Acta Oeconomica, Vol. 56 (1) pp. 117–126 (2006)
DOI: 10.1556/AOecon.56.2006.1.5

BOOK REVIEWS

Douglass C. North
Understanding the Process of Economic Change
Princeton and Oxford: Princeton University Press, 2005, 187 pp.

Douglass North[1] inspired a revolution in economic history in the 70s by demonstrating that economic performance is determined largely by the kind and quality of institutions th at support markets. In two volumes[2] now considered among the classics he showed that transaction costs and property rights are fundamental determinants of economic development. At that time North's views contributed to the birth and development of New Institutional Economics which focuses precisely on the interaction between individuals and social institutions within neoclassical economics. The first phase of North's work was embedded largely in this context, eventually gaining him the Nobel Prize in Economics in 1993.

However, since his 1990 book North has started to deviate from the neoclassical roots (Vandenberg 2002) by arguing for the importance of cognitive elements and uncertainty more and more vehemently, and by analysing non-efficient situations. This differs significantly from his previous line of research where he applied transaction costs and property rights in a neoclassical analysis of economic history. In this regard his recent volume is a continuation of his 1990 book. Here it becomes clear that North joined those economists who were not satisfied with

[1] Douglass C. North is Professor of Economics and Spencer T. Olin Professor in Arts and Sciences at Washington University in St. Louis, and Bartlett Burnap Senior Fellow at the Hoover Institution.

[2] These two books are *The Rise of the Western World* (co-author: Robert P. Thomas, Cambridge: Cambridge University Press, 1973) and *Institutions, Institutional Change, and Economic Performance* (Cambridge: Cambridge University Press, 1990).

"rigorously scientific" economics[3] interested exclusively in model-building, in which human beings are reduced to "dependent variables" in a series of mathematical equations. In this economics the individual becomes a mere passive "reactor" to various "constraints" in the market, and the surrounding political, legal and economic institutions are simply treated as the analytical "background". The question of how these institutions emerge and evolve, and how men's ideas and actions may influence these institutions over time were almost not discussed in neoclassical economics at all.[4]

By focusing exactly on these issues in his book, North develops a new way of understanding of the process by which economies change. Douglass North's analysis goes into territories unfamiliar to most economists, such as social psychology and cognitive science. His ultimate question is: why, despite the production capacity of modern technology, do many nations fail to prosper?

In answering this question North continues the route opened up in his path-breaking 1990 book. The whole argument is based on his definition and classification of institutions: they are formal and informal rules that constrain economic behaviour. But he goes further than in his previous book and extends his analysis to explore deeper determinants of how these rules evolve and change.

North's starting point is to emphasise the inherent uncertainty and unpredictability of the world (chapter two), which, according to him, precludes the application of the type of static and deterministic mathematical models that dominate economics textbooks. He also points out – as an echo of Hayek's or, more broadly, the Austrian economics' view – that our knowledge is inherently imperfect: "To know the future we would have to know today what we will know tomorrow", which explains that "to achieve a better understanding of where we are going we must necessarily focus on the way in which the mind works and makes sense of our external environment" (p. 21).

North lays much emphasis upon the system of beliefs and ideas compared to his previous book (chapters three and five). As he argues, "it is not that the rationality assumption (*of the mainstream economics* – J.K.) is 'wrong'. Rather it is that it does not provide us a guide to understanding the choices humans make" (p. 24). The belief system is transmitted between generations and solidified in customs, traditions, and other cultural institutions. The institutional order is the cumulative

3 Of course there are several branches of economics that are, to some extent, opposed to the mainstream neoclassical economics (e.g. evolutionary economics, old institutionalism, and Austrian economics) but of them only Austrian economics rejects mathematical model-building on a methodological ground.

4 According to North, neoclassical economics has three major deficiencies: "it is frictionless, it is static, and does not take into account human intentionality" (p. 65).

result of generations, its "structure reflects the accumulated beliefs of the society over time" (p. 49). North also argues that some of these institutions are formally designed, but a great many are informal rules that are learned and often not fully articulated. When describing the intergenerational transfer of norms, values and ideas, North refers on many occasions to Hayek's theory (Hayek 1960) on the transmission of accumulated knowledge (theory of cultural evolution). But, contrary to Hayek, who emphasised the spontaneous character of the evolution process, North lays special emphasis on human deliberation in the process of change.[5]

North argues that human beings possess qualities that are uniquely distinct from the objects of natural sciences: intentionality and creativity (chapter four). He demonstrates how intentionality emerges as the product of social learning and how it shapes the economy's cultural foundations. As North argues, the capacity of an economy to adapt to changing circumstances depends also on intentionality. "Adaptive efficiency" is crucial in a society's effectiveness in creating institutions that are flexible enough to be changed and replaced when they need to be.

North strives for "building a new framework that will take into account the limitations of the current theory to provide a better understanding of the process of economic change" (p. 71). Taking stock in chapter six he defines economic change as follows: "Economic change consists of a change in the material and physical well-being of humans broadly conceived to include change that can be quantified not only in national and personal income data, in physical measures of human well-being, but also in the less precisely measured but important aspects of human well-being embodied in non-market activity" (p. 78). As North argues, beliefs are the key to building such a theory.

In chapters seven to eleven he outlines the general contours of the evolving human environment and shows how beliefs and ideas evolved in a way that made the development of the institutions of the modern market economies possible. He summarizes a number of historical changes in Western Europe, especially in banking, commercial contracts, which contributed to the economic growth and prosperity in Europe. The rule of law, property rights, relatively unrestricted market are among the most important conditions for economic growth. North also shows how wrong beliefs systems lead to institutions where governments have too much power like in the Soviet Union. Accordingly, as North argues, the dilemma is that the right "lessons" are not always learned from history. As he puts in chapter twelve, there is too much "noise" in the historical process, and it is not always clear what causes what. Freedom and prosperity are not always guaranteed in any

5 As a consequence of this view, later he contends that "a variety of governmental interventions … may be essential in the short run to be competitive" (p. 164).

society, even successful societies may regress and decay due to the rise of beliefs and ideas that bring about wrong institutional change.

As a conclusion North summarises the message of the book in that in order to be able to improve economic performance we have to understand the process of economic growth, which varies from economy to economy. Insight into the intricacies of institutional change constitutes a crucial component of this understanding.

References

Hayek, F. A. (1960): *The Constitution of Liberty.* Chicago: University of Chicago Press.

Vandenberg, P. (2002): North's Institutionalism and the Prospect of Combining Theoretical Approaches. *Cambridge Journal of Economics,* 26: 217–235.

Judit Kapás

Vladimir Mau
From Crisis to Growth

London: Centre for Research into Post-Communist Economies, New series, No. 21, 2005, 305 pp.

It is always intriguing to read monographic assessments of controversial issues of development where the author can go beyond the limitations imposed upon him by the constraints of a journal article, or by the editors in case of the currently predominant collective volumes in the academic market. Russia has always deserved particular attention by virtue of being the largest and most powerful country of Europe and the former second pole of international relations in the post-World-War II period. Russia has always been perplexing her students, domestic and international, by her unforeseeable changes and unexpected outcomes, defying most expectations, rational or else, developed in the community of academics and policy-makers alike. More recently, the sustaining growth rates, well above 6% per year, the ebbing of inflation to about 13% in 2005 and single digit by 2006, the sustaining current account surplus, running up to 25% and more of Russian export revenues by the year all surprised analysts trained in the overall gloom and doomsday scenarios of the 1990s. Likewise, consolidation and even the strengthening of centralised power structures under the first and second Putin Presidencies have dispelled claims of inherent chaos, disintegration and decay of state structures. All in all, while many analysts consider Russia to have become "just a normal country" (Shleifer – Treisman 2004), the dissimilarities of Russian development from the mainstream, exemplified by the new EU members of Central Europe, have become striking indeed by the middle of the first decade of the 2000s.

The author of the present volume, Rector of the Academy of National Economy, adviser to the President and one of the most prolific authors in the Russian academic life has attempted the impossible: giving a comprehensive account of the still open-ended process of Russian transformation in mere 300 pages. This is daring, since Russia is interesting not only in her own right, but also – for most analytically minded social scientists – as an example of a misconceived, failed, or, on any account unconvincing attempt at social engineering that may serve as a deterring example for the rest of the world of how not to introduce a market economy (Stiglitz 2002; Gray 2005).

Mau, as a frequent conference goer, is obviously aware of the challenge, thus aims at several audiences while relying upon the insider knowledge of the observing participant. Capitalising on his countless articles and several previous monographs published not only in Russian, but also in French and English, he paints a landscape with a broad brush. He adopts a conventional line of presentation by dividing his arguments in three major blocs: history, future challenges and policy implications. He has interesting and controversial points to make in each of these areas.

In Part One he underscores a basic feature often neglected by outsiders, namely that the change of the system in Russia (and elsewhere) was not an outcome of "public choice", but of a historic cataclysm, triggered by the cumulation of a series of crises. By the same token, the room for social engineering has been limited until recently. Whatever were the projects of the "system designers", these could hardly influence the outcomes in such a straightforward manner, as more theory minded observers would have expected. In chapter three he characterises Russian changes as revolutionary that explain most of the features blamed by outsiders on policymakers, such as the weak state, the collapse of output and the sustaining lack of rule of law. In chapter four he argues that financial stabilisation was indeed a precondition for growth to resume. While the author is positive on most of the substantive – democratic and economic – features of the Constitution adopted in December 1993 upon the aftermath of the violent crushing of the Supreme Soviet (pp. 133–138), he calls for the preservation of a functioning constitutional order, which seems legitimate against the background of ongoing policy improvisations. The role of foreign assistance is addressed in a separate chapter, together with its limited role in shaping outcomes (pp. 156–160), particularly in large countries like Russia.

Part Two is devoted to issues of economic growth and social development. He calls attention to the time dimension of change: the broader the institutional changes, the longer it will take until the outcomes become palpable in terms of quantitative indicators. Still, without adapting to changes – i.e. pain – no gain is feasible. On the other hand, recovery of previous levels of output – which still has some way to go – is not to be mixed up with conditions of sustainable development which need to be created in addition. Adjusting antiquated economic and social structure inherited from socialism to the requirements of post-industrial development was bound to take time. The role of the state (pp. 199–212) in this phase is not so much to pick winners than to create side conditions and institutional arrangements for development, such as stable property rights, low inflation, investment in public health and education, managing long overdue judicial and military reforms and the like. However, the author cautions against the mere copying of solutions pre-existent in most advanced societies.

Finally, Part Three is devoted to elaboration of policies that may be conducive to sustaining growth. These include tax and budgetary reforms, deregulation and cutting back red tape, introducing competition where previously "natural monopolies" existed and financial sector reform. While one cannot but agree with the normative view, it is hard to overlook that all international observers, from OECD to EBRD and The Economist Intelligence Unit tend to have found minuscule, if any progress in each of the listed areas in the 2000–2005 period, while rule of law considerations obviously have been de-emphasised in a policy focusing on re-establishing central power against the regions and the oligarchs. Mau dwells on yet another controversial policy area, that of WTO accession and partial adjustment to the EU acquis in a separate Chapter 10. While in terms of the former he sees no need to hurry (p. 254), in terms of the latter he is more upbeat. On pp. 262–270 he calls for a selective unilateral adoption of EU rules that may serve as a point of orientation in shaping the more technical fields of regulation. The concluding Chapter 11 assesses the prospects of economic change under conditions of "one and a half party democracy", which the author considers to be a defining/lasting feature of Russian development. He shows that lack of consensus in terms of values and strategic orientation among major social groups in Russia render unlikely the prospect that Russian democracy and market economy be identical/overlapping with western mainstream equivalents (pp. 282–286). However, not being an adherent to universalist approaches he does not consider this to be a major problem. The book closes with a critique of the governmental line of "protecting achievements". Instead, he advocates further radical reforms, particularly in the financial institutions and governance, both at public policy and corporate levels.

The book can be read in two different ways. If one looks it through a narrow angle of technical economics, the spectrum as well as the language can be found as too broad, abundant with overgeneralizations about history, revolutions and legal systems. References are patchy, statistics serve merely illustrative purposes in several places. Also, a concluding chapter should be addressed to the general reader, not to the policy-maker, offering academic rather than policy insights, highlighting the specifics/value added of the monographic contribution. But this may be too high-browed, indeed. If, however, we look the book through the glasses of policy analysis, this is perhaps the best summary of the Russian economic and political developments of the 1990–2005 period, presented in a condensed fashion and in a readable style. It is interesting to the expert, still accessible to a broad spectrum of social scientists. A welcome contribution to the literature. The publisher deserves praise for the fast production, not, however, for the quality of the book, carrying features of a *samizdat,* such as the lack of index and lacking page numbers in the contents.

László Csaba

References

Gray, J. (2005): The World is Round. *New York Review of Books,* 11 August.
Shleifer, A. – Treisman, D. (2004): A Normal Country. *Foreign Affairs,* (83)2: 20–38.
Stiglitz, J. E. (2002): *Globalization and its Discontents*. London: Allen Lane.

Imre Fertő
***Agri-food Trade between Hungary and the E**U*
Budapest: Századvég, 2004, 257 pp.

Imre Fertő, a well-known agricultural economist, department leader in the Institute of Economics of the Hungarian Academy of Sciences and one of the editors of "Közgazdasági Szemle" (the Hungarian Journal of Economics), wrote a book in English based on his postgradual studies at the University of Newcastle upon Tyne following his numerous Hungarian publications.

The Hungarian agri-food trade was chosen as a field of analysis focusing mainly on bilateral relationships between Hungary and the EU. The main novelty of the book for Hungarian agricultural economists will be the author's quantitative approach using econometric methods in order to measure and explain economic processes of the 1990s.

The book consists of *eight chapters* that profoundly and thoroughly cover the topic. Following the first, introductory chapter, the volume includes two chapters of traditional analysis on Hungarian economics and agriculture of the 1990s and on agri-food trade. The consecutive four chapters deal with econometric analysis, and the last chapter concludes. The inner structure of econometric chapters follows the logic of research work starting with theory, methods, results and finally findings or conclusions.

The author used the database of the OECD, either detailed for more than 250 agri-food products or aggregated to 22 product groups within the system of Standard International Trade Classification (SITC). At the time of writing, the last statistical figures were available for 1998, so the period of 1992–1998 was chosen for analysis.

The first analysis was based on the Constant Market Share (CMS) model (Chapter 4). Its basic assumption is that the share of the country in a market should remain the same if competitiveness does not change in the country. According to a related interpretation, any change in trade is induced from alterations either in the export pattern or in competitiveness. The different CMS models disaggregate the total change of trade to various impacts using different variables for explanation. The author also applies several CMS models with various specification and decomposition for analysing trade flows between Hungary and the EU. According to all three CMS models, higher import demand of the EU constituted the main source of growth in trade.

Competitiveness of Hungarian agri-food exports decreased both in absolute and also relative to the country's three most important trade partners (Austria, Germany, Italy), at the same time increasing competitiveness was observed for some product groups (e.g. meat, grain, sugar, beverage, tobacco, vegetable oil). Though the reader may sense some contradiction in these results, it is worth to note that a similar pattern characterised the EU-15: the competitiveness of agri-food trade declined, while that of some products improved (e.g. sugar, oil seeds, live animals, vegetables).

In Chapter 5, Revealed Comparative Advantage (RCA) is analysed. A widely used approach in studying trade data, the concept has a central role in contemporary trade theory. The first person who elaborated an index for RCA measure was Béla Balassa (1965), later variants of this index were developed and are still popular today. The author discusses the different theoretical and empirical models for the calculation of RCA. Fertő distinguishes between three trade relations treating bilateral, regional and global competitiveness of Hungarian agriculture separately. While four variants of the RCA measure revealed comparative advantage in regional and global relations for half of the 22 product groups, this was the case only for 5 product groups in case of bilateral trade with the EU (live animals, meat, vegetables and fruits, oil seeds, woods). The RCA measures proved to be stable over the period of 1992–1998, at the same time comparative advantage decreased in some product groups covering 22% of individual products.

Chapters 6 and 7 deal with *Intra-Industry Trade* (IIT). This kind of trade indicates product groups with simultaneous exports and imports where individual products can substitute each other. A substantial part of growth in world trade comes from IIT. Balassa created an index for measuring this feature as well, by comparing the value difference of exports and imports to the value of whole trade. Small difference implies a high rate of specialisation within intra-industry trade. Gruber and Lloyd (1975) perfected the method; their GL index is still popular nowadays. Fertő devotes the longest section (nearly 70 pages) to the problem of detecting "still a large gap between the theory of IIT and empirical studies on food products" (p. 167). According to the author, "a high level of intra-industry trade between two countries suggests an advanced degree of economic integration and a high level of economic development" (p. 168). The analysis is focused here on the bilateral trade between Hungary and EU-15.

The IIT indices of Hungarian agriculture are generally low (<0.3), although they show a growing trend, differing by product and country groups. IIT measures of richer EU member countries are higher. In this part of the volume the reader may also come across an interesting comparison between Hungarian agriculture and industry, industry's GL indices are higher (0.47–0.57) than those of agriculture. From this and other findings Fertő concludes that restructuring in Hungarian agriculture 'is far from complete' (p. 197). The reader may find other important conclusions here, e.g. about the dominance of vertical IIT and the better estimation of factors influencing degrees of IIT if vertical and horizontal IIT are distinguished. From the analysis of marginal IIT, the author draws the conclusion that adjustment costs are low, probably because of a complemented development of trade.

In the last chapter the author deals with the possible direction of *future research,* and suggests three areas in particular. Firstly, the elimination of distortions in trade data caused by government policies and interventions in calculating RCA indices, secondly, the study of industry-specific factors (beside country-specific ones) of IIT measures, and third, an extension of marginal intra-industry trade analysis.

As its *largest merit,* the book may serve as a precedent for young Hungarian researchers as to how to apply econometric models and tests on a chosen field of agricultural economics. The author's careful work manifests itself in the literature studied, the choice of measures and models, the stability tests of results, and in extending his analysis to factors influencing comparative advantage, competitiveness or intra-industry trade.

The *summaries* interpreting and evaluating results, which can be found not only at the end of the book but also in each chapter, are also worth appreciation. At the same time, it is respectable that the author calls for caution when interpreting results (e.g. p. 130).

Statistical data and results are well documented in detailed tables containing time series, which enables researchers to contrast novel results with recent ones in the future. In this sense, the book may be considered as a case study or monograph for Hungarian agri-food trade.

Of course, an econometric analysis cannot answer all the possible questions of agri-food trade, e.g. how to improve competitiveness. This stems from the retrospective, descriptive and explanatory nature of econometrics. Hence surges the need for research of a different orientation such as problem-solving or policy research, which uses other kinds of quantitative methods and extends its focus to production besides trade.

Perhaps it follows from this "documentary evidence" character (p. 161) of the work that the use of literature is not balanced in every respect. While referring to a great body of literature from foreign economists, the author makes only few references to Hungarian works (less than ten, not considering four publications of Balassa). While the discussion of trade theories starts with Ricardo (section 1.2), that of competitiveness (which is an important concept of the book) only from the 1990's on, leaving earlier works neglected (section 2.4).

Finally, although it is not a primary aspect in the case of an econometric work, the slow publication process of this book should also be criticised. The last references are from 2001, so the publication itself took three years. The last figures in the time series are from 1998 so the delay of international statistical data and the author's work with data processing and writing required another three years. Overall, this may be regarded as a rather lengthy process, considering that on the international book market several works published in 2005 are full of references from 2004.

To sum up, this book is highly welcome; thanks to the econometric approach and its high standard it will surely fill a gap in Hungarian agricultural economic literature. Of foreign readers, this book can be recommended first of all to those who are interested in Hungarian agricultural trade. Of domestic readers PhD students may make the most profit of it using the book as a manual (taking specific features of trade measures into account). Moreover, this book may also be of interest for Hungarian agricultural economists and politicians having proficiency in English. Finally, Hungarian economists dealing with trade or comparison of industries of national economy may also benefit from studying Fertő's thorough work.

Sándor Mészáros

References

Balassa, B. (1965): Trade Liberalization and Revealed Comparative Advantage. *The Manchester School of Economic and Social Studies,* 33: 99–123.

Grubel, H. G. – Lloyd, P. J. (1975): *Intra Industry Trade.* London: Macmillan.