Transfer Problem Dynamics:
Macroeconomics of the Franco-Prussian War Indemnity

Michael B. Devereux
University of British Columbia
Hong Kong Institute for Monetary Research

and

Gregor W. Smith
Queen's University, Kingston Ontario Canada

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Summary

We study the classic transfer problem of predicting the effects of an international transfer on the terms of trade and the current account using a dynamic general equilibrium formulation. A two-country model with debt and capital allows for realistic features of historical transfers: they usually follow wartime increases in government spending and are financed partly by international borrowing. The model is applied to the largest ever historical transfer, the Franco-Prussian War indemnity of 1871-1873. In these three years, France transferred to Germany an amount equal to 22 percent of a year's GDP. We investigate the ability of our model to account for the historical path of French GDP, terms of trade, net exports, and aggregate consumption. On its own, the transfer can account well for the movement in the terms of trade and the current account. When combined with measured shocks to fiscal policy and productivity over the period, the model provides a very close fit to the historical sample path of GDP and consumption also. This makes a strong case for the dynamic general equilibrium approach to studying the transfer problem. More generally, our results provide striking evidence of the importance of international capital markets in the nineteenth century.