FINANCIALISATION IN THE EUROPEAN PERIPHERY AND THE SOVEREIGN DEBT CRISIS: THE PORTUGUESE CASE[1,2,3,4]

ABSTRACT

The financial sector has acquired a great prominence in most developed economies. However, some authors argue that the growth of finance is at the roots of the current financial and economic hurdles. This paper aims to analyse this claim by looking at financialisation in the European periphery, focusing on the Portuguese case. The emergence of this phenomenon is contextualized in an historical, economic and international perspective. Based on the analysis of several indicators, the paper concludes that the Portuguese economy exhibits symptoms of financialisation. It also argues that financialisation has put in evidence structural weaknesses of the Portuguese economy, playing an important role in the emergence of the recent Portuguese sovereign debt crisis.

KEYWORDS

The Portuguese Economy, Financialisation, Liberalisation, Deregulation, Integration and Globalisation, The Sovereign Debt Crisis

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1. INTRODUCTION

In recent years, finance has acquired a great prominence in most developed economies and has assumed a growing dominance over the overall economy (e.g. Krippner, 2005 and 2011, Epstein, 2005, Palley, 2007, Orhangazi, 2008 and Davis, 2009), such that *"it is difficult to escape the impression that we live in a world of finance"* (Krippner, 2005, p. 173). This process, which according to Kus (2012) has begun in the US during the early eighties, due to the deregulatory reforms of the Reagan Administration, has been referred to as financialisation.

Against this backdrop, a growing body of literature has emphasized the causes, patterns and consequences of financialisation all over the world. In the wake of the Great Recession, many authors point to financialisation has contributing to the subprime crisis and to exacerbate the levels of anaemic growth, unemployment, inequality and poverty and the loss of welfare already before this crisis (e.g. Palley, 2007, Freeman, 2010, and Kedrosky and Stangler, 2011).

This paper aims to evaluate the process of financialisation of the Portuguese economy during the last three decades, contributing to the literature in two aspects. Firstly, it analyses the origins, specificities and evidences of financialisation in a peripheral euro area country, whereas most of the studies on that subject focus on the most developed economies. Secondly, the paper stresses the role of financialisation in the recent sovereign debt crisis affecting Portugal.

We find that the liberalisation and deregulation of the financial sector preceded a strong growth of this sector. These evolutions together with the indebtedness of the non-financial sector, the behaviour of non-financial corporations, the growth of markets and banks' credit policy are all characteristic features of financialisation processes and have all been part of the evolution of the Portuguese economy in recent decades. Initially, and until the end of nineties, that process implied a strong economic dynamism, mainly supported by high credit growth. In the turn of the millennium, the economy started to lose momentum and its structural weaknesses emerged clearly, and later in 2010, in an adverse international context, they gave rise the sovereign debt crisis. We argue that the process of financialisation played an important role in creating the conditions that made possible the Portuguese debt crisis.

The remainder of the paper is organized as follows. Section 2 presents a selected literature review on the concept of financialisation and its main empirical evidences around the world. The change in the regulatory framework of the financial sector in Portugal is discussed in Section 3. In Section 4, the main evidences of financialisation in the Portuguese economy are highlighted. In Section 5, we emphasize the role of the financialisation in the emergence of the Portuguese sovereign debt crisis. Finally, Section 6 concludes.

2. THE LITERATURE REVIEW ON FINANCIALISATION

Although there is not a unique and generally accepted definition of financialisation (Krippner, 2004, and Leiva and Malinowitz, 2007), one of the broadest concepts defines it as *"[...] the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operations of the economy and its governing institutions, both at the national and international level"* (Epstein, 2001, p. 1). Epstein (2005) adds that the process of financialisation exists in most developed economies since the eighties, and has been characterized by the significant increase in financial transactions, the rise of real interest rates, and the higher profitability of financial corporations in relation to non-financial corporations. Different definitions of financialisation tend to emphasize a slightly different ingredient of the process at hand. Krippner (2005) defines financialisation as the accumulation of profits from financial activities instead of from non-financial activities. Crotty (2007) argues that financial interests have overlapped the economic, social, environmental and political interests.

In turn, Menkhoff and Tolksdorf (2001) highlight the growing importance of stock markets, capital flows and international financial transactions during the past three decades. These authors also express that there has been a change in the role of the financial sector during the last decades. They advocate that, while in the past the financial sector supported and boosted economic growth, in the last ten or twenty years events on the financial sphere have followed their own logic (the "decoupling hypothesis") and the relationship between the financial and non-financial sectors has become "disruptive".

Against this backdrop, there have been an increasing number of authors that attempt to assess the main features regarding financialisation. Most of them admit that this phenomenon encompasses some of the following features (FESSUD, 2012): development and proliferation of financial markets; deregulation of the financial system and of the economy in general; the emergence of new financial instruments, institutions and markets; the dominance of finance over other industry in terms of investment, production and employment; the rise of income inequality deriving from market mechanisms, public policies, and wages stagnation; significant growth of consumption supported by credit; the diffusion of market and financial logics in economic and social areas previously not affected by these logics; and the emanation of a culture oriented to individualism, self-interest, rationalism and market values.

The concept of financialisation typically offers a negative perspective on the impact of excessive growth of finance in the economy. This is in sharp contrast with the dominant view in mainstream Economics, according to which the growth of finance is in general a positive phenomenon. In the latter case, the development of the financial system is seen has fostering economic growth, since financial markets are considered efficient in processing information, guaranteeing an optimal allocation of resources and a decrease of liquidity constraints. The conventional economic theory tends to ignore the existence of crisis related to the formation of financial bubbles.

The "pessimist view" on the role of finance put forward by the concept of financialisation has gained momentum more recently in the wake of successive international financial crisis (especially after the collapse of the US subprime market in 2007). A large range of authors have emphasized the negative effects of financialisation, tipically putting forward some of the following criticisms (FESSUD, 2012). Firstly, financialisation reduces the level and efficacy of real investment, as funds are diverted to financial activities, which results in slower economic growth. Secondly, corporations aim to maximize their financial value, normally in the short-run, overlooking their long-run survival and other social values. Thirdly, economic and social public policies are pushed to accept market mechanisms in all areas of economic and social life, sometimes with deleterious consequences in terms of efficiency and equity. Finally, growing areas of economic and social life are exposed to volatility and crises, which often characterise financial markets.

Crotty (2005) adds that the demand of financial markets for more income pressures non-financial corporations into financial operations, which contributes for the stagnation of economic growth.

Some authors have argued that the process of financialisation has contributed to the subprime crisis in the US economy in the end of the last decade (e.g. Freeman, 2010, and Kedrosky and Stangler, 2011). Palley (2007) concludes that the process of financialisation makes economies more vulnerable to debt-inflation episodes and prolonged recessionary environments.

In this regard, a large body of empirical literature has emerged over the last decades dedicated to evaluate the causes, patterns and consequences of financialisation all over the world. Krippner (2005) defends that the US economy presents signs of financialisation since the early 1970s, as is demonstrated by the growing importance for non-financial corporations of financial revenues and the increasing relevance of the financial sector as a source of profits for the economy. The evidence on financialisation in the US is also confirmed by Palley (2007), Orhangazi (2008), Stockhammer (2010), among others.

Although the research on this topic has often been focused on the US economy, financialisation is a common phenomenon across all industrialized economies (Palley, 2007, Power *et al.*, 2003, Jayadev and Epstein, 2007, Leiva and Malinowitz, 2007, Orhangazi, 2008), including many economies that lie outside the core of the world economy. Notwithstanding, most of the literature on financialization is focused on the more advanced economies, often neglecting the peculiarities and dynamics of financialisation on the periphery (Becker *et al*., 2010).

However, a few works analyse the specificities of the process of financialisation in peripheral economies. Leiva and Malinowitz (2007) suggest that the process of financialisation has deteriorated the real economic performance of the North (developed) and South (developing) economies, namely delineating weak growth rates and lower levels of employment due to the decline of productive investments. Other consequences of that phenomenon include the deregulation of labor-capital relations, the intensification of mergers and acquisitions to boost shareholder value, the reduction of the room of manoeuvre of public policies, and rising income inequality.

Assa (2012) observed that the process of financialisation has taken place in all OECD countries and had negative consequences on growth, employment and equality. Similarly, Kus (2012) confirms that financialisation has raised inequality for a set of 20 OECD countries between 1995 and 2007.

Other studies focus on specific, non-core countries. Yeldan (2000) concludes that the process of financialisation has had a negative impact on economic growth, unemployment and income distribution in Turkey. Becker *et al.* (2010) focus their analysis on the financialisation in two countries from Latin America (Brazil and Chile) and other two from Eastern Europe (Serbia and Slovakia), finding that this phenomenon has been extremely crisis-prone in all four cases. They also add that the crisis faced by these countries has fostered the adoption of further measures towards financialisation (supported by IMF or other international institutions), namely the privatisation of the pension systems in Chile and Slovakia.

Orsi and Solari (2010) analyse the changes in the financial systems of Southern European economies in the last 15 years. According to these authors, these financial systems are bank-based, with banks controlling all credit, the stock exchange and investment in shares by acting as advisers, mediators, issuers, treasurers and investors. They sustain that, in those countries, universal banks are able to decide who can invest, where can invest, who makes profits and who loses. These authors also consider that the most evident sign of financialisation of these economies comes from the strong importance of banks, which sustains the dynamism of the economy granting high levels of credit, especially for durable goods.

In what follows, we discuss of the specificities of the process of financialisation in the Portuguese case.

3. THE CHANGE IN THE REGULATORY FRAMEWORK: CREATING THE CONDITIONS FOR FINANCIALISATION

The development of the Portuguese financial system occurred relatively late when compared with the other EU countries, mainly due to the nationalisation of the banking system in the aftermath of 25^{th} of April 1974 Revolution and of the two agreements established with the IMF in 1977 and 1983.

After the 1974's Revolution and following a socialist-oriented policy, governments announced the nationalisation of banking activity, in order to prevent capital flight and to control the development of the economy. The issuer banks (*Banco de Portugal¸ Banco Nacional Ultramarino and Banco de Angola*) were nationalised in September 1974 and the other financial institutions (including non-monetary institutions) in March of 1975. In 1976, the new Portuguese Constitution stipulated the irreversibility of the nationalisations and the prohibition of banking activity to private agents.

In the beginning of the 1980s, as a result of the nationalization process, most of the banks were State-owned, with only mutual and cooperative institutions (*Caixas Económicas* and *Crédito Agrícola*) and foreign banks remaining outside the direct control of the State. In 1991, the State-owned banks accounted for nearly 75% of the assets of the banking system (Antão *et al*, 2009). As such, the banking system was under the direct control of the government and there were restrictive regulations on banks activities, namely on the amount of credit and interest rates. At the same time, the State-owned banks were restructured, leading to an increase in the concentration of the industry. The financial system was essentially repressed, characterized by weak levels of competition, innovation and efficiency (Caixa Geral de Depósitos, 2010).

On the other hand, the two agreements established with the IMF were also responsible for the delay in the development of the financial system. Indeed, those agreements attempted to correct the external imbalances of the Portuguese economy, imposing measures to contain the growth of domestic demand and money supply. These measures included credit limits, administrative control of interest rates, and limitations on the number and location of branches.

In 1986, Portugal joined the European Union and started the integration in the European Single Market, which required the gradual dismantling of the constraints on the financial system, particularly regarding State ownership of banks and insurance companies. The elimination of restraints had already begun in 1983, when a law was passed which reopened banking and insurance activities to national and international private corporations. At the end of the 1980s, a new set of liberalizing measures were adopted, including the progressive elimination of administrative limits to interest rates, to credit growth and to the number and location of banks' branches (Table 1). Simultaneously, some explicit restrictions related to the composition of bank's assets were also removed, especially the compulsory investment in national sovereign debt.

Table 1 – Main measures of financial liberalisation and deregulation adopted in Portugal

Date	Measure
February 1984	Start of the removal of barriers to the entry of new banking institutions and the removal of restrictions on the expansion of the network of bank branches
June 1984	Liberalisation of deposit rates, excluding the rate on deposits with a maturity of 180 days up to 1 year
August 1985	Liberalisation of lending rates, excluding those on operations with a maturity of 90 up to 180 days, 2 up to 5 years and over 5 years, for which a ceiling was set
1986	Start of the removal of capital controls (FDI and portfolio investment)
September 1988	Liberalisation of lending interest rates, excluding those related to loans for house purchase
March 1989	The reprivatisation process begins and the ceilings on all lending rates are removed
1990	New regulatory framework for Bank of Portugal
October 1990	Crawling-peg exchange rate regime ends
January 1991	Elimination of restrictions on credit, replaced by open market operations and reserve requirements
April 1992	*Escudo* joins to the European Monetary System
May 1992	Liberalisation of all deposit interest rates
December 1992	Conclusion of the process international capital movements liberalisation

Source: Based on Castro (2007)

Consequently, from the second half of the 1980s onwards, a significant number of foreign banks opened activity in Portugal. These foreign banks were important to the modernization and development of the Portuguese financial system, contributing to increase efficiency and innovation. Nonetheless, the foreign banks, traditionally focusing on retail banking, continued to account for a relatively small share of the domestic market, being unsuccessful in the first years due to high levels of non-performing loans (Honohan, 1999).

Concurrently, new domestic banks were created and, after the second half of the 1980s, the number of domestic and foreign banks increased considerably and the number of branches more than doubled. In 1985, there were 22 banks and in 2000 there were 62 (Bank of Portugal, 1997 and 2000).

In 1989, amendments to the Constitution abolished the principle of irreversibility of nationalisations, allowing the beginning of the re-privatization of banks. In 1996, at the end of this process, only one bank, *Caixa Geral de Depósitos*, remained Stated-owned, with around 20% of the assets of the banking system, a share that it still holds in 2013 (Banking System Statistics from Bank of Portugal, *Associação Portuguesa de Bancos* and Antão *et al.*, 2009).

Banks' re-privatisation represented an important milestone on the evolution of the financial system, enhancing competition and innovation. Since re-privatisations were carried out mainly through public offers, they contributed to increase the depth of the stock market and led to greater diversification in investors' portfolio. The promotion of 'popular capitalism' was by then a motto. Commercial banks profited from this process by giving credit to small investors wishing to buy stocks, whereas investment banks gained by advising the government on the reprivatisation operations.

Subsequently and especially after 1994, as a consequence of the increased competition from foreign banks and the efforts towards rationalisation, several waves of takeovers took place that increased the market concentration. In many cases, the institutions involved in these operations did not actually merged, but rather formed banking conglomerates, with only a few institutions disappearing completely. Either by mergers and acquisitions or by internal growth, the re-privatisation process boosted the formation of large financial groups, consolidating the dominance of five of them. Since 1996, these five banking groups have controlled around 80% of the banking system in terms of assets, credit, resources and results.

The adoption of European law has contributed decisively to the liberalisation and deregulation of the Portuguese financial system. Under European inspiration, the new Organic Law of the Central Bank was established in 1990, strengthening the role of supervision on the financial system. Another important step was taken in late 1992, with the transposition of the Second Banking Coordination Directive to the Portuguese law, which extended the Single Market to financial services.

This new regulatory framework also established the principle of universal banking, eliminating the legal imposition of segmentation of banking activities (commercial, savings and investment banks). Banks also started to offer other specialized products that were not strictly banking products, such as *factoring* or *leasing*. Moreover, banks seized the opportunity to start internationalizing, by opening branches in other countries.

Another important regulatory change was brought by the implementation of the EU Capital Adequacy Directive in Portugal between 1990 and 1993, which aimed to establish uniform capital requirements for both banks and non-bank securities corporations.

Despite the liberalization process, no financial crisis has occurred for two decades in Portugal, contrary to what succeeded in other OECD countries, as emphasized by Kaminsky and Reinhart (1999). The only events were the default of two small local banks (*Caixa Económica Faialense* and *Caixa Económica Açoreana*), with no systemic impact.

In the first six years following the accession to the EU, Portugal's GDP per capita (in purchasing power parities) rapidly converged with the EU15 average, from 54% of that average in 1986 to 68% in 1992. This process of catching-up was interrupted during the crisis of the European Monetary System (EMS) in 1992-1993. The economic dynamism until 1992 was partially explained by the faster growth of credit since 1991, for which the liberalization of the banking system has contributed. GDP growth was also boosted by the political stabilization and the accession to the EU, which favoured the substantial transfer of structural funds from the EU, the access to loans from the European Investment Bank and the significant inflows of FDI (fostered, in particular, by the single market program).

4. EVIDENCES OF FINANCIALISATION IN PORTUGAL

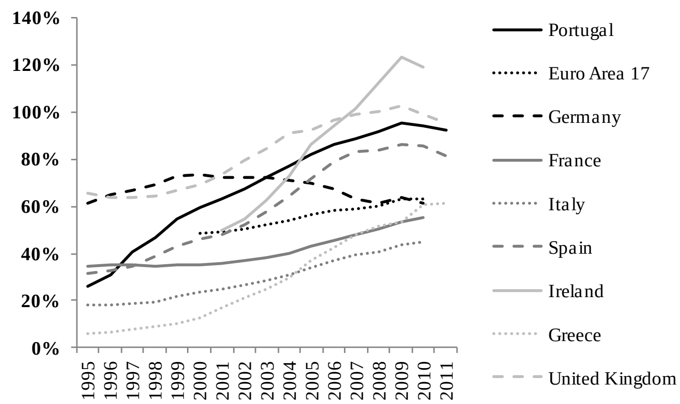
The liberalisation, deregulation and integration of the Portuguese economy in the EU markets created the necessary conditions for the financial sector's growth during the last three decades. In this section, we will examine to what extent the Portuguese economy has mirrored symptoms of financialisation by analysing the indebtedness of the private sector, the financial sector's growth, the rise of financial assets, the engagement of non-financial corporations in financial activities, the rise of financial interests in other areas apart from the financial area, the existence of public policy benefits to the financial sector, and the evolution of credit by sectors.

4.1. INDEBTEDNESS OF THE PRIVATE NON-FINANCIAL SECTOR

One sign of financialisation of the Portuguese economy was the strong growth of indebtedness since 1995. In the beginning of the 2000s the Portuguese households and corporations were among the most indebted of the euro area. During the eighties, the real growth of credit (obtained by the difference between the nominal growth and the inflation rate) was very low and even negative in some years (Figure 3), due to slow economic growth, nominal instability and also as a consequence of the IMF intervention. In 1995, a cycle of strong growth of credit started, reaching more than 25% per year in 1999. This growth was associated with the process of European integration, which affected both demand and supply of credit. On the demand side, the participation in the European Monetary Union increased current and expected output, decreased unemployment and led to a sharp decline in nominal and real interest rates. Initially, these changes were seen as permanent by economic agents, favouring a substantial increase in credit demand.

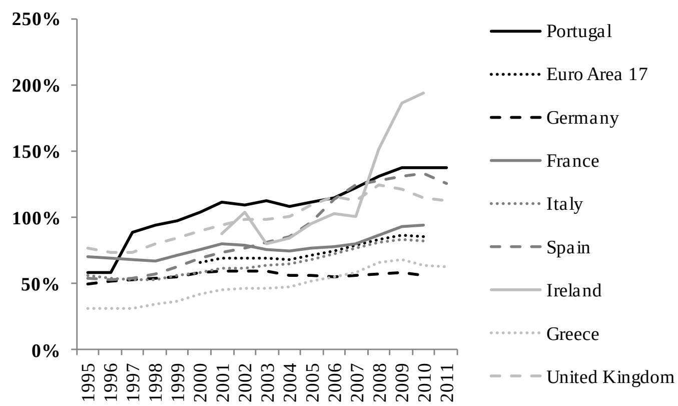
On the supply side, greater competition between banks also increased the availability, sophistication and diversification of financial products, particularly in the credit segment. The greater availability of credit was allowed by the domestic banks' wide access to international financial markets, which occurred even before the arrival of the euro, with the elimination of capital controls and an expressive reduction in the escudo's exchange risk. After Portugal joined the euro, the exchange risk virtually disappeared and the access to European financial markets has become even easier. Portuguese banks could diversify their funding sources by selling government bonds from their portfolios and borrowing on the euro interbank and bonds markets, or on the ECB, making them less dependent on deposits that were decreasing. Moreover, the increase use of loans' securitization also facilitated banks' financing and has become an important funding source.

Figure 1 – Households' debt (% of GDP)



Source: Eurostat

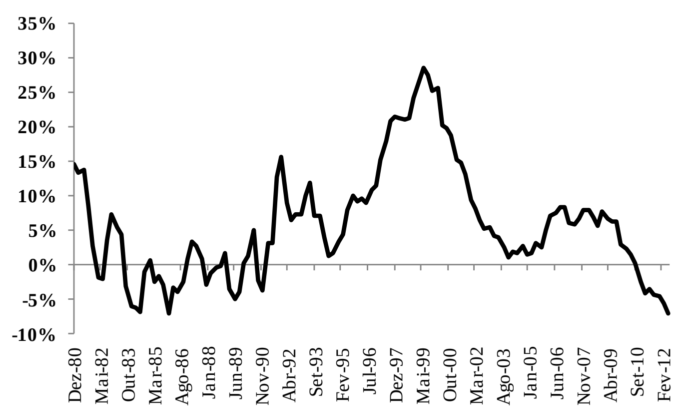
Figure 2 – Corporations' debt (% of GDP)



Note: Debt includes loans, securities other than shares and trade credit

Source: Eurostat

Figure 3 – Total loans (annual real growth rate)



Note: Excluding financial non-monetary institutions and securitised credit

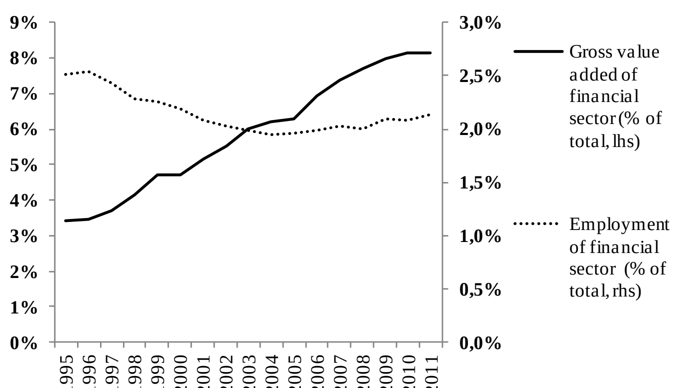
Source: Bank of Portugal

In this context, the easier financing allowed banks to satisfy the demand for credit, feeding the increase of households and corporations indebtedness (Figure 1 and Figure 2). The high levels of households' debt are essentially explained by the growth of mortgage credit since the beginning of the nineties, which boosted house ownership in Portugal, with around two-thirds of households living in houses owned by them. House ownership was fostered by the malfunctioning of the rental market, as well as by the existence of subsidized mortgage loans by the government until September 2002. In relation to non-financial corporations, the segment that exhibited higher growth was medium and long-term credit to finance investments.

4.2. FINANCIAL SECTOR'S GROWTH

In a context of liberalisation, deregulation and integration within European markets, the growth of banks' credit feed the growth of the financial sector, which can be interpreted as a symptom of financialisation (Figure 4). It is worth nothing that the larger increase in the importance of the financial sector in terms of value added occurred precisely in the first five years after the reopening of the sector to private agents. In contrast, the importance of the financial sector in terms of employment registered a small decrease, translating into an increase in labour productivity.

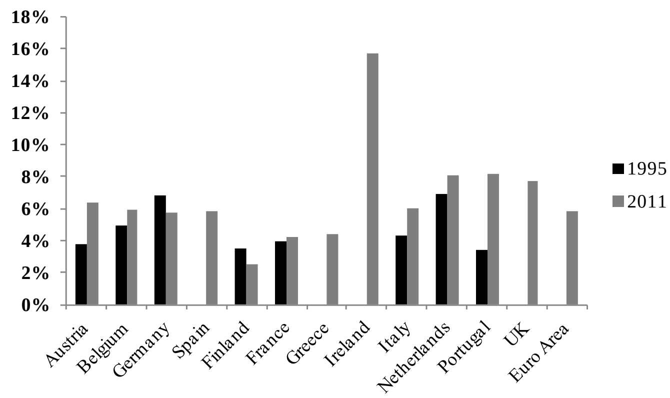
Figure 4 – The importance of the financial sector (% of total gross value added and total employment)



Source: Eurostat

Comparing the importance of financial activities on total value added with the euro area (EA) partners (Figure 5), we can see that in 1995 the Portuguese financial sector was one of the smallest in the EA. Nevertheless, from 1995 to 2011 there was a quick growth of the financial sector, leading its weight in the Portuguese economy to be above that of the EA average in 2011.

Figure 5 – The importance of the financial sector (% of gross value added)



Note: The values for euro area reflect the "changing composition".

Source: Eurostat

In the evolution of the financial sector in Portugal it is worth highlighting two points. Firstly, banks have been financing increasingly non-monetary financial institutions. The proportion of credit to non-monetary financial institutions in proportion of the credit to non-financial corporations jumped from 2,1% in 1980-89 to 21,7% in 1990-99, and increased to 24,1% in 2000-10 (data from Bank of Portugal). This is an indication of a financial system in a progressive process of decoupling from the non-financial sector. Secondly, the rapid growth of credit has allowed banks to have a large Return-on-Assets (ROA). Before the 2008 financial crisis, the average ROA of Portuguese banks was one of the largest in the EA. For instance, on average in 2005 and 2006, the ROA of Portuguese banks was 0,93% and the unweighted average ROA of EA12 was 0,69% (ECB, 2007).

The growth of banking credit created two fragilities in the Portuguese financial system. Between 1997 and 2010 there was a strong decline on banks' capital adequacy ratios, which in 2010 were among the lowest of the EA11. On that year, the Portuguese banking system had a ratio of 10,3% and on average the EA11 had a ratio of 13,6% (data from ECB Statistics on consolidated banking data). Additionally, because the growth of credit was not accompanied by the growth of deposits, the loans-to-deposits ratio increased considerably from 57% in 1989 to 172% in 2008, making banks too dependent of market financing (data from Bank of Portugal).

Another weak point of the banking system resulting from the recent evolution was the large concentration of loans to the real estate sector (households, construction and real estate corporations), which weight on loans to the private non-financial sector increased from 17% in 1980 to 59% in 2008. Comparing with four European countries (Austria, Germany, Italy and the Netherlands), in 2008 the weight of residential real estate in proportion of total loans (including to government and non-residents) was larger in Portugal: 32% in Portugal and 18% on the average of the four countries[5]. The large importance of credit to the real estate sector exposes banks to a downturn in real estate prices. Notwithstanding, Portugal did not experience a boom and bust cycle in the housing market (See Section 5.2.).

4.3. FINANCIAL ASSETS

Another way of assessing financialisation is by analysing the importance of financial assets in the economy[6] and their distribution across financial sectors. In Portugal, financial assets accounted for around 719% of GDP in 2010, which is the third highest value in EA11. On the other hand, in 1995-2000 the growth of financial assets was quite considerable in Portugal (Table 2). According with Cingolani (2012) that upward trend gives an indication on the relative speed at which financial stocks and productive revenues have developed over time and, therefore, measures indirectly the accumulation of "financial rents". Besides, Aglietta (1998) and Toporowski (2010) emphasize that the growing importance of financial assets in percentage of GDP in most European countries could be a symptom of asset price inflation. Indeed, even if one discount future gains, it is relatively unlikely that the value of accumulated financial assets could grow much faster than GDP, which is the real wealth distributed.

Table 2 – Financial assets of the economy (% of GDP)

Country	1995	2000	2010	Change 1995-2000 (p.p.)	Change 2000-2010 (p.p.)
Euro Area 17	n.a	418%	563%	n.a.	145
Belgium	218%	350%	480%	262	130
Germany	474%	670%	722%	249	52
Ireland	n.a.	n.a	2389%	n.a.	1284
Greece	57%	59%	105%	48	47
Spain	353%	467%	586%	232	119
France	88%	177%	272%	184	95
Italy	51%	105%	116%	65	11
Netherlands	847%	1091%	1447%	600	357
Austria	384%	469%	633%	249	165
Portugal	**445%**	**579%**	**719%**	**274**	**140**
Finland	316%	403%	684%	369	282

Note: Consolidated figures. The change for Ireland corresponds to the period between 2001 and 2010

Source: Eurostat (Annual Sector Accounts)

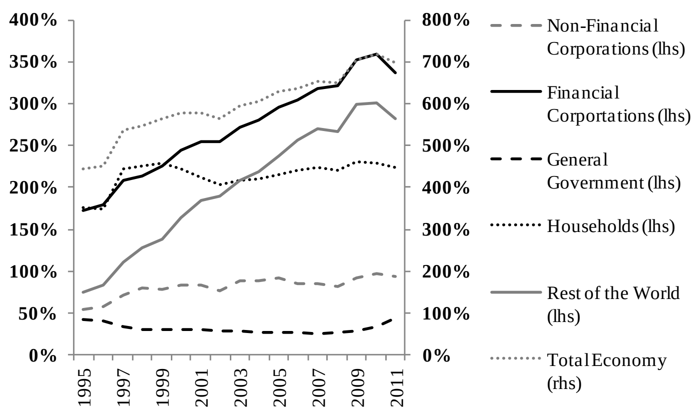
On the other hand, like in EA17, in Portugal most of the financial assets were owned by financial corporations (including central bank, banks and other non-monetary financial institutions). From 1995 to

[5] This is based on IMF Financial Soundness Indicators, and for Italy we used data of 2011 and for Germany of 2007.
[6] According to the Eurostat, financial assets include currency and deposits, securities and other shares, loans, shares and other equity, insurance technical reserves and other instruments receivable/payable.

2011, there was a fast growth of financial assets hold by financial corporations. In 1995, financial assets owned by households and financial corporations each represented around 175% of GDP. In 2011, financial corporations basically doubled their assets' holdings to 337% of GDP and households increased their assets only to 224% of GDP. The growth of financial corporations' assets represented a convergence of Portugal with the EA in terms of distribution of assets by institutional sectors (Figure 6 and Figure 7). The rapid growth of financial assets held by financial corporations may reflect a transfer of wealth from productive sectors (non- financial corporations and households) to the financial sector (Cingolani, 2012).

In the same period, an even larger growth in the holdings of financial assets was registered for 'the rest of the world'. This translates the high current account deficit, which was financed by transferring assets to foreign investors.

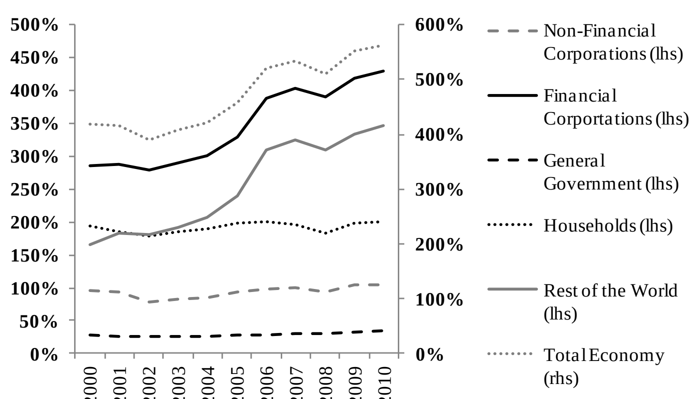
Figure 6 – Financial assets by institutional sector in Portugal (% of GDP)



Note: Non-cumulative and consolidated figures. Households includes the non-profit institutions

Source: Eurostat (Annual Sector Accounts)

Figure 7 – Financial assets by institutional sector in the EA 17 (% of GDP)



Note: Non-cumulative and consolidated figures. Households includes the non-profit institutions

Source: Eurostat (Annual Sector Accounts)

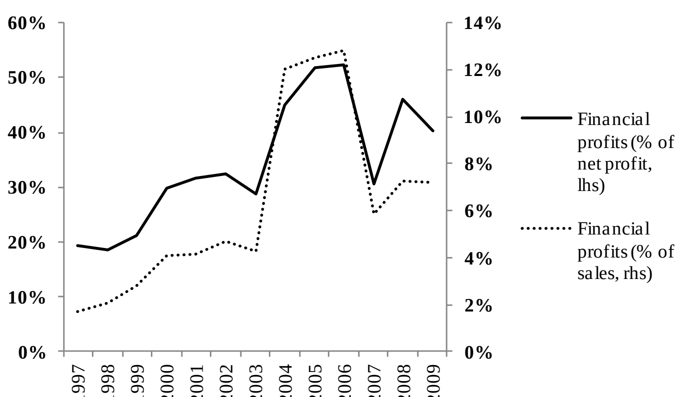
Another point worth nothing is that financial assets owned by non-financial corporations denoted an upward rise of 42,4 p.p in Portugal from 1995 to 2010. The increase in the importance of these assets since 2000 was slightly larger in Portugal than in the EA17, but in 2010 non-financial corporations owned slightly less financial assets in Portugal than in the EA17 (Figure 6 and Figure 7). Since non-financial corporations should not accumulate financial assets, a large increase in the financial assets owned by those corporations indicates that they are diverting resources from productive applications to financial accumulation, distorting their main goal.

4.4. FINANCIAL ENGAGEMENT OF NON-FINANCIAL SECTOR

Krippner (2005) claims that financialisation has two implications for corporations' profitability and activity. On the one hand, non-financial corporations become increasingly involved in financial activities and, thus, their financial profits grow in comparison with the profits from productive activities. One the other hand, a growing fraction of profits of the economy comes from financial corporations.

We already saw that financial assets owned by non-financial corporations have increased in Portugal since 1995, which indicates the increasing engagement of non-financial corporations in financial activities. This evidence is corroborated by the rise of financial revenues (interests, dividends and capital gains on financial investments) of non-financial corporations in percentage of total net profit (or total sales) (Figure 8).

Figure 8 – Financial revenues of non-financial corporations (% of net profits and sales)

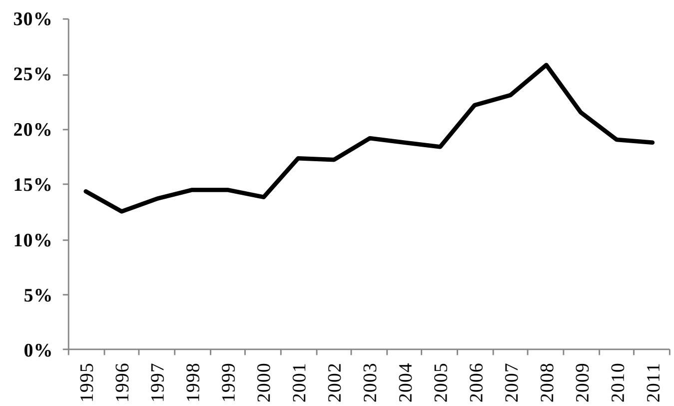


Note: The sample comprises the non-financial corporations with over 20 employees until 2003 and the total of non-financial corporations thereafter

Source: INE (*Sistemas de Contas Integradas* and *Empresas em Portugal*)

At the same time, there has been a growing importance of the financial sector as a source of surplus for the economy comparing to the non-financial sector since 1995, which is visible on the rise of gross operating surplus (GOS) of financial corporations in relation to the GOS of non-financial corporations (Figure 9). Since the GOS synthesises the remuneration of capital (rents, interests and profits), those data tell us that a larger share of capital's remuneration is coming from the financial sector.

Figure 9 – GOS of financial corporations (% of GOS of non-financial corporations)



Note: The values for 2010 and 2011 are forecasts

Source: INE (*Sectores Institucionais* from *Contas Nacionais*)

4.5. ENLARGEMENT OF PRIVATE INTERESTS ON THE ECONOMY

In the recent past, private interests have penetrated in areas previously reserved to the State, namely on the areas of health and construction and management of public infra-structures. The health sector has aroused the interest of private enterprises, including financial groups, and since 1995, several private hospitals have been created. The largest financial groups also own clinics and hospitals and provide medical services articulated with private health insurances. Despite the existence of a public health service, which is the main provider of medical cares to the population, the demand of private health insurances exists for reasons of easier access and (supposed) higher quality of medical services.

Besides the increase of private interests in health, the public sector has also suffered a transformation in the direction of introducing more market-oriented mechanisms. Important examples are the establishment of public-private partnerships (PPP) for construction and clinical operations of new hospitals, increase of autonomy of state-owned hospitals that were transformed into public firms, and the imposition of user fees. These changes were promoted with the goal of increasing efficiency and raise more revenues for the State, in a context of increasing difficulty in financing the NHS.

The establishment of PPP in the health and infrastructures sectors started in 2002. In the health sector, those partnerships include almost always the construction, maintenance and management of the infrastructure. In the typical PPP operation, there is a leading private corporation responsible for obtaining finance and to construct and manage the infrastructure. Banks finance the operation and the leading corporation of the partnership may also belong to a banking group. The State pays over several years a rent to the private firm in exchange for the construction and management of the hospital. In conclusion, PPP seem to be a profitable business also for banks.

According to *Direcção-Geral do Tesouro e Finanças* (2011), the amount contracted under PPP is very significant, particularly in the period 2015 to 2018, in which it is estimated that the costs of current PPP could reach two thousand million euros per year. The costs with current PPP account for around 1,0% of GDP each year between 2011 and 2015. Most of these contractual investments pertain to road infrastructures, followed by healthcare infrastructures. In sum, PPP represent a negative pressure on the fiscal budget in the medium and long-term.

The increasing role of private enterprises and PPP on the health sector has other social and economic implications. Firstly, this process has only benefited the population of the main urban centres (Porto, Lisbon and Faro) and with medium and high incomes and, therefore, it could increase social exclusion and inequality. Secondly, the transfer of health professionals from the public to the private sector has increased. Finally, the increasing penetration of markets in the health sector and in other sectors formerly in the sphere of the State may affect the values of individuals (Bowles, 1998). The prevalence of market institutions may change the behaviour of individuals towards more market-oriented values, as a larger emphasis on competition with other individuals and less tendency towards solidarity.

4.6. TAXES AND PUBLIC POLICY

One contribution of the financial sector to society is through the payment of taxes. According the Portuguese Tax Authority, the effective tax rate of financial and insurance activities was larger than the national average in the period between 2007 and 2010. However, the national average was pushed down by social and other activities characterized by a high degree of informality. When we restrict the comparison to manufacturing industry, real estate activities, construction or health activities, financial and insurance activities have paid a tax rate 3 to 4 p.p. lower than those sectors, which could mirror a certain benefit to this sector. According to the *Associação Portuguesa de Bancos* (2010), the lower average profit tax rate of the financial sector is related in part with the use of the Madeira's Off-shore (valid up to 2011), which allowed to obtain tax exemption for the profits of bank's subsidiaries located there (up to 15% of the total profit of the credit institution). Note that profits generated by banks on the Madeira's Off-shore and profits obtained elsewhere and transferred to that location were tax exempt, a benefit that was not available to other corporations.

The State took other significant measures that helped finance and market mechanisms to prosper: privatization of banks and other corporations, liberalization of the banking market, fiscal incentives to households for buying houses and shares on privatizations, zero taxation on capital gains on the stock market up to recently, integration of pension funds on public social security, and creation of PPP. Some of these decisions, namely the latter two, did not emerged spontaneously from political parties' programs, but aimed at solving immediate public finance problems.

4.7. SECTORIAL DISTRIBUTION OF CREDIT ACROSS INDUSTRIES

Analysing the growth of credit by industry (Table 3) in the period 1993-2007, it is clear that the banking system has given more credit to construction, real estate and other non-tradable activities than to manufacturing. The survey on investment conducted by INE (*Inquérito Qualitativo de Conjuntura ao Investimento)* asks corporations if they have faced credit constraints to their investments. The results show that the industries which faced the greatest difficulties in obtaining credit between 1998 and 2007 were manufacturing, construction (especially since 2004), and transportation and storage.

The larger difficulty of manufacturing in obtaining credit may be related with its slower output growth or with the fact that banks assess manufacturing as a higher risk sector, exposed to higher competitive pressures from abroad. On the other hand, this stance may also reflect the interests of banking groups in some non-tradable sectors, such as real estate and health.

Table 3 – Credit by sector (average annual growth rate)

Sector	1993-1999	1999-2007	2007-2011
Agriculture	1,7%	8,5%	9,0%
Mining	3,0%	2,0%	2,8%
Manufacturing	**2,8%**	**3,5%**	**3,6%**
Utilities	1,3%	7,9%	16,9%
Construction	29,5%	14,0%	-1,1%
Trade	12,4%	4,5%	0,1%
Transport	6,0%	12,3%	5,4%
Hotels and Restaurants	69,3%	18,3%	11,9%
Information and Communication	52,6%	1,3%	10,0%
Holdings	7,5%	11,5%	4,8%
Real Estate	29,5%	16,7%	0,9%
Consultancy	14,7%	12,5%	1,2%
Education and Health	n.d.	0,3%	9,9%
All Activities	**12,8%**	**9,4%**	**2,9%**

Source: Bank of Portugal

In any case, the growing importance of the non-tradable goods sector in relation to the tradable goods sector and the concomitant deindustrialisation of the Portuguese economy were associated with the smaller amount of credit to the tradable goods sector.

4.8. FINANCIALISATION AND ECONOMIC GROWTH

As emphasized by Stockhammer (2010), the process of financialisation has given rise to two different growth models (or “varieties of financialisation”) in the last three decades: a consumption-driven growth model and an export-oriented growth model. The model that seems to describe better the Portuguese case is the consumption-driven growth model, which was also present in the US, Ireland, Spain and Iceland (Alvarez, 2012). Such model is characterized by a period of strong economic growth fuelled by credit and, therefore, with increasing levels of indebtedness. The growth of credit is supported by large capital inflows and causes significant current account deficits. In other countries, but not in Portugal, the growth of credit was accompanied by the emergence of a real estate bubble.

In line with model’s predictions, Portugal had a strong economic dynamism, particularly until the end of the nineties, with the country converging with Europe in real terms, as well as maintaining the public deficit under control. Given the high economic growth in the period 1995-2000 (4,3% annually) and the scenario of low interest rates, the levels of indebtedness looked relatively sustainable and, therefore, did not seem to pose a significant risk to the economy.

The good economic performance was also the result of the favourable momentum of the international economy, low oil prices, favourable exchange rate developments (with an appreciation of the dollar against the euro) and the rise in social expenditures and public investment on the sphere of the welfare state.

5. THE ROLE OF FINANCIALISATION ON THE PORTUGUESE CRISIS

5.1. THE TURN OF THE MILLENNIUM: STRUCTURAL PROBLEMS AND THE FIRST SIGNS OF CRISIS

In 2000, the Portuguese economy was faced with some structural problems blocking its growth potential. As Mamede (2012) highlights, the most relevant constraints to development were (and still are in the present) the low levels of education of the labour force, the profile of economic specialisation (which is still dominated by industries with low value-added and highly exposed to competition from Eastern European and emerging economies) and the peripheral position in relation to the main European and world markets (which entails relevant cost disadvantages). A significant effort was made to improve all these blockages through private and public investment, but the distance to advanced Europe was still large.

To add to those limitations, in the beginning of the 2000s, the Portuguese economy also faced the consequences of the growing competition from Asian emerging economies (partly as a result of the agreements reached by the EU in the WTO and other forums), which had a substantial impact on a number of traditional industries responsible for a significant part of the manufacturing work force (namely, textiles, wearing apparel, footwear, wood and paper, metal products and non-metallic mineral). Moreover, many multinational corporations (especially in the automotive and related industries) shifted their productive capacity to some of the new member states deriving from the enlargement of the EU to the Eastern in 2004 (taking advantage of lower wages, higher educational levels, and the geographical proximity to the main European markets).

An additional problem was that the increase in aggregate demand in the preceding years raised the cost of labour, reducing external competitiveness and originating the loss of exports market share. Other factors also played a key role in the loss of external competitiveness: the appreciation of the euro and the lack of preparation of Portugal for the knowledge-based economy.

The loss of export shares and strong increase in aggregate demand from 1995 implied large successive current account deficits, originating high foreign indebtedness. These problems are at the root of the Portuguese crisis (Higgins and Klitgaard, 2011). Current account deficits accrued from a lack of savings to support investment. During the convergence process of Portugal to the euro, interest rates declined significantly, and up to 2007 the Portuguese Government bond yields were almost similar to the German yields. The reduction in interest rates led to an increase in consumption above disposable income, originating a reduction in savings. With investment reducing slightly but continuing at high levels, domestic saving was not enough to finance domestic investment, leading to an increase in foreign indebtedness. Investment was directed to non-tradable goods sectors that do not contribute to the improvement of the current account and have a slow growth of productivity. Indeed, the overall marginal efficiency of investment has declined since 1986[7]. Focusing in the period after 1992 up to 1998 the marginal efficiency of capital was larger in Portugal than in the EA: 0,117 and 0,091 respectively. After the creation of the euro, in the period 1999-2012, the picture changed dramatically, with the efficiency of capital in Portugal becoming inferior to EA average: 0,02 and 0,07, respectively.

The structural limitations of the economy implied that at the turn of the millennium, the evolution of the Portuguese economy started to lose momentum. Soon after the inception of the euro, and in reaction to what appeared to be signs of overheating in the EA, the ECB started to tighten its monetary policy, leading to an increase in Euribor. As a consequence and given the high rates of public and private investment in the preceding years, essentially financed through banking credit, the steep increase in interest rates had a significant negative impact on the levels of available income and, consequently, on the Portuguese domestic demand. This event shows clearly that financialisation has made the Portuguese economy more vulnerable to interest rate shocks.

In the meantime, the bursting of the ‘dot.com bubble’ (starting in March 2000 and lasting through 2001) triggered the first international economic crisis of the new millennium. This event together with the increase in ECB key interest rates were largely accountable for the Portuguese recession of 2003 and the increase of the Portuguese public deficit to 4,3% of GDP in 2001, making Portugal the first country in the EA to break the Stability and Growth Pact’s (SGP) 3% limit. In the following years, the Portuguese authorities were committed to comply with the SGP rules, following pro-cyclical and recessionary fiscal policies.

Against this backdrop, in 2003 starts a sequence of years of dismal economic growth and a decade-long period of divergence in relation to the other European countries. With lower economic growth, debt ratios of households and corporations continued to raise considerably, which increasingly translated into lower private consumption and investment and, consequently, even lower economic growth, rising unemployment rates and public debt ratios (which surpassed the EA average for the first time in 2006, reaching 63,9% of GDP). In that sense, the first negative consequences deriving from the

[7] The marginal efficiency of capital is calculated as the change in GDP at constant market prices of year T per unit of gross fixed capital formation at constant market prices of year T-5 (AMECO).

increasing financialisation of the Portuguese economy became evident, particularly in relation to the levels of indebtedness of economic agents.

5.2. THE SUBPRIME CRISIS

At the end of 2007 and 2008, the international economy was affected by the collapse of the subprime credit segment in the US. As it is well known, the securitization of subprime credits and its selling worldwide created a global crisis. As a result, some segments of interbank money markets have dried, mainly in longer maturities, which led to a liquidity shortage with direct effects in the reduction of banking credit and in the rise of loans' interest rates. The credit restraint sagging confidence and hitting household demand and business investment, namely for consumer durable goods and housing, caused the steepest downturn on record since the Great Depression in the European economy. The strong trade connections between countries have also facilitated the rapid cross-country propagation of the economic crisis.

In Europe and in Portugal, there was not a subprime market like in the US (Bank of Portugal, 2008). For that it contributed the marked differences between the mortgage market in the US and Portugal (Bank of Portugal, 2008). First of all, the percentage of households with mortgage credit is substantially lower in Portugal (30%) than in the US (45%), and indeed in other European countries like the Netherlands (38%) or the UK (40%). On the other hand, Portugal has one of the lowest ratios of credit instalments-to-income in the EA (around 14%), and exhibited also a low loan-to-value ratio.

On the other hand, Portuguese house prices had a modest increase when compared with other countries, like the UK, Ireland or Spain. Notice that nominal Portuguese house prices increased much less than the euro area average between 2000 and 2011: 21,1% and 54,2%, respectively. Bank of Portugal (2010) highlights that in Portugal house prices have evolved in line with the fundamentals. From the second half of the nineties, the increase in the supply of new houses avoided a surge in house prices.

In addition, Portuguese banks did not held in their portfolios "toxic financial products", having avoided the losses associated with these products. The main difficulty faced by the Portuguese banks in consequence of the subprime crisis was to obtain funding in international financial markets. In result of the high degree of mistrust between banks, the risk premium between Euribor and T-Bills jumped and the amount of funds traded felt sharply. Despite this, the funding difficulties of Portuguese banks were overcome by the State guarantee to the issue of securitized debt by banks, as well as by the large liquidity offered by the ECB at low interest rates. Additionally, the increase in the demand for deposits by households, in a context of high risk aversion, helped to mitigate funding difficulties of the Portuguese banks. More generally, saving rate has reversed the downward trend observed since the beginnings of the

2000s. In the same vein, the Portuguese banks also followed more commercially aggressive strategies for attracting deposits.

The increase of perceived credit risk led Portuguese banks to increase credit interest rate spreads, which implied a considerable deceleration of credit (see Figure 3) and domestic demand. Since 2007, the difficulty in obtaining credit increased faster than overall limitations to investment, becoming the third most important limiting factor to investment in 2011 (INE *Inquérito Qualitativo de Conjuntura ao Investimento*).

5.3. THE SOVEREIGN DEBT CRISIS

Against this backdrop, the Portuguese economy slipped into an unprecedented recession in the post-war period in the third quarter of 2008, like the majority of international economies. However, the Portuguese economy was initially less affected by the subprime crisis than the EA, with a decrease of GDP smaller than the EA in 2009. That happened due to the strong anti-cyclical response of the government during 2009 and its support to the financial sector, following the European guidelines and the Keynesian recipe. Consequently, fiscal deficit grew expressively during 2009, surpassing the growth in other EA countries. However, this occurred in a country that struggled to maintain the public deficit below 3% between 2001 and 2008. So, in 2010, Portugal was one of the EA countries with worse fiscal deficit (10,2% for Portugal and 6,4% for EA12). As a consequence, public debt increased to levels considerably above the EA average in 2010 and 2011, when it was close to that average in 2009.

The high levels of debt in the private and public sectors, which translated into high levels of external indebtedness of the Portuguese economy, started to raise doubts on international investors regarding the capacity of households, corporations and the State to pay their debts in a scenario of low structural growth. From 2007 onwards, in a global context of higher risk aversion, the perception that the risk of Portuguese public debt had increased, meant that the interest rates charged to the Portuguese government and, consequently, to banks started to increase to very high levels, making the financing of the State and banks more costly. Notice that the risk premium between German and Portuguese long-term interest rates increased to the highest level since the creation of the EA. The contagion from the Greek situation was also an important factor pushing Portuguese long-term interest rates up.

Given the continuous deterioration of the Portuguese situation, especially on the bond market, the most important rating agencies adopted a set of downgrades of the Portuguese sovereign debt during 2010, which was quickly reflected in the reduction of credit rating of most Portuguese companies, including the main financial institutions. In a few months, the Portuguese private and public debt felt into a junk status, worsening funding conditions in the international financial markets.

5.4. THE FINANCIAL RESCUE AND CURRENT ADJUSTMENT PROCESS

Against this background, the Portuguese government requested financial assistance from the EU, the IMF and the ECB on April 2011. In exchange for financing, Portugal agreed on a set of structural reforms to increase potential output growth, the deleveraging of the financial system and a trajectory of fiscal consolidation. The range and the details of this program contrast with the two previous interventions of the IMF in Portugal. In past interventions, the main goal of IMF was to control public deficit and credit, and promote exchange rate devaluation, without the concern of suggesting detailed structural reforms.

The financial assistance covers the period between 2011 and 2014 and contemplates a total funding of 78 billion euros. At the end of the program, the Portuguese State should be able to obtain financing in the debt market at sustainable interest rates. Initially, the program implied the reduction of public deficit from 9,8% of GDP in 2010 to 3,0% in 2013 (a target which was recently adjusted to 4,5%, given the unanticipated degree of recession associated with the austerity program).

The reduction of fiscal deficit will be guaranteed by the execution of traditional policy measures that aim an increase of public revenue and a decrease of public spending. Some of the measures prescribed by the Troika address problems created or amplified by financialisation. Firstly, although the programme implies the privatization of several state-owned corporations, it criticizes implicitly the way PPP were used in the past, and requires their re-examination, in order to diminish financial obligations for the State. Regarding structural reforms, in the housing market, the main structural changes aim to guarantee greater efficiency in the rental market, in order to improve labour market mobility and reduce the level of private sector indebtedness (Bank of Portugal, 2010b).

Concerning the financial system, this program aims to ensure its stability, with the priorities oriented to the process of deleveraging of the banking system and increase of its solvency. Some important measures have been taken, such as the strengthening of banks' collaterals for borrowing at the ECB, state guarantees for debt issues, periodic targets to reduce leverage ratios, and a recapitalization plan.

For the medium and long-term, the adjustment program assumes that low wage growth, a decrease in government's expenditures, the control of public debt, together with a number of structural reforms in the labour and goods and services markets will help to restore the competitiveness of the economy and put it back on a growth track. However, until the beginnings of 2013, the recessionary implications of the adjustment process, in the context of a decelerating European economy, were larger than initially expected.

6. CONCLUSION

This paper aimed to analyse if there was a process of financialisation in the Portuguese economy during the last three decades. The growth of the financial sector occurred relatively late compared to EU countries due to the nationalisation of all banking system in the sequence of the 1974 Revolution and the two agreements established with the IMF. Nonetheless, the progressive integration in the EU after 1986 lead to the liberalisation and deregulation of the financial system, with the formation of large banking groups, creating the conditions for the development of financialisation.

We find evidences of financialisation in Portugal, namely in the deregulation and liberalization of the financial sector and of the economy in general, privatization of State firms, the increasing importance of the financial sector and financial assets on GDP, the involvement of non-financial corporations in financial activities, the decrease of the efficiency of real investment, the increase of financial interests in the health-care sector and in the construction and management of public infra-structures, the larger credit growth directed to the non-tradable goods sector and, finally, the strong indebtedness of the private sector.

The Portuguese economy demonstrated a great momentum until the turn of the millennium, particularly boosted by the higher availability of credit at lower interest rates that resulted in strong robustness of domestic demand, in accordance with a consumption-driven growth model.

Nevertheless, in the last decade, the Portuguese economic growth started to lose strength, due to the emergence of structural weaknesses paved in the previous two decades. The Euro facilitated the financialisation in Portugal and imposed rigidity on the response of the economy to shocks, by limiting the use of fiscal policy and making impossible exchange rate devaluation. After the Great Recession, the counter-cyclical fiscal policy and the larger risk aversion of international bond investors, plugged with high levels of private debt in a context of slow structural growth, caused a fast and large worsening of the funding conditions of the Portuguese government, which was forced to request financial assistance from IMF, ECB and EU. The Portuguese case shows that financialisation makes the economy more prone to financial crisis.

Troika has imposed a demanding austerity program, aiming at increasing the potential output growth, ensure the deleveraging of the financial system and guarantee a trajectory of fiscal consolidation. This program has originated a strong deterioration of the Portuguese economy, but fiscal consolidation has not been achieved yet. The economic recovery seems difficult to achieve without expansionary policies at the European level and the resolution of the structural supply weaknesses of the Portuguese economy. While being part of the EMU, whose rules and policies are designed for the whole block, and which are short of mechanisms to address asymmetric developments across economies, Portugal will probably face a long and painful macroeconomic adjustment in the coming years.

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