**Response to Referee 1**

We would like to thank you for your insightful comments. 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 editor and the other referee:

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.

1. **Comments on the introduction.**

As suggested, we now give more prominence to the discussion on the possibility of data misreporting/falsification. We borrow from Morelli and Moretti (2022) the narrative from Argentina’s episode of reporting lower than actual inflation which implied raising reported GDP growth increasing the payout on their GDP warrants. In the case of Greece, we believe that the scrutiny of the Troika in the form of their frequent missions to the country is already convincing evidence of effective oversight. Moreover, we are now aware of any data misreporting since Greece issued the GDP-linked bonds.

1. **Comments on the calibrations**

To clarify your concern on the debt level target, for our baseline calibration, we now take the same exact targets in Chatterjee and Eyigungor (2011). These are documented below:

|  |  |
| --- | --- |
|  | Target |
| Mean Spread | 815 |
| Spread volatility | 443 |
| Default rate | 3 |
| Mean debt level | 17.4 |

With respect to your concern on the default probability, the new subsection XXX provides an alternative calibration targeting a default rate of 5.4%. We show that the message of the paper is robust to this modification.

1. **Comments on simulations**
2. **Comments on the results**

We now conduct the exercise of pricing the marginal bond of various forms using the policy functions from the model with non-state contingent debt (rather than using the difference in equilibrium interest rates when all debt is switched to SCDIs). The results are presented on page XXX, and show that XXX.

We also include tables of all relevant targeted and untargeted moments computed over the long run stationary distribution implied by the model. Finally, in the appendix, we report the various alternative parameterizations used for the different recalibrations throughout the results and robustness checks sections of the paper.

In sum, we believe we have been able to incorporate your recommendations (and the ones of the editor and the other referee), and this has greatly improved the paper. Many thanks!