**Responses to the first referee report**

The report was very useful and gave good ideas how the paper should be improved. I agree with the main points and I think I have to take into account the referee's comments.

- *The referee pointed out that the author should explain whether the model is able to match other empirical regularities. The referee also pointed out that "[i]n particular, do we see a nominal appreciation following a technology shock in the data?"*

  I agree that this is obviously an important point. If the main point of the paper is that the expenditure switching effect of a nominal exchange rate change can cause a transitory decline in employment it essential know to whether the exchange rate appreciates following a technology shock. Therefore it is essential to cite empirical papers that address the effect of productivity shocks on the nominal exchange rate.

- *The referee wrote: "Several authors, e.g. Larry Christiano and others, have challenged the results of Gali on various methodological grounds. There is also quite some evidence showing an increase in employment, i.e. the conventional RBC result."*

  Perhaps - a part of the text that is now mentioned (hidden?) in Footnote 1 should be included in the main text. For example, it might be useful write in the main text (not in Footnote 1) that "Christiano, Eichenbaum and Vigfusson (2004) find that employment rises after a technology shock. They show that Gali's (1999) results are sensitive to specifying the VAR in terms of the level (as opposed to the first difference) of employment. However, other empirical work finds evidence that Gali's (1999) results are robust to using different VAR specifications, data sets and measures for technological changes."

- *The referee highlights that "[t]he paper does not mention monetary policy. Which role could the policy rule play in this model? The author should touch upon this."*

  I agree that this question should be briefly addressed in the final version of the paper. However, the effect of any economic shock (including a technology shock) on employment (or any other endogenous) is not independent of monetary policy! The monetary policy rule naturally affects the response of employment to a technology shock. Having said that, I believe that it is might be still useful to mention something about the role of monetary policy.

  The previous literature shed some light on the question of how a monetary policy rule could affect the results of this paper. In the Introduction, I wrote that [in Gali (1999)] "When technology improves, employment declines unless the central bank expands the money supply at least in proportion to the improvement in technology. Gali (2003) demonstrates that this result generalises to a model with staggered price setting." In addition, Gali and Rabanal (2004) show that the response of employment to a technology shock is negative also in the case where monetary policy characterized by an interest rate rule similar to Taylor (1993).

In the final version of the paper I could mention that something about the role of monetary policy and provide a short discussion on this topic.

**Minor comments**: In the final version of the paper I could refer to Gali's (1999) paper as a "seminal paper" not as a "significant paper".