

**Referee report for:**

***Real Exchange Rate Dynamics in Macedonia: Old wisdoms and New Insights***

The main aim of the paper is to empirically analyze the driving forces of the real exchange rate dynamics in Macedonia. In doing so, special emphasis is put on the intricacies related to the relationship between the real exchange rate and productivity developments, along the lines of the Balassa-Samuelson framework. The paper concludes the irrelevance of the BS-effect, although it finds a positive co-integrating relationship between productivity differentials (as well as government consumption and openness) and the real exchange rate.

The paper is interesting, very well written and provides a sound and thorough analysis of the subject. There are some (minor) caveats:

1. I have some doubt about the main conclusion of the paper about the irrelevance of the BS-effect. In fact, the empirical tests prove that there is a positive and statistically significant relationship between productivity and real exchange rate. What is this if not a confirmation about the relevance of the BS effect? It may well be that the effect is not strong, but this is a different story.
2. If I rightly understood the series for explanatory variables are not expressed in relative terms (to trading partners). This may bias the results. In fact, given that Macedonia trades with some fast growing countries, it may well be the relative productivity (to other countries) was negative over the sample period, which would be consistent with the observed depreciation of the real exchange rate.
3. Data series should be explained in more details. First, as mention above, it is not clear if the explanatory variables are in relative terms. Second, it is not sure what the time dimension of the data is. Figure 2 reports data from 1990-2005, Figure 4 from 1997Q1-2005Q2 and 1997Q1-2004Q3, Figure 5 from 1997Q3-2006Q3 and 1997Q1-2006Q1.
4. As to NFA: as in other developing countries remittances may probably play an important role in total flows and this could also have some important influence on exchange rate behavior in Macedonia.
5. Usually in BEER specifications one adds interest rate differentials to capture short term influences on the real exchange rate developments related to capital flows. Given the shallowness of the Macedonia's financial market this may not be very important, although the issue could be mentioned somewhere in the paper.

