Traditional trade theory emphasizes trade creation (allowing cheaper products from TA members to substitute for more expensive domestic products) and trade diversion (substituting products from non-TA members that were cheaper before the TA with products from TA members that are cheaper now due to the TA reducing tariffs) (Schiff, Winters and Schiff, 2003) and argues that the impact of TAs depends on the comparative advantage of member countries. In particular, it argues that TAs magnify the impacts of a country’s comparative advantage, relative to the world and to other member countries signatories of a common TA. If member countries of a TA have a comparative advantage on a factor endowment relative to the world, but one country also has a comparative advantage on the same factor endowment relative to the other member countries, the country with the “extreme” advantage will be more vulnerable to trade diversion effects, while countries with “intermediate” advantages will gain from trade creation effects, predicting divergence of trade outcomes, and winners and losers among member countries. (Venables, 2003). This emphasis on the trade creation and trade diversion effects among member countries with significant differences in the comparative advantage of their factor endowments relative to the world and to each other, suggests that, when the country with the “extreme” comparative advantage is a high-income country, relative to a lower-income country with an “intermediate” comparative advantage, the lower-income country should seek a TA with the other high-income country as it will gain more. On the contrary, if both members are lower-income countries, the country with the “extreme” comparative advantage, should not seek a TA with the other low-income member country as it will be vulnerable. (Sanguinetti, Siedschlag and Martincus, 2010). This logic can be easily extended to the North-South and South-South types of TAs, as “North” countries will reasonably have an “extreme” comparative advantage in skill-intensive goods relative to “South” countries, while “South” countries will reasonably have an “extreme” comparative advantage in labour-intensive goods relative to “North” countries. Furthermore, it is also argued in the literature that benefiting from economies of scale through South-South economic integration is more difficult because member countries do not have complementary production and trade structures, nor high interpenetration of each other’s markets on intra-industry trade. (Schiff, Winters and Schiff, 2003). Also, South countries can benefit from greater technological diffusion from North-South TAs as the “North” countries have higher industrial development as well as investment in research (Schiff and Wang, 2008). Finally, as the trend in manufacturing has been in favour of vertical specialization or value chain fragmentation (Krugman, 1995), North-South TAs are preferable as developing countries strive to capture a greater portion of the value added. Based on these arguments, developing countries should therefore be better off entering into North-South rather than South-South agreements.

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