

Reply to the points raised by Referee 1:

1. Our focus is on testing a long run version of UIP condition, where it is assumed that changes in exchange rates and the risk premium are $I(0)$, which are eminently met in the case of the major economies that we are considering. This long run version can be tested by checking whether rr^* is stationary. Of course, in the short run $r-r^*$ in each country will be influenced by changes in exchange rates and interest rates in all countries. The GVAR allows for all these channels of interactions and thus provide a more appropriate test of the relationship in individual economies.

2. It is clearly possible to use different types of weights for aggregation of different types of variables. The problem is one of data availability and empirical feasibility. But we do not think that the choice of the weights is critical for the results. We have addressed this issue partly in DdPS (2007) by considering time-varying trade weights. Also in the case of equity and bond prices that tend to move very closely across different economies it is unlikely that using other weights could matter much. Trade weights also provide good proxies for general international relations across economies and are the only set of relevant weights that are available historically for a relatively long period.

3. While the risk-sharing condition (RSH) is certainly an interesting one, the testing of this condition would involve the inclusion of relative consumption variables across countries within the model increasing further the number of parameters to be estimated. The existing variables included in the model were chosen on the basis of, in our view, being the most important to summarize the economic environment while maintaining model parsimony. Given that the number of observations per country is limited we do not find the inclusion of an extra variable to be appropriate. However the RSH relation could be tested within a different set up of the GVAR model, which is however beyond the scope of the present study. But it is perhaps worth noting that the output gap relations included in the model could in principle capture some of the main aspects of the risk-sharing in the global economy that you might have in mind.

4. We now provide a more detailed account of the theory-based long run relations and provide references to the literature. In particular, we clarify the theoretical basis of the various long run relations. We are not claiming that there are tight relations between the GVAR and the DSGE models. This issue is discussed in Pesaran and Smith (2006) which we now cite. The paper by Chudik, also cited in our paper, does attempt a theoretical link between a global DGSE and the GVAR. But, as we make clear, our primary objective is the analysis of long run relations which does not require a complete formulation and solution of a global DSGE model.