Abstract:

Amid shifting global financial environment, emerging market economies face transition challenges. Global financial factors, however, --which play an important role for fluctuations in emerging economies' country spreads and business cycles--, are largely overlooked by the existing theoretical literature. In this paper, I derive from first principles the intrinsic role global financial factors play for cross-border flows and its repercussions on emerging countries. Developing a small open economy model of cross-border capital flows, the results show that (i) characteristics of global banks, e.g. funding risk on their activities or their leverage, are key determinants of cross-border flows; (ii) country risk premium emerges endogenously and is determined by marginal values of cross-border borrowing. Last, a sudden rise in funding stress in international financial markets results in a lower volume of cross-border flows, and for emerging economies, it leads to higher country spreads, and in turn triggers an endogenous cycle of deterioration in domestic financial conditions and a fall in real economic activity.