. To this end, it shows that the position of the EU Courts, and more generally of the EU institutions, is far from unquestionable, in light of the relevant economic literature. First, there is no undisputed theoretical or empirical evidence that parallel trade improves short-term consumer welfare (I). Second, parallel trade may harm long-term consumer welfare, through a detrimental effect on

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¹ CJ, C-501/06 P, *GlaxoSmithKline Services Unlimited v Commission and Others*, not yet reported para. 43.

² CJ, C-468/06 to C-478/06, *Sot. Lélos kai Sia EE and Others v GlaxoSmithKline AEVE*, [2008] ECR I-7139, para. 56.

³ In the field of trademarks, see, ECJ, C-355/96, *Silhouette International Schmied GmbH & Co. KG and Hartlauer Handelsgesellschaft mbH*, [1998] ECR I-4799.

⁴ CFI, T-168/01, *GlaxoSmithKline Services v Commission*, [2006] ECR II-2969.

⁵ Opinion of AG Jacobs in C-53/03, *Synetairismos Farmakopoion Aitolias & Akarnanias (Syfait) and others v GlaxoSmithKline AEVE*, [2005] ECR I-04609.

commercial and technological innovation (II). Third, parallel trade promotes speculation and other wasteful economic activities (III). Third, parallel trade may generate a host of collateral welfare-reducing effects on society at large (IV).

I. Parallel Trade does not improve the Short-Term Welfare of Consumers absent any Substantial Effect on Price and Competition

Proponents of parallel trade often intuitively argue that it leads to downward price equalization,⁶ and increased intra-brand competition (competition between perfect substitutes, *i.e.* products/services of a same brand) to the benefit of consumers (Abbott, 2007). Upon closer examination, this view is disingenuous at best. The short-term benefits of parallel trade on consumer welfare are indeed poorly documented in the empirical economic literature (1.1). Rather, from an economic standpoint, parallel trade may generally harm short-term consumer welfare, in preventing suppliers from engaging into socially efficient price differentiation (1.2). More specifically, parallel trade may also decrease the satisfaction of positional goods consumers (1.3).

1.1 The Short-Term Welfare Effects of Parallel Trade on Consumers have not been Empirically Proven

To date, the very few *empirical* economic studies devoted to the effects of parallel trade on consumer welfare have reached inconsistent results. To focus only on the EU internal situation – where parallel trade is lawful –⁷ a first strand of studies have invalidated the perception that parallel trade enhances consumer welfare in the short-term through price reductions. In 1999, a survey conducted in relation to a wide range of trademarked products (*e.g.*, compact disks, cars, cosmetics and perfumes, soft drinks, clothing, etc.) reported for instance that the “*effect of [parallel trade] on retailers and consumers was largely seen as neutral*”, and consequently that the case for parallel trade is “*simply stated and rests on the assumption that this will deliver lower prices to consumers*” (NERA, 1998, pp.17 and 8 respectively).

In the same vein, a 2004 London School of Economics (“LSE”) study empirically tested the effects of parallel imports on six pharmaceutical product categories in six EU Member States.⁸ It found that “*the hypothesis that pharmaceutical parallel trade stimulates price competition and drives prices down in destination (importing) countries over the long-term is rejected. There is also very little evidence lending support to the argument that parallel trade stimulates (price) competition among exporting and importing countries. Thus, the arbitrage hypothesis of price equalisation or price approximation is also rejected*” (LSE, 2004, p.13).

A similar finding was reached in a 2003 study, which demonstrated that parallel imports of pharmaceutical products in Finland had not intensified price competition, and has thus only generated nominal savings (Linnosmaa, Karhunen and Vohlonen 2003).

⁶ Parallel trade leads in principle to price equalization (in case of perfect arbitrage) or price approximation (in case of imperfect arbitrage: when transaction costs are >0).

⁷ The situation of the EU provides what economists call a good “*natural experiment*”.

⁸ Accounting for 21% of the retail market.

A second strand of empirical studies has, however, pointed out to a contrary conclusion. In 2001, a study showed that the price of drugs subject to parallel imports in Sweden had risen less than the price of other drugs (Glandsandt and Maskus 2001). Similarly, a 2003 study focusing on patented drugs in Denmark, the United Kingdom (“UK”), Germany, Sweden and the Netherlands found that prices had decreased with competition from parallel trade between 1997 and 2002 (West and Mahon, 2003). In the same vein, another study covering 50 pharmaceutical products in Denmark, Germany, the UK and Sweden found in 2006 that parallel imports competition had exercised a downward effect on prices (Pedersen, Enemark and Sorensen, 2006).

Finally, a third strand of studies offers nuanced, ambiguous results. For instance in 1999, a report of the Swedish Competition Authority indicated that the magnitude of the price increases arising from a prohibition of parallel imports was at best limited (Swedish Competition Authority, 1999). To add even more confusion to this complex state of affairs, an academic paper published in 2003 argued that the price pressure exerted by parallel imports was highly product specific and often immaterial (Persson, Anell and Persson, 2001).

Overall, the empirical economic literature hardly provides any conclusive evidence that parallel trade delivers lower prices to consumers. In addition, most of the abovementioned studies relate to pharmaceutical products, subject to patents. One may thus wonder whether their findings apply across the board, to other industries and other forms of IPR. Finally, from a purely methodological standpoint, the robustness of those empirical studies is not entirely convincing because they either: (i) are based on unverifiable proprietary information; (ii) rely on unreliable stakeholders surveys (Glansandt and Maskus, 2007); or (iii) have been financed by industry stakeholders.⁹

1.2 Parallel Trade injures Short-Term Consumer Welfare by removing the Ability of Producers to engage into Socially Efficient Price Differentiation

In addition to the lack of clear-cut empirical evidence in support for parallel trade, economic theory puts another dent in the blanket intuition that parallel trade improves short-term consumer welfare. Many economists consider that parallel trade is indeed detrimental to consumer welfare because it prevents firms from charging different prices in countries where consumers have different preferences (Malueg and Schwartz, 1994).

The core of this idea revolves around the fact that in real world markets, consumers often exhibit a different ability or willingness to pay. This may be due to differences in wealth, taste, investment in “branding”, taxes, cultural differences, local purchasing power, insurance system, etc. (NERA, 1999; Swedish Competition Authority, 1999). For instance, a bottle of Polish-branded vodka might be perceived as a special product in Western Europe – hence western EU consumers are ready to pay a high price for this product – and by contrast, be perceived as a relatively standard product in Poland – hence Polish consumers are only willing to pay a low price for this product. In a setting of this kind, the vodka producer will charge different prices in Poland and in the western European countries, according to the consumers’ ability to pay (economists talk of consumer elasticity) (Heimler, 2008).

From an economic perspective, there is “*nothing intrinsically bad*” about such forms of “*price discrimination*” (NERA 1999). On the contrary – as long as production costs are covered –

⁹ Many studies are based on surveys because data on parallel trade is often confidential.

differential pricing entitles firms to serve markets where consumers' ability to pay is limited. Those consumers would likely not be served if producers had to set a uniform EU-wide price (Ganslandt and Maskus, 2007, p.21). Price differentiation thus allows producers to make some consumers better off (those of the low price country), without making other consumers worse off (those of the high price country). As long as consumption increases, price differentiation is thus a "*Pareto-efficient*", welfare enhancing practice (Pigou, 1920; Robinson, 1933; LSE 2004, p.41; Heimler, 2008). In addition, in industries where fixed costs are high (*e.g.*, in R&D or advertisement-intensive sectors), any increase in the quantities produced (and sold) generates economies of scale. Hence, price differentiation also improves the welfare of producers (*see*, for a similar argument, Hilke, 1988; NERA, 1999, p.6).

By contrast, in a legal system which forbids all restrictions of parallel trade, a producer can no longer price discriminate, absent means to close off parallel imports from low price to high price countries. If parallel trade undermines his profitability in the high price market,¹⁰ the producer may choose to sell at a single price across all markets, possibly leaving some markets unserved (Szymanski and Valletti, 2005, p.2). The producer holder may even decide to shut down distribution activities in low price markets (Grossman and Lai, 2008, fn 4). This, in turn, is likely to trigger a spate of other harmful economic side-effects (*e.g.*, job losses, etc.), particularly if the low price country is a developing economy (Kenny and McNutt, 1999). In summary, parallel trade is likely to discourage manufacturers from selling to countries where prices are very low.

From a public policy standpoint, the upshot of the above analysis is that rules forbidding price differentiation (such as the above-mentioned case law or the so-called principle of international exhaustion) yield welfare-reducing effects on consumers (LSE 2004, p.41). Such rules are indeed likely to lead to increased, uniform prices or alternatively to reduced products/services availability in low price countries (Gallini and Hollis, 1999). Conversely, from a welfare-oriented perspective, rules maintaining some wiggle room for producers to price discriminate are socially beneficial to consumers. This is all the more true when consumers across markets exhibit heterogeneous characteristics (Malueg and Schwartz 1994, p.22). To date, only a few, solitary studies have challenged the view that price discrimination is socially efficient (Abbott 2007, pp.5-7; Raff and Schmitt, 2007).

1.3. Parallel Trade may reduce the Satisfaction of Customers on Specific Product Markets

Parallel imports may reduce the satisfaction which consumers derive from certain products/services (often, trademarked products/services) in the case of positional goods (or "*Veblen goods*"), such as luxury cars, high-end wines, etc. In a system of unfettered parallel trade, the influx of low-price imports (i) will decrease in the *short-term* the personal satisfaction of consumers located in the high price country (Kenny and McNutt, 1999); and (ii) might in the *long-term* dry out demand for the product/service, which will no longer be perceived as an exclusive or high status good

II. Parallel Trade harms the Long-Term Welfare of Consumers, through a Detrimental Effect on Commercial and Technological Innovation

¹⁰ Not because prices will decline, as explained in §I, but because parallel importers reduce the quantities sold by the producer, and reduce its market share.

Parallel trade also yields harmful effects on long-term consumer welfare, in chilling producers and retailers incentives to innovate. To start, it is a reasonable assumption that *producers* take the future profitability of their purported products/services into account when devising their R&D or advertising programmes. Hence, the very fact that parallel imports may depress *ex post* profit margins, will reduce producers' *ex ante* incentives invest (Li and Maskus, 2006) in costly R&D, advertising campaigns or product-quality improvement programmes (Valletti and Szymanski, 2006).¹¹

Interestingly, in *GlaxoSmithkline*, the EU General Court (“GC”) seemed, albeit implicitly, open to the view that restrictions on parallel trade could stimulate R&D financing.¹² This case concerned a distribution agreement between a pharmaceutical firm and its wholesalers which, in essence, sought to limit parallel trade from Spain to high-price countries. In a 2001 decision, the Commission had refused to admit that the agreement contributed to R&D funding, and denied the benefit of the exception rule enshrined in Article 101(3) TFEU. On appeal, the Court vacated the Commission's decision. It considered in particular that the Commission had not sufficiently examined whether the agreement gave rise to an “*economic advantage*” by contributing to the financing of pharmaceutical innovation.

Likewise, parallel trade may undermine *retailers* incentives to invest (Yonathan, 2008) into before-sale (*e.g.*, marketing, promotional advertisement, product information, websites), sale (*e.g.*, testing, advice, etc.) and after-sale (*e.g.*, technical assistance, service workshops, etc.) services. On close examination, the chilling effect of parallel trade on retailers *ex ante* incentives to invest is twofold. First, the fact that *retailers*' investments will help parallel traders capture sales without incurring similar costs (and procure the goods at a lower price) is perceived by the latter as “*free-riding*” on their investments (Telser, 1960; Perry and Porter, 1986; Chard and Mellor, 1989; LSE, 2004).

Second, in a regime of unfettered parallel trade, the influx of low price imports may induce official dealers to focus on price reductions and neglect service (Yonathan, 2008, p.66). Of course, this is likely to introduce a jolt of *intra-brand* competition in the market. Meanwhile, however, this may reduce *inter-brand* competition, which crucially hinges on the ability of market players to promote their brands through efficient retail services.

Unfortunately – and despite their immediate impact on consumers – *retailers*' investments are often overlooked because unlike producers' costly R&D and advertisement programmes, they do not involve substantial numbers.

III. Parallel Trade incentivizes Speculation and other Wasteful Economic Activities at the Expense of Society

3.1 Parallel Trade as a Driver for Speculation

Like most, if not all, economic operators, parallel traders are profit-maximizers. Yet, unlike a majority of economic operators, parallel traders must make little, if any, investments in the

¹¹ Rey (2003) reaches the same conclusion in a scenario of government price regulation and finds that parallel trade reduces incentives to invest in R&D. *See also* Danzon (1998), p.32.

¹² CFI, T-168/01, *GlaxoSmithKline Services v. Commission*, 27/09/2006, [2006] ECR II-2969.

course of their business.¹³ They simply hedge against transport, transactions and regulatory costs, as well as exchange rates differentials.¹⁴ In plain language, parallel traders are speculators. They buy and sell products with the sole purpose of taking advantage of market price differentials. Their business model is devoid of any value-adding, innovative activity.

With this in mind, it becomes obvious that parallel traders have every incentive to keep their purchasing price secret from their clients (LSE, 2004, p.88);¹⁵ charge high prices; and pocket-in the widest possible profit margin when exporting products/services. Parallel traders' ability to speculate is magnified when end-consumers are not price sensitive, such as when their purchases are refunded by national healthcare systems (for instance, through social security schemes) (LSE, 2004).

Against this background, and provided that the existence of parallel trade does not improve the welfare of end-consumers,¹⁶ the question whether a system of unrestrained parallel trade is desirable revolves around what economists term a “*distributional*” (or transfer) issue. Indeed, a system of parallel trade is tantamount to a tax on investments. Put simply, governments should decide whether they want (i) to give preference to producers that have incurred investments (and their official retailers) by affording them a degree of protection against parallel imports; or; (ii) to confiscate part of their revenue, and distribute it to parallel traders.¹⁷

The resolution of this issue involves a discretionary policy choice. This being said, any such decision ought to be based on a comparative assessment of the contribution that parallel traders and producers respectively bring to economic welfare. In this regard, the very fact that long-term innovation strategies and investments are critical to economic growth should steer public policy choices towards increased protection of inventive firms. By contrast, governments should resist the temptation to assist opportunistic operators, who speculate on short-term imbalances between markets, and free-ride on others' investments.

3.2 Parallel Trade encourages Inefficient and Wasteful Economic Behaviour

Some proponents of parallel trade have argued that besides improvements to short-term consumer welfare, parallel trade also yields additional welfare-enhancing effects. In the normal course of their business, parallel traders must indeed proceed to repackaging, relabeling, marketing and other handling activities (Swedish Competition Authority, 1999, p.28). Arguably, those activities give rise to job opportunities, and should thus be encouraged. Moreover, parallel trade would arguably allow retailers subject to cyclical demand vacillations on their home market (fluctuations in fashion, for instance), to offload inventory on other markets, thereby encouraging timely rationalization measures (Swedish Competition Authority, 1999, p.30).

¹³ In their daily business, parallel trader incur only two types of costs. First, they support indirect costs, which are basically search costs in low price countries. Second, they incur direct costs, which are the costs associated with meeting regulatory requirements in export countries (*e.g.*, safety, repackaging, etc.). See LSE, 2004 p.88.

¹⁴ Economic studies demonstrate that parallel trade is boosted in times of rapid changes in currency exchange rates (*see*, for instance, the survey of Hilke in the US in 1988).

¹⁵ It ought to be noted here that parallel trade only rarely occurs at the retail level. See NERA, 1999.

¹⁶ The majority of benefits arising from arbitrage accrue to those who perform it (Danzon, 1998; Linoosmaa *et al.* 2003; Persson, Anell, Persson, 2001).

¹⁷ Along those lines, unbridled parallel trade favours jobs in unofficial outlets, and hinders jobs in official distribution channels (NERA, 1999, p.26).

One close examination, those allegations deserve to be mitigated. The first argument is an economic misnomer. Economic theory considers that welfare is maximized when as little of society's scarce resources (capital and labour) are consumed to produce a given good/service. This means that the ratio between input and output is optimized. When a parallel trader engages into repackaging, relabeling, marketing, and handling activities, he consumes additional scarce society resources, without however, increasing output. This business activity is thus socially inefficient.

The second argument is equally misconceived. Virtually all business management textbooks teach that efficient operators anticipate demand fluctuations, and accordingly adjust their procurement needs. Rules entitling firms to freely offload quantities on external markets fare poorly with this principle. They are likely to trigger input overconsumption dynamics (thereby misallocating scarce resources within society). Anticipating that there will be external markets on which they can sell whenever they want, retailers will be induced to order large quantities.

IV. Parallel Trade generates a Host of Adverse Collateral Effects

6.1 Parallel Trade generates Welfare-Reducing Effects on Other Products/Services

A first harmful collateral effect of parallel trade may arise when the supplier is active on several markets, where he provides a range of complementary products/services (*e.g.*, a car manufacturer that provides also credit and financial services to customers). Faced with parallel imports with respect to one product/service but not to others, the supplier holder may seek to recoup the profits lost on the product subject to parallel imports through price increases on the other product/service. This is clearly detrimental to the short-term consumer welfare in the market for the product not subject to parallel-imports. Alternatively, the supplier may decide to cut down on investments in other products/services (Swedish Competition Authority, p.21), thereby again harming the “*interests of consumers*” in terms of quality and choice (NERA, 1999, p.6). For instance, the car manufacturer will decide to cease providing credit and financial services.

6.2 Parallel Trade exacerbates the Costs of Fighting Against Counterfeiting and Piracy

Parallel trade facilitates counterfeiting. An OECD report noted that in the area of sportswear, “*it is not uncommon for parallel traders to send genuine samples to the importer and mix the consignment with counterfeits*” (OECD, 1998, p.13). Because parallel imported product consignments sometimes conceal pure counterfeits, it is critical that suppliers holding IPR can avail themselves of border controls and import suspension measures against parallel imported products/services. Such protections are generally absent from countries endorsing a full parallel trade regime. This is why it is generally considered that “*allowing parallel imports would weaken a number of defences against counterfeiting and piracy*” (NERA, 1999, pp.7 and 14).

Besides this, economic literature suggests that in industries subject to counterfeiting, an optimal response for suppliers holding IPR is to keep their product distinct from (potential) counterfeiters. The maintenance of distinctiveness is seen as a “*prerequisite*” for effective anti-counterfeiting strategies (Bosworth and Yang, 2006). To this end, IPR holders must invest significant resources into branding and other market promotional activities. However,

the fact that parallel trade reduces the profitability of IPR holders limits the resources that can be devoted to the fight against counterfeiting.

6.3 Parallel Trade encourages Manufacturers to engage into Socially Wasteful Behaviour

A system of unlimited parallel trade is likely to prompt suppliers to adopt a range of private remedies in order to curtail parallel trade. From an economic perspective, such remedies are socially wasteful because they consume resources which could otherwise be allocated to productive and innovative investments. Illustrations of such practices include: re-labelling on export markets, change of the product specifications in export markets; adoption of different trademarks in each country to discourage gray trade; modification of product/service characteristics across countries (Hilke, 1988, p.6).

6.4 Parallel Trade discourages Efficient Distribution Systems

Systems of parallel trade limit the dissemination of products/services throughout society. A certain degree of protection against parallel imports might be necessary to increase the density of a distribution network (and in turn, foster intra-brand service competition). A prospective distributor contemplating the decision to join a distribution network will typically request assurances from the supplier that he will not be confronted with cut-throat price competition from parallel importers. Absent such assurances, he might be reluctant to join the distribution network in the first place. A similar argument applies to technology transfer agreements and the dissemination of information (Fink, 2005; Conley, 2008).

6.5 Parallel Trade conflicts with Other Global Policy Goals (Sustainable and Economic Development)

6.5.1 Parallel Trade is Incongruent with Sustainable Development

In recent years, many of the world's nations have repeatedly insisted on promoting economic strategies which "*meet the needs of the present without compromising the ability of future generations to meet their own needs*" (United Nations World Commission on Environment and Development, 1987). Worldwide, this commitment has led governments to incentivize – and sometimes coerce – economic operators to optimize energy generation and consumption patterns.

A salient, often overlooked feature of parallel imports is to trade-off the long-term preservation of natural resources against short-term economic benefits in the form of intra-brand competition. This is because parallel trade duplicates transport flows, for instance through "*reimports*". In addition, parallel trade may lead suppliers to relocate their production facilities towards low-costs, energy-inefficient countries. This, in and of itself, is wholly inconsistent with the current fervor for sustainable development and the use of eco-friendly production techniques (Swedish Competition Authority, p.40).

6.5.2 Parallel Trade is Incongruent with Economic Development

From the standpoint of low price, developing countries, "*it is unclear whether parallel trading brings net benefits to the economy*" (World Bank, 2000, p.36). To draw a glaring – yet controversial – analogy, in the parallel trading ecosystem, developing countries are akin to large shopping malls, where massive quantities of products/services can be sourced under

attractive conditions. As a result, an increasing number of parallel traders source products/services from developing countries, and one cannot exclude that the needs of the local populations will not be fully ensured. Albeit not a developing country, it has been reported that Greece – a low price country which has positioned itself as a primary source of parallel trade in the EU – has experienced shortages in pharmaceutical products (LSE 2004, p.85).

A second reason evincing the adverse effects of parallel trade on economic development lies in the fact that suppliers are unable to price discriminate across nations. As a result, many manufacturers simply refuse to operate in countries where prices are low (Kenny and McNutt, 1999, p.11). Some observers have, however, contended that this issue was not a cause of concern. They argue that in a system of parallel trade, welfare is “*additive*”.¹⁸ The gains of consumers located in the import country would allegedly be greater than the losses for consumers located in the export country, because the former value the product/service more. Hence, from a welfare-oriented standpoint, parallel trade would be beneficial, regardless of the fact that consumers in the low price country are no longer served.

It is submitted that this argument is wholly unpersuasive, and contrary to basic principles of economics and natural justice. Under standard economic theory, a welfare optimizing outcome arises when all the customers that are ready to pay the producer’s costs are served. In the above setting, consumers in the export country are not served, regardless of their ability to pay a price which compensates the producer’s costs. Economic welfare might thus not be maximized. A more optimal outcome could, however, be attained with international price discrimination. The producer would set its price above costs, but would serve consumers in the export and the import countries at different prices (LSE, 2004, p.32).

Conclusion

Legal standards often have a profound impact on economic growth. They should thus be based on sound economics, and in particular on an objective assessment of the costs and benefits of alternative legal principles.

In light of the above, the EU institutions’ firm stance in favour of unbridled parallel trade does not seem really founded from an economic standpoint. Beyond the intuitive view that parallel trade stimulates intra-brand competition to the benefit of consumers, the opinion that most economists hew to is that parallel trade may wield welfare-reducing effects. The current legal paradigm has thus more to do with politics – the commitment to market integration inherited from the late 1950s – and/or legal conservatism – the Court’s reluctance to recast entrenched legal standards – than with sound economics.

¹⁸ It draws on what economists generally label a “*total welfare*” perspective.

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