

Yin and Yang in International Trade: Where Is Pareto When We Need Him?

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Abstract. Several types of international transactions are examined to assess the relative value of exchanges that are not Pareto-optimal. Informational asymmetries are frequently present in international trade, providing sound reasons to doubt that Pareto optimality can always be assumed. The balance posed by yin and yang provides a better approach. “Lemons” outcomes can challenge finances and threaten health. International policies to provide reliable information on price and quality are found to be partly successful. Notably, in many countries the core market institution, competition policy, is defective or non-existent.

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1. Yin-Yang and Pareto-Optimality

Yin and yang are “two components of the whole” demonstrating mutual dependence. The outer circle represents “everything”, while the two opposing elements make up the whole. Success is based on balance: the dark side or the light side cannot become bigger or stronger without the whole being weakened by the imbalance. In a trade setting, a yin-yang frame of reference does not fit with an adversarial legal approach; it poses a higher degree of dependence or cooperation. Pareto optimality is slightly weaker. The criterion requires only that for an exchange to be an improvement, one party is made better off without making the other party worse off.

2. Asymmetric Information

A primary reason why outcomes fail the test of Pareto optimality is asymmetric information. The economic result has been understood since Akerlof’s classic article (1970), but is rarely applied to trade theory. The importance of the lemons outcome has proven to be highly useful in consumer economics, particularly in matters dealing with deceptive sales practices and redress. Non-Pareto-optimal transactions (NPOTs) are routine outcomes resulting from the incentive structure. Internationally, the magnitude of the impact of asymmetric information is not evident: certainly it has not been thoroughly explored. Joseph Stiglitz was early to research asymmetry and

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later he became a clear proponent of the need for better balance in trade treaties.² A promising UN effort to provide better balance of legal capability in treaty writing has not had meaningful success.³ Most of the theoretical research in trade simply assumes Pareto optimality without asking about informational imbalances or differences in expertise. Obviously, asymmetry is much more central in research published by the Athenian Policy Forum in the *Journal of Economic Asymmetries*.⁴

What accounts for the short-sightedness with respect to informational asymmetry? One cause of myopia is based in unintentional ethno-centrism. Most of the highly consulted economic journals are published in developed countries, and these are countries that do have institutions in place to protect the marketplace. Fundamental institutions are:

- competition policy,
- truth-in-exchange regulations, and
- legal traditions developed for impersonal markets.

Even so, countries with a framework of exchange to enhance the legal status of “truth” may still find that market asymmetries can arise. No one doubts the importance of informational errors in crises involving asset-backed commercial paper, novel packages of sub-prime mortgages or other opaque financial innovations. Many explanations exist, but rarely does one hear how well the outcome can be explained by examining information asymmetries.

What general characteristics account for the presence of market-based information asymmetries? Two factors dominate the imbalance between a novice on one side of the exchange facing sophistication on the other (no balance of yin and yang). The first force is C, the size and complexity of the challenge faced by the buyer. The second factor is the capability of the consumer. This includes individual skills (K_1) multiplied by (the quantity and effectiveness of) public capital such as a food and drug administration, a securities and exchange commission or the rule of law (K_2). Vulnerability (V) can therefore be measured as a ratio of C, the “challenge” (based on the complexity of the product or the sophistication of the seller) to the response capability of a consumer:

$$V = C / K_1 \times K_2$$

A novice and illiterate shopper in a country without a public health and safety administration is particularly vulnerable to the marketing of “lemons”. In business-to-business transactions, a sophisticated buyer usually faces a sophisticated seller, so vulnerability is usually low and NPOTs will be rare. It is in business-to-consumer (or government-to-consumer) markets that we expect a yin-yang imbalance and trade that is not Pareto optimal.

² “What is needed, if we are to make globalization work, is an international economic regime in which the well-being of the developed and the developing countries are better balanced...” (Stiglitz, 2006; p. 285).

³ The 2007 Report of the United Nations Commission on International Trade Law regretted the lack of financial support to allow developing countries to participate (UN 2007; Article 6 at page A/62/449).

⁴ We all salute Chris Paraskevopoulos for providing leadership in addressing the role and importance of informational asymmetries.

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