Response to referee 1.

We will improve the English and make the paper more concise and focused.

Response to referee 2.

1. Theoretical model.

   a. The theoretical model ends with a comparative statics exercise where the effect of changes in interest on the onshore exchange rate are described by taking the total differential of equation (13), which summarizes the model. When doing a comparative statics exercise other variables are kept constant. There are three endogenous variables in the model; the onshore exchange rate E, the offshore exchange rate e and the volume of exports that show up in the onshore market X^L. Other variables, such as the foreign rate of interest, the intensity of the monitoring of capital controls, expectations of the future onshore exchange rate and the country risk premium as well as the level of debt are exogenous.

   The model as it stands is static, we study the effect of changes in interest rates on the exchange rate taking the level of debt, the risk premium and foreign rate of interest as given. There is no assumption that dD=0 and so on. We are only finding the instantaneous effect of one variable, interest rates, on another, exchange rates, taking the others as given as is done in comparative statics exercises.

   We can respond to the referee's comment by both doing a comparative statics exercise where the effect of change of each of the exogenous variables, not just the domestic interest rate, on the exchange rate are derived and by showing, as we do, how the effect of interest rates on the exchange rate depends on the level of debt and the monitoring of capital controls.

   b. We can respond to this comment by adding the effect of changes in the level of debt, the monitoring of capital controls and exchange rate expectations on the onshore exchange rate to our model. These effects can be derived from the total differential of equation (13) as explained above.

   Our model does not describe the effect of changes in interest rates on the future evolution of debt and the risk premium since the latter two are exogenous to the model. The model only describes the instantaneous effect of changes in interest rates on the exchange rate taking other variables, such as the risk premium and the stock of debt, as given.

   Empirically, the sudden stop of capital flows made the banks go bankrupt and default on their external debt. Thus at the start of our sample the major adjustment of debt had already occurred. During the 2009-2015 period there remained the leftovers of the carry trade (about 37% of GDP in 2009) which gradually declined to about half its initial value measured in domestic currency. The risk premium on government debt

(CDS) also declined through this period but there were not abrupt changes in this series either. The monitoring of capital controls was more or less constant after November 2009. These empirical observations justify our modelling strategy in the theory part of the paper.

c. We will define leakages more precisely in a revision, describe them in technical terms and add references to the literature on capital flight. We already mention papers on the sudden stop of capital flows but can add more papers to our list of references.

2. We decided not to estimate the structural model but to show how a shock to interest rates would affect the onshore and the offshore exchange rate with a VECM with little structure imposed. As it stands, the theoretical model shows that the instantaneous effect of changes in the interest rate on the exchange rate is uncertain while the empirical part explores the relationship in the data over time.

Exploiting the theoretical model further is problematic because the model shows only the instantaneous effect of interest rate changes on the exchange rate, it is static in nature. Another reason is that we not have a direct measure of the monitoring of capital controls. Moreover, the fall in the debt level from 2009-2015 is a linear decline without much variation. The shock to the level of debt occurred earlier, that is in late 2008.

One thing we could do is to add the CDS on government debt to the VAR since that variable shows more variability. The objection here would be that there was a very think market with infrequent trading over this period but if the editor and the referee agree that we should add this variable to our VAR then we are happy to do so.

The prediction of the theoretical model is that the sign of the effect of changes in interest rates on the exchange rate is ambiguous and depends on the level of debt and the monitoring of capital controls. Since the monitoring was strengthened in November 2009 we could redo the analysis by omitting the period January – October 2009 to see if the impulse response functions are different.

3. The parameter estimates for the equilibrium relationships can be found in the caption under table A1.6. This should be made more visible and clear, for example put into the table itself. The identifying restrictions are the Phillips normalization which is the default in the statistical software used.

We can use different and more meaningful restrictions to allow better interpretations of the long run equilibrium relationships in a revision of the paper.