I would like to thank the referees for their very valuable comments. I attach below, my reactions.

Response to Referee Report - Anonymous - November 21, 2007 - 10:35

Comment 1)
The paper emphasizes the consideration of both monetary and real aspects, which allows to analyze just monetary shocks (Section 4.1.1), just real shocks (section 4.1.2), and the correlation of the two types of shocks (Section 4.1.3). The main standard results of the optimum currency area literature hold; however, the more nuanced the role of openness comes precisely from the consideration of monetary and real aspects, as discussed in Section 4.4. The relative importance of all effects can effectively be assessed only at the empirical level. I am working on a paper that calibrates the model on the basis of data for many countries over the past 30 years, in order to identify optimum currency areas at the world level.

Comment 2)
The extension to a third country is definitely an interesting one, worth pursuing in a separate project. The key intuitions can be seen in multi-country models, such as those offered by Alesina and Barro (2002) and Bayoumi (1994).

Comments 3&4)
As mentioned above, I am working on a calibration at the world level that potentially can address some of the questions being raised here. However, I can speculate that transaction costs are unlikely to be able to explain (by themselves) the large coefficient found by Rose (2000) for the effect of a currency union on trade.

Response to Referee Report - Anonymous - November 21, 2007 - 10:38

Comment 1)
Presenting the results in Sections 3 and 4 also in Tables will require very rich tables with thick detailing, make them hard to read. The extensive summary aims at guiding the reader through the results.

Comment 2)
A footnote has been added to the definition presented on p.2 (Section 1) to clarify this point. I would push the referee's point further and take this opportunity to mention a big shortcoming of the whole literature: a currency area (whether comprised of a currency union or of countries with pegged exchange rates) may have a managed float—and not a flexible exchange rate system—versus some other currencies. To formalize such a scenario would substantially complicate the framework and it is left for future work.

Comment 3)
A citation to Swofford (2000) has been added.

Comment 4)
The title is appropriate, as traditionally the optimum currency area literature has been concerned with discussing/analyzing the corresponding costs and benefits.

Comment 5)
A reference to benefits has been added in introduction.

Minor comments have been incorporated.

Response to Referee Report - Anonymous - November 23, 2007 - 09:41

Comment 1)
The extension to a third country is a valuable extension that is left for future work. Some key insights in that direction are offered by Alesina and Barro (2002) and Bayoumi (1994).

Comment 2)
First, the feature that demand shocks are fully neutralized by an endogenous response of the exchange rate under flexible exchange rate regimes is chosen for simplicity and elegance of the presentation and does not qualitatively affect the results related to openness. The main objective is to show that the adjustment to asymmetric real shocks is more difficult under a fixed exchange rate regime than under flexible rates: in the spirit of the OCA literature, this would still be true if the adjustment were modeled as incomplete under flexible rates. And even in the presence of partial adjustment under flexible rates, it would still be true that openness would increase the relevance of trade shocks, which is the second effect of openness listed in Section 4.4 (it is the simultaneous consideration of the three effects listed in that section that leads to the ambiguity of the role of openness).
Second, the referee correctly points out that exchange rate shocks (not neutralized by the exchange rate themselves) would increase the cost of flexible rates. Such a feature was deemed unnecessary, as it would not add much to the intuition of the adjustment process.

Comment 2)
For simplicity, asymmetric shocks are presented via demand rather than supply shocks (for a treatment based on supply shocks, see Bayoumi (1994)). Pass-through would reduce the effectiveness of the exchange rate as a form of adjustment. The model is tailored to adjustment process over the horizon where the presence of nominal rigidities render the

exchange rate an effective form of adjustment: as such, it neglects the long run where such rigidities fade.

Overall, the referee correctly points out that several simplistic features of the model would obviously alter quantitatively the effects, a fact which is particularly relevant for the reader that aims at bringing the model to the data. However, these features bear little qualitative effect on the results.