**Response to Referee 2**

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. **Default probability and debt recovery.**

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. **Welfare decompositions.**

We added these decompositions, which are in pages XXX.

1. **Pricing of marginal state-contingent bond issuance.**

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.

1. **Footnotes 3, 5 and 8**
2. **Why would the GDP growth rate "be less manipulable over the longer term"?**

We believe that for political reasons, it is unlikely that a government in power would report lower actual growth numbers systematically over 4-5 years (the typical length of an administration).

1. **Why don't they issue threshold bonds for inflation indexation? Is there something the authors could add about these new questions?**

We believe that the main reason that countries have issued threshold bonds for GDP indexation is that GDP-linked bonds have been typically issued in the context of debt restructurings. The threshold design was typically the outcome of the desire to bridge the gaps in views regarding economic outlook and debt servicing capacity between creditors and debtors. The underlying idea was that this bond structure may allow for appropriately conservative base case scenarios that minimize the risk of future defaults.

1. **Notation: Since the optimal parameter values of linear indexing and threshold debt also depend on theta, shouldn't the notation be explicit about it (as it is for the optimal design)?**
2. **Table 6 could show the non-contingent benchmark again or it could be merged with Table 5. The same could be done with the tables for robustness exercises.**

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!