**Response to the Editor**

Dear Cristina,

We would like to thank you and the referees for your insightful comments and for the opportunity to revise our paper. We believe that we have been able to address all of them, and that they have improved the quality of the paper. Let us first present a summary of the main changes introduced in the paper as a response to your comments and those of the referees:

1. We added decompositions of government bond spreads between default probability and ambiguity aversion in the baseline economy, both for the noncontingent bond and for the state contingent bond.
2. We now show that the mechanisms that the paper highlights are robust to adding debt recovery and targeting higher default probabilities.
3. We shortened the paper to 45 pages by streamlining the section of the stylized model.

The main result in the paper is robust to these and other modifications introduced in the revised version: the typical threshold bond structure used in practice generates substantial welfare losses when lenders are robust, and, when designed optimally, the gains from state-contingent are reinstated.

Below, we provide a detailed explanation of how we have addressed your recommendations. We are also sending you a detailed response for the comments of each referee.

1. **The novelty premium and spread decompositions.**

We added these decompositions, which are in pages XXX.

1. **Stylized model and length of the paper.**

As you recommended, we shortened this section to contain only the essential points and figures. We shortened the paper to 45 pages as you suggested.

1. **Robustness on debt recovery and default probability target.**

The new subsection XXX now presents a version of the model that allows for debt recovery (we set the recovery rate at 60% as documented by Cruces and Trebesch, 2013), and calibrate this version of the model to target a default probability of 5.4% (relative to the 3% in our baseline). These modifications do not alter the main message of the paper.

1. **Parameters of the state-contingent bond**

The parameterization that better approximates the threshold bond that countries have used in practice corresponds to \tau = mean(y) and \alpha = 1. We now establish this more explicitly on page XXX.

In sum, we believe we have been able to incorporate your recommendations (and the ones of the referees), and this has greatly improved the paper! Thanks!

Best regards,

Francisco Roch