3.3.2 What is intra-firm trade?

Intra-firm trade (IFT) can be regarded as the replacement of market transactions by internal transactions within MNEs.[44] Internalization theory recognizes that market imperfections and high transactions costs are incentives for firms to bypass traditional market arrangements. The literature also points out that intangible assets are particulary difficult to transfer by market mechanisms. These assets include such items as R&D, industrial expertise and firm-specific knowledge, such as of production techniques. Empirical evidence is consistent with this theory, since intra-firm trade is shown to be more highly concentrated in manufacturing industries which are R&D or knowledge intensive.[45] IFT is also postulated to be affected by different tax and trade policies. Since FDI is a pre-condition for IFT, this argument makes sense to the extent that the macroeconomic environment and the investment regime of a country must be conducive to FDI if there is to be IFT.

Most studies on IFT, however, have proven to be largely inconclusive concerning the validity of internalization theory and the importance of intra-firm trade. It is probable that IFT exists where there would not otherwise have been trade, but it is not conclusive whether this is cancelled out by lost trade by other firms or related industries. The difficulty is that there is no "control" environment in which the effects of FDI and IFT can be isolated from other economic conditions. Although, theoretically, FDI and trade in goods are considered substitutes, empirical evidence seems to indicate that they are complements. Certainly, high levels of intra-firm trade appear to go hand-in-hand with investment abroad and it seems unlikely that this is all displaced trade. Moreover, foreign-controlled firms tend to have a higher propensity to trade than domestic firms. The net effect, then, of FDI on trade would seem to be that the intra-firm and other trade created by foreign investment more than offset trade that is diverted by the investment.

3.3.3 Empirical evidence

First, some caution must be applied concerning data. Intra-firm trade refers to the international trade of goods and services within individual MNEs. Although there is general agreement that this off-market trade is a large part of total trade flows, data limitations prevent a determination of its true volume at the world, or even the OECD,

[44]OECD, *Intra-Firm Trade Study,* para. 48.

[45]See Section 3.3.3.