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The Relationship between the Financial and the Real Sector and the Present Financial and Economic Crisis – Portugal

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I. Introduction

This chapter develops our previous work (Lagoa et al., 2013) on the Portuguese financial system's evolution in the past three decades. In that work we have extensively documented the various signs of financialisation in the Portuguese economy. For example, by 2007 Portugal had the fourth highest share of finance and insurance in GDP (after Ireland, the UK, and Cyprus), being among the countries in which this indicator had increased the most since the mid-1990s. Between 1997 and 2008, the Gross Operational Surplus (GOS) of financial corporations rose from nearly 12% to more than 23% of the total GOS of Portuguese firms (including both financial and non-financial firms). Largely as a result of the strong expansion of bank credit, financial assets increased from nearly 450% of GDP in 1995 to over 650% in 2008, while household debt and non-financial corporations reached the highest levels among EU Member States.

In the present context we focus on the effects of financialisation in Portugal on the long-run macroeconomic development and, especially, on the financial and economic crises that hit the country in recent years.

The remaining of the chapter is divided into four main blocs. In section II we discuss the main features of the development of the Portuguese economy since the early 1980s until the recent economic and financial crises and the main links to changes in the domestic financial system. Section III develops this analysis by looking in greater detail at four different channels through which financialisation affects the evolution of the Portuguese economy: income distribution; investment in capital stock; private consumption; and the current account. Finally, section IV presents the main conclusions. [ii]

II. The long boom and the early bust: the Portuguese economy in the era of financialisation

Between 1980 and 2013 the Portuguese economy grew at an average rate of 2% per year – the 8th highest rate among the 15 Western European countries that formed the EU until 2004[iii]. In spite of this median performance, the aggregate behaviour of the Portuguese economy over this period did not coincide with the EU average: first, as is typical of small countries, it exacerbated the moves throughout each cycle, growing faster than the average during the upturns and falling deeper in downturns; more importantly, there is a sharp contrast in aggregate economic performance before and after the turn of the millennium.

Between 1986 (the year in which Portugal accessed the EEC) and 2000, the Portuguese economy experienced the third fastest growth rate among the EU15 countries (only after Ireland and Luxemburg), with GDP increasing at an impressive average annual rate of 4.1%, in real terms. In contrast, between 2000 and 2013 economic growth nearly stalled, with an average rate of 0.1%, the second lowest in the whole EU (only higher than Italy's). Contrary to what occurred in other countries on the periphery of the euro area – such as Greece, Ireland, and Spain –, the dismal performance of the Portuguese economy in the recent past is not just a post-subprime crisis phenomenon. Portugal started to fall behind the EU average GDP growth rate from 2000 onwards – while the economies of the other three former 'Cohesion countries' kept growing until 2007 at average growth rates that varied between 3.4% and 5%.

The strong growth experienced by the Portuguese economy from the mid-1980s to 2000 was mostly driven by domestic demand: private consumption was responsible for 70% of GDP growth in the period, gross fixed capital formation (GFCF) for 36%, and public consumption for 21%[iv]. Although private consumption remained the main contributor to GDP growth over the period, GFCF played an outstanding role in the Portuguese growth experience of the late twentieth century, when compared to other EU15 countries (the contribution of GFCF to GDP growth in 1986-2000 was higher only in the Spanish case).

The investment dynamics in Portugal during this period is both a cause and a result of economic growth: high growth expectations fostered new investments, which in turn contributed to stimulating further growth.

In fact, the second half of the 1980s was a favourable period for the European economies, namely as a result of declining oil prices and the implementation of the European Single Market programme. In the Portuguese case, economic growth was also fostered by accession to the EEC (in 1986), the massive inflow of FDI (which peaked in the early 1990s) and of European structural funds[v], as well as the overall climate of economic stabilisation and liberalisation that followed an IMF-led bailout programme in 1983-1985 (which was marked by financial repression and harsh austerity measures)[vi]. Moreover, real wages increased fast between 1985 and 2000, reflecting both the strong GDP growth over the period and an improvement in the wage share of GDP in the early 1990s.

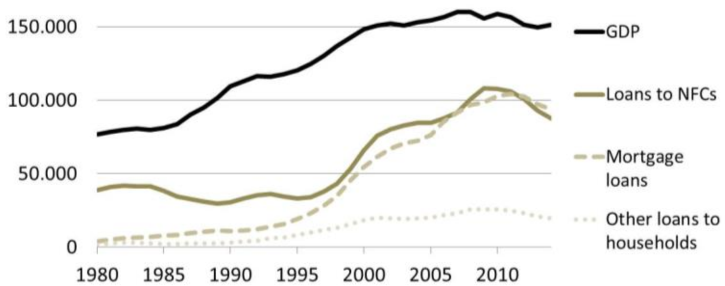
No less importantly, the surge in investment experienced by Portugal would hardly have been possible without the wide availability of credit for domestic firms and households, in particular from the mid-1990s onwards. This, in turn, was a result of both supply- and demand-side developments in the financial system.

Regarding the supply-side, the Portuguese banking sector went through a deep process of privatisation, liberalisation, and deregulation from the mid-1980s, which led to: a rapid increase in the number of banking institutions (from 27 in 1989 to 47 in 1995); a strong reduction of public bank assets (from 74% of total banking sector assets in 1991 to 22% in 1996); the entrance of foreign banks in the Portuguese market (increasing from 3% of bank assets in 1991 to 8% in 1995-1996); and an increase in competition (Antão et al., 2009). These developments in the Portuguese banking sector, combined with easier access to external financing by banks, allowed for a substantial expansion of credit to the domestic economy.

On the demand side, the growth of credit was fostered by: (i) a sharp decline in nominal and real interest rates[vii] (as a result of the 'nominal convergence' process, in anticipation of the European Monetary Union); and (ii) the increase in real incomes, which was diffusely perceived as permanent (as a result of the extended period of strong economic growth).

Thus, between 1995 and 2000, outstanding loans to non-financial corporations (NFCs) and households more than doubled in real terms, increasing from 50% to 93% of GDP (Figure 1). Nearly 3/5 of this growth was directed at households, ¾ of which were mortgage loans. Loans to NFCs also increased rapidly in the second half of the 1990s, from 28% to 44% of the GDP. Construction and real estate activities were responsible for a substantial part (nearly 2/5) of the growth in credit to NFCs, although the expansion of credit during the period was a common feature across industries. After 2000, the pace of growth of bank credit in the Portuguese economy slowed down, and became even more focused on household mortgage credit and on credit to NFCs operating in real estate and construction industries.

Figure 1 – GDP and bank loans to households and non-financial corporations, 1980-2014 (in M€, at 2005 prices)

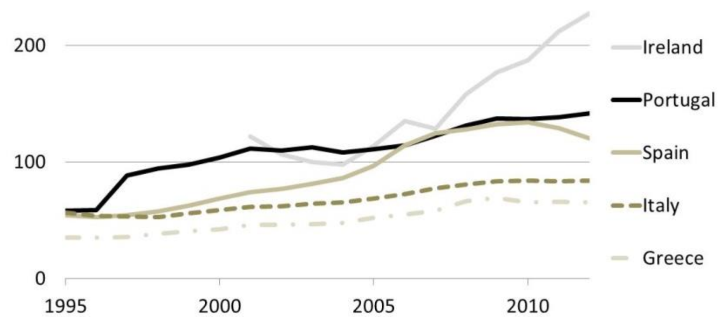


Source: Bank of Portugal and AMECO

By 2007, Portuguese households had the 6th highest level of debt[viii] in percentage of GDP among the EU Member States, while the Portuguese NFCs held the 4th position in the corresponding ranking[ix]. Far from being a specific feature of the Portuguese economy, the rapid increase of private indebtedness from the mid-1990s until the advent of the subprime crisis was common to all the countries on the periphery of the euro area. What is peculiar about the Portuguese indebtedness experience is the timing: while in other countries the levels of indebtedness grew slowly until the turn of the century, accelerating only after 2000, in the Portuguese case the reverse happened – private sector debt in percentage of GDP grew most rapidly in the second half of the 1990s, growing slowly thereafter (particularly in the case of non-financial firms –

Figure 2).

Figure 2 – Debt of NFCs (% of GDP) on the periphery of the euro area, 1995-2012



Source: Eurostat

While the rapid growth of credit and private indebtedness in Portugal in the second half of the 1990s is explained by developments both in the supply-side and in the demand-side of the financial markets, the slow growth of credit in the first years of the new millennium was determined by: (i) the high levels of private indebtedness, which were already evident by the turn of the century; and (ii) the aggregate performance of the Portuguese economy in the following years.

As mentioned before, the contrast between the economic performance of Portugal between 1986-2000 and 2000-2007 is overwhelming – in fact, it has no parallel among the EU15 countries[x]. A number of events account for this dramatic change of course.

Soon after the inception of the euro, in reaction to signs of overheating in the euro zone, the ECB started to tighten its monetary policy, increasing the main reference interest rate from 2.5% in early 1999 to 4.75% in late 2000. As a result, the Euribor 6-month rate doubled, from 2.6% to 5.2%. Given the high levels of debt accumulated in the previous years, the steep increase in interest rates had a significant impact on the levels of available income and, consequently, on domestic demand. In the same period, the bursting of the 'dot.com bubble' in the stock markets (starting in March 2000 and lasting through 2001) triggered the first international economic crisis of the new millennium. These two events combined had a strong negative impact on domestic demand and employment, being largely accountable for the increase in the Portuguese public deficit, which reached 4.8% of GDP in 2001[xi]. As a result, Portugal was the first country in the euro area to break the EU Stability and Growth Pact (SGP).

The following year, the Portuguese authorities were committed to complying with the SGP rules, following a pro-cyclical, contractionary fiscal policy, which further contributed to the 1% drop in GDP in 2003.

Concomitantly, the Portuguese economy was facing the consequences of a combination of structural weaknesses and international developments (Mamede et al., 2014). In particular, growing competition from the emerging Asian economies (largely as a result of the agreements reached by the EU at the WTO and other fora) had a substantial impact on a number of traditional industries (namely textiles, wearing apparel, footwear, wood and paper), which were responsible for a significant part of the manufacturing value added, exports and employment. Moreover, anticipating the EU's Eastern enlargement in 2004, several multinational firms (especially in the automotive and related industries) shifted their productive capacity to some of the new member states, taking advantage of lower wages, higher educational levels, and the geographical proximity to the main European markets. Additionally, after 2000 Portugal experienced a real exchange rate appreciation, largely as a result of the strong appreciation of the euro against the US dollar[xii], imposing further pressure on exporting industries that are highly reliant on cost-competitiveness.

The combination of a weak specialization profile with deleterious trade and real exchange rate developments had a devastating impact on the traditional Portuguese productive fabric. Between 2000 and 2007 Portugal lost jobs in manufacturing at an average annual rate of 2%, one of the fastest rates of deindustrialization in the EU (Mamede, 2014)[xiii]. Similarly, the growth of manufacturing valued added in the same period was the 4th lowest in the EU (after Cyprus, UK, and Denmark), at a meagre 0.5%.

When subsequent external shocks hit the international economy – namely, the successive increases in ECB interest rates in 2005-2008, the substantial appreciation of the euro against the dollar in 2007-2008, the peak in oil and commodity prices in 2008 and, finally, the Great Recession – Portugal was still going through an adjustment process characterised by low economic growth, rising unemployment rates (from 4.5% in 2000 to 8.9% in 2007) and, largely as a consequence, a steady rise in the public debt ratio (which surpassed the euro zone average for the first time in 2006, reaching 63.9% of GDP).

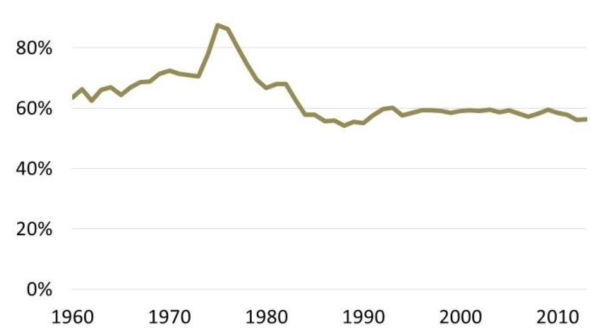
III. Long-run effects of financialisation on the economy through different channels

The long-term effects of financialisation on the economy can be transmitted through different channels. In this section we discuss the relevance of the following main channels in the Portuguese case: the distribution of income; investment in capital stock; consumption; and the current account.

III.1. Financialisation and distribution

Financialisation processes are often associated with increasing income inequality, both in terms of functional (Stockhammer, 2012) and personal income distribution (Kus, 2012). Regarding the former, the adjusted wage share in Portugal decreased between de mid-1970s and the early 1990s, indicating a worsening of functional income distribution (Figure 3). However, between 1994 and 2009 the adjusted wage share remained essentially constant, only declining after 2010 in the context of economic crises and adjustment.

Figure 3 – Adjusted wage share as percentage of GDP at current market prices per person employed



Note: adjusted for full time equivalent employees

Source: AMECO

If financialisation is responsible for the decline in wage share, rentiers should benefit from it. From 1980 to 2013 property income (dividends, interest and rents received less paid by households) did not show an overall positive tendency[xiv]. However, this type of income increased between 2003 and 2013 from 6% to 8.5% of the GNI, basically due to the increase in dividends.

Inequality in personal disposable income, as measured by the Gini coefficient, increased strongly in 1989-94 (+3.1 p.p.), that is, before the fast growth of finance in 1995-2009[xv]. After 1995, there was an overall decline in income inequality from 37.0% in 1995 to 34.5% in 2012, with a temporary increase in 2001-05 (+1 p.p.) and another increase of 1 p.p. in the period of economic crisis (2011-12). Despite the improvement in disposable income distribution in the past two decades, in 2010 Portugal was still one of the most unequal countries in the EU15. Moreover, since 1995, the reduction in inequality has been achieved by the improvement of the position of the poorest households, and not of the middle classes (with regard to the richest households). In fact, there was also a clear increase in the share of income held by the top 0.1% incomes, from 1.5% in 1989 to 2.5% in 2005[xvi]. Thus decrease in overall inequality seems to result from the distributive policies put in place over the period: the Gini coefficient of income before taxes and social transfers in the period 2004-11 actually increased by 3.3 p.p.

In summary, we do not find a generalised increase of either personal inequality (after taxes and social transfers) or functional inequality in the period in which finance grew the most. However, three remarks need to be made. Firstly, there may be some negative effects of financialisation on inequality because there was an increase in the Gini coefficient of disposable income between 2001-2005, an increase in the Gini coefficient of income *before* taxes and social transfers in the period 2004-11, an increase in the rentier income share in 2003-2013, a substantial increase in the share of income held by top incomes from 1989 to 2005, and the middle class did not improve its position. Secondly, the economic crisis in Portugal, partially explained by the growth of finance, substantially increased both functional and personal income inequality. Thirdly, there were other factors avoiding the increase in inequality at the period, namely the growth of social policies.

III.2. Financialisation and investment in capital stock

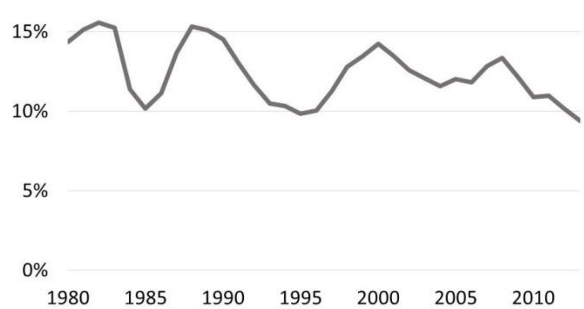
The investment rate in Portugal increased to relatively high values between 1994 and 2001 from 21.6% to 26.2% of GDP, with two key explanatory factors being the reduction in interest rates during the convergence process to the euro and the rapid growth of credit. Investment was also favoured by the increase in the proportion of long-term loans in total debt from 52% in 1995 to 69% in 2001 (this trend continued until 2011).

In contrast, after 2001 the share of *total* investment in GDP declined to 16.4% in 2013 due to a combination of factors, including high levels of indebtedness of households and firms, low growth prospects, an increase in interest rates, and the exhaustion of investment needs in earlier periods[xvii].

Regarding the ratio of Gross Fixed Capital Formation of non-financial corporations (NFCs) to GDP, we observe a slightly negative trend since 1980 and especially after 2000 (

Figure 4). The indebtedness level of NFCs may be a factor explaining the slowdown after 2000, since it increased the difficulty in getting additional funding.

Figure 4 –Gross Fixed Capital Formation of NFC in % of GDP



Sources: INE Contas Nacionais (up to 1994) and Eurostat (from 1995).

There is a stream of research within the financialisation literature (Orhangazi, 2008b; Hein, 2009; among others) that analyse the impact of financialisation on corporate investment through two main channels: the rise of investment in financial assets by NFCs and the pressure exerted over these corporations to increase their payments to financial markets[xviii]. In Portugal, financial receipts in percentage of Gross Operating Surplus (GOS) increased from 11.8% in 2002 to 33.7% in 2008; while financial payments increased from 40.2% to 88.1% in the same period. The main effect of financialisation may have been felt through an increase in dividends (both paid and received), which had a long term tendency to increase since 1985. Therefore, the increase of financial payment and receipts in 2002-08 may have contributed to the decline in NFC's investment.

Econometric analysis confirms the negative effect of financial *payments* – but not of financial receipts – on NFCs' investment, mostly through the long-run relation among the variables (Barradas and Lagoa, 2014). Likewise, firms' debt also has a negative effect on investment.

The effect of financialisation on investment of NFC may have also resulted from the increase of household indebtedness (Mamede, 2014). After household debt reached high values, it implied a slow growth in aggregate demand, leading to a reduction of investment by firms oriented to the domestic market.

Arguably, financialisation leads to increasing payments by NFCs to shareholders and debtholders, thus reducing internal funds available to finance investment. In Portugal, we observe that the period of highest growth of finance was characterised by a slight decrease in the internal finance of investment: this source represented 66% of NFC's investment in 1986-94 and only 60% in 1995-2008[xix].

In conclusion, the negative effects of financialisation on investment have been felt in four areas: an increase in payments to financial investors (mainly in 2003-08), a decrease in the internal means to finance investment, an increase of the debt to equity ratio of NFC to high values (especially after 2000), and a rise in indebtedness of households.

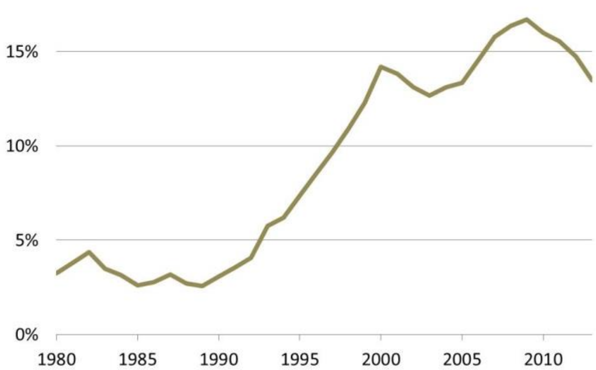
III.3. Financialisation and consumption

Since the mid-1980s Portugal has witnessed a huge transformation in the behaviour of the country's households. Their savings rate dropped from more than 20% to nearly 7% before the economic and financial crisis beginning in late 2007. The fall was particularly pronounced during the decade that followed Portuguese accession to the EEC in 1986. Private consumption grew fast between the mid-1980s and 2000, fostered by the greater availability of credit for consumption and a reduced need of savings for precautionary reasons. This period was also marked by a change in consumption habits, evidenced, for example, by the rapid diffusion of retail trade chains, big shopping centres, and hypermarkets, all of which selling international brands at prices that were gradually becoming accessible to the expanding middle class.

The further deregulation of the financial system and easier access to foreign funds by domestic banks from the mid-1990s led to a strong growth in credit, with mortgage credit growing faster than credit for consumption. Although bank credit to Portuguese households has been largely dominated by mortgage loans, bank credit to households for consumption and other purposes also grew considerably between 1990 and 2000, from 2.6% to 14.2% of GDP (

Figure 5). In order to finance their consumption (namely, of cars, home appliances, furniture, etc.), besides borrowing from banks, households also borrowed from nonbank financial institutions, especially Societies for Acquisition by Credit and, to a much lesser extent, Leasing Societies .

Figure 5 – Bank credit to households for consumption and other purposes (% of GDP)



Source: Bank of Portugal

The growth of consumption was fuelled by the liberalisation of the financial system (after a period of financial repression associated with the IMF interventions of 1977/78 and 1983/85), the significant drop in nominal and real interest rates from the early 1990s, and the strong growth of GDP and real wages until 2000.

Recall that, since the mid-1980s, the Portuguese financial system (in particular, the banking system) developed fast. The opening of the banking sector to new entrants in 1985, the end of the credit ceilings regime (in which the central bank set the maximum amounts that each bank could lend) in 1990, the creation and development of the Interbank Money Market from 1991, and the new legislative framework in 1992 – all these factors contributed to an increase in the banking sector's ability to supply loans to meet increasing demand both from households and firms. Moreover, a new legal framework – named "General Regime for Credit Institutions and Financial Societies" – established the ground that allowed the aforementioned Societies for the Acquisition by Credit and Leasing Societies to thrive.

Financial liberalisation produced a strong wealth effect through the reduction of liquidity constraints faced by households, which translated into higher levels of consumption. Castro (2007) and Farinha (2008) both confirm this effect empirically, showing that it was higher than in the US or in other European countries. Wealth related with houses had a larger effect on consumption than financial wealth, which indicates that households use mortgage loans to finance consumption.

Thus, private consumption in Portugal grew markedly between the middle 1980s and the end of the century. After 2000, though, and even before the subprime crisis, Portugal displayed the 6th lowest level of consumption growth in the EU, reflecting the sharp slowdown in economic growth discussed in detail in section II, partly resulting from the debt accumulated by Portuguese households in the preceding period.

III.4. Financialisation and the current account

Portugal has historically displayed a negative current account balance, the intensity of which has changed from period to period. Between 1960 and 1973, the current account deficit remained at around 2.5% of GDP, increasing to an average of nearly 9% in the following decade (1974-1985), due to the combination of the international crises of the 1970s and the social and political upheavals in the aftermath of the Portuguese democratic revolution of 1974[xx]. The external imbalances accumulated during this period led to two IMF interventions in Portugal (1977/78 and 1983/85)[xxi], which favoured a rapid improvement of the goods and services balance (from -20% of GDP in 1982 to -6% in 1986).

The combination of gradual macroeconomic stabilisation and financial liberalisation, and the decrease in interest rates in the international markets, contributed to the improvement of the balance of net primary income from the mid-1980s onward, partly compensating for the return of the external trade deficits to levels around 10-12% of GDP. As such, between 1986 and 1995 the current account deficit averaged 6% of GDP, while the economy's net borrowing was around 4% (given the positive contribution of capital transfers from the European structural funds to the Portuguese external balances).

After 1995 and until the subprime crisis the Portuguese current account experienced substantial deterioration, from an average of -4.7% in 1995-1997 to -10.4% in 2005/2007 (-2.2% to -9.1%, when current and capital accounts are both considered). By 2007 Portugal had the 8th highest current account deficit (as a percentage of GDP) in the EU28 and the 5th highest in the euro area. Lately, the current account deficit peaked at 12.6% in 2008 and decreased since then, turning to a modest surplus (driven by the steep improvement in the balance of goods and services) as a result of the recession and the adjustment strategy being followed since 2010[xxii].

The deterioration of the current account after 1995 is common to all the countries of the Southern periphery of the euro area, and indeed to most EU Member States[xxiii]. The aggravation of the current account deficit in Portugal between 1995/1997 and 2005/2007 (6.9 percentage points of GDP) was, in fact, less severe than in Ireland (7.9), Spain (9.1), and Greece (11.7).

Analysing in greater detail the evolution of the main components of the current and capital accounts, before and after the turn of the century, the negative change in the Portuguese external accounts between 1996-1997 and 2006-2007 was mostly determined by the following four main factors (in decreasing order of relevance):

(i) *the outflow of investment income*;
(ii) *the growth of imports of goods*;
(iii) *the decrease in net current and capital transfers from the EU*; and
(iv) *the decrease in remittances from emigrants* (in percentage of GDP).

The last two factors – which together account for nearly half of the weakening of the Portuguese external accounts between the mid-1990s and the eve of the subprime crisis – are essentially explained by broad institutional, demographic, and international exchange rate phenomena. That is, they cannot be directly associated with the financialisation of the Portuguese economy.

As regards the determinants of the increase in imports of goods in Portugal after 1995 (point ii above), one should distinguish between different periods. As discussed in section II, domestic demand experienced strong growth in the second half of the 1990s, fostered by the rapid expansion of credit to households (mostly in mortgage loans) and to non-financial firms (across all industries, but especially in construction and real estate). As a result, GDP grew fast, and imports grew even faster over this period, from 29% of GDP in 1995 to 35% in 2000. During this period, financialisation had a direct impact on the growth of imports, by fostering domestic demand. In later periods (especially after 2003), the growth of imports is explained by a combination of the aforementioned nominal exchange rate appreciation with the increase in unit labour costs (see Section II): this led to an appreciation of the real effective exchange rate, leaving the traditional Portuguese industries even more exposed to competition from the emerging economies, which translated into an increasing penetration of imports in the domestic market of the corresponding industries (which are essentially based on consumer products).

Finally, the impact of the financialisation of the domestic economy on the deterioration of the Portuguese external balances after 1995 is even clearer in the case of the outflow of investment income. The growth of the latter was essentially determined by the payment of interest by residents to foreign creditors.[xxiv] In turn, the increase in interest paid to foreigners is explained by the strong growth of credit to households and non-financial corporations since the mid-1990s[xxv].

The persistence of high external deficits in Portugal since the mid-1990s was fostered by the country's participation in the European monetary union. The nearly full elimination of the exchange risk premium and the easier access to intra-EU monetary markets allowed for the prolonged financing of external deficits in Portugal. Had Portugal maintained its own currency, not only would the flow of foreign capital to finance the growth of credit to domestic agents have been reduced, but also the outflow of capital would have favoured an exchange rate depreciation, which would have contributed to improving the current account.

IV. Financialisation and the economic and financial crises as the crisis of finance-dominated capitalism

The first point to grasp about the nature of the successive crises that have affected the Portuguese economy since 2007 is that they did not originate either in the bursting of a domestic house price bubble or the significant exposure of the Portuguese financial system to 'toxic products'.

In Portugal, as in most European countries, there was no subprime market as in the US, despite a similar evolution of interest rates and the upward trend of house prices in some European countries (Bank of Portugal, 2008). Instead, the crucial aspect of the financialisation process in Portugal was the strong increase in credit to households and firms that took place from the mid-1990s. As we have discussed in the previous sections, this has led to high levels of private debt, as well as the decrease in Portuguese banks' solvability to low levels in comparison to other European countries (Lagoa et al, 2013).

According to the Bank of Portugal (2010), Portuguese house prices have evolved in line with fundamental factors, contrary to what happened in other countries. This report quotes an IMF study stating that in 2007 deviations of house prices in relation to fundamentals were around 30% in the UK, 20% in Ireland, between 10% and 20% in France, Spain, Italy and the Netherlands; and about 7% in the US. In Portugal, the deviation was close to 0%.

In the same vein, Portuguese banks did not hold 'toxic financial products' in their portfolios, having avoided the losses associated with these products. The main problem faced by Portuguese banks in the immediate aftermath of the subprime crisis was the difficulty in obtaining funding in international financial markets.

Still, this funding difficulty was overcome by the Portuguese government's scheme of state guarantees for the issue of securitised debt by Portuguese banks, as well as the huge liquidity offered by the ECB. Moreover, the ECB reduced its key interest rate from 4.25% in October 2008 to 1.00% in May 2009, also putting in place some extraordinary full-allotment refinancing operations. At the beginning of 2012, the ECB again reduced its key interest rate to 0.75%, a new record low since the creation of the euro area.

Additionally, in a context of high risk aversion and the intensification of flight-to-quality, the increase in demand for deposits by households helped to mitigate the funding difficulties of Portuguese banks. Synek (2009) asserts that after the outbreak of the subprime crisis Portuguese households increased their investments in cash, deposits and public debt, to the detriment of shares, investment funds, and other financial assets. During this period, Portuguese banks adopted aggressive strategies for attracting deposits, offering high interest rates compared with other financial instruments such as Treasury bonds.

Nonetheless, the profitability of Portuguese banks fell strongly in 2008, reflecting the drop in commission fees, the increase in funding costs, and losses in investment portfolios. The international activity of banking groups mitigated these negative results, namely through the increase of the financial margin.

Yet the increase in perceived credit risk led Portuguese banks to increase interest rate spreads in credit, which implied a considerable negative impact on private consumption and gross fixed capital formation. According to the Bank of Portugal (2010), Portuguese households also decreased their investment in housing due to the higher level of interest rates. This contributed to the slowdown in the growth of house prices between 2007 and 2009. Given the deterioration of consumer confidence, as well as the reduction in employment, the savings rate has reversed the downward trend observed since 2005, which also impacted negatively on private consumption.

In this context, the Portuguese economy began to decelerate in the first quarter of 2008 and slipped into a recession, unprecedented in the post-war period, in the third quarter of 2008, similarly to most advanced economies.

Initially, the Portuguese economy was not especially affected by the subprime crisis, experiencing a decrease in GDP that was smaller than the euro area's in 2009. In part this was a result of the counter-cyclical effect of both discretionary and non-discretionary fiscal policies which were in place during 2009[xxvi]. However, this led to an increase in the public deficit that was more pronounced than the euro area average. This took place in a country that struggled to maintain the public deficit below 3% between 2001 and 2008. As a consequence, Portuguese public debt increased to levels considerably above the euro area average in 2010 and 2011, when it was close to that average in 2009.

With a record of dismal GDP growth since 2000, high levels of indebtedness of both firms and households, a gradual increase in public debt until 2008 and a rapid one thereafter, the Portuguese economy was particularly vulnerable to the speculative attacks against sovereign bonds in the euro zone which started in late 2009. Following Greece in early 2010 and Ireland later that year, Portugal submitted a request for financial assistance to the European Financial Stability Facility (EFSF) and the International Monetary Fund (IMF) in April 2011. The Memorandum of Understanding between the Portuguese Government and the troika composed of the European Commission, the European Central Bank and the IMF – which established the terms of the adjustment programme that would accompany the EFSF's loan – fixed as its main objectives the rebalancing of Portuguese public finances and the adoption of a number of measures to strengthen the competitiveness of the Portuguese economy.

In general, the adjustment programme implemented in Portugal between May 2011 and May 2014 did not represent a dramatic break with the recent past with regard to the measures relating to public finances. Several policy initiatives in this field had been adopted in previous years, including the following: reducing the number of public sector workers and their real wages; reducing the number of public agencies and managers; cutting back social expenditure; downsizing public investment programmes; privatising state-owned firms; decreasing tax benefits for household expenditure on education and healthcare; imposing extra taxes on pensions and decreasing tax benefits for pensioners; increasing the VAT rate; increasing the maximum marginal rate in personal income tax; introducing a new tax on stock market capital gains; extending the base of social security contributions to previously excluded forms of compensation; among others. Concerning these domains, the Portuguese adjustment programme essentially emphasised the need to proceed with the implementation of the measures already in place and, in some cases, to reinforce some of them (for example, imposing stricter limits on social benefits, greater cuts in public investment, and stricter control of the budgetary process at all levels – central and local administration, quasi-public agencies, and state-owned firms).

Such austerity measures have resulted in a steep decrease in economic activity and employment, which was much more severe than initially foreseen: while the original adjustment programme forecast a GDP year-on-year change of -1.8% in 2012 and 1.2% in 2013, the actual figures were -3.2% and -1.4%, respectively; the unemployment rate was expected to peak at 12.9% in 2012, but reached 16.5% in 2013 (notwithstanding the historically high levels of emigration). These outcomes had a negative impact on public finance targets: the budget deficit was expected to be cut from 9.1% of GDP in 2010 to 3% in 2013, but by the end of this year it was still at 5%; public debt was expected to peak at 108.6% of GDP in 2013, but it was by then near 130% – and growing. The failure to achieve the fiscal targets led the troika and the national authorities to introduce additional austerity measures, which further hindered the economic recovery.

One area in which the programme was considered successful was the evolution of the external balances. According to the initial programme, the current account deficit was expected to decrease from 10% of GDP in 2010 (a value similar to the average of the decade ending in that year) to near 0% in 2015. Such an impressive result was expected to accrue from the combined effects of low wage growth and reforms to the labour market (namely, easing dismissal restrictions, restricting the scope of collective agreements, reducing the duration and amount of unemployment benefits, etc.), which, it was expected, would help to restore the competitiveness of the Portuguese economy. In fact, the Portuguese current account became slightly positive in 2013. This, however, is largely explained by the steep decrease in imports, due to the drop in domestic consumption and investment, raising doubts regarding the sustainability of the recent improvement in the current account in the event of a recovery.

V. Summary and conclusions

To sum up, the process of financialisation in Portugal was essentially characterised by an exponential increase in bank credit to the private sector. In a first moment this fostered a rapid growth of GDP, led by private demand, which translated into high levels of private indebtedness, and ultimately proved to be unsustainable. In this sense, the experience of the Portuguese economy in the past two decades has not been substantially different from those of Greece, Spain, and Ireland – although in the case of Portugal the period of fast growth induced by easier access to cheap credit ended earlier. Thus, we suggest that the experience of those four countries, notwithstanding some national specificities, could be subsumed under the label ‘debt-led domestic demand growth’ – rather than distinguishing, as Hein (2012) does, the Portuguese experience from the remaining three cases (labelling the former ‘domestic demand-led growth’ and the latter ‘debt-led consumption boom’).

In this report we have discussed more deeply the effects of financialisation on the development of the Portuguese economy through four different channels: income distribution; private consumption; real investment; and the current and capital accounts. While the impact of financialisation on the external accounts is clear – as was mentioned above, it is essentially related both to the increase in interest payments and to losses in cost competitiveness – its impact through the remaining channels is less obvious.

As regards income distribution, we have shown that the levels of personal income inequality (after taxes and social transfers) and functional inequality have not changed substantially during the period in which finance grew the most (1995-2009). However, it should be noted that other factors were at work during this period which affected income distribution in Portugal, namely the growing size of social policies.

The wide availability of cheap credit had a strong impact on corporate investment in the second half of the 1990s. Investment was also favoured by the extension of average maturities of bank loans. In contrast, after 2001 the share of total investment in GDP declined in Portugal due to a combination of factors, including the high levels of indebtedness of households and firms. The available econometric analyses conclude that financialisation has had a negative impact on investment through the growth of financial payments by Portuguese firms; this suggests that corporate investment in Portugal was negatively affected by a reduction in "internal means of finance" (borrowing the expression from Hein, 2009, 2012; and Hein and Dodig, 2013), one of the channels through which, according to the literature, financialisation may constrain real investment.

Finally, the growth of private consumption in Portugal from the late 1980s benefited not only from the expansion of credit for consumption and, especially, for house purchase (which was partially used for consumption purposes), but also from the wealth effects deriving from the drop in real interest rates (especially since the mid-1990s). However, as argued before, the increasing levels of household indebtedness have ultimately contributed to reducing income available for private consumption, putting a further constraint on consumption growth (on top of the growth in unemployment since the turn of the century, which is itself partially related to the process of credit-led accumulation of debt).

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[ii] We thank the comments of Eckhard Hein and of the participants in the FESSUD Conference Understanding and Responding to the Financial Crisis, October 16-17, Warsaw, Poland. The usual disclaimer applies.

[iii] Data for Germany before 1991 refer to the Federal Republic of Germany only.

[iv] This means that net exports had a negative contribution to GDP growth in this period.

[v] Leading to considerable annual surpluses in the capital account – see section III

[vi] The IMF intervention in Portugal in this period was due to a Balance of Payment crisis, which resulted from a combination of external factors (relating to the oil crises of the 1970s) and internal ones (mostly associated with the social, economic and political upheaval that followed the 1974 democratic revolution). See Lagoa et al. (2013).

[vii] Real long-term interest rates in Portugal fell from an average of 4.8% in 1993-1996 to 1.8% in 1997-2000.

[viii] Household debt includes: Securities other than shares, excluding financial derivatives; and Loans.

[ix] Debt of non-financial corporations include: Securities other than shares, excluding financial derivatives; Loans; and Trade credits and advances.

[x] The difference in average annual GDP growth rates between the two periods is 3.p.p in the case of Portugal (4,1% to 1%), followed by Ireland with 2.p.p. (6,9% to 5%). Both the Spanish and Greek economies grew actually faster in 2000-2007 than in 1986-2000.

[xi] This is both a result of automatic stabilisers and discretionary policies: according to the Bank of Portugal, the change in the structural primary balance of the Portuguese government was moderately negative, both in 2000 and in 2001.

[xii] See section III.4.

[xiii] Nearly 2/3 of the jobs lost in Portuguese manufacturing occurred in the country's traditional export industries, namely textiles and textile products, footwear, and wood and cork products.

[xivxiv] Data obtained from INE Contas Nacionais (up to 1994) and Eurostat (from 1995).

[xv] Rodrigues and Andrade (2013).

[xvi] The World Top Incomes Database.

[xvii] Note that we are referring to *total* investment, which also includes household mortgage investment.

[xviii] Even though in Portugal financial markets are not very relevant, we generalise this reasoning assuming that the pressure for payments is exerted outside financial markets.

[xix] Computed based on data from INE and Eurostat, financial transactions and National Accounts.

[xx] These factors translated into capital flight, higher imports and lower exports (see Lagoa et al., 2013).

[xxi] The measures of the IMF interventions during this period included the following: adoption of a crawling-peg exchange rate regime (with regular and pre-announced devaluations of the currency) from 1977, strong restrictions on capital movement, credit limits aiming to control aggregate demand and the external deficit, direct control of credit growth, administrative restraints on interest rates, and the liberalization of foreign trade.

[xxii] See sections **Error! Reference source not found.** and IV.

[xxiii] The exceptions are Lithuania, Denmark, the Czech Republic, the Netherlands, Malta, Sweden, Austria, and Germany – a group which largely overlaps with the ‘export-led mercantilist’ economies in Hein’s (2012) typology.

[xxiv] To a lesser extent, it was also influenced by the negative change in net direct investment income. During this period, especially after 2002, there was some increase in the inflows of investment income related to Portuguese direct investment abroad, but this was insufficient to compensate for the growth in investment income outflows.

[xxv] Note that the relation between Portuguese households and firms and foreign creditors is mostly indirect, being mediated by domestic banks.

[xxvi] The public deficit in 2009 amounted to 14.1 billion euros, representing a deterioration of 8.9 billion compared to 2008 as a result of a 6.1 billion euro decrease in revenues and an increase in spending of 2.8 billion euros. Of these, only 824 million euros correspond to discretionary, counter-cyclical measures (Abreu et al, 2013).