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# The logic of compromise: Monetary bargaining in Austria-Hungary, 1867–1913

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This article examines the historical record of the Austro-Hungarian monetary union, focusing on its bargaining dimension. As a result of the 1867 Compromise, Austria and Hungary shared a common currency, although they were fiscally sovereign and independent entities. By using repeated threats to quit, Hungary succeeded in obtaining more than proportional control and forcing the common central bank into a policy that was very favourable to it. Using insights from public economics, this article explains the reasons for this outcome. Because Hungary would have been able to secure quite good conditions for itself had it broken apart, Austria had to provide its counterpart with incentives to stay on board. I conclude that the eventual split of Hungary after World War I was therefore not 'written on the wall' in 1914, since the Austro-Hungarian monetary union was quite profitable to Hungarians.

This Austro-Hungarian political feeling was an entity so curiously constructed that it seems almost useless to try to explain it to someone who has not experienced it. It was not made of a Hungarian part and an Austrian part which would have, as one might have thought, completed each other, but indeed of a part and of a whole, that is, of one Hungarian feeling and of one Austro-Hungarian, the latter being at home in Austria, so that Austrian citizens had properly speaking no homeland. Austrians therefore only existed in Hungary, and even there, only as an object of aversion; at home they called themselves citizens-of-the-kingdoms-and-lands-of-the-Austro-Hungarian-monarchy-represented-at-the-Imperial-Council, which amounted to saying 'one Austrian plus one Hungarian minus that very same Hungarian'; and they did so less out of enthusiasm than for the sake of an idea they disliked, since they could not stand the Hungarians more than the Hungarians could stand them, which further complicated the matter.

Robert Musil, *Der Mann ohne Eigenschaften*, 1930

Except perhaps for Sissi, the Habsburg dual monarchy, over the course of its last half-century of existence, has never been too popular. Novelist Robert Musil's famous mockeries on 'Cacania' (as he nicknamed the defunct Empire) are still in our minds: but his jokes merely followed a venerable tradition, dating back to such writers as Elysée Reclus who had defined

the monarchy as ‘political chaos complicated with bureaucratic fancy’.<sup>1</sup> The Romantic nineteenth century had had sympathies with the nationalist uprisings that followed the French Revolution and its principle of self-determination. One must side with the French at Valmy, with the Italians at Magenta. Can one resist siding with Hungary, another victim of Austria? The Talmud says that even if it is the Just who tyrannise the Unjust, God is with the Unjust. What else can we do?

For modern European economic historians, there are two reasons to take the standard interpretation of the dual monarchy with a grain of salt. The first has to do with being Europeans: one century of exacerbated nationalism has led us to accord ‘nations’ less respect. We find virtues in the creation of cosmopolitan institutions if they can be conducive of peace and prosperity: Cacanania has merits. The second reason has to do with being economic historians. Cliometrics, with its arsenal of data, hypotheses and counterfactuals, is especially well endowed to determine the economic logic that consciously (or, since Vienna is involved, unconsciously) presided over political arrangements.

This article thus deals with the Austro-Hungarian ‘Compromise’ of 1867 in the period before World War I.<sup>2</sup> The Compromise was a constitutional treaty that secured fiscal sovereignty for Hungary. It had been obtained from Austria by the Magyar elite in return for political obedience at a time when the Habsburgs were at a disadvantage, being defeated by Prussia at Sadowa and losing Venetia to Italy. After its initial signature in 1867, the Austro-Hungarian compact would be renegotiated every ten years: four drawn-out and quite painful ‘Compromise rounds’ prolonged its life until World War I gave it a lethal blow.<sup>3</sup> Because the Compromise was precisely meant to prevent secession, it has often been portrayed as the continuation of the Habsburg rule in a new guise, and as a result inherited much of the Habsburgs’ unpopularity. Musil (1930) again summarised the majority view quite well when he pronounced the Compromise ‘more difficult to comprehend than the Mystery of the Holy Trinity’. This article takes a different view. In line with the early opinion of the British newspaper *The Economist*, defining the Compromise as ‘the ultimate adjustment of all common interests between Austria and Hungary’ (17 January 1903), it argues that it should be studied as an economic bargain.

The importance of *trade* within the Habsburg Empire has already attracted the attention of economic historians. Some years ago, John Komlos’ seminal study (Komlos 1983a) demonstrated that, contrary to traditional prejudice, the Austro-Hungarian customs union provided huge benefits to Hungary: Magyars were hardly victims. They gained from access to a wide market for

<sup>1</sup> Reclus (1878), p. 131.

<sup>2</sup> *Ausgleich* in German or *kiegyezés* in Hungarian.

<sup>3</sup> In 1877, 1887, 1897, and 1907. Negotiations usually started early and ended late.

their agricultural products. Indeed, the measured effect of the Habsburg union on bilateral commerce was a three-fold increase (Flandreau and Maurel 2005). Moreover, substantial productivity gains were achieved by Hungary between 1890 and 1910 in the agricultural sector (Schulze 2003).

However, nobody has examined the *monetary* aspects of the Compromise so far, because nobody has looked at the Habsburg Empire as a monetary union. This is because of the deceptive nature of the Compromise: The Austro-Hungarian monetary union was not the result of a monetary marriage but the by-product of a fiscal divorce. Austria and Hungary became in 1867 two sovereign budgetary entities. In the process, they retained a common bank of issue and thus formed a *de facto* monetary union that would operate until its post-World War I collapse (Nemec 1924, Zeuceanu 1924, and Garber and Spencer 1994).

One consequence of this set-up was the development of a debate, not over union, but over the mirror image problem of secession. Of course, the reasons for not breaking free from a monetary union cannot be very different from the reasons for joining it. This observation is in effect at the heart of the modern political economy of the size of nations (see, for instance, Alesina and Spolaore 1997). Consider a monetary union comprising two parts, a ‘large’ (Austria) and a ‘small’ (Hungary) country. The common central bank delivers a range of services that are valuable to both parts, but not equally. The exact mix of services produced depends on the division of power. If power is proportional to size, the small country has very little control over common decisions. It is bound by the discipline of the union without being able to influence decision-making in a way that would address its own specific interests. Co-operation (that is, participation in the union) is sub-optimal and the small country prefers to quit. Sustained co-operation requires that the large country accepts a decision-making process in which the small country receives a greater voting share than size alone would predict.

Thus smaller ‘nations’ influence monetary unions disproportionately. However, it is not clear why the large country should accept this dilution of power. The normal outcome should therefore be secession: that is, a multiplication of political entities customised to meet the demands of heterogeneous groups of agents. Conditions to prevent this result include Olson and Zeckhauser’s free rider problem where the large agent cannot really avoid free-riding by smaller members and prefers to commit them by giving them a greater controlling share (Olson and Zeckhauser 1966); and Kindleberger’s benevolent ‘hegemon’ case where the large agent internalises the costs of anarchy (Kindleberger 1973). More relevant to the issue of monetary unions however is the work of Casella (1992) who shows that if co-operation delivers a number of public goods that are useful to all parts, then the large country may nonetheless accept a reduction of its relative ability to set decisions, since the additional output may compensate for the initial loss.

The current article uses this class of insights to analyse the economic logic of monetary bargaining in the Habsburg Empire, 1867–1913. The vantage point it takes is that of the small country – Hungary – showing how secessionist threats succeeded in increasing its controlling share over the common central bank. The article proceeds as follows. Section 1 gives a narrative of Austro-Hungarian monetary negotiations between 1867 and 1899. It shows that Hungary consistently increased its formal control before reaching full parity with Austria. Section 2 focuses on the 1900s when secession was seriously considered before being somewhat mysteriously discarded. Section 3 disposes of the view that fear of adverse consequences of secession on reputation is what deterred Hungary from breaking apart. Finally, Section 4 finds the explanation for the Hungarian turnabout in the policies of the Austro-Hungarian Bank, which began supporting Hungary over and beyond what statutes stipulated. The conclusion wraps up the argument and makes suggestions for future research.

### **1. Monetary union as deal-making: 1867–1899**

The 1867 ‘Compromise’ delineated powers that were shared from those that weren’t. Austria and Hungary would share a common market and trade policy, monetary standard, legal system, army, diplomacy, foreign representatives, and the Emperor of Austria would also be King of Hungary. On the other hand, each part would have its own parliament, government, and budget.<sup>4</sup> Gerschenkron (1962, 1977) has emphasised the role of government spending in Central European development policies in the nineteenth century (see also Wysocki 1975 and Brandt 1978): In effect, a key concern of Hungarian elites when they requested fiscal sovereignty was to be able to finance infrastructure spending, such as the building of railways.

Money had not been discussed in detail. The Compromise only provided that the inconvertible notes of the Austrian National Bank, a private institution under government charter, would continue to be legal tender with the joint guarantee of the two parts. Moreover, through a separate agreement between the two governments (not ratified by parliaments: see Zuckerkandl 1908), Hungarians assumed the obligation not to allow any bank of issue to be created in their territory. This was acknowledging that the Austrian National Bank was the sole bank of issue of the whole monarchy.<sup>5</sup> Hence while ‘monetary union’ between Austria and Hungary was not an explicit part of the Compromise, it was an implication. The dual monarchy was a *de facto* monetary union.

<sup>4</sup> The budgetary set up of the Habsburg monarchy can be called confederate. A common budget served to pay for the army and the foreign policy, but this ‘federal’ level had no authority over taxation. Its resources were, apart from the custom duties, transfers from the two countries’ individual budgets. For details, see Flandreau (2003).

<sup>5</sup> Agreement of 12 September 1867: Zuckerkandl (1908).

However, in the nineteenth century, ‘banks of issue’ were seen as important instruments for nation-state building. They provided the national public good of a national market via homogenisation of the currency and contribution to financial integration (Helleiner 1999 and 2003). Controlling credit was also seen as a policy instrument for redistribution across regions and sectors. Finally, it was felt that ability to rediscount ‘national’ bills would encourage the ‘national’ economy and the creation of ‘national banks’ was supported by economic elites.<sup>6</sup>

The Austrian National Bank was thus not long in seeking formal recognition from the Hungarian Diet. Hungary had conditions: an autonomous *Direktion* in Budapest (as opposed to the existing *Subsidiary*), with more resources. The bank refused (Kövér and Pogány 2002). Hungary’s requests escalated as the 1873 crash of the Vienna and Berlin stock exchanges led to widespread calls for bank support to depressed areas (Bailey 1876). The expiration of the privileges of the ÖNB at the end of 1876 was also in sight. It conveniently happened to coincide with the renegotiation of the Compromise. Monetary bargaining involved the Austrian government, the Hungarian government and the shareholders of the Austrian National Bank. Experimenting with a technique that would be used repeatedly, the Magyars threatened to set up a National Bank of Hungary. On the other hand, shareholders were worried about granting control to a ‘foreign’ authority (shareholders were mostly citizens of Austria). The Austrian government was concerned among other things with preserving the political unity of the monarchy. In the end, on 1 July 1878, the Bank became the Austro-Hungarian Bank (*Österreichisch-ungarische Bank* in German – *Osztrák-magyar bank* in Hungarian).

By this act, the new bank (which inherited the balance sheet of its predecessor) became a ‘federal’ institution. It had two main ‘Managements’ (*Hauptanstalten*) in Vienna and Budapest respectively, run by a ‘Managing Board’ (*Direktion*) and a central office in Vienna, headed by the General Council (*Generalrath*), the executive body of the bank in charge of setting the discount rate. The sophisticated design of the Bank’s organisational chart is a suggestion of the intricacy of the discussions involved (see Noël 1889, Conant 1895, and Zuckerkandl 1908 for details). The Governor was to be appointed by the Emperor and King upon joint nomination of the Austrian and Hungarian finance ministers. He was to be seconded by two Vice-Governors, one Hungarian and one Austrian, appointed by their respective governments from a list submitted by the shareholders. There were also twelve Councillors: at least two had to be Austrian and two Hungarian, and the rest were appointed at the will of the assembly of shareholders. The

<sup>6</sup> Hungary was a case in point. During the 1848 uprising, the emergency Magyar government had given the exclusive right of issue to a *Hungarian Commercial Bank* in which Kossuth, hero of the Revolution, played a major role (see Lévy 1911a, p. 137 and 1911b).

Governor, the Vice-Governors and the Councillors formed the General Council. The Managing Boards were presided over by the Vice-Governors of the respective nationalities. The two governments were entitled to a share of the profits.<sup>7</sup> Finally, the new charter had a short duration of ten years, against 25 years for earlier ones.<sup>8</sup> This was obviously the Compromise's signature.

Austro-Hungarian arrangements were renewed without substantial change or resistance in 1887.<sup>9</sup> However, during the 1890s, the decision to stabilise the paper florin onto a gold parity (called the crown and worth 0.5 florins at the current exchange rate) reopened difficult issues. The reform envisioned the transfer of all monetary prerogatives from the fiscal authorities (national governments) to the Bank (Flandreau 2003). Specifically, governments had to repurchase early issues of state notes and discontinue silver coinage for their own account. Since new issues of state notes had been ruled out in 1867 and silver coinage was marginal, there was no loss of monetary control. But the repurchase of government paper was costly. The Austrian government used this as an excuse to claim some form of control, and it was supported by Hungary who was not so sure it should contribute to repurchase pre-Compromise paper issues. According to external observers 'the general opinion is that there ought to be substantial restrictions on the autonomy of the Bank'.<sup>10</sup> The Bank insisted that the credibility of the currency would gain from this so that no further compensation was needed.<sup>11</sup> It also wanted a longer duration of its charter to be protected from the political hazards of periodic compromise rounds.

Hungary floated its now routine secessionist threat. Premier Wekerle suggested creating two separate banks of issue.<sup>12</sup> The fall of the Hungarian cabinet removed part of the urgency, facilitating monetary stabilisation.<sup>13</sup> Despite no agreement being reached, the Bank nonetheless began pegging the florin exchange rate within gold points, a scheme that would last until World War I (Flandreau and Komlos 2006). But Hungarians insisted that they wanted full parity within the common bank, and made it an absolute

<sup>7</sup> Austria was entitled to 70 per cent and Hungary to 30 per cent of the portion of dividends that was not distributed to shareholders.

<sup>8</sup> Such short charters were rare by European standards : see Flandreau et al. (1998).

<sup>9</sup> Law of 21 May 1887.

<sup>10</sup> Crédit lyonnais Archives, '*Réforme de la Valuta*', Crédit lyonnais Archives, DEEF 73211.

<sup>11</sup> This was the substance of the so-called Mecenseffy memorandum of 1894: Flandreau (2003).

<sup>12</sup> '*Aujourd'hui, la Banque appelée à proposer ses conditions les a faites tellement exorbitantes qu'on a pensé à créer à sa place deux Banques nouvelles: une Autrichienne et une Hongroise*'. Crédit lyonnais Archives, DEEF 73211, '*Réforme de la Valuta*'. See also Conant (1895), p. 233: 'The tendency towards local institutions in Hungary has led to considerable discussion of the project of separate banks of issue [...] and this was one of the reasons why the project for the renewal of the charter proposed by the Imperial bank in the Spring 1894 was not accepted by the two governments'.

<sup>13</sup> According to Lyonnais' economists, '*depuis la chute de M. Vékerlé (sic), cette idée paraît abandonnée*' (Crédit lyonnais Archives, DEEF 73211).

condition for their continued co-operation. After two more years of muddling through they eventually got their way.<sup>14</sup> The new Charter, granted by the law of 21 September 1899, was valid until 1910 (that is, slightly beyond the date when the next Compromise was to be renegotiated, in 1907). It formally acknowledged that each nation retained the right to set up its own bank. Monetary sovereignty was thus a political prerogative, and the common central bank, an alienation of that right. Moreover, statutes resulted in establishing full parity. The influence of shareholders over appointments was reduced to drawing up a list of eligible candidates, which Hungary and Austria formally designated. The autonomy of each regional direction was enhanced (Michel 1976, p. 20). It was further decided that the shareholders assembly would meet in either Vienna or Budapest depending on the majority's country of residence.<sup>15</sup> Profits accruing to the two governments became a function of where bank income originated. Finally, the influence of the two national commissaries was increased beyond their former purely consultative vote.<sup>16</sup> After 1899, they had a veto right, motivated by exceptional circumstances (*'raison d'état'*).<sup>17</sup>

There was thus a definite trend in Hungary's formal influence within the common Bank. This trend was also reflected in substantive policies of the Bank, such as the coverage of the Magyar territory by subsidiaries. As Figure 1 shows, the Austro-Hungarian National Bank transformed itself from being a predominantly Austrian institution in 1867 into being a truly binational institution. There were only five Hungarian branches out of 23 in 1878 (21 per cent), but 19 out of 50 in 1888 (38 per cent), and 29 out of 69 in 1900 (42 per cent). One sure criterion by which to assess the achievements of Hungary is to compare its 'share of the cake' with economic size: with about 40 per cent of the dual monarchy's population, Hungary controlled 50 per cent of the decision-making process. And with about 30 per cent of the Habsburg GDP, it hosted 42 per cent of the Bank's branches. Therefore, Hungary had a more than proportional influence. Moreover, we saw that this had been secured by threatening to set up its own bank. In light of the theoretical elements discussed in the introduction, the implication must be

<sup>14</sup> The account given by Pressburger (1966) is interesting. The Austrian government would have presented the Bank with a choice of increased Austrian control or Hungarian parity. It apparently wanted to corner the Bank in order to secure increased control. The Bank opted for the latter despite a long tradition of Austrian support against Hungary. The Bank may have wanted to encourage rivalry between governments. It must have discounted the risk of collusion.

<sup>15</sup> In practice, the vast majority of shareholders were Austrians and until 1914 the Assembly always gathered in Vienna.

<sup>16</sup> Crédit lyonnais Archives, DEEF 40407, *Banque Austro-Hongroise*, 1918, p. 3.

<sup>17</sup> According to external observers, this had been introduced under Hungarian pressure to restrain Austria's influence: Crédit lyonnais Archives, DEEF 40407, *Banque Austro-Hongroise*, 1900, p. 23. Note that since the veto did not encompass the setting of the discount rate, monetary policy was essentially free from government interference. But Hertz (1903) is less confident.

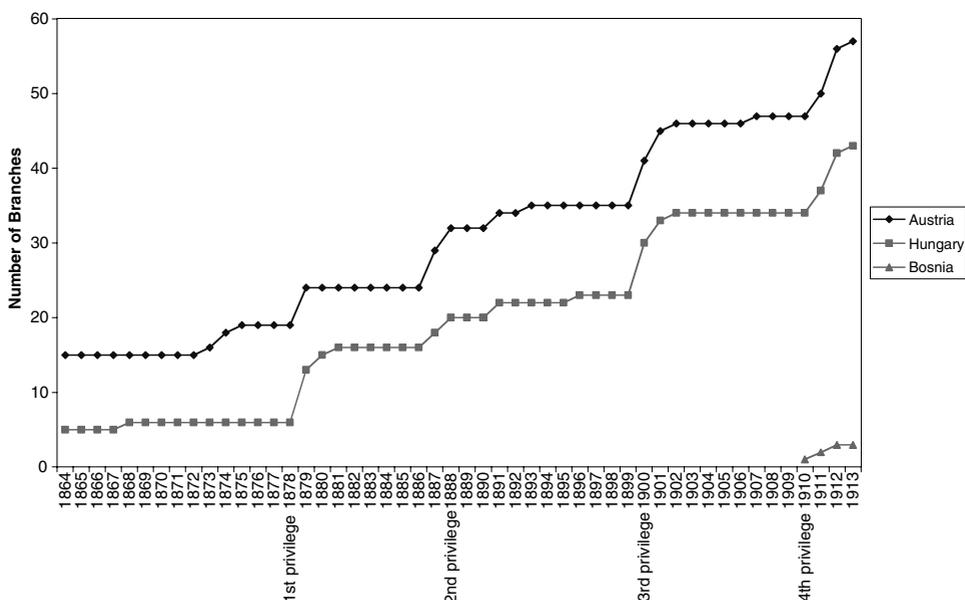


Figure 1. *Total number of agencies (branches plus management) in Austria and Hungary.*

Source: Annual reports of the Austrian National Bank and of the Austro-Hungarian Bank, National Library Vienna.

that Hungarians would have been able to secure better terms for themselves had they actually quit the union than the ones they would have faced if those favourable adjustments had not taken place. And of course, it must also be the case that both Austria and the Austro-Hungarian Bank found the deal palatable – the alternative being that they had no choice.

## 2. The independent Hungarian Bank: rise and fall

On January 26, 1905, a coalition led by the Independence Party, or ‘Party of 1848’, defeated the incumbent Liberal Party. The Independence Party was headed by Ferencz Kossuth, son of the 1848 hero. Despite the Emperor and King’s animadversions, Kossuth was received in Vienna in late February. His party’s claims were a separate army, diplomacy, trade policy, and custom duties *inside* the union. They could not be readily implemented, because they did not represent the coalition’s consensus.<sup>18</sup> However, former supporters of the Liberal Party, led by Wekerle, set up their own ‘Dissidents’ group, and leant towards Kossuth. On 8 April 1906, a Wekerle cabinet was created, in which Kossuth participated. At this point, monetary secession, the only kind

<sup>18</sup> For a chronicle of the episode, see *The Economist*, 11 February, p. 229, 25 February, p. 316–17, 1905.

of separation that was feasible without Vienna's formal agreement, became the focus of nationalists.<sup>19</sup>

In the Spring of 1905, separatists began a campaign against the Austro-Hungarian Bank, criticising 'overly restrictive' monetary policies, 'unsuitable' to Transleithania.<sup>20</sup> Attacks on the monetary union were taken seriously: special arrangements to decide on a unit of account in the event of secession were considered. Austrian banks such as the *Boden Creditanstalt* took steps to make sure credits would always be paid back in Austrian money.<sup>21</sup> The Compromise of 1907 did contain provisions for the liquidation of crown debts.<sup>22</sup> The fate of the bank remained pending. On 30 December 1907, a worried General Assembly of shareholders requested from the Imperial and Royal governments a renewal of the charter before its scheduled expiration date of December 1910.<sup>23</sup>

By that time, however, it had become clear that secession had stirred much debate within Hungary. In March 1908, the Wekerle government set up a special parliamentary committee, the 'Hollo Commission',<sup>24</sup> to examine the technicalities of separation from Austria. A questionnaire was sent out to leading economists.<sup>25</sup> Hearings turned out to be a forum of dissenting opinions (Michel 1976). Despite the exiguity of Hungary's ruling classes, two opposed views emerged.<sup>26</sup> On the one hand was Budapest, where bankers feared that monetary secession would make it difficult to tap the Vienna money market. The Hungarian land-owning gentry, who lived in Budapest and were Count Tisza's Liberal Party's base, also shared this position. It feared that dissolution of the monetary union would herald the collapse of the custom union. Austria might then increase tariffs on corn and force Hungarian producers to compete against Russia for their

<sup>19</sup> External observers saw monetary secession as a consequence of the Kossuth program. Conant, for instance, describes it as 'one of the projects which grew logically out of the movement which gained momentum at the beginning of the twentieth century for the restoration of Hungarian independence' (Conant 1915, p. 249).

<sup>20</sup> Similar attacks on 'too high' interest rates had been repeatedly heard in the past, but this time they were crystallising. Michel (1976, p. 229–30).

<sup>21</sup> Michel (1976, p. 230).

<sup>22</sup> The so-called 'Benedikt clause' (after Moritz Benedikt, famous owner of the Austrian newspaper *Neue Freie Presse*) was negotiated between the two governments, but not presented to the Parliaments. It recognised the need, should monetary separation occur, to fix the value of the Austro-Hungarian exchange rate in order to protect outstanding contracts against the exchange risk which might follow secession.

<sup>23</sup> Crédit lyonnais Archives, DEEF 40407, *Banque Austro-Hongroise*, p. 6. The demand was officially transmitted to each government on 30 December 1908.

<sup>24</sup> The choice of 21 members in the commission symbolically evoked the 1892 commission of experts on the adoption of the gold standard in the dual monarchy; see Conant (1915).

<sup>25</sup> *L'Economiste Européen*, 10 April 1908, XXXIII, p. 473.

<sup>26</sup> According to Tatu Vanhanen's Polyarchy database, these were below 7 per cent of the population before World War I. On Hungarian parliamentarism, see Hajdu (1987).

market. An Austrian observer argued: 'One thing is certain: just as it is absolutely necessary to have a common currency and a common bank for a common trade area, it is impossible to keep together a common trade area without a common bank and a common currency. The leaders of the Independence Party seem to believe that it is politically easier to obtain a monetary separation than a division of the trade area, and consequently tenaciously pursue their goal of a separate bank, in the hope that the customs union will collapse by itself as a result' (Federn 1910, p. 466–7).

On the other hand the pro-secession group comprised 'provincial' interests. These included chiefly the Chambers of Commerce representing industrialists and regional bankers. The industrialists discarded the risk of exchange depreciation, which at worst would boost their competitiveness (Michel 1976, p. 231). They were also prepared for custom duties within the monarchy, since this meant protection against Austria's industry. They also wanted cheap credit and believed that a national bank would be successful at meeting their specific needs. Regional bankers concurred, complaining that the Austro-Hungarian Bank was not paying enough attention. They claimed they were victims of discrimination and credit rationing. The contrast between bankers' views in Budapest and the provinces is really intriguing. How could Budapest and the Provinces differ so much?

As divisions became apparent in 1908, two evolutions took place. First, regional interests, and especially bankers, began adopting more union-friendly tones. The chasm between financiers in Budapest and the regions was being bridged over. In February 1910, a congress of provincial bankers acknowledged that access to the common bank's discounting facilities was quite useful. The conference concluded with a declaration reflecting the turnabout: 'This century is not devoted to disruption but to intense and pervasive exchanges, to mutual understanding, to reasonable compromises. Agreeing on the basis that is necessary to the satisfaction of all parts involved is in no way a lack of patriotism.'<sup>27</sup>

Second, evidence that a fraction of the public wanted to retain some benefits of a common central bank led Wekerle to produce an alternative secession scheme. It combined full separation between the two parts of the Austro-Hungarian Bank along with a cartel agreement between the two resulting entities. The 'Central Bank Cartel' would impose a uniform interest rate throughout both countries, and a fixed exchange rate between each part. That would still be a monetary union, but the centralisation of decision-making would be restricted to a minimum. From what we can understand, it seems that the scheme envisioned reciprocal par acceptance of the notes issued by each bank. The free-rider problem was obvious, and resulted in depriving Austria of control over the money supply. Agents would have obtained credit where it was cheapest (in Hungary), and monetary policy

<sup>27</sup> Quoted in *Neue Freie Presse*, 4 February 1910.

would have been set in Budapest. The Austrian reaction was ‘quick and violent’.<sup>28</sup> It could not prevent Hungary from setting up its own bank, but it could refuse cooperation with that scheme.<sup>29</sup> On 25 April 1909, the Emperor Franz-Josef vetoed the Cartel on the ground that it endangered the solidity and credit of the Austro-Hungarian bank of issue.

By the Autumn of 1909, the Independence Party was disintegrating: extremists led by Justh insisted on the strict application of the initial project of a fully sovereign Hungarian National Bank. But a more moderate faction, led by Kossuth and Count Apponyi, resisted. The Wekerle Cabinet fell in January 1910.<sup>30</sup> Hungary began to negotiate a renewal of the Austro-Hungarian Bank’s charter for another ten years. In the Spring of 1910 a new election sealed the fate of the Independence Party.<sup>31</sup> An arrangement was arrived at with the Bank before the former statutes expired. The charter of October 1910 extended the life of the common bank for another round in essentially the same shape as in 1899. The independent central bank project had collapsed, apparently of Hungary’s own accord. In 1912, the Hungarian finance minister Teleszky would declare: ‘The common bank is a better deal for us than an independent bank of issue would have been’.<sup>32</sup> What had changed between 1899 and 1910 that made secession so much less attractive?

<sup>28</sup> Federn (1910, p. 456).

<sup>29</sup> This mechanism is known as the inflationary bias of common currencies: if, in a monetary union, money issues are decentralised, an inflationary bias will emerge with each central bank seeking to exploit the union by exporting the costs of inflation. Flandreau (1993) argues that if central banks retain the right to discriminate against foreign notes, they can enforce discipline. This was understood by contemporaries. According to Federn (1910, p. 457): ‘Where did the risk lie? In the maintenance of the value of notes. The Hungarian notes, if there was no legal obligation to take them at par in Austria, would have been very much as the notes of other foreign banks – a fluctuating value in the Austrian bourse. [...] The Hungarian bank would have had to make sure that it would always hold a metallic treasure so that nobody would doubt the capacity of Hungary to meet its foreign obligations, in gold if necessary. Hungary would have had for this purpose to raise its discount rate in order to prevent the excesses of credit that would cause too big an efflux of notes, and a disequilibrium between the reserve and the outstanding circulation. On the other hand, if Hungarian notes were to be taken at par in Austria, Hungary would have neglected to behave, because it could always have poured into Austria its surplus of notes. Then the problem would have been Austria’s [...] The advantages of the independent bank of issue, if they exist, would have been for Hungarians, with Austrians eliminating the risks.’

<sup>30</sup> See *Economiste Européen*, 7 May 1909, XXXV, p. 601. The newspaper also mentions that the Budapest stock exchange welcomed the collapse of the central bank cartel project. The cabinet was not replaced until January 1910.

<sup>31</sup> According to Lévy ‘the elections of the Spring of 1910 have given a large majority which is hostile to extreme solutions; the renewal of the privilege of the Common Bank seems more and more likely’, p. 145–6.

<sup>32</sup> *Neue Freie Presse*, 24 September 1912, ‘Eine Grosse Anlehenemission in Ungarn’, p. 13–14. Quoted in Michel (1976, p. 232).

### 3. Reputation and secession

Supporters of secession vituperated that the change of mind had resulted from their adversaries' skilful propaganda. They accused them of having threatened the 'less knowledgeable categories of national production' with apocalyptic and of course unfounded predictions such as a 'constant, ruinous increase of the discount rate'.<sup>33</sup> Given the elitist nature of the debate, it is not clear that such accusations were warranted. One does find evidence of sophisticated contemporary discussions of the economics of secession, as illustrated for instance by two survey articles published in 1910. The first, by Federn, editor of the *Österreichische Volkswirt*, supported the continuation of monetary union. The second, by one Aberdam, popularised the views of Béla Földés (a Professor of Political Economy at the University of Budapest and expert for the Hungarian monetary commission of 1892), who supported secession.<sup>34</sup> Taken together, the two articles provide a comprehensive review of the arguments.

Protagonists concurred that assessing properly the costs of secession hinged critically on measuring the cost of capital with and without monetary union. Thanks to the pioneering work of economist Frigyes Fellner on Hungary's balance of payment (Fellner 1903, 1909, 1917), contemporaries were aware of Hungary's dependence on foreign capital.<sup>35</sup> Hungarian government bonds were largely held in Austria, even if this fraction was declining in the early 1900s, owing to purchases by Hungarians investors (Figure 2). Moreover, scattered evidence pointed to a substantial reliance of Hungary on short-term capital from Vienna.<sup>36</sup> Overdrafts and deposits from Viennese banks helped finance credit expansion in Hungary.<sup>37</sup>

Opponents of secession emphasised that the lack of a common currency might complicate Hungary's management of its external books. For instance, Viennese banks would not be as willing to supply money to their Hungarian counterparts as they had been previously. Difficulties could also arise if Austrians were to dump Hungarian securities on the market. Federn argued that 'Austria removes the problem of stabilization of the currency from Hungary, and that is probably the greatest service which Austria gives to the Hungarians, through the banking and monetary community'.<sup>38</sup> Finally there would be exchange rate fluctuations, which, albeit small (they would

<sup>33</sup> Aberdam (1910, p. 226).

<sup>34</sup> See his opinions on monetary stabilisation in *Gutachten über die Österreichisch-ungarische Währungs-Reform*, p. 8–9.

<sup>35</sup> See especially Fellner (1917, p. 80–1). Michel (1976, p. 223) emphasises Hungary's dependence on 'Austria and the rest of the world, not only for government bonds but for railways and other sectors as well, such as banks (only 35 per cent of Hungarian banks' capital was held in Hungary in 1899). See Pammer (1998) for new material.

<sup>36</sup> See Flandreau and Gallice (2005) for a discussion of the mechanisms involved.

<sup>37</sup> Michel (1976) provides estimates of the extent of this support.

<sup>38</sup> Federn (1910, p. 456).

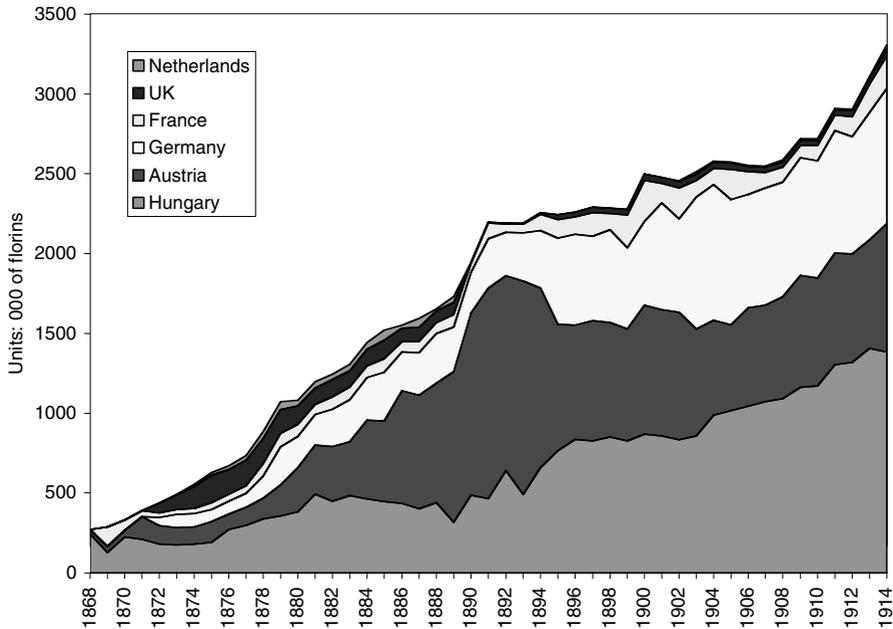


Figure 2. *Breakdown of Hungarian state securities.*

Source: Fellner, 1917. The figures were derived from information on where the coupon on Hungary’s ‘special debt’ was paid. This does not include the part of the pre-1867 ‘common debt’ for which an annuity was paid to Austria.

occur within ‘gold points’ since it was generally agreed that a sovereign Hungary would be on gold) would require the National Bank of Hungary to raise interest rates when needed. But would the new Bank of Hungary enjoy the experience and credibility of the Austro-Hungarian Bank?<sup>39</sup> Secession might have perverse effects given its intended objective of a greater supply of credit.

Secessionists conceded that over the short run there might be some costs, due to the inevitable ‘jolts of transition, lack of experience and age-old traditions on behalf of the new Bank, and exchange rate fluctuations’.<sup>40</sup> But the process would generate self-stabilising forces in a ‘neo-classical’ fashion: with Austrian sales of Hungarian securities, yields would rise, but this would encourage foreigners to increase their holdings of Hungarian bonds, restoring equilibrium. To the notion that an adverse balance of payments meant losing gold and forced discount rate increases, secessionists objected using an early variant of the monetary approach to the balance

<sup>39</sup> The new Bank, warned Federn, ‘would have to take care that its notes get a stable price in foreign exchanges, if it wanted to prevent damaging its reputation’, Federn (1910, p. 458).

<sup>40</sup> Aberdam (1910, p. 226).

of payments (Frenkel and Johnson 1976).<sup>41</sup> International gold flows were determined by national monetary requirements, not by the current account. The international monetary equilibrium produced a ‘smooth distribution of gold between the various countries, according to each nation’s needs’.<sup>42</sup> If gold leaked out in excess of needs, interest rates might rise but only transitorily, and this would check the export of gold thus ruling out the supposed need for continued interest rate hikes (this is similar to McCloskey and Zecher 1976). After all, other debtor countries were able to retain their gold reserves.

Thus, secessionists disregarded the transition to the post-separation equilibrium as a problem of secondary importance. Perfect international arbitrage (the ‘resources of modern finance’ and the ‘speed of communications’ in the language of the time) would ensure that monetary equilibrium be obtained at low cost. Some institutional details could determine the cyclical behaviour of interest rates.<sup>43</sup> But a carefully designed exit strategy would prevent interest rates from rising.<sup>44</sup> If a given security is indeed a low risk, someone will inevitably end up holding it at the right price: the question thus boiled down to a matter of ‘credit standing’.<sup>45</sup> Secession only required ‘foreign confidence, on which in the last analysis all economic relations rest. As long as Hungary knows how to retain that trust, its transactions will not encounter, on the international money market, any serious difficulty.’<sup>46</sup>

<sup>41</sup> « *Si la solidarité étroite du mouvement de l’or et de la balance des dettes et des créances existait, le pays à balance défavorable se verrait – en bonne logique – vite dépouillé de son métal précieux [...] Conclusion évidemment absurde* », Aberdam (1910, p. 227).

<sup>42</sup> Aberdam (1910, p. 228).

<sup>43</sup> This included the precise institutional design of the central bank. Among options, Aberdam (1910, p. 227) identifies the British model of assertive interest rate increases to check gold outflows, the French one of gold devices, and the German system of moral suasion. Separatists found that the British case required a degree of financial development Hungary had not reached, and opted for one of the Continental models.

<sup>44</sup> Aberdam (1910, p. 229). Secessionists even called mathematical economics to the rescue, emphasising that the ultimate determinant of interest rates was marginal productivity of capital, which was bound to equalise across the world. Aberdam explicitly quotes the work of the Italian economist (and later politician) Francesco Saverio Nitti, who had demonstrated in 1898 that ‘in the ideal case of a pure credit economy, the maximum interest rate is given by the average profit rate’. It seems that Aberdam was referring to *La misura delle variazioni di valore della moneta*, quoted by Fisher (1911).

<sup>45</sup> Such was the conventional view among contemporaries. As James de Rothschild had reminded the Austrian minister of finance a few months after the first Compromise was signed ‘the price of public securities is, with good reasons, considered as the exact measure of the degree of trust which national credit deserves. It is on that basis that the credit of all national companies is in turn assessed, and, from that point of view it has a tremendous influence on the development of prosperity’. Quoted in Gille (1967).

<sup>46</sup> Aberdam (1910, p. 230).

On this account, secessionists emphasised that the Magyar government had ‘never abused its creditors, never reneged on its commitments’<sup>47</sup>.

Who was right? This paragraph focuses on one aspect of the debate, namely the effect of secession on bond prices. In 1905, Hungary’s public debts comprised two parts: on the one hand were Hungary’s ‘domestic’ paper bonds, denominated in crowns. On the other hand were the ‘gold’ bonds, denominated in Western European gold convertible currencies. The concern opponents to secession had was that paper bonds, denominated in the union’s currency, were ‘at home’ both in Vienna and Budapest, and in effect largely held in Vienna. Haupt (1896) indicated that around 1890, 52 per cent of Hungary’s paper debts were held in Hungary, 44 per cent in Vienna and only 4 per cent abroad.<sup>48</sup> But this situation would only continue for as long as Hungary remained within the monetary union. In the event of monetary secession, and even if debts were denominated in Austrian currency as they normally would have been (redenomination in Hungarian currency being equivalent to a default since it had not been considered in initial contracts), Austrians might have become much less eager to hold such bonds. As for investors outside the Habsburg Empire – in Berlin, Paris, or London – they might not have been willing to make up the difference and buy what Austria might be selling. This, not so much because of distrust, but rather because of the transaction costs they faced when cashing their coupons or performing arbitrage operations. The market for crowns in, say, Berlin, was less liquid than the market for, say, sterling, explaining why such a modest fraction of Hungary’s crown paper debts (4 per cent in 1890) was held outside the dual monarchy. Therefore, the argument would go, the bulk of Hungary’s crown debts would have inevitably fallen back into Hungarian hands, causing a deterioration in borrowing conditions.

But this problem could be taken care of via financial innovation. One only had to combine secession with a conversion of the crown debts into gold debts. Indeed this was the standard purpose of including foreign exchange clauses in debt contracts – to secure a liquid market abroad (Flandreau and Sussman 2005). Haupt (1896) provides evidence on the effects of gold clauses circa 1890: the breakdown of Hungarian gold debts was 82 per cent abroad, 12 per cent in Austria, and 6 per cent in Hungary.<sup>49</sup> Unsurprisingly, therefore, financially literate Hungarian separatist authorities opened talks with international banks in 1905 in order to organise a conversion of Hungarian government debts traded in Vienna into some gold-denominated

<sup>47</sup> See Kövér (1988) on how Hungary acquired a reputation in the early 1870s by agreeing to pay the Corporation of Foreign Bondholders a balance that was due by Austria.

<sup>48</sup> Haupt’s source was Dr Ignaz Gruber, *Tabellen zur Währungsfrage* (Vienna: Ministry of Finance, 1893). Corresponding numbers for Austria are: 81 per cent of government paper debts held in Austria, 9 per cent in Hungary and 10 per cent abroad.

<sup>49</sup> Corresponding totals for Austrian gold debts were: held abroad 81 per cent; held in Austria 19 per cent; held in Hungary 0 per cent.

international instrument (Michel 1976). As they discovered, the size of the required conversion would be manageable. Standing at 57 per cent of Hungary's so-called 'special debts' in 1890, paper debts declined to 36 per cent in 1898 and 20 per cent in 1907.<sup>50</sup>

Thus the whole issue boils down to measuring the impact of secession on the yield on gold-denominated government securities. While this cannot be measured directly, it is possible to address a tightly related question. We can determine whether Hungary benefited from better borrowing conditions as a result of her being part of the Habsburg Empire. In Flandreau and Zumer (2004), we used contemporary data to price gold bonds yields for an almost comprehensive list of European nations (plus Argentina and Brazil) in the late nineteenth century (1880–1914). The study found that debt burdens, measured as the ratio of debt service to government revenues, accounted for most of the cross-sectional and time series variations of long term interest rates. Because the sample precisely contains sovereign countries of varied size, location, and reputation, it provides an estimate of the average elasticity of borrowing terms to the debt burden for a sovereign nation, and can thus serve to simulate what would have been Hungary's borrowing costs, had it been sovereign.

If being part of the Habsburg Monarchy improved Hungary's borrowing prospects, then we should find that Hungary faced lower rates than those implied by its 'fundamentals', using the general formula that applies to sovereigns.<sup>51</sup> Figure 3 provides a visual test of the value of being part of the Habsburg Empire. It depicts the actual spread between Hungarian and Austrian yields, the simulated one (obtained using the general formula for sovereign countries), and confidence margins. If Hungary benefited from union, we should expect the simulated spread to be *significantly above* the observed one. But the actual and simulated spreads are very close to one another, and discrepancies are neither large (at most 10 basis points) nor significant.<sup>52</sup> One can reject the hypothesis that membership of the Habsburg monarchy entailed credibility gains. Hungary was essentially priced as a sovereign nation.<sup>53</sup> One interpretation, of course, is that Habsburg membership was never taken very seriously by the market, given all the secessionist threats, so that investors had already priced Hungary as a

<sup>50</sup> Author's computations, from Crédit lyonnais Archives. Figures refer to the fraction of post-1867 debts. I have included the crown debts of the 1900s on the understanding that these included fixed exchange rate clauses.

<sup>51</sup> For details, see Flandreau and Zumer (2004, p. 38–44 and 72–93).

<sup>52</sup> Interestingly, the 1905 election might have played a role in marginally deteriorating borrowing conditions, but the effect remains very modest.

<sup>53</sup> Contrast with the discussion in Eddie (1982) who argues that Franz-Joseph would never have accepted that Hungary would default. That Hungarian rates were on average above Austrian rates is evidence that investors disagreed. And this is the only thing that matters when measuring the costs of secession.

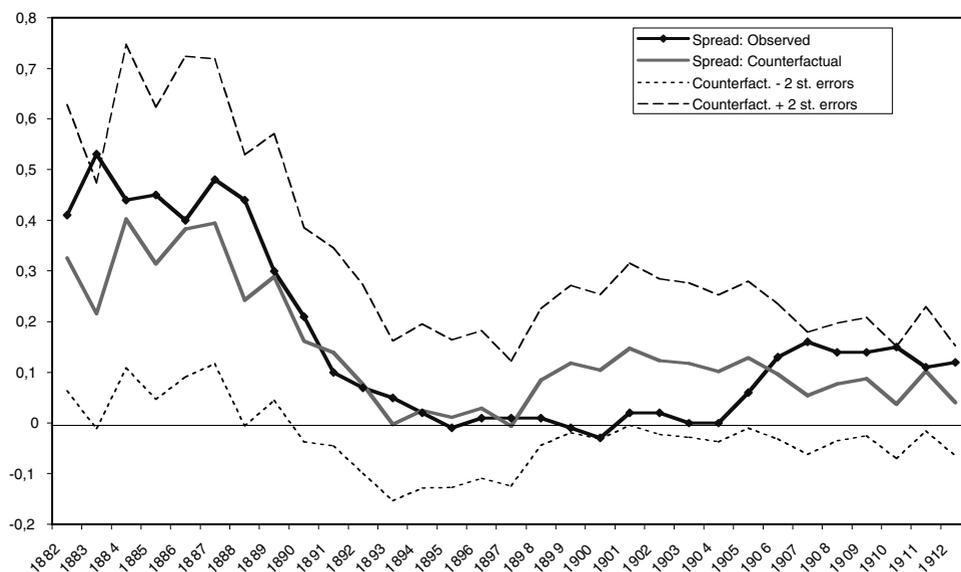


Figure 3. *Hungarian premium: observed and simulated.*

Source: Author's computations (see text and Appendix).

sovereign country; in which case we may understand why secession could not have affected borrowing costs.

Strictly speaking, this finding says nothing about what would have actually happened in the event of secession. Hungarians authorities might of course have become crazy, they might have printed money, issued debt, defaulted, and so on. Or they might have been able to cut military spending, improve their fiscal capacity by raising custom duties, and similar measures. All these moves would have influenced yields in one way or another, so that a 'complete' counterfactual is just not feasible. The point, however, is that they might have followed just the same policies as they actually did, and wouldn't have behaved worse than any other sovereign nation of the time. But that's all we need to prove: that in this case the market would not have penalised Hungary. In sum, we should not look in the bond market for participation incentives, for they were just not there.

#### 4. 'A better deal for us': the Austro-Hungarian Bank and the Compromise

So why didn't Hungary secede? This article's interpretation of why monetary union turned out to be a better deal for Hungary rests on two complementary arguments, having to do with national and international monetary integration respectively. Consider international monetary integration first.

The previous section has shown that the credibility costs of secession were probably inessential since financial innovation could secure a replacement for Vienna as supplier of capital. Not all costs could be escaped, however. In a sovereign Hungary, private credit, in the form of bill discounting, would be conducted at higher costs than if the Magyars remained part of the Empire. This is because, as long as they were part of the Empire, Hungarian borrowers could draw crown-denominated bills of exchange on Viennese correspondents. These bills could then be sold anywhere in the world where Viennese financiers had connections. Flandreau and Jobst (2005) show that the Austro-Hungarian currency was traded in a very large number of centres. It was bought and sold in virtually every European market and in a few non-European markets such as Mexico. Its international standing was comparable to that of the Dutch florin or Belgian franc, two important European currencies.

Moreover, Flandreau and Jobst (2006) report evidence of a tight correlation between international circulation (measured by the number of markets where a given currency was traded) and short-term commercial rates. At a time when fixed exchange rates ruled, persistent interest differentials must be interpreted as liquidity premiums. Figure 4 illustrates this relation for 1910. As can be seen, currencies traded in the smallest number of foreign markets had short-term interest rates at least 200 basis points above London rates (and possibly much more since it is quite likely that the true relation was non-linear). The currency of the Habsburg monarchy, which enjoyed regional circulation, had rates on average only about 50 basis points above London. Against this background, a reasonable guess on the rates that would have prevailed in an independent Hungary can be inferred. Roughly speaking, Hungary would not be very unlike Romania, or roughly 150 basis points above London. A more rigorous measure is to use empirical data to predict the number of markets where the Hungarian currency would have been traded.<sup>54</sup> The answer one gets is that it would have been traded in one foreign market at most – Vienna. Using the regression line in Figure 4, we may conclude that Hungarian short term spreads against British rates would have stood at about 100 basis points above what they were when Hungary was part of the dual monarchy. This is one measure of the cost of secession, and it is substantial.

An independent Hungary would thus have had a higher discount rate than if it had remained part of the Habsburg union. This helps in understanding the commitment of Budapest bankers to monetary union, discussed earlier,

<sup>54</sup> The procedure is to use the estimated parameters of the determinants of foreign quotation considered in Flandreau and Jobst (2006), and then simulate the number of expected quotations on the basis of data for Hungary. For simplicity, it is assumed that Hungarian trade patterns are constant post-secession. Given the pre-secession concentration of Hungarian trade this provides an upper bound to the likely number of quotations.

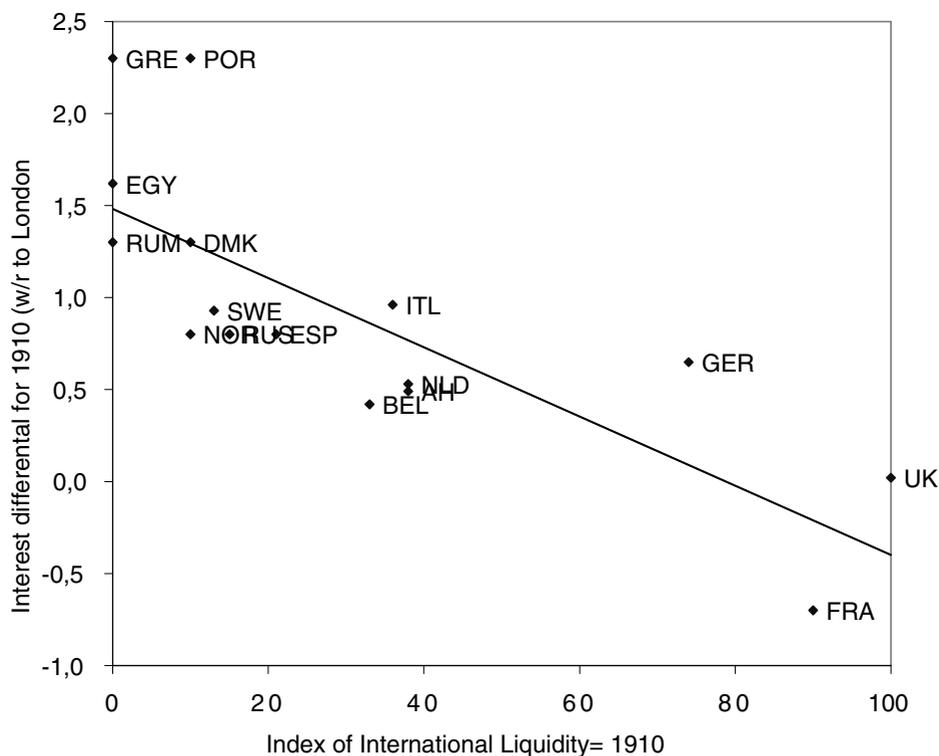


Figure 4. *International circulation and interest rates.*

Source: See text. Indices of international liquidity are from Flandreau and Jobst [2005]. Interest rates are from Flandreau and Jobst [2006].

and their concerns that secession would mean a higher price for working capital. But how to understand then that Hungarians could be so bold and so successful when threatening secession? And how could regional bankers fail to understand this? To explain this paradox, we must take into account the existence of very poor regional monetary integration of Hungarian provinces with the rest of the monarchy, including Budapest. While precise data on this are lacking, anecdotal evidence suggests that Hungary’s provinces had substantially higher interest rates than the rest of the monarchy.<sup>55</sup> Moreover, a parallel may be drawn with the findings of David Good for Austria (Good 1977a, 1977b). Good reports evidence of higher interest rates in Austria’s provinces than in Vienna during the period 1870–1910, and shows that these differentials declined in proportion to the decrease in transaction costs

<sup>55</sup> According to Michel (1976), p. 20, the Austrian Vice-Governor argued during the Generalrath meeting of 26 June 1901 that the current bank rate was ‘certainly too low’ given Hungary’s systematic tendency to have higher rates.

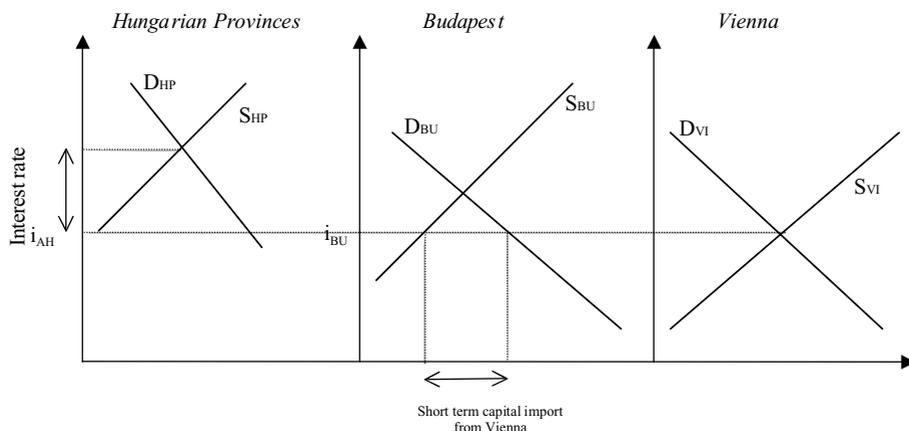


Figure 5a. *Setting circa 1900: integration between Budapest and Vienna, no integration between Budapest and Hungarian provinces.*

and the greater circulation of capital across regions.<sup>56</sup> Most critically, Good specifically acknowledged the importance of the central bank in fostering market integration in Austria. In any case, all evidence we have on the relative development of the two parts of the monarchy, both economic and financial, points to Hungarian retardation and a worse situation in its provinces.<sup>57</sup> Therefore, there was gap between the credit conditions in Hungarian regions and those in Budapest. For the Provinces, the benefits of being tied to an international currency could be offset by local inefficiencies. A better course of action was thus to set up an independent bank in Budapest. This would create higher benchmark rates in Budapest, but could also help to push down local rates.

A simple model of credit markets can help clarify the intuition (Figures 5a to 5c). We consider the situation around 1900. Bankers in Budapest can rediscount bills at the Austro-Hungarian Bank's rate. Interest rates in Budapest are thus equal to interest rates in Vienna. Hungarian Provinces are isolated by large transaction costs and face high rates. Figure 5b shows what would have happened had secessionists got their way. Conditions in Budapest would have deteriorated, but conditions in the Provinces would have improved given that the Hungarian National Bank would have improved Hungarian money market integration. Obviously, the net gain from secession depends on balancing the costs and benefits: but we do not need to get into that to explain the conflict between alternative groups of bankers identified earlier. Of course, a superior arrangement (from the point of view of all

<sup>56</sup> Some partial results on Hungary, supporting the intuition here, but for an earlier time period are provided by Good (1984).

<sup>57</sup> For traditional references, see, for example, Hertz (1947), Katus (1970), Berend and Ranki (1974), Rudolph (1976) and Eddie (1989). Modern references include Komlos (1983b), Good (1994), and Good and Ma (1998).

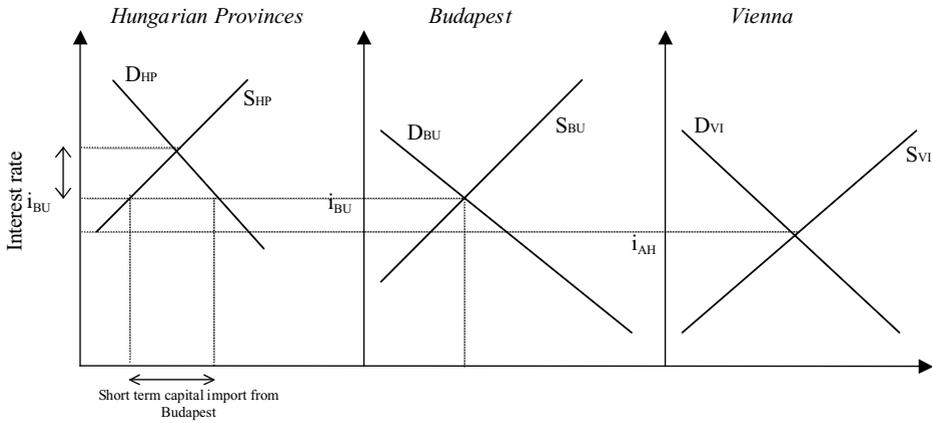


Figure 5b. Counterfactual effects of secession: higher rates in Budapest, lower rates in Hungarian provinces.

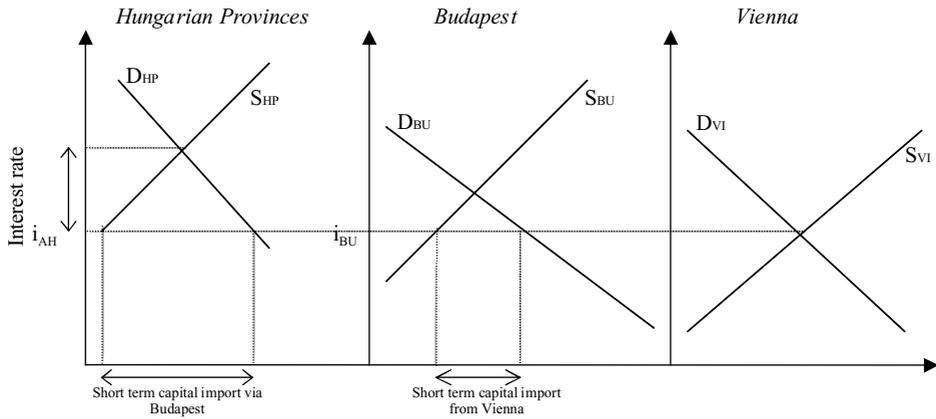


Figure 5c. Effects of market integration and monetary union.

Hungarian interests) is one where the Austro-Hungarian Bank takes care of fixing Hungary’s regional integration problem. Then, both Budapest and the Hungarian provinces gain. A prediction of this analysis, shown in Figure 5c, is that there should be a massive transfer of credit to Hungarian Provinces.

Figure 6 shows what happened to the Austro-Hungarian Bank’s portfolio of commercial bills after the victory of the Independence Party in 1905. Four items are identified: ‘Vienna’, ‘Budapest’, ‘Austrian branches’ and ‘Hungarian branches’. Between 1906, when the campaign against the bank began, and 1912, when Teleszky pronounced the common bank ‘a better deal’, the share of the Hungarian branches’ discounts increased from being the lowest to being the highest. This is exactly the prediction in Figure 5c. A better deal indeed: Hungary’s second thoughts may be easier to understand now.

Further evidence can be obtained by looking at Figure 7, which shows the average maturity of bills held. In Hungarian branches, maturity was

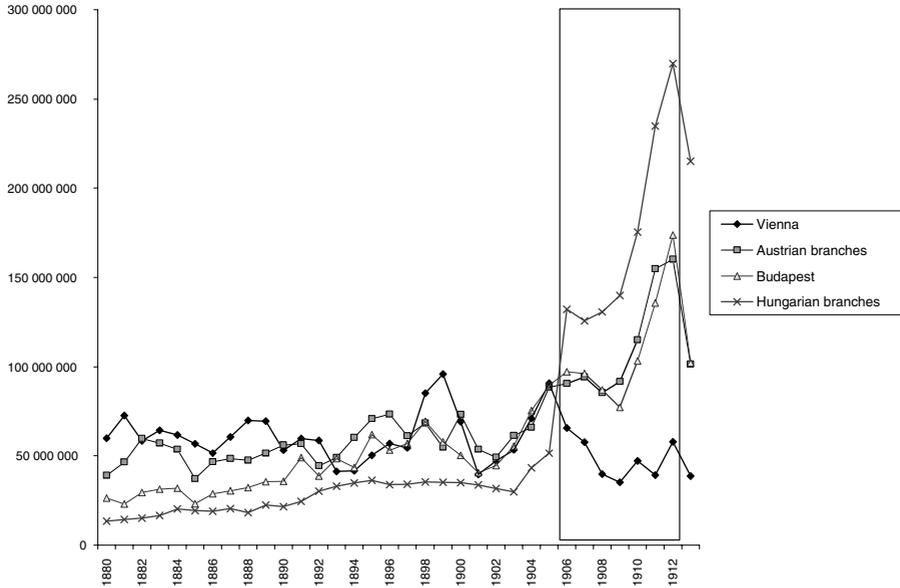


Figure 6. *Breakdown of Austro-Hungarian Bank's bills portfolio (florins).*

Source: See Appendix.

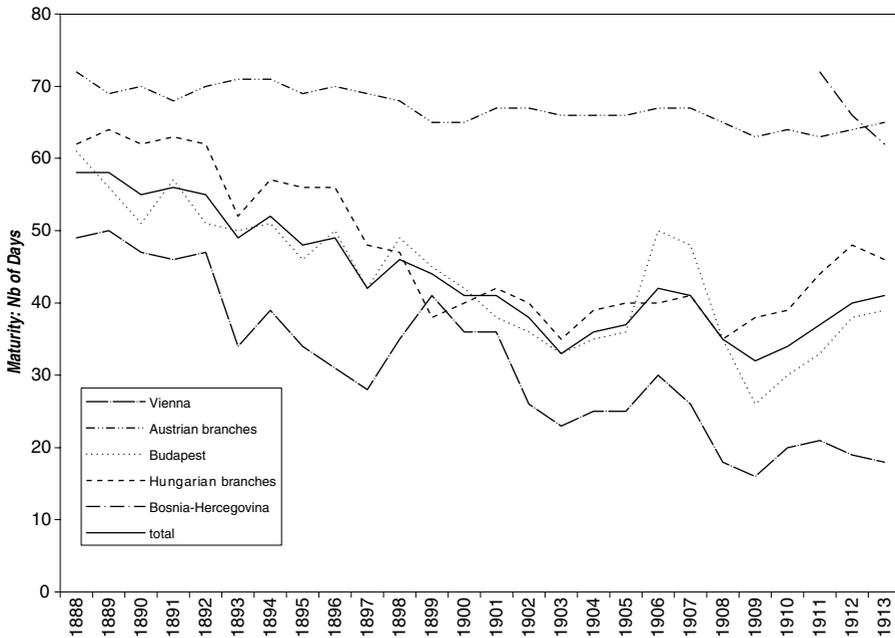


Figure 7. *Average maturity of Austro-Hungarian Bank's bills portfolio (by location).*

Source: See Appendix.

close to two months throughout the entire period under study. It was by contrast much lower in Budapest and in Austrian provinces, and even lower in Vienna (30 days). This shows that, while the Bank acted in Vienna more like a ‘modern’ central bank, rediscounting bills from bankers, it behaved in Hungarian provinces as a primary discount house, probably supplying funds to merchants, industrialists and certainly local financiers. Combining this with the evidence of an increase in overall lending, we must conclude that the Austro-Hungarian Bank became after 1906 a powerful engine of regional market integration in Hungary.

These elements point to a simple interpretation of the failure of the Hungarian National Bank project. The reason why secessionists lost the support of the provincial elites is because the Bank bought in this group. The generous share of the total credit supply of the Bank that the Hungarian provinces received aligned their incentives with their Budapest counterparts. By standing ready to give credit in Hungarian Provinces at conditions close to those in Vienna, the Austro-Hungarian Bank provided a net benefit that would be lost in the event of secession. This is what stabilised the bargaining relation within the monarchy. Historian Bernard Michel once suggested: ‘Financial links between Vienna and Budapest were one of the strongest foundations of the continuation of the Compromise’ (Michel 1976, p. 233). This article has provided some elements on why and how this was the case.

### **Conclusions**

This article has argued that the Austro-Hungarian Compromise of 1867 should be studied as a bargain in which monetary interests loomed large. But if the compromise was a ‘deal’ then the natural instruments of investigation should be the tools of public economics and political economy. We found that the survival of the monetary union between Austria and Hungary really resulted from an adjustment of incentives. Hungary had been able to secure formal control over the common central bank. Moreover after 1900 it was also able to secure an increasing share of Austro-Hungarian Bank lending. This evolution makes perfect sense in the light of the theoretical elements put forward in the Introduction. Because the Magyars had pretty definite ideas about what their development strategy should look like, and because they were prepared to discontinue their membership of monetary union if they did not have their way, their negotiating counterparts had to give in, or face the prospect of secession.

What remains to be fully understood, therefore, are the motives for Austria and the Austro-Hungarian Bank shareholders’ behaviour. Future research should explore this matter systematically, but a few leads seem obvious. For Austria, candidate explanations include security, dynastic and imperial considerations. Economic factors might have played a role as well: for instance, one such is the maintenance of the crown as an international

currency. It is likely, and in effect, consistent with the evidence in Flandreau and Jobst (2006), that the size of the dual monarchy was a critical factor in explaining the international success of its currency: Austria might have suffered from becoming smaller as a result of Hungary's secession. An additional important item was the impact of the monetary union on bilateral trade. There again, Austria would have lost from secession. Another promising research avenue is to explore the co-operation incentives of the Austro-Hungarian Bank. However it may have been willing to extend its business in Hungary for purely political motives: because Austria wanted it and because the Bank could not afford to upset the master. On the other hand, increasing its activity in Hungary might have turned out to be a lucrative job. Before more work is done, we can conservatively remark that we do not know that the Bank became less profitable after it extended its activity in Hungary. Keeping Austria and Hungary together might have been a rewarding business. The conclusion would be that central banks are powerful political/bureaucratic actors in monetary unions. Because they may benefit from expanding their size, they are concerned with supporting the union and thus tend to transform themselves, over time, into a tool for redistribution.

To conclude, we should note that the evidence on the monetary aspects of the Habsburg union reported here reinforces earlier suggestions (Komlos 1983b) that the Habsburg union was a good deal for Hungary, in blatant contrast with the conventional views on the matter. Recast in terms of the classic debate on 'centrifugal' vs. 'centripetal' forces in the pre-World War I Austro-Hungarian monarchy, this article's main finding is that strong co-operative forces were at work in the period under study, as evidenced by the ability to strike a series of monetary deals and by the failure of the secessionist project. The eventual break-up of the Austro-Hungarian Empire was by no means 'written on the wall'.

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### **Data appendix**

Several series used in the article were collected and constructed from archival or scattered sources, and are provided for reference. The specific financial organisation of the Habsburg monarchy identified, aside from each country's 'special budget', a 'common budget' that was essentially a transfer system, bound to be in equilibrium each year. This required a number of transformations of the primary data in order to identify proper 'Austrian' and 'Hungarian' accounts. First, gross interest service numbers needed to be corrected since Austria assumed the service of pre-1867 debts, but received an annual contribution from Hungary. Hungary's contribution to Austria needed to be added to Hungary's official interest service but subtracted from Austria's. Revenues were constructed using the rule that defined the breakdown of 'common resources' (the income from customs). The yields are the return on Austrian and Hungarian 4% Gold Bonds in Paris, from *Le Rentier*. Using other markets (such as London, Berlin or Vienna) to compute yields gives identical results. Population is from *Crédit lyonnais* archives.

Table A.2 contains data on Austro-Hungarian Bank's (AHB) holdings of commercial bills (discounts) at the end of each year. The source is the official reports of the Austro-Hungarian Bank.

Table A.3 gives the average maturity of commercial bills held by the Austro-Hungarian bank, depending on where these bills were discounted (this definition should not be mixed up with a breakdown of bills according to where they are payable. Since it often happened that bills discounted in Austria originated in Hungary, while the opposite was much less frequent (owing to the importance of the Austrian banking system at large for Hungary), the numbers reported here and in the text underestimate the extent of the actual support of the AHB to Hungary. This, of course, only strengthens our point.

Table A1. Macroeconomic statistics (millions of florins unless otherwise stated).

	Austrian Interest Service	Hungarian Interest Service	Austrian Revenue	Hungarian Revenue	Gold Bonds Yields Austria (%)	Gold Bonds Yields Hung. (%)	Population Austria (in 000)	Population Hungary (in 000)
1875	81.4	66	375	198	na	na	21,750	15,080
1876	85.2	65	367	211	na	na	21,920	15,210
1877	91.9	72	373	221	na	na	22,090	15,350
1878	92.3	71	377	227	na	na	22,260	15,450
1879	100.3	80	384	254	na	na	22,430	15,570
1880	103	86	412	249	5.21	na	22,600	15,700
1881	103.9	88	434	279	4.89	na	22,770	15,860
1882	114.2	91	471	286	4.92	5.33	22,840	15,910
1883	115.7	95	475	320	4.71	5.24	23,050	16,060
1884	128.8	110	496	310	4.62	5.06	23,260	16,200
1885	131	105	517	321	4.48	4.93	23,550	16,470
1886	132.7	108	513	312	4.28	4.68	23,770	16,680
1887	129.1	111	521	324	4.41	4.89	24,100	16,860
1888	133	115	497	351	4.38	4.82	24,300	17,030
1889	137	117	546	360	4.25	4.55	24,590	17,230
1890	136.5	118	568	417	4.16	4.37	24,640	17,400
1891	134.7	119	583	443	4.13	4.23	24,780	17,530
1892	145.4	118	601	449	4.10	4.17	24,890	17,640
1893	154.2	118	643	494	4.08	4.13	25,090	17,770
1894	155.3	126	644	507	3.98	4.00	25,220	17,900
1895	161.8	126	685	526	3.87	3.86	25,380	18,030
1896	166	128	700	519	3.81	3.82	25,580	18,160
1897	165.3	129	731	577	3.80	3.81	25,800	18,290
1898	160.1	129	773	547	3.85	3.86	26,480	18,770
1899	160	128	790	530	3.94	3.93	26,160	18,250
1900	159.8	129	818	566	4.01	3.98	27,371	19,250
1901	159.3	129.5	821	546	3.91	3.93	27,642	19,410
1902	163.9	130	841	562	3.82	3.84	27,914	19,570
1903	165.1	127	869	567	3.86	3.86	27,836	19,730
1904	163.2	127.5	889	600	3.91	3.91	28,758	19,890
1905	164.6	129	925	599	3.95	4.01	28,159	20,050
1906	169.7	130.5	984	650	4.02	4.15	28,401	20,210
1907	182	131	1,103	725	4.07	4.23	28,643	20,370
1908	182.5	135	1,172	755	4.03	4.17	28,884	20,530
1909	203.7	136	1,355	774	3.97	4.11	29,126	20,690
1910	221.9	137	1,442	833	3.94	4.09	29,368	20,850
1911	223.1	157	1,524	898	3.99	4.10	29,650	21,050
1912	226.2	148.5	1,569	957	4.13	4.25	29,892	21,210

Source: Constructed from information in the *Crédit lyonnais* archives and the *Statesman's Yearbooks*.

Table A2. *Portfolio of commercial bills outstanding, at 31 December of each year (florins).*

	Vienna	Austr. branches	Budapest	Hun. branches
1880	60,084,220	39,107,620	26,390,234	13,526,745
1881	72,739,414	46,347,159	23,053,158	14,405,214
1882	58,444,807	59,783,162	29,432,231	15,008,040
1883	64,325,699	57,283,746	31,208,563	16,527,050
1884	61,854,663	53,682,657	31,872,574	20,302,983
1885	56,833,935	37,100,859	23,127,476	19,380,713
1886	51,464,331	46,502,127	28,743,370	18,955,850
1887	60,737,950	48,354,976	30,363,071	20,376,747
1888	69,870,015	47,539,356	32,234,295	18,163,785
1889	69,513,059	51,462,763	35,454,457	22,450,472
1890	53,253,908	56,136,589	35,688,571	21,539,837
1891	59,883,219	56,883,726	48,950,410	24,471,937
1892	58,669,012	44,429,846	38,584,311	30,233,789
1893	41,248,241	48,974,175	48,455,419	33,021,191
1894	41,649,846	60,379,908	43,410,815	34,813,102
1895	50,245,301	70,901,622	62,005,394	36,322,164
1896	57,114,963	73,447,845	53,219,460	33,809,897
1897	54,439,769	61,342,058	57,020,762	34,134,337
1898	85,210,393	68,500,508	69,344,169	35,428,024
1899	95,932,169	54,833,038	57,949,463	35,088,884
1900	69,272,006	73,262,106	50,200,046	35,016,401
1901	39,593,329	53,697,406	40,499,507	33,737,333
1902	47,096,894	49,228,898	44,606,574	31,655,706
1903	53,325,329	61,423,501	55,527,962	29,852,422
1904	71,098,043	66,063,310	75,479,767	43,177,196
1905	90,778,536	88,588,814	89,708,632	51,560,733
1906	65,662,001	90,472,375	97,232,268	132,105,166
1907	57,754,525	94,281,879	96,289,784	125,707,860
1908	39,749,391	85,376,699	87,033,509	130,606,760
1909	35,068,571	91,738,445	77,247,884	139,837,298
1910	47,189,517	115,052,863	103,302,291	175,353,662
1911	39,149,475	154,708,598	135,693,395	234,926,437
1912	57,930,289	160,155,891	173,779,399	269,883,939
1913	38,690,724	101,407,799	102,233,875	214,901,374

Source: Annual Reports of the Austro-Hungarian Bank, National Library, Vienna.

Table A3. *Average maturity of bills: number of days.*

	Vienna	Austrian branches	Budapest	Hungarian branches	Bosnia- Herc.	Total
1888	49	62	61	72		58
1889	50	64	56	69		58
1890	47	62	51	70		55
1891	46	63	57	68		56
1892	47	62	51	70		55
1893	34	52	50	71		49
1894	39	57	51	71		52
1895	34	56	46	69		48
1896	31	56	50	70		49
1897	28	48	42	69		42
1898	35	47	49	68		46
1899	41	38	45	65		44
1900	36	40	42	65		41
1901	36	42	38	67		41
1902	26	40	36	67		38
1903	23	35	33	66		33
1904	25	39	35	66		36
1905	25	40	36	66		37
1906	30	40	50	67		42
1907	26	41	48	67		41
1908	18	35	35	65		35
1909	16	38	26	63		32
1910	20	39	30	64		34
1911	21	44	33	63	72	37
1912	19	48	38	64	66	40
1913	18	46	39	65	62	41

Source: Annual Reports of the Austro-Hungarian Bank, National Library, Vienna.