ABSTRACT

When sovereign governments choose to tax different classes of agents at different rates, the ability to liquidate assets to favored agents is valued by exposed agents. This paper introduces a model where foreign investors can profitably liquidate foreign direct investments, but not debt claims. The model predicts that the value of the liquidation option increases as the riskiness of the host country increases, implying that the optimal share of foreign direct investment in the inward investment portfolio should be positively correlated with sovereign risk exposure.

This prediction is tested using two indicators of sovereign risk for 52 developing countries, using survey data from foreign investors from 1979 through 1989 which rank the countries on the basis of credit worthiness, and measures of observed politically unstable events. The empirical results provide support for the model: Decreases in a country's survey rating and four out of five event study indicators are positively correlated with the share of foreign direct investment in private investment flows.