

I would like to thank the referee and the editor for their valuable comments and suggestions. I have done a substantial revision of the paper. Let me summarise here what changes have been made in response to the referee's comments.

General:

My understanding and knowledge of the new approach has improved since I stumbled on the idea and wrote the paper over two years ago. In particular, I found a branch of literature, mainly outside econometrics, known as 'structural equation models with latent variables' (SEMWLTV). I realise that my idea resembles a special case of SEMWLTV, where factor analysis is used as a measurement tool for latent theoretical constructs to be modelled in *a priori* given postulated structural equations. The knowledge gives me a better way of interpreting or presenting the PPP problem I was trying to tackle – its mainly a measurement problem, and the errors-in-variables attenuation could be a key cause of the extant weak evidence. I have revised the paper accordingly, including adding a path diagram of the DF-ECM following the SEMWLTV literature as well as a few references of that literature. The reinterpretation should help the referee's assessment of the DF-ECM approach as compared with the standard approach.

Particulars:

— On the first section: The link of the two strands of literature with the DF-ECM is strengthened. Basically, I see two relevant types of research efforts to mine: one trying to tackle aggregation by going into micro data and the other trying to tackle dynamics by going into more elaborate dynamic modelling methods. The novel point of the DF-ECM approach is that it tackles the two issues together. I have added a few references on the dynamic panel modelling side, thanks to the referee's suggestion.

— On the formal presentation of the method: All the notations and equations are revised, as well as the related descriptions.

— On the verbal presentation: The text has been revised carefully. As for the parts referring to modelling methods, new references are added. For example, Hendry's textbook (1995) is added at the place describing 'model reparameterisation' to help readers who might want to learn more details about the procedure.

— On the estimation method used at the ECM stage: The explanation is added. It actually ties well with the new interpretation of the errors-in-variables attenuation problem. As known from econometrics textbooks, the OLS estimator of a regression model: $y = \beta X + u$ is inconsistent when X is measured with errors, say by $\tilde{X} = X + v$; the coefficient estimate will converge to zero in probability when the measurement error, v , is substantive. Since the standard approach does not filter out any idiosyncratic shocks in country-level data, the real exchange rate measures used there suffer from serious attenuation, which is reflected in numerous insignificant estimation results. The current approach corrects that measurement error by using latent factors, serving virtually as instrumental variables, at the ECM stage. Hence, there is no need to consider using a different estimator here.

— On the presentation of the results: All the quarterly results have been removed. The tables and figures are re-organised to make them as compact as possible.

— On the comparison with the standard results: This issue is clarified above in the general point as well as the point on the estimation method. The use of *REER* in the standard ECMs is not a 'hybrid' form in the sense that *REER* has been used for testing PPP via various means of cointegration analyses by many other authors. I have added some references and a short explanation. Basically, *REER* is just one measure of real exchange rate. I chose this measure for its closer correspondence than bilateral real rates to the multilateral setting of DFMs.

— On the minor points: All have been revised as best as I can.