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Financialisation and the Financial and Economic Crises: The Case of Portugal

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Financialisation and the Financial and Economic Crises: The Case of Portugal

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Abstract: The notion of 'financialisation' broadly refers to the growing weight of finance in contemporary economies. Taking this into account, the present study focus on the long-run macroeconomic development and recent financial and economic crisis of the Portuguese economy. Contrary to Greece, Ireland, and Spain, the dismal performance of the Portuguese economy is not solely a post-subprime crisis phenomenon. The sharp discontinuity in GDP growth around the turn of the century is a distinctive feature of Portugal in the EU context and, although several factors account for this discontinuity, the process of financialisation of the Portuguese economy is an essential part of the explanation. This process in Portugal was essentially characterised by a large increase in bank credit to the private sector, resulting from a combination of demand- and supply-side factors that produced a wide availability of credit at historically low interest rates. Thus, we suggest that the Portuguese experience can be labelled a 'debt-led domestic demand growth' model. However, after 2000 the Portuguese economy experienced a succession of shocks, and an exhaustion of the domestic debt-led growth at a much earlier stage than other countries, resulting in a sharp economic slowdown, with negative consequences for public finances. The high levels of public and private indebtedness were a decisive factor behind the steep rise in the Portuguese sovereign bonds interest rates between 2010 and 2012. Finally, we assess the impact of financialisation in the current account, investment, consumption, and inequality; articulating these domains with the general growth model. Our conclusion is that the increase in the importance of finance ended having a clear negative impact on the three former domains, while the negative impact on income inequality was less pronounced.

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Key words: Portugal, financialisation, credit, economic growth, investment, consumption, trade balance, income inequality, financial and economic crisis.

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Contents

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I. Introduction

Although different definitions can be found in the literature, the notion of 'financialisation' broadly refers to the growing weight of finance in contemporary economies. This trend, visible in several countries in recent decades, largely stems from the deregulation of the financial system, as well as the liberalization of international capital movements (Stockhammer, 2012).

In Lagoa et al. (2013) we have extensively documented the various signs of financialisation in the Portuguese economy. 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. Following the euro area trend, stock market capitalisation of quoted shares increased from 20% of GDP in 1995 to 60% in 1999, oscillating around 40% thereafter, although always remaining below the euro area average level. Instead, market capitalisation of securities other than shares issued by non-financial corporations increased faster than, and well above, the euro area average since the middle 1990s (and especially after 2003), from a level of 5% of GDP in 1993 (similar to the euro area average) to 10% in 2000 and almost 20% in 2007 (which compares to 7% in each year in the euro area).

The present report complements the analysis of the Portuguese financial system's evolution put forward in Lagoa et al. (2013) by focusing on its effects on the long-run macroeconomic development and, especially, on the recent financial and economic crises in Portugal. After this introduction, the report 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. Long-run development in the era of financialisation since the early 1980s and the economic and financial crises

This section starts with an overview of the evolution of the Portuguese economy since the early 1980s, in order to grasp the main features of the financialisation process and its relation to the overall patterns of economic development in Portugal in recent decades. On the basis of this analysis, in subsection II.2, we discuss the classification of the long-run development of the Portuguese economy in the era of financialisation, referring to Hein's (2012) typology.

II.1. The long boom and the early bust: the Portuguese economy in the era of financialisation

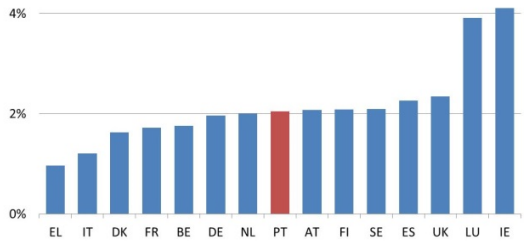
Between 1980 and 2013 the Portuguese economy grew at an average rate of 2% per year – the 8th highest rate among the 15 Western European countries that formed the EU until 2004 (Figure 1)[1]. In spite of this median performance, the aggregate behaviour of the Portuguese economy over this period did not coincide with the EU average (Figure 2): 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. As Figure 2 shows, Portugal started to fall behind the EU average GDP growth rate from 2000 onwards – while the economies of the other three

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

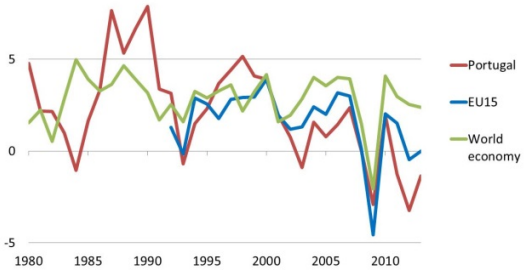
former 'Cohesion countries'[2] kept growing until 2007 at average growth rates that varied between 3.4% and 5%.

Figure 1 – Average annual GDP growth rates in the former EU15 countries, 1980-2013



Source: AMECO

Figure 2 – Annual GDP growth rates in Portugal, the former EU15 and the world economy, 1980-2013



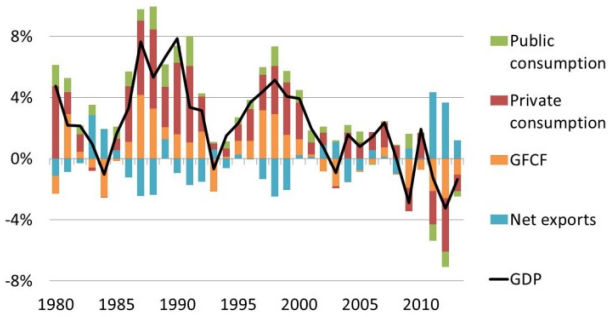
Sources: AMECO and IMF (WEO database)

The strong growth experienced by the Portuguese economy from the mid-1980s to 2000 was mostly driven by domestic demand (Figure 3): private consumption was responsible for 70% of GDP growth in the period, gross fixed capital formation (GFCF) for 36%, and public consumption for 21%[3]. 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 (Figure 4).

[2] The so-called "Cohesion countries" were the EU Member States which were eligible for the EU Cohesion Fund when this was created in the early 1990s, for having a GDP which at the time was less than 90% of the EU average. These included Ireland, Greece, Portugal, and Spain.

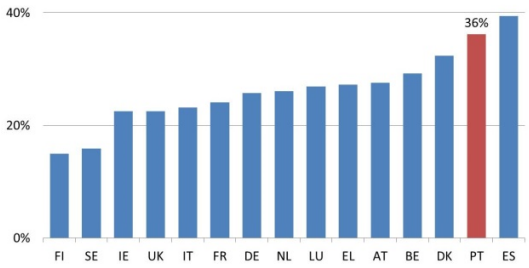
[3] This means that net exports had a negative contribution to GDP growth in this period.

Figure 3 – GDP growth and contributions of the main demand aggregates, 1980-2013



Source: AMECO

Figure 4 – Relative contribution of gross fixed capital formation to GDP growth between 1986 and 2000



Source: AMECO

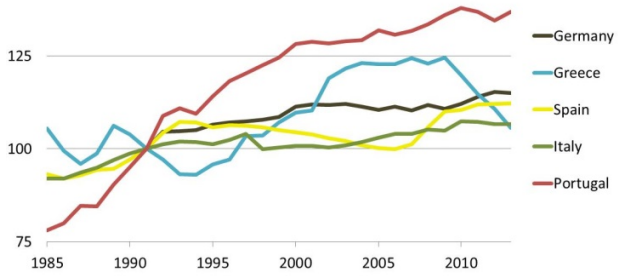
As Mamede (2014) puts it, the investment dynamics in Portugal during this period is both a cause and a result of economic growth: high growth expectations fostered new investments, which in turn contributed to stimulating further growth.

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[4], 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)[5]. Moreover, real wages increased fast between 1985 and 2000 (Figure 5), reflecting both the strong GDP growth over the period and an improvement in the wage share of GDP in the early 1990s (Figure 6).

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

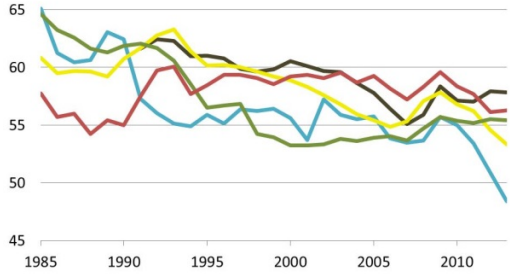
[5] The IMF intervention in Portugal in this period was due to a Balance of Payment crisis, which resulted from a combination of external factors (relating to the oil crises of the 1970s) and internal ones (mostly associated with the social, economic and political upheaval that followed the 1974 democratic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

Figure 5 – Real compensation per employee (1991=100)



Source: AMECO

Figure 6 – Adjusted wage share (% of GDP)



Source: AMECO

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[6] (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).

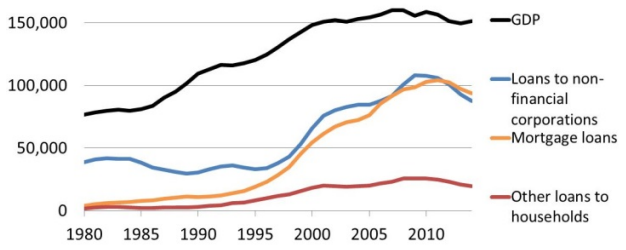
[6] Real long-term interest rates in Portugal fell from an average of 4.8% in 1993-1996 to 1.8% in 1997-2000.

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 7). 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 (Figure 8), although the expansion of credit during the period was a common feature across industries.

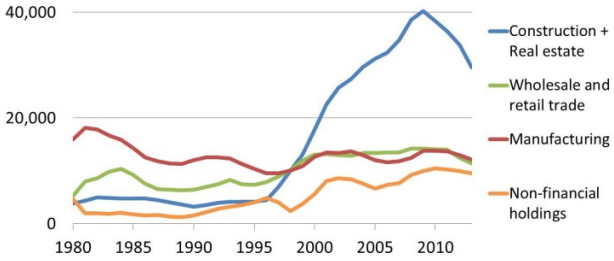
After 2000, the pace of growth of bank credit in the Portuguese economy slowed down, and became even more focused on household mortgage credit and on credit to NFCs operating in real estate and construction industries.

Figure 7 – GDP and bank loans to households and non-financial corporations, 1980-2014 (in M€, at 2005 prices)



Source: Bank of Portugal and AMECO

Figure 8 – Loans to non-financial corporations by industry, 1980-2014 (M€, at 2005 prices)



Source: Bank of Portugal and AMECO

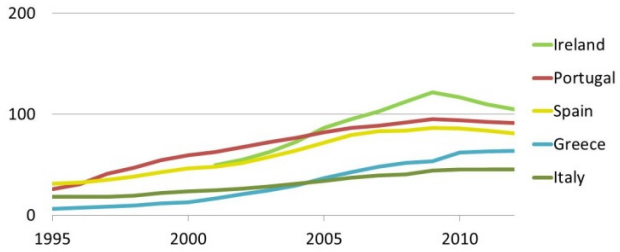
By 2007, Portuguese households had the 6th highest level of debt[7] in percentage of GDP among the EU Member States, while the Portuguese NFCs held the 4th position in the corresponding ranking[8]. Far from being a specific feature of the Portuguese economy, the rapid increase of private indebtedness from the mid-1990s until the advent of the subprime crisis was common to all the countries on the periphery of

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

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

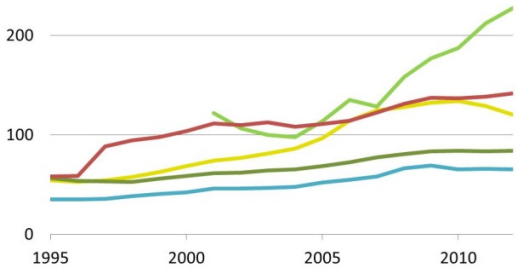
the euro area. What is peculiar about the Portuguese indebtedness experience is the timing: while in other countries the levels of indebtedness grew slowly until the turn of the century, accelerating only after 2000, in the Portuguese case the reverse happened – private sector debt in percentage of GDP grew most rapidly in the second half of the 1990s, growing slowly thereafter (particularly in the case of non-financial firms) (Figure 9 and Figure 10).

Figure 9 – Household debt (% of GDP) on the periphery of the euro area, 1995-2012



Source: Eurostat

Figure 10 – 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 (Figure 9 and Figure 10); 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[9]. A number of events account for this dramatic change of course.

[9] 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.

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[10]. 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. 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[11], imposing further pressure on exporting industries that are highly reliant on cost-competitiveness.

[10] 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.
[11] See section III.4.

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 (Mortágua and Mamede, 2014)[12]. 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).

II.2. Classifying the long-run development of the Portuguese economy in the era of financialisation

Hein (2012) puts forward a classification of long-run development patterns in the era of financialisation, consisting of four types of development paths: the 'debt-led consumption boom'; the 'domestic demand-led'; the 'weak export-led'; and the 'export-led mercantilist'. These types are identified on the basis of variables related to: the financial balances of the different institutional sectors in each country; the contribution of GDP demand components to GDP growth at the national level; and the current account and its components.

According to Hein's classification, Portugal belongs to the 'domestic demand-led' type of long-run development (e.g., Hein, 2012a). This corresponds to a group of countries in which domestic demand gives positive contributions to GDP growth without dominance of private consumption, while the balance of goods and services contributes negatively to economic growth. According to Hein's typology,

[12] 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.

the 'domestic demand-led' type contrasts with the 'debt-led consumption boom' type not only by a weaker reliance on private consumption as a growth engine, but also by the latter's negative financial household balances. In turn, both the 'domestic demand-led' and the 'debt-led consumption boom' types differentiate themselves from the 'export-led' development paths by the current account deficits that characterise the countries belonging to the former types (due not only to their tendency to run negative balances of goods and services, but also to the recurrent negative financial positions of the private sector in those countries).

In building his typology, Hein (2012a) takes as his reference the period between the euro's inception in 1999 and the subprime crisis in 2007. In order to take into account the sharp discontinuity in the performance of the Portuguese economy around 2000, emphasised in the previous subsection, we look at the key variables in Hein's analysis for two different periods: 1995-2000 (a period of strong economic growth and pervasive expansion of credit across institutional sectors and economic activities) and 2001-2007 (marked by economic stagnation, low credit growth, and an overweight of credit for housing, construction, and real estate purposes in total credit).

Table 1 presents data on GDP growth and on the corresponding contributions of the main demand components in those two periods, for the following economies: Portugal and Italy (both 'domestic demand-led' types); the three countries classified by Hein as 'debt-led consumption boom' types (Ireland, Greece and Spain); Germany (an 'export-led mercantilist' type); and the EU15 as a whole.

Table 1 – GDP growth and contributions of the main demand components in 1995-2000 and 2001-2007 (annual average, at 2005 prices)

	1995-2000					2001-2007				
	GDP growth	Contribution of:				GDP growth	Contribution of:			
		Private consum-ption	Public consum-ption	Gross fixed capital formation	Net exports		Private consum-ption	Public consum-ption	Gross fixed capital formation	Net exports
Ireland	9,5%	3,7%	1,0%	3,1%	1,8%	5,0%	2,3%	0,9%	1,4%	0,6%
Greece	3,4%	1,9%	0,8%	1,4%	-1,2%	4,2%	2,9%	0,6%	1,8%	-0,8%
Spain	3,9%	2,1%	0,5%	1,7%	-0,4%	3,4%	2,0%	0,9%	1,5%	-1,0%
Portugal	**3,6%**	**2,4%**	**0,7%**	**1,8%**	**-0,9%**	**1,1%**	**1,0%**	**0,3%**	**-0,3%**	**0,1%**
Italy	2,0%	1,4%	0,1%	0,8%	-0,2%	1,3%	0,5%	0,4%	0,4%	-0,1%
Germany	1,8%	0,9%	0,3%	0,4%	0,1%	1,4%	0,2%	0,1%	0,1%	1,0%
EU15	2,7%	1,6%	0,3%	0,8%	0,0%	2,1%	1,1%	0,4%	0,5%	0,1%

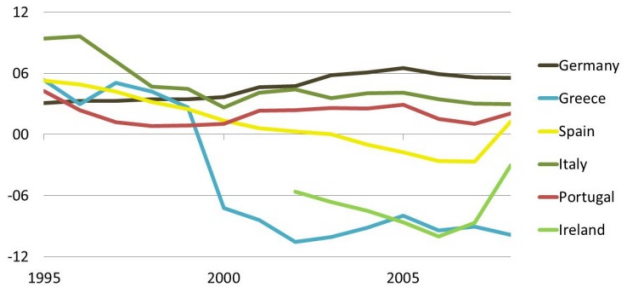
Source: AMECO

The contrast between Germany and all the remaining countries included in the table is clear for the period 2001-2007 (the right-hand part of the table): in the former case GDP growth was essentially driven by net exports, whereas in the latter cases economic growth accrued from domestic demand (with net external demand giving a negative contribution in most countries). However, the contrast between Portugal and the three 'debt-led consumption boom' type countries is less marked. Note that according to Hein's typology, the 'domestic demand-led' type differs from the 'debt-led consumption boom' type by a weaker reliance on private consumption as a growth engine. Table 1 shows that the contribution of private consumption to GDP growth in Portugal was the highest among the countries considered here – Ireland, Greece, and Spain (although GDP growth in Portugal was much lower than in these three 'debt-led consumption boom' type countries). As regards the period 1995-2000, the Portuguese case is actually indistinguishable from those observed for the 'debt-led consumption boom' type countries.

One should bear in mind, however, that the distinction between the 'domestic demand-led' type and the 'debt-led consumption boom', according to Hein's classification, relies not only on the variables presented in Table 1, but also on the financial balances of households (which tend to be positive in the former type and negative in the latter one). Figure 11 presents the evolution of the net lending/net

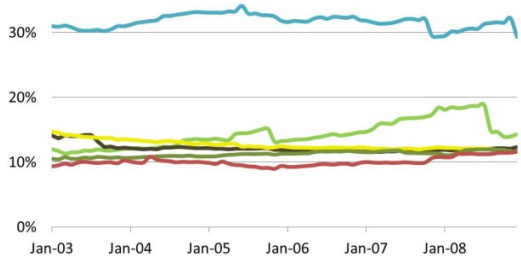
borrowing position of households between 1995 and 2008. It shows, indeed, that Irish, Greek, and Spanish households had negative positions in their financial transactions in most or all of the years between 2001 and 2007[13], in contrast with the case of Portuguese households (which maintained a net lending position over the period).

Figure 11 – Net lending (+) or net borrowing (-), households (% of GDP), 1995-2008



Source: AMECO

Figure 12 – Credit for consumption (as % of total loans to households)



Source: ECB

Note, however, that: (i) the liabilities of households are essentially determined by loans; (ii) with the exception of Greece, loans to households in the countries under analysis are overwhelmingly driven by mortgage credit, while the share of credit to consumption is modest (Figure 12); and (iii) the deterioration of the net lending/net borrowing position of households was faster in the Portuguese case before 2000, the difference with regard to the other countries being that the financial position of Portuguese households has stabilised since then.

The stabilisation of Portuguese households' financial position is consistent with the slowdown of credit growth discussed in the previous section (see Figure 7 and Figure 9), which is essentially explained by the dismal economic growth experienced by the Portuguese economy after 2000 (in sharp contrast to the other EU 'cohesion countries'). In other words, the reason why the net lending position of Portuguese households remained positive after 2000 (contrary to Greece, Spain, and Ireland) is that their indebtedness levels were already too high by the turn of the century, leading to a reduction in the

[13] Data for Ireland are only available from 2002 onwards.

growth of mortgage credit thereafter (again, contrary to those countries). In fact, the gross debt-to-income ratio of Portuguese households was 84% in 2000 – clearly above the euro area average (75%), and the values for Spain (69%) or Italy (34%)[14].

In sum, both the analysis of the contributions to GDP growth and of the financial positions of households suggests that the difference between Portugal and the 'debt-led consumption boom' countries is more related to timing than to substance. In this sense, the long run-development of Portugal after 1995 would arguably be better described as a '*debt-led domestic demand boom*' type – rather like Ireland, Greece, or Spain – in which GDP growth started to lose momentum at an earlier stage. We refer to 'domestic demand' since GDP growth in the second half of the 1990s was pushed both by private consumption and investment. Both were debt-led in the sense that the growth of investment and private consumption were strongly associated with a rapid increase in the levels of indebtedness of both private firms and households.

[14] The corresponding data are unavailable for Greece and Ireland.

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

In this section we discuss the long-run effects of financialisation in Portugal transmitted through four main channels: the distribution of income; investment in capital stock; consumption; and the current account.

III.1. Financialisation and distribution

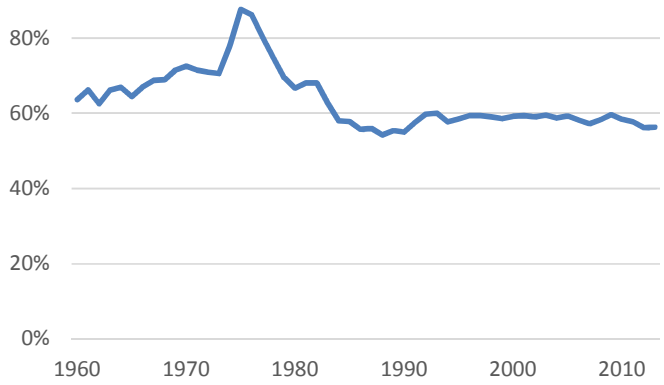
Financialisation processes are often associated with increasing income inequality, both in terms of functional and personal income distribution. We will discuss each of these in turn.

Functional income distribution

Functional income distribution refers to the distribution of income between workers and capital owners. In order to assess this we analyse the adjusted wage share, i.e., the ratio of compensation of employees to GDP (Figure 13). [15]

[15] AMECO defines adjusted wage share as [(Compensation of employees / (GDP at current factor costs)]/ [(Total full time equivalent employment)/ (Full-time equivalent employees)]. The adjustment factor corrects for part-time workers and for self-employment.

Figure 13 – Adjusted wage share as percentage of GDP at current market prices per person employed



Note: adjusted for full time equivalent employees. Source: AMECO.

The evolution of the adjusted wage share in Portugal in the last half century can be divided into five main periods.

From the early 1960s to the early 1970s, the wage share rose gradually, as a result of two main factors (Lagoa et al., 2013): the rapid industrialisation of the Portuguese economy, which followed accession to the European Free Trade Association (EFTA) in 1960; and the Colonial War (1961-1974), which had multiple implications for the evolution of the Portuguese economy and society, including a rise in real wages.

During the revolutionary period of 1974-1976 – following the military coup which led to the democratisation of the country after 48 years of conservative dictatorship – real wages rose sharply in comparison to labour productivity, as a result of social pressure for fast improvements in living conditions and radical left-wing oriented economic policies. This explains the large increase in the labour share in the period 1975-76.

In the post-revolutionary period the adjusted wage share decreased steeply, from 88% in 1976 to 54% in 1988. This was a period marked by international economic crises, recurrent external imbalances at the national level, and two adjustment programmes conducted by the IMF (see Lagoa et al., 2013), which translated into a drop in real wages. In contrast, between 1988 and 1993 the adjusted wage share increased to 60%, reflecting the strong economic growth experienced by Portugal during this period.

Since the mid-1990s and until the global recession following the subprime crisis, the adjusted wage share remained stable, decreasing thereafter as a result of the increase in unemployment, as well as the adjustment measures implemented after 2010 (which translate into wages reductions, both in the public and the private sector). The stabilisation of adjusted wage share since the mid-1990s to 2010 occurred despite a reduction in the power of the unions and the increase in competition from abroad (more on this below).

In sum, the increasing importance of finance after 1995 did not translate immediately into a decline in the wage share in Portugal. Other factors may have been at work which affected the evolution of the wage share, as will be discussed below.

The determinants of the labour share

The decline in the labour income share has been a common trend in most advanced economies since the early 1980s. Several authors relate this trend to the process of financialisation that occurred over the same period (Stockhammer, 2009 and 2012; Kristal, 2010; Peralta and Escalonilla, 2011; Seguino, 2011; Estrada and Valdeolivas, 2012; Dünhaupt, 2011, 2013a and 2013b; Hein, 2013; among others).

Three different channels through which financialisation has led to an increase in functional income inequality can be pointed out (e.g., Hein, 2012, 2013). The first channel is associated with a change in the sectorial composition of the economy, visible in the increasing importance of the financial sector in relation to the non-financial sector and the decreasing weight of government activity in the respective gross value added. The second channel is related to a rise in the profit claims of the rentiers, given the emergence of the paradigm of "shareholder orientation" that has led to a reduction in labour costs. Finally, the third channel is connected with the weakening of the power of the trade unions and, as such, with workers' reduced bargaining power. Explanations for the recent decline in trade union power include: the aforementioned paradigm of "shareholder orientation" in corporate governance; the increasing importance of finance; the downsizing activity of the public sector; the deregulation of labour markets; and liberalisation and globalisation.

Despite the increasing amount of theoretical work on the effects of financialisation on the functional distribution of income, empirical studies of this phenomenon do not abound (Peralta and Escalonilla,

2011; and Dünhaupt, 2013). Nonetheless, a relatively small body of empirical literature has emerged in recent years econometrically assessing the impact of financialisation on functional income distribution. Most of these empirical studies find statistical evidence supporting the theoretical claim that financialisation has been driving the increase in functional income inequality, which is visible in the rise of profit shares in detriment of labour income shares (Stockhammer, 2009; Kristal, 2010; Peralta and Escalonilla, 2011; Dünhaupt, 2013; Lin and Tomaskovic-Devey, 2013; Karanassou and Sala, 2013).

Against this backdrop, Barradas and Lagoa (2014a) estimate an aggregate labour income share function for Portugal, including control variables (technological progress, globalisation, education and the business cycle) and four other variables to isolate the effects of financialisation (financial activity, government activity, shareholder orientation, and trade union density). They use annual data between 1978 and 2010 and the methodology related with ARDL models. It is found that the variables are cointegrated and in the long term all variables are statistically significant at traditional significance levels, as demonstrated in Table 2.

Table 2 – The long-term estimations: labour share as dependent variable

Variable	*Coefficient*	*Standard Error*	*T-Statistic*
TP	*-1,625****	*0,131*	*-12,361*
GL	*-0,302****	*0,043*	*-7,097*
ED	*0,135****	*0,013*	*10,422*
BC	*0,965****	*0,087*	*11,137*
FA	*0,426****	*0,105*	*4,063*
GA	*1,134****	*0,176*	*6,444*
SO	*0,522****	*0,080*	*6,557*
TU	*0,640****	*0,038*	*16,945*
Constant	*0,286****	*0,055*	*5,244*

Note: *** indicates statistically significance at 1% level. ***TP*** – Total Factor Productivity (growth); ***GL*** – Globalization (exports and imports divided by GDP); ***ED*** – Education (schooling-rate of upper-secondary education); ***BC*** – Business Cycle (GDP growth); ***FA*** – Financial Activity (gross value added of financial and real estate activities divided by the total gross value added of the economy); ***GA*** – Government Activity (gross value added of general government divided by the total gross value added of the economy); ***SO*** – Shareholder Orientation of NFCs (difference between dividends paid and received divided by gross value added); ***TU*** – Trade Union (wage and salary earners that are trade union members divided by the total number of wage and salary earners).

The most important finding is that all the variables related with financialisation have a positive effect on labour income share. While the positive impact of government activity and trade union are expected,

the effect of financial activity and shareholder orientation are unexpected from the literature. The positive effect of financial activity could be associated with the fact that wages in the financial sector in Portugal are higher than in other sectors. On the other hand, the positive impact of shareholder orientation may be related with the fact that a higher level of pay-out ratio could be associated with a better economic and financial situation of the non-financial corporations, which may also promote an increase of wages of their workers.

Another aspect of income inequality regards personal income. Some studies attempt econometrically to assess the role of financialisation on personal income distribution (e.g., Assa, 2012; Kus, 2012; Czaplicki and Wieprzowski, 2013; and Karanassou and Sala, 2013). These studies use the traditional measure of Gini coefficient as dependent variables, concluding that financialisation has had a significant negative impact on personal income equality levels. To the best of our knowledge, there is no similar study for Portugal, possibly due to the non-existence of long historical data on Gini coefficients.

Rentier income

In the past two decades, in most industrial countries the wage share has declined. If financialisation is responsible for this decline, then rentiers should benefit from it. The analysis of the rentier income share on the national income of Germany and the US has been done by Dunhaupt (2012). In order to conduct a similar study for Portugal, we start by noting that the net national income is obtained as:

Wages + (Operating Surplus) + (Indirect taxes) – Subsidies

Property income is paid out of the operating surplus, and it corresponds to:

(distributed income of corporations) + Interests + Rents + (reinvested earnings of FDI) + (property income attributed to insurance policy holders)

For the economy as a whole (if there was no rest of the world), the net property income (received minus paid) would be zero, as the income paid by one sector is received by another.

Therefore, to obtain the rentier income we use only the net property income of households since they are the recipients of the money paid by corporations and the Government[16]. Confirming this argument is the fact that corporations have a very small net property income.

Rentier income is only one of the components of the net national income, which is obtained as:

> (Rentier income) + (Compensation of employees) + (Operating surplus/mixed income of households) + (Primary income of Government) + (Primary income of non-financial and financial corporations)

The latter element is approximately the retained earnings of corporations. Using this formula we can assess the evolution of the other elements of the national income in comparison with the rentier income, namely the compensation of employees and the retained earnings of corporations.

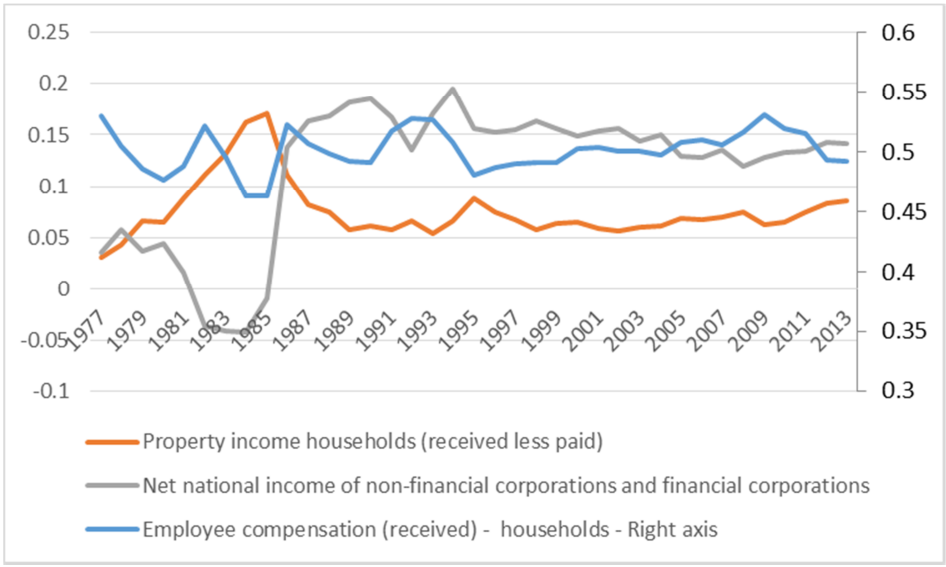
Looking at Figure 14, over the whole period we observe that property income has not shown a tendency to increase. Property income grew significantly only in the period 1977-1986, due to the increase in deposit interest rates (which reached a historical maximum in 1984/85). Possibly as a result of the high interest rates, during the period 1977-1986 there was also a strong decline in the gross primary income of corporations, which indeed became negative in some years.

After a period of mild decrease in 1995-2002, there was a slow and small increase in property income during 2003-2013.

Between 1995 and 2008 there was a tendency for an increase in employee compensation, which was matched by a decrease in the gross primary income of corporations. In 2009, the economic crisis led to a fundamental change, with a decrease in compensation and an increase in retained earnings and rentier income.

[16] In a different approach, Power, Epstein and Abrena (2003) define the rentier income as the profit of financial firms plus the interest income of the rest of the private economy. Since they exclude dividend payments, an important component of the financialisation of corporations, we opt not to use this definition of rentier income.

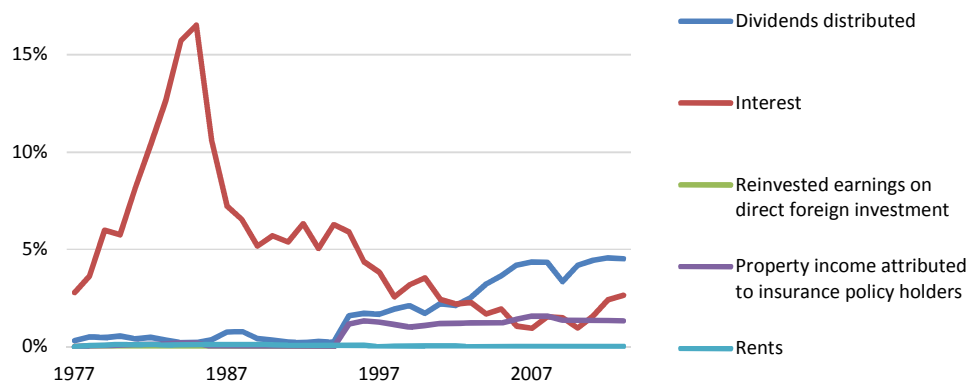
Figure 14 – Property income and its counterparties (in proportion of gross national income)



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

In terms of the components of the rentier income, rents are insignificant, while property income of insurance policy holders has gained some importance since 1995, but it has remained roughly constant since then (Figure 15). The two major components of the rentier income, interests and dividends, had different evolutions. The interest share decreased up to 2010 in line with the decrease in interest rates. From 2011 to 2013 there was an increase in interest received, partially explained by the increase in the interest rates of deposits and government securities. Instead, distributed dividends had an upward trend from 1995. From 2003 to 2008 the increase in the share of dividends explains the increase in the property income of households.

Figure 15 – Breakdown of primary income (in percentage of gross national income)



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

Until now we have referred to gross national income due to the lack of data for the consumption of fixed capital before 1995. However, Duenhaupt (2012) computes the rentier share for Germany and the US using the net national income. For comparative purposes, we re-calculated the rentier income in proportion of the net national income from 1995 (see Figure 47 in Appendix).

Using the data in Duenhaupt (2012) for Germany and the US, we observe that during the whole comparable period property income in Portugal was smaller than in Germany. In 2008 that indicator was around 17% in Germany and 7.4% in Portugal; in 2006, it was 7% in the US and 6.6% in Portugal.

Personal/household distribution of income

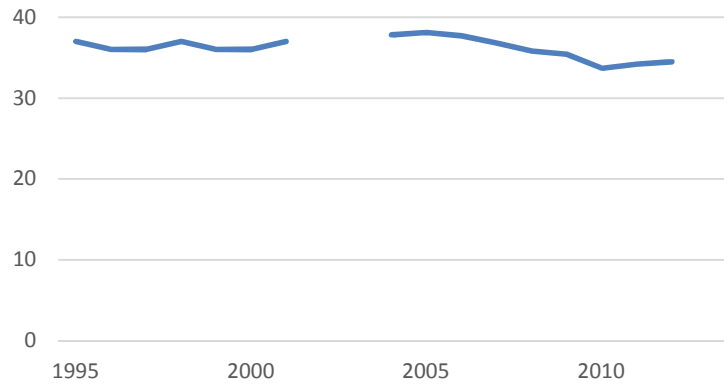
Another dimension of income inequality regards personal income. The Gini coefficient of income is the most common measure of personal income inequality. Some studies econometrically assess the role of financialisation on personal income distribution (i.e. on the Gini coefficient), as is the case of Assa (2012), Kus (2012), Czaplicki and Wieprzowski (2013) and Karanassou and Sala (2013). In general, they conclude that financialisation has a significant negative impact on personal income equality levels. To the best of our knowledge, there is no econometric study analysing this issue for Portugal, possibly due to the non-existence of long historical data on Gini coefficients.

In fact, there is no comparable series for the Gini coefficient from 1980 in Portugal, and one has to resort to several sources to get a complete picture of the whole period. Although different sources cannot be compared, they can be used to characterise the evolution of income inequality during the period for which they are available.

Between 1980 and 1990 the inequality of income measured by the Gini coefficient decreased slightly from 33% to 32% (Gouveia and Tavares, 1995). From 1989 to 1994 the evolution is the opposite with the Gini coefficient of total income going from 31.5% to 34.6% (Rodrigues e Andrade, 2013).[17]

From 1995 onwards, data is available from Eurostat[18], showing that household income inequality was roughly constant until 2001, while from 2001 to 2005 the Gini coefficient increased by 1 percentage point (p.p.) (Figure 16). From 2006 to 2010 income inequality decreased strongly (4 p.p.). In 2011 and 2012 the Gini coefficient increased almost 1 p.p., probably due to the effects of the sovereign debt crisis. Despite some oscillations, between 1995 and 2013 the overall tendency is for a decrease in income inequality.

Figure 16 – Gini-Coefficient of Equivalised Disposable Income (%)



Source: Eurostat

[17] Using disposable income by equivalised adult, total income - including non-monetary income - based on the INE Household Budget Survey.

[18] Eurostat data excludes non-monetary income. Disposable income includes market income (received from work and from investment and property) and social transfers in cash including old-age pensions. Disposable income is obtained by deducting direct taxes from gross income.

The only source that shows comparable data covering the period from 1989 to 2009 is Rodrigues and Andrade (2013). According to these data, the Gini coefficient of total income[19] grew from 31.5% in 1989 to approximately 36.3% in 2009, indicating a clear increase in personal inequality during the whole period.

Comparing the Gini coefficient between Portugal and other European countries, we conclude that Portugal is the third most unequal country in the EU (after Spain and Latvia). Nevertheless, the comparative evolution of inequality in Portugal between 1995 and 2012 was positive, with the Gini coefficient decreasing by -2.5 p.p. in Portugal and only -0.3 p.p. in the EU15. The reduction observed in Portugal was one of the largest in the EU15. These results are confirmed if we measure income inequality using the ratio of total income received by the top quintile to that received by the lowest quintile (Lagoa et al., 2013).

It can be argued that the reduction of inequality, especially after 2005, was obtained due to social transfers. But even if we look at the Gini coefficient before social transfers (pensions included in social transfers) there is a slight decrease in the indicator (-0.9 p.p.) between 2005 and 2011 (Table 2).[20] After social transfers the decline is much larger, -3.9 p.p., showing the relevance of social transfers in reducing income inequality.

However, looking at the Gini coefficient before *taxes* and social transfers from the OECD, we observe an increase in inequality in the period 2005-11, which was even larger than in the EU15 (Table 3). Even excluding the crisis years from our analysis, and focusing on the period 2004-08, we still have an increase in inequality in Portugal (+2.2 p.p.) larger than in Europe (-0.5 p.p.). Moreover, these data show that the tax system has been paramount in decreasing disposable income inequality.

[19] Total income includes monetary income plus consumption of own production, wages in kinds, imputed rents of house owners, etc.

[20] Eurostat has only released data for this indicator since 2004.

Table 2 –Gini coefficient before and after social transfers

	2005	2011	2005-11
Gini coefficient after social transfers			
EU 15	29.9	30.9	1.0
Portugal	38.1	34.2	-3.9
Gini coefficient before social transfers (pensions excluded from social transfers)			
EU 15	35.7	37.0	1.3
Portugal	41.3	38.5	-2.8
Gini coefficient before social transfers (pensions included in social transfers)			
EU 15	48.9	51.4	2.5
Portugal	51.2	50.3	-0.9
Gini coefficient before taxes and social transfers			
EU 15 (simple average)	47.4	50.4	3.0
Portugal	50.3	53.7	3.3

Source: Eurostat. Data on the Gini coefficient before taxes and social tranfers is from the OECD. These data are also based on the EU Survey of Income and Living Conditions (EU SILC).

An important indicator to characterise the extremes of the distribution is the ratio between the proportion of income of the tenth and first (the lowest) deciles (Indicator S90/S10). Between 1980 and 1990 we observe a slight reduction in the difference between the income held by the tenth and first deciles (Gouveia and Tavares, 1995) (Table 3).

Table 3 – Indicators S90/S10 , S50/S10 and S90/S50 (1980 and 1990)

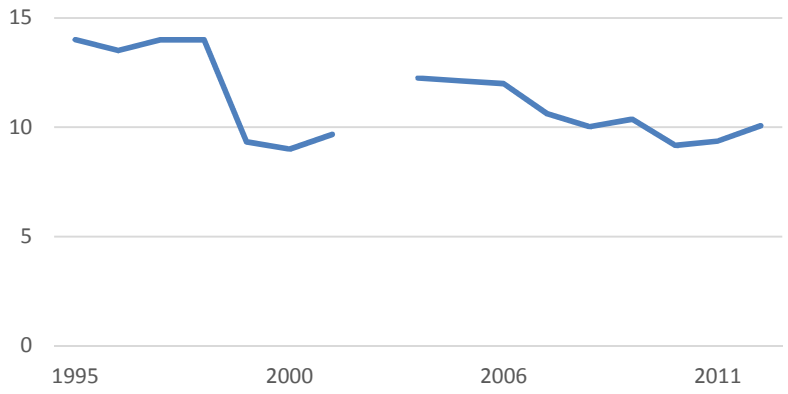
	1980	1990
Tenth decile / First decile	8.9	7.8
Tenth decile / Fifth decile	3.5	3.4
Fifth decile / First decile	2.5	2.3

Source: computed with data from Gouveia and Tavares (1995)

From 1989 to 1994 that indicator had an increase from 7.9 to 9.4 (Rodrigues and Andrade, 2013). For the period 1995 to 2012, we used data from Eurostat (not fully compatible with Gouveia and Tavares, 1995; and Rodrigues and Andrade, 2013), concluding that the inequality between the richest and the poorest reduced from 14 to 10 (Figure 17). Nevertheless, between 2001 and 2004 the gap between the

richest and the poorest increased. Overall, the indicator S90/S10 confirms the picture drawn with regard to the Gini coefficient.

Figure 17 – Indicator S90/S10 (1995-2012)



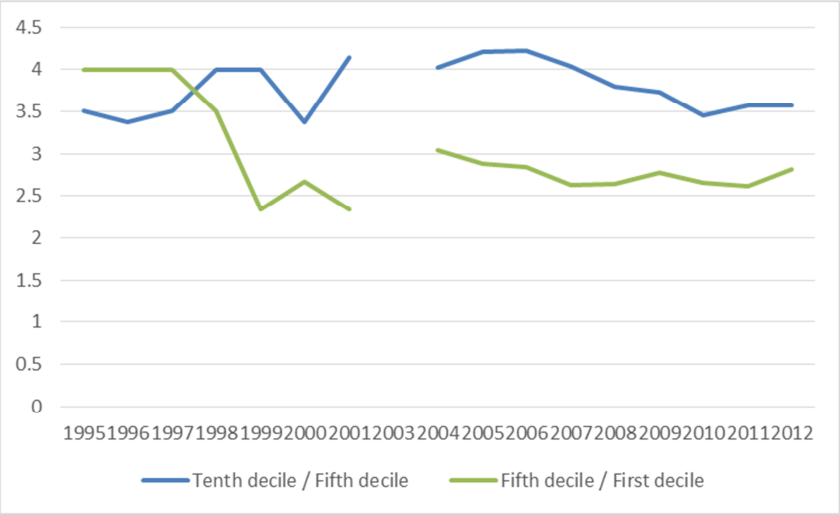
Source: Eurostat

For the whole period 1989-2009, Rodrigues and Andrade (2013) compute the indicator S90/S10, and the overall picture is similar to that obtained with the Gini coefficient computed by the same authors.

In order to assess the evolution of the 'middle class', we now study the ratio between the deciles at the extremes and the middle decile, S90/S5 and S5/S1. Between 1980 and 1990 the income of the poorest population improved with regard to the middle income group, and there is also an approximation of the middle income to the highest income group (Table 3).[21] Between 1995 and 2012 the situation is different (Figure 18): in 2012 the population in the middle of the distribution maintained the same position that they had in 1995 in comparison with the richest persons; however, the poorest persons improved their position in relation to the middle income population. That is, the middle class did not improve its position with regard to the richest from 1995 onwards.

[21] We do not have data for this indicator for the period 1989 to 1994.

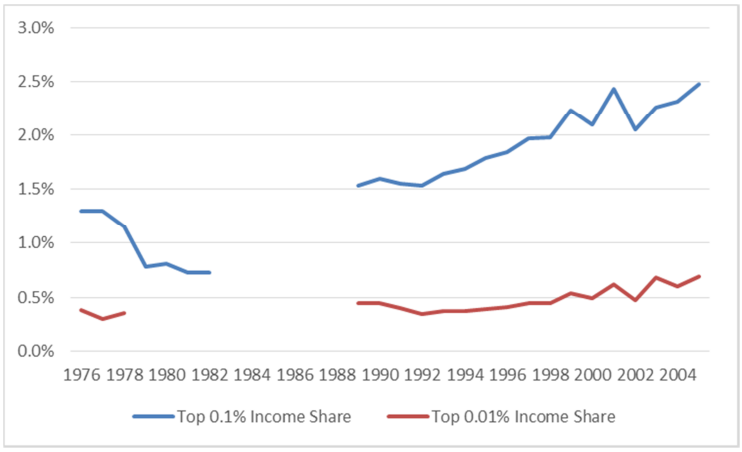
Figure 18 –Indicators S50/S10 and S90/S50 (1995-2012)



Source: Eurostat

Looking at the very rich group of the population (top 0.1%), we observe a decline in the share of their income between 1977 and 1982, but from 1989 to 2005 their income share increased considerably (Figure 19).

Figure 19 – Income of the very rich population (in proportion to total income)



Source: The World Top Incomes Database

Evolution of poverty

In what follows, we complement our previous analysis of inequality indicators with other measures of population well-being, namely the at-risk-of-poverty rate after social transfers (referred to as 'poverty rate')[22].

In 2010, Portugal was one of the countries with the highest percentage of population at-risk-of-poverty (17.9%), only supplanted by Greece, Spain and Italy. These data reveal that the Southern countries have a model of capitalism that generates more poverty than the rest of the EU15 (Hall and Soskice, 2001). Despite this, between 2000 and 2010, Portugal made one of the strongest efforts to reduce poverty in the EU15. In that period, poverty declined 3.1 p.p. in Portugal and increased 1.3 p.p. in the EU15. The increase of poverty in the EU15 may result from a set of factors that challenged the European Social Model in the early 2000s, namely: globalisation, Europe's slow economic growth, and population ageing (Marques, Salavisa e Lagoa, 2012).

A similar picture is obtained if we look at the indicator of at-risk-of-poverty *and social exclusion*[23], which combines three indicators: persons living in households with very low work intensity, persons at-risk-of-poverty after social transfers, and severely materially deprived persons.

By looking at the percentage of people at-risk-of-poverty before and after social transfers (data not reported), the Portuguese Welfare State seems to be able to bring more people out of poverty than the Italian and Greek, given the higher impact of social transfers in reducing the poverty rate. It is worth noting, however, that the poverty rate in Portugal experienced a slight decline from 27% in 2000 to 26.4% in 2010, even before considering social transfers.

[22] The poverty rate is the proportion of persons with an equivalised disposable income below 60 per cent of the national median equivalised disposable income (after social transfers).

[23] Eurostat, EU-SILC.

In conclusion, the preceding analysis indicates that in 2010 Portugal was one of the most unequal countries of the EU15 and had one of the highest poverty rates, although the situation has improved in both dimensions since 2000. Regarding the high levels of inequality in Portugal in the EU context, this is a structural characteristic of the Portuguese economy that was already present before the growth of finance in the past decades. As such, it is hard to sustain that the former has been driven by the latter.

Other effects of financialisation and additional factors explaining personal income inequality

Another channel through which financialisation may affect income inequality is the decrease in trade union power. This decrease has indeed occurred in Portugal as shown by the continued decrease in union rate membership (Figure 52). The reduction of union power cannot be attributed only directly to financialisation, also because the major decrease in that indicator did not occur during the period of larger growth of finance. There are other factors, indirectly related to finance, that contributed to decreasing union membership rates, such as: the deindustrialisation of the economy (also as a result of the decrease of inward FDI directed at industry); the reduction in the number of public sector workers (only in the period 2005-2012); privatisations; and the increase in the precariousness of labour relations, partially as a result of the liberalisation of the labour market.

One further factor that may have contributed to the growth of income inequality was the increase in competition from abroad, reflected in a higher degree of openness of the Portuguese economy (Figure 51). As was mentioned in Section II, given its trade specialisation, the Portuguese economy was particularly hit by growing competition in trade and FDI attraction from the emerging Asian economies and Eastern and Central European countries. According to the Heckscher-Ohlin model of international trade, an increase in trade between developed and developing/emerging countries will equalise wages, with wages in developed countries decreasing. This creates pressure for an increase in inequality in developed countries, as the lower wages connected to more labour intensive activities are the ones that suffer a larger effect from international competition. The inequality impact of trade is lower when the commercial exchanges are among developed countries, where intra-industry trade prevails. Moreover, the increase in the international mobility of firms, both national and international, reduces the bargaining power of workers, leading to lower wages and worse working conditions.

On the other hand, a set of factors may explain the overall decrease in personal income inequality registered between 1995 and 2013. Firstly, the increase in government expenditure is a key explanatory factor (Figure 48 in the Appendix), since, as we have seen, inequality after social transfers had a much larger decline than inequality before social transfers.

Secondly, educational levels have improved significantly since 1998 (Figure 49 in Appendix). In general, the economic and social conditions in Portugal converged with the European average, which implies an increase in many indicators, among which a reduction in income inequality. The growth of the economy was high from 1996 to 2001, and was accompanied by a reduction in unemployment and considerably small unemployment rates (Figure 50). This helps to explain the rapid increase in real compensation per employee between 1995 and 2000 (Figure 5). Yet economic growth slowed down after 2002, and unemployment increased considerably, making the reduction in inequality in that period even more surprising.

Conclusion

From 1980 to 2013 the wage share declined, indicating a worsening of functional income distribution. But in the period between 1994 and 2009 the wage share remained essentially constant, and from 2010 to 2013 it declined considerably due to the crises hitting Portugal.

For the whole period of 1980 to 2013 property income did not show a tendency to increase. However, rentier income share increased between 2003 and 2013, basically due to an increase in dividends.

Regarding personal disposable income inequality, it increased strongly in 1989-94 before the major growth of finance in 1995-2009. After 1995, there was an overall decline in income inequality, with a temporary increase only in 2001-05. Despite improvement in disposable income inequality and poverty rates, in 2010 Portugal was still one of the most unequal countries in the EU15, having one of the highest poverty rates. Since 1995, the reduction in inequality has been achieved by the improvement of the position of the poorest households, and not by upgrading the position of the middle class. Yet there was also a clear increase in the share of income held by top incomes from 1989 to 2005. Another indicator pointing to a deterioration of income distribution is the increase in the Gini coefficient of income before taxes and social transfers in the period 2004-11.

In summary, we do not find a generalised increase of personal inequality (after taxes and social transfers) and functional inequality in the period in which finance grew the most (1995-2009). 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, is substantially increasing both functional and personal income inequality. Thirdly, there were other factors positively affecting inequality in the period, namely the growing size of social policies.

III.2. Financialisation and investment in capital stock

There is a stream of research within the financialisation literature (Orhangazi, 2008a and 2008b; Hein, 2009, 2012; Hein and van Treeck, 2010; Hein and Dodig, 2013; among others) that analyse the impact of financialisation on corporate investment through two main channels.

The first channel is associated with the rise of investment in financial assets by non-financial corporations. Given the fact that both external and internal funds are limited, it is argued, corporate investment in financial assets diverts funds from real activities (the "crowding out" effect). It is therefore a "management's preference channel", as labelled by Hein (2009, 2012) and Hein and Dodig (2013). Different explanations are put forward to describe this stance of non-financial corporations, such as: *(i)* the tendency to focus on current profitability, rather than long-term growth (Crotty, 1990; Orhangazi 2008a and 2008b; Hein, 2009); *(ii)* the predominance of shorter planning horizons (Crotty, 2005); *(iii)* the reduction of profits from the real sector and the increase in the costs of external funds since the 1980s (Crotty, 2005; Orhangazi, 2008a and 2008b); and *(iv)* macroeconomic uncertainty and institutional changes at corporate governance level (Akkemik and Özen, 2014).

The second channel through which the effects of financialisation are transmitted to corporate investment is related with the strong pressures exerted over non-financial corporations to increase their

payments to financial markets in the form of interests, dividends and/or stock buybacks. According to this stream of literature, this leads to lower retention ratios, which also reduces the available funds to put in place new real investments. It is an "internal means of finance" channel, as Hein (2009, 2012) and Hein and Dodig (2013) call it. This behaviour has been exacerbated by different factors, such as: *(i)* the high levels of indebtedness of non-financial corporations, which lead to the growth in interest payments (Orhangazi, 2008a and 2008b); *(ii)* a new design of corporate governance in favour of the maximisation of shareholder value (Lazonick and O'Sullivan, 2000; Stockhammer, 2010; van der Zwan, 2014); *(iii)* the existence of remuneration schemes based on the short-term evolution of stock prices (Orhangazi, 2008a and 2008b); and *(iv)* the growing importance of institutional investors (Orhangazi, 2008a and 2008b).

Despite the increasing amount of theoretical work on the effects of financialisation on corporate investment, empirical studies on this impact do not abound, as noted by Onaran et al. (2011). Nevertheless, a number of works use investment equations to estimate the impact of financialisation on real investment (Stockhammer, 2004; Orhangazi, 2008a and 2008b; Van Treeck, 2008; and Onaran *et al.*, 2011). Typically, the first channel is measured through the share of dividends and interest received (i.e., financial receipts), while the second channel is proxied by the weight of dividends and interest paid (i.e., financial payments). Most of these empirical studies find statistical evidence supporting the theoretical claim that financialisation does indeed have a negative impact on real investment by non-financial corporations.

The Evolution of investment in Portugal

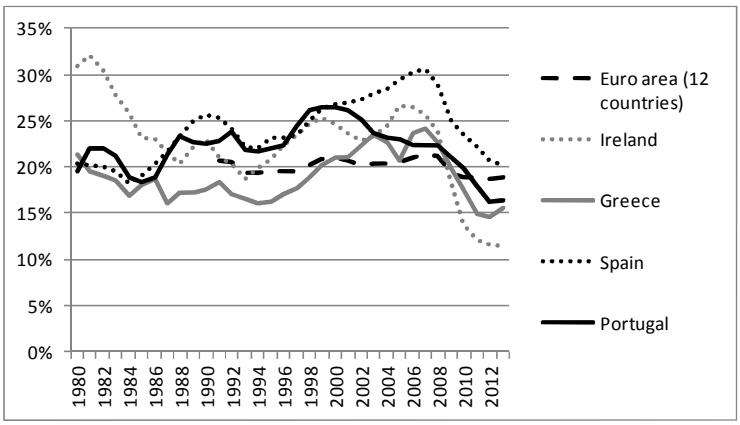
Arguably, one negative consequence of financialisation is that financial activities crowd-out real investment, reducing its level and efficacy. In order to understand whether this was the case in Portugal, we start by taking a broader view on investment, as financial factors are only part of the determinants of investment.

For the whole period of 1980-2008, investment in Portugal (in percentage of GDP) was above the EA12 average; in fact, it was high even in comparison to the remaining cohesion countries (Greece, Ireland, and Spain) – see Figure 20. The reasons for the high investment rate in that period are largely found in the underdevelopment of public infrastructure and the need to modernise firms' technology, especially

in the period 1980-2000. Investment was also fostered by the reduction in interest rates during the convergence process to the EA, the rapid growth of credit and by the EU structural funds.

In contrast with the high levels of investment until 2000, from 2001 to 2008 the share of total investment in GDP declined in Portugal due to a number of factors, such as: low growth prospects (associated with the dismal performance of the domestic economy and the increasing competition from outside the EU), growing levels of indebtedness, the increase in interest rates in some years, and also the fulfilling of investment needs in earlier periods (especially, with regard to public infrastructure). The rapid decline in investment after 2008 in Portugal can be attributed to the international crisis of 2008 and 2009 and, later, to the so-called 'sovereign debt crisis' starting in 2010, which implied a strong reduction in credit and even drearier prospects of economic growth.

Figure 20 – Gross fixed capital formation at 2005 prices (% of GDP)



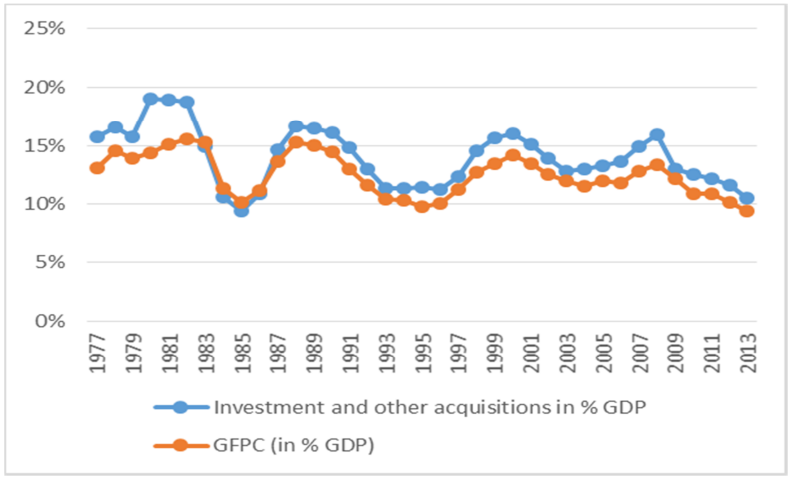
Source: AMECO

As regards investment by non-financial firms, since the 1980s the Gross Formation of Physical Capital (GFPC)[24] of NFC has evolved in cycles, largely in line with the evolution of the business cycle. However, we can observe a slight negative trend in GFPC to GDP since 1980, which is more pronounced after 2000, as occurred in total investment.

[24] Investment includes GFFC, change in inventories and other acquisitions (including of land).

The reasons for the negative trend in the investment of NFC after 2000 are similar to the ones presented for total investment, namely the negative trend in the growth rate of GDP from 1999 and the increase in the cost of capital (real interest rate) from 2005 (Figure 53 in the Appendix). Another factor contributing to the decline in investment was the decline in the profitability of NFC (Profit/Gross value added) between 1999 and 2008 (Figure 54 in the Appendix).

Figure 21 –Investment and GFPC of NFC in % of GDP



Source: Ine Contas Nacionais (up to 1994) and Eurostat (from 1995).

The question that we will try to answer in the following sections is whether financialisation may have contributed to the decline in investment of NFC, especially after 2001, through the channels previously discussed.

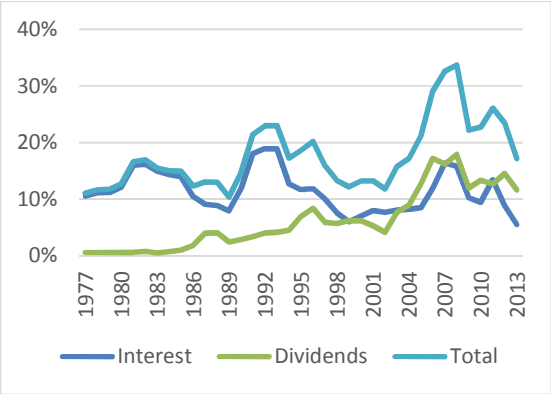
Contribution of financial profits to operating surplus

As previously discussed, financialisation has arguably two effects on NFCs. On the one hand, firms tend to invest more in financial activities, thus diverting funds from real investment. On the other hand, financial markets demand more payments from NFC, therefore reducing the capacity to finance real investment through retaining earnings. Note that the latter effect may be linked to an increase in indebtedness, which leads to increasing interest payments by corporations.

Regarding the first effect, total financial receipts in percentage of Gross Operating Surplus (GOS) had an overall positive trend in Portugal, despite some oscillation (Figure 22). The main increase occurred between 2003 and 2008. Looking at the components of financial receipts (interest and dividends), we observe that interest received does not have a clear tendency and fluctuates considerably with the interest rate; in contrast, dividends followed a positive trend from the mid-1980s.

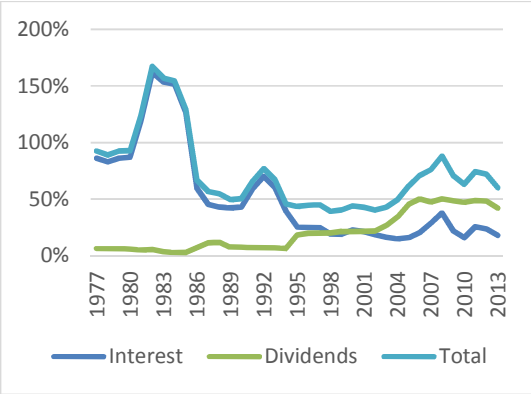
Regarding the second effect of financialisation, there was a decreasing trend on financial payments in proportion of GOS from 1982 to 1994 (Figure 23). Between 1995 and 2003 financial payments in proportion of GOS remained relatively stable, then increasing between 2004 and 2008, and slightly decreasing thereafter. The decline in financial payments up to 2003 is determined by the decline in interests paid, which is explained by the large decrease in interest rates. Inversely, the increase in interest paid in 2006-08 is explained by the increase in interest rates in the period, clearly illustrating the risks associated with interest rate rises in a context marked by high corporate debt ratios. As regards dividends paid, these increased moderately from the mid-1990s, and more rapidly in the mid-2000s, stabilising thereafter.

Figure 22 – Receipts of NFC in % of GOS



Sources: INE National Accounts by institutional sector

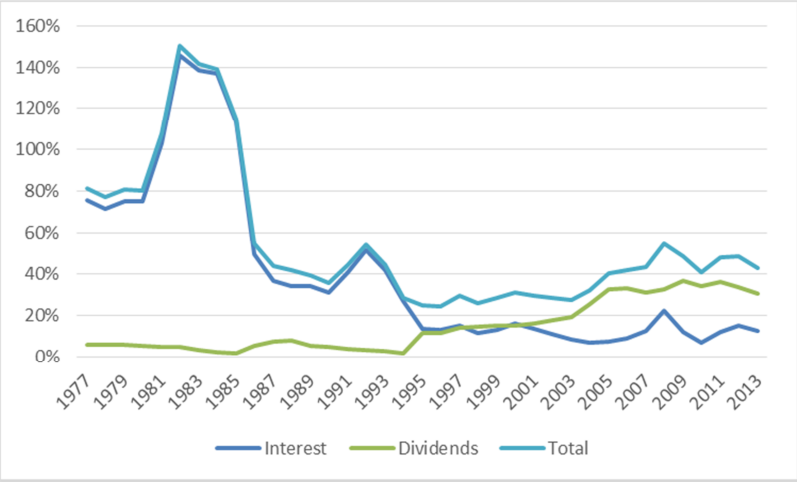
Figure 23 –Payments of NFC in % of GOS



Source: INE National Accounts by institutional sector

Given that, as expected, financial payments were higher than financial receipts, in net terms the Portuguese NFC displayed a negative position against financial markets and institutions. Net payments to financial markets decreased considerably between 1982 and 1996, increased from 1997 to 2008, and declined slightly from 2009 (Figure 24).

Figure 24 – Payments minus receipts of NFC (% of GOS)



Source: INE National Accounts by institutional sector

The rise of payments to financial actors between 2003 and 2008, and the rise of financial receipts between 2004 and 2008, may have contributed to a decline in investment through the two channels referred to above. The rise in net payments between 1997 and 2008 may also be added as a factor contributing to the negative trend in NFC investment since 2001. The main effects of financialisation may have been felt through an increase in dividends (both paid and received), which show a long term tendency to increase.

Sources of financing

Arguably, financialisation leads to increasing payments by NFCs to financial markets and institutions, thus reducing the funds available to finance investment. The question to which we now turn is whether the internal financing of Portuguese firms has decreased since the 1980s.

Investment can be financed by internal financing (measured by the gross savings of the NFC), by capital transfers (including investment grants) and by net borrowing[25]. Net borrowing corresponds to external financing through loans, securities other than shares, shares and other equity, other accounts receivable/payable, currency and deposits and others[26].

The importance of each source of financing for investment in Portugal changed considerably over the years. During the period 1980-2013 the most important source of financing on average was internal financing, representing 43.1% of total investment, followed by loans (39.7%) and shares and other equity (13.2%) (Table 4). The importance of internal finance in Portugal is lower than in Germany, where, in the period 1980 to 1994, internal finance always represented more than 70% of investment (Corbett and Jenkinson, 1997).

In order to assess the impact of financialisation on internal finance, we compute averages for three periods: 1980-1994, 1995-2008, and 2009-2013. Our purpose is to isolate the period 1995-2008 in which the importance of finance grew the most. Comparing the whole period of 1980-94 to 1995-2009 we observe that internal finance was more important in the latter period. However, the average for 1980-1994 is negatively affected by some years (1980-85) in which internal finance had a negative contribution to finance investment, a rather unusual situation, only explained by the severe economic crisis felt in Portugal in that particular period. If we remove these years from the analysis, we observe that the period in which finance grew the most was accompanied by a decrease in internal finance and a

[25] If NFCs have a surplus, then the sector can lend to other sectors.

[26] Each item corresponds to the difference between the transaction of liabilities and assets. From 1995 it was obtained from the Financial Transactions of Eurostat. Before 1995 data was obtained from the Portuguese National Accounts.

growth in loans. One should note, however, that other factors besides financialisation may explain the decline in internal financing in this period.

Table 4 – Financing sources of investment (in proportion of investment)

	80-94	95-08	09-13	86-95
Internal financing (Gross savings)	0.24	0.60	0.53	0.66
Capital transfer	0.17	0.05	0.06	0.14
Monetary gold and special drawing rights (SDRs)	0.00	0.00	0.00	0.00
Currency and deposits	-0.17	-0.10	0.02	-0.13
Securities other than shares	0.03	0.06	0.10	0.02
Loans	0.60	0.37	-0.13	0.19
Shares and other equity	0.13	0.11	0.20	0.13
Insurance technical reserves	-0.02	0.00	0.00	-0.01
Other accounts receivable/payable	0.01	-0.09	0.20	0.00
Statistical discrepancy	-0.01	0.00	0.03	0.00

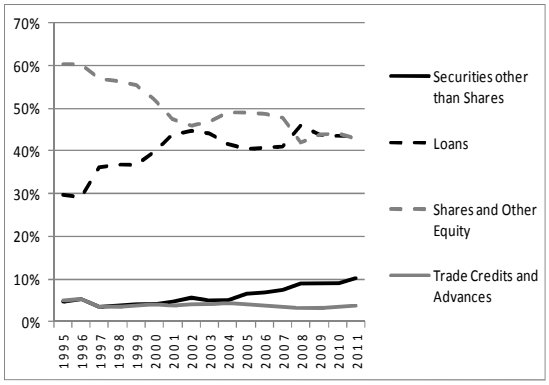
Note: from 1986 to 1995 other accounts receivable/payable are in loans. Source: INE and Eurostat, financial transactions and National Accounts

Firms' financing structure: liabilities and equity

We now look at how Portuguese firms finance their activities by *external* means. Firms' savings or retained earnings are not considered here. In 2011, the external financing of Portuguese firms was essentially obtained through loans (it represented 43.5% of liabilities plus equity) and shares and other equity (42.8%), with debt securities having a minor role (10.0%). The importance of loans in financing firms increased substantially between 1995 and 2011, from 29.8% to 43.5% of total liabilities plus equity (Figure 25). Securities other than shares also increased from 4.7% in 1995 to 10.0% in 2011, but they remained at residual importance, as firms prefer to use banks instead of financial markets to raise debt. In general, only a few corporations are financed through capital markets, either by shares or by bonds emissions, reflecting the predominance of micro, small and medium corporation sized (SMEs in short) in the Portuguese productive system.

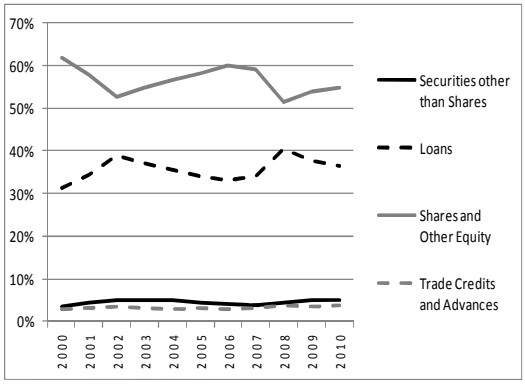
Portuguese firms have been more dependent on bank loans than EA16 firms (Figure 26) and they have less equity.

Figure 25 – Financing structure of Portuguese firms (% of liabilities plus equity)



Note: Based on consolidated data. Source: Eurostat

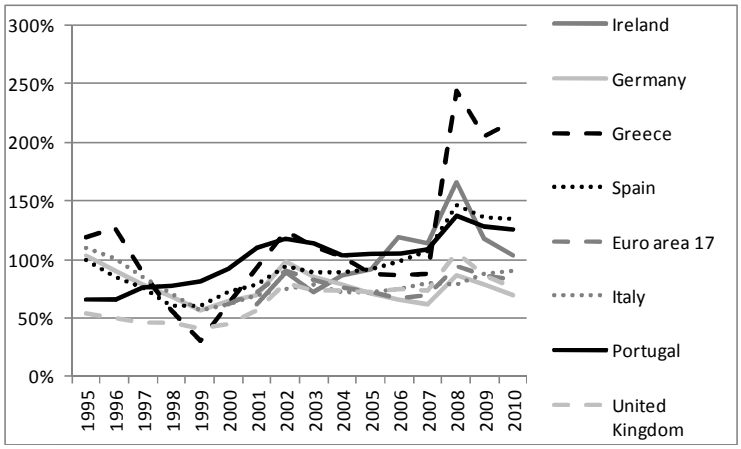
Figure 26 – Financing structure of EA16 firms (% of liabilities plus equity)



Note: Based on consolidated data. Source: Eurostat

Since Portuguese firms relied more on debt, the ratio of debt-to-equity more than doubled between 1995 and 2010, from 66% to 126% (Figure 27). In 2010, the ratio of debt-to-equity of non-financial corporations in Portugal was one of the highest of the Euro area, being only smaller than in Greece or in Spain.

Figure 27 – Debt to equity ratio of several European countries



Note: Debt includes Loans, Securities other than Shares and Trade Credit. Source: Eurostat

Distinguishing between long-term and short-term loans, we see that 48% of the loans to Portuguese NFCs in 1995 concentrated on short term maturities (Figure 55 in the Appendix). This was clearly above the value observed in the majority of EA countries (Figure 56 in the Appendix), and probably implied that Portuguese firms faced higher obstacles in financing long-term investments. However, between 1995 and 2010 the proportion of long term loans increased substantially, and in 2010, 82% of loans to firms were long-term loans, which was larger than the EA average.

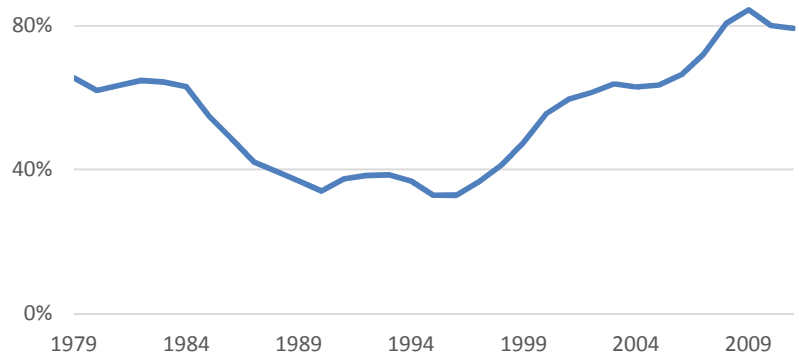
Regarding debt securities issued by NFC, we observe a reverse evolution, with the growth in importance of short-term debt, from 27% of total debt securities in 1995 to 59% in 2010. This value was clearly an exception in the Euro area, where short-term debt only represented 9% of total debt in 2010.

As a proportion of GDP, long term debt securities represented 8.9% in 2010, which was similar to the euro average of 8.5%. It is in short-term debt that Portuguese firms contrast with their EA partners. Indeed, this debt represented 12.9% of GDP in Portugal and 0.8% in the Euro area. This short-term debt was mainly commercial paper mostly held by banks.

Corporation debt

Before 1995 we do not have a full picture of firms' debt, due to a lack of data. The data available for this period refer only to bank loans to NFC in proportion of GDP, showing a decline from 1985 to 1996, and a clear increase between 1997 and 2009 (Figure 28).

Figure 28 –Bank loans to NFC (% of nominal GDP)



Source: Bank of Portugal, monetary synthesis

From 1995 onwards the data on the debt of NFC include loans, debt securities and trade credit[27], allowing for a broader analysis. As mentioned before, between 1995 and 2000, strong GDP growth stimulated investment by the corporate sector, which induced further economic growth. In a context marked by declining interest rates (in level and volatility), increasing bank competition, easier access by banks to foreign financing, and the adoption of new methods for assessing credit risk, bank credit became a major source of funds to finance corporate investment. The growth in credit was largely directed at firms which previously did not have access to this type of funding (Antão et al, 2009: 526). As a result, there was a strong increase in firms' total debt (recall Figure 10).

[27] The financial sector only finances around 50% of NFC debt, and the remainder is financed by other corporations, private individuals, and the external sector.

Since the decision to invest may not be independent of the financial situation of the firm (Antão et al, 2009: 525), firms with greater access to credit can invest more. Consequently, the growth in firms' debt was related to the quick growth in investment between 1995 and 2000 (Figure 20).

Access to credit was not homogenous across firm size classes. Between 2007 and June 2012, micro and small firms had a much smaller increase in debt (2 p.p.) than medium (5 p.p.) and large firms (7 p.p.) (Figure 57 in the Appendix). This may be a symptom of credit rationing in relation to micro and small firms, although micro and small firms may have been more affected by the recession than medium and large firms.

In synthesis, there was a considerable increase in corporation debt, reaching relatively high values. While this may have had a positive effect on investment, above a certain limit it may represent excess indebtedness and produce a decline in investment. It can, then, be suggested that the high level of debt of NFCs may be one factor explaining the decline in the investment rate after 2000.

Financialisation and investment in Portugal: Econometric analysis

Barradas and Lagoa (2014) estimate an aggregate investment function for Portugal, including some control variables (profitability, debt, cost of capital, savings rate and the business cycle) and proxies to capture the two channels of financialisation (financial receipts and financial payments) on NFCs. Using annual data between 1977 and 2013, and a Vector Error Correction Model, they reached the results presented in Table 5 and Table 6. The former table presents the cointegration relation, while the latter displays the short-term impact of the variables, including the effect of the deviations from the long run relationship.

Table 5 – The long-term estimations of investment

Variable	P_{t-1}	D_{t-1}	CC_{t-1}	SR_{t-1}	BC_{t-1}	FR_{t-1}	FP_{t-1}	Constant
I_{t-1}	1,490***	-0,442***	-1,066***	0,528***	0,499***	1,140***	-0,221***	-0,425***
	(0,135)	(0,061)	(0,101)	(0,154)	(0,131)	(0,206)	(0,073)	(0,069)
	[-11,019]	[7,213]	[10,542]	[-3,432]	[-3,816]	[-5,547]	[3,022]	[6,204]

Note: Standard errors in ( ), t-statistics in [] and *** indicates statistical significance at 1% level. *I* – investment of NFCs , *P* – Profits of NFCs (GOS/Value Added), *D* – increase in debt of NFCs, *CC* - Cost of capital (real interest rate), *SR* – Savings rate of households, *BC* – Business Cycle (GDP growth), *FR* – Financial receipts of NFCs, *FP* – Financial Payments of NFCs. Source: Barradas and Lagoa (2014)

Table 6 – The short-term dynamic

Variable	Error correction term t-1	ΔI_{t-1}	ΔP_{t-1}	ΔD_{t-1}	ΔCC_{t-1}	ΔSR_{t-1}	ΔBC_{t-1}	ΔFR_{t-1}	ΔFP_{t-1}
ΔI_t	-0,287**	0,193*	0,283**	-0,145*	-0,042	0,370*	0,068	0,423	-0,182
	(0,168)	(0,137)	(0,161)	(0,099)	(0,131)	(0,236)	(0,158)	(0,347)	(0,162)
	[1,700]	[1,404]	[1,751]	[-1,456]	[-0,317]	[1,567]	[0,432]	[1,219]	[-1,118]

Note: Δ is the operator of the first differences, standard errors in ( ), t-statistics in [], ** indicates statistical significance at 5% level and * indicates statistical significance at 10% level. See notes in Table 5. Source: Barradas and Lagoa (2014)

In the long-term, the two financialisation variables are statistically significant, but only financial payments have the expected sign (Table 1). Indeed, financial receipts are a positive determinant of investment in the long-term. A 1 p. p. increase in financial receipts increases investment by around 1.1 p.p. This seems to indicate that investment in financial activities has not significantly diverted funds from real activities, excluding a "crowding out" effect. Instead, this means that the returns of financial investments are used to finance real investments, rather than to fund further financial activities. This apparent contradiction with the literature on financialisation could be explained by the strong

importance of small and medium enterprises (SMEs) in Portugal that face high financial constraints and therefore are more dependent on any income to undergo new investments. Orhangazi (2008) uses a similar argument for SMEs in the US. In Portugal we find that such argument hold for the whole economy, possibly because SMEs dominate the entrepreneurial landscape. The small number of Portuguese corporations quoted in the stock market could also explain this result, since these corporations have fewer funding sources. Finally, financial payments have a negative impact on real investment, in accordance with the predictions of the literature on financialisation. A rise of 1 p.p. in financial payments decreases investment by about 0.2 p.p.

Debt has a negative effect on investment both in the long and short run (Table 2). The financialisation variables do not have a significant impact on the short run, with their main effect being felt through the long-run relation.

Conclusion

Between 1995 and 2001 the investment rate in Portugal increased to relatively high values, with two key explanatory factors being the reduction in interest rates during the convergence process to the EA and the rapid growth of credit. Investment has also been favoured by the increase in the proportion of long-term loans in total debt.

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. [28]

Regarding the ratio of investment of non-financial firms to GDP, we observe a slight negative trend since 1980, and especially after 2000. The indebtedness level of NFC may be a factor explaining the slowdown after 2000, since it increased the difficulty in getting additional funding.

The increase of (gross and net) financial payment and financial receipts in some periods after 2000 may also have contributed to the decline in NFC investment. The main effect of financialisation may have

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

been felt through an increase in dividends (both paid and received), which have a long term tendency to increase.

Econometric analysis confirms the negative effect of financial payments on investment, mostly through the long-run relation among the variables. Likewise, firms' debt also has a negative effect on investment. An additional effect of financialization on investment of NFC was felt through the increase of household indebtedness (Mortágua and 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 serve the domestic market.

In addition, we observe that the period of highest growth of finance (1995-2009) was characterised by a decrease in the internal finance of investment.

In conclusion, the negative effects of financialisation on investment have been felt in three areas: an increase in payments to financial actors (mainly in 2003/04-08), a decrease in the internal means to finance investment, and an increase of the debt to equity ratio to high values (especially after 2000).

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 (see Figure 29)[29]. The fall was particularly pronounced during the decade that followed Portuguese accession to the EEC in 1986. As discussed in section II, the Portuguese economy went through a period of harsh financial repression, in the context of an IMF-led adjustment programme which lasted from 1983 to 1985, followed by a far-reaching process of financial liberalisation, which took place in a context of very strong GDP growth and real wage rises. As a result, private consumption grew fast in the second half of the 1980s, fostered by the greater availability of

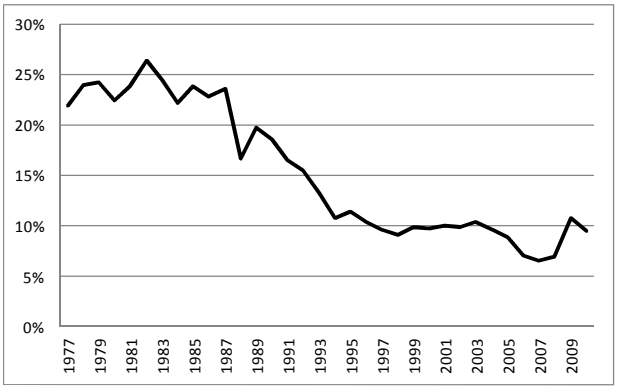
[29] One should bear in mind that household savings in Portugal are very asymmetric across income groups: according to Alves and Cardoso (2010), 20% of Portuguese families are responsible for 90% of savings, these being mainly families belonging to the top segments of income and wealth.

credit for consumption (Figure 30) and a reduced need of savings for precautionary reasons. Both as a consequence and a cause, this period was 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.

As also discussed in section II, 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.

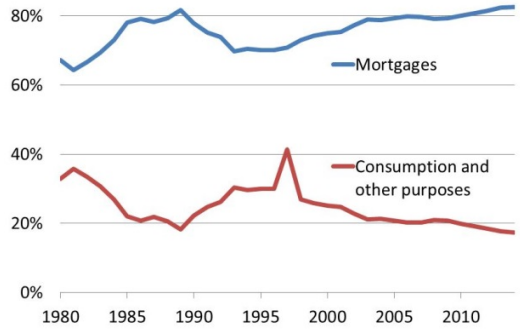
Household savings rate remained stable around 10% of disposable income for nearly a decade after 1995, falling to 7% in 2007 as a combined result of slow growth in real wages, continuing price increases, growing unemployment, and substantial increases in interest rates (see section II).

Figure 29 – The savings rate of Portuguese households (% of disposable income)



Source: Bank of Portugal (Economic Bulletin)

Figure 30 – Bank credit to household – mortgages and other purposes (% of total loans)

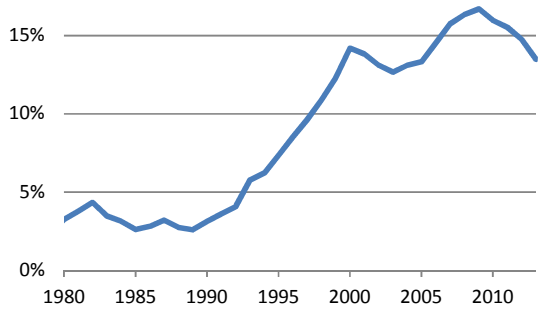


Source: Bank of Portugal

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 31). In order to finance their consumption (namely, of cars, home appliances, furniture, etc.), besides borrowing from banks, households also borrowed from

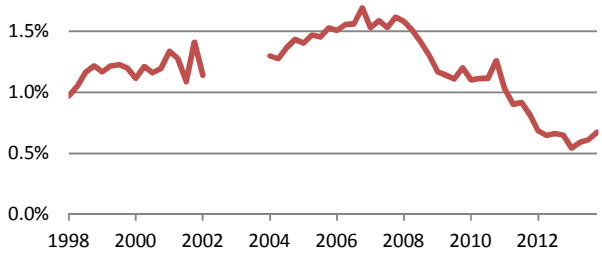
nonbank financial institutions, especially Societies for Acquisition by Credit and, to a much lesser extent, Leasing Societies[30] (Figure 32).

Figure 31 – Bank credit to households for consumption and other purposes (% of GDP)



Source: Bank of Portugal

Figure 32 – Loans from consumer credit companies to households (% of GDP)



Source: Bank of Portugal

Several factors concur to explain the drop in Portuguese households' savings rate and the growth of credit for consumption after the mid-1980s, many of which have already been discussed in section II. They include: 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[31].

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 –

[30] The use of this type of financial solution is often suggested to households by sellers of consumption goods.

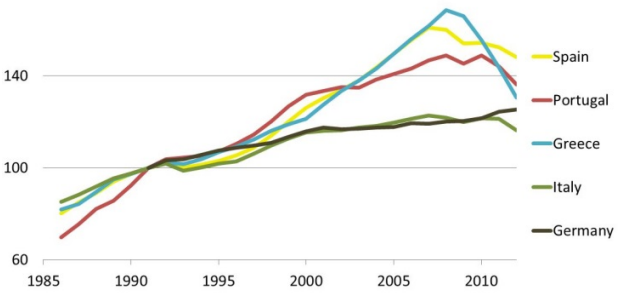
[31] To these we can add the development of new consumption practices by an expanding middle class, the diffusion of shopping centres and hypermarkets, among other factors.

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. Although to a much lesser extent than in other parts of the world, Portuguese banks also used securitisation as a means of offloading part of the risk they incurred in when supplying loans. Loans securitised by Portuguese banks (as a percentage of total credit to the private non-financial sector) grew from 1.6% in 2001 to 11.5% in 2007 (and 20.5% in 2011). This allowed banks to increase even more their lending to households and other economic agents, especially in the 2000s.

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.

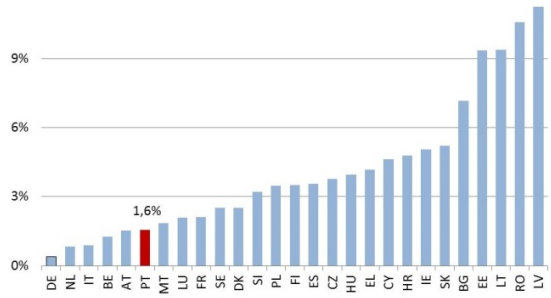
Thus, private consumption in Portugal grew markedly between the middle 1980s and the end of the century (Figure 33). After 2000, though, and even before the subprime crisis, Portugal displayed one of the lowest levels of consumption growth in the EU (Figure 34), reflecting the sharp slowdown in economic growth discussed in detail in section II, partly resulting from the debt accumulated by Portuguese households in the preceding period.

Figure 33 – Private final consumption expenditure at 2005 prices (1991=100)



Source: AMECO

Figure 34 – Average annual real growth of private consumption, 2000-2007 (%)



Source: AMECO

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[32]. The external imbalances accumulated during this period led to two IMF interventions in Portugal (1977/78 and 1983/85)[33], which favoured a rapid improvement of the goods and services balance (from -20% of GDP in 1982 to -6% in 1986).

As discussed in section II, the second half of the 1980s was a rather favourable period for the Portuguese economy. 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 (Figure 35), 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[34].

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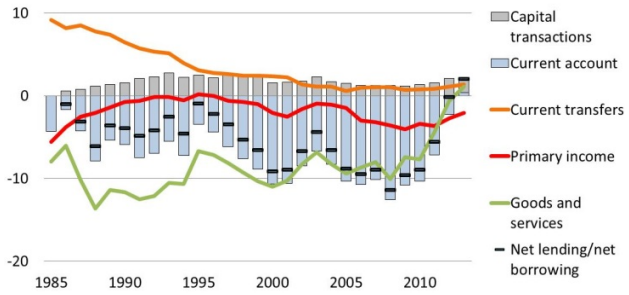
[32] These factors translated into capital flight, higher imports and lower exports (see Lagoa et al., 2013).

[33] 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.

[34] See sections II and IV.

This project has received funding from the European Union's Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800

Figure 35 – Net capital transactions and current account and its components, Portugal, 1985-2013



Source: AMECO

Table 7 – Changes in the external balances between 1995/1997 and 2005/2007 (in p.p. of GDP)

	Goods and services	Primary income	Current transfers	Capital transactions	**Net lending**
Ireland	-1.9	-3.3	-1.7	-1.0	-7.9
Greece	-4.9	-4.8	-2.8	0.7	-11.7
Spain	-6.6	-1.0	-1.1	-0.4	-9.1
Portugal	**-1.4**	**-2.4**	**-2.0**	**-1.1**	**-6.9**
Italy	-4.5	1.4	-0.7	0.0	-3.9

Source: AMECO

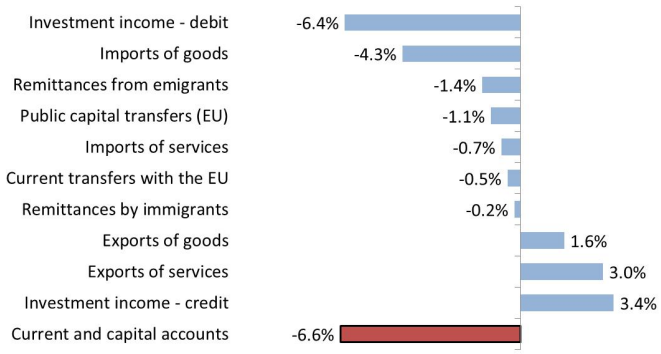
The deterioration of the current account after 1995 is common to all the countries of the Southern periphery of the euro area (see Table 7), and indeed to most EU Member States[35]. With few exceptions, all components of the current and capital accounts have contributed to expand those countries' external deficits.

Comparing the Portuguese case with those of Ireland, Greece, Spain, and Italy, there are some differences which are worth mentioning: (i) the aggravation of the current account deficit in Portugal between 1995/1997 and 2005/2007 (6.9 percentage points of GDP) is less severe than in Ireland, Spain, and Greece; (ii) Portugal is the country in which the balance of goods and services contributed less to an increase in the current account deficit, in sharp contrast with the Spanish case; (iii) also at odds with Spain (and in line with Ireland), the net primary income is the component with the highest contribution to the deterioration of the Portuguese external balances; and, finally, (iv) almost half of the negative change in the Portuguese external balances between 1995 and 2007 is related to current transfers and capital transactions.

[35] 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.

In order to understand the relation between the deterioration of the Portuguese external accounts and the process of financialisation of the domestic economy, it is useful to analyse in greater detail the evolution of the main components of the current and capital accounts, before and after the turn of the century (Figure 36).

Figure 36 – The contribution of the most relevant components to the change in the current and capital accounts between 1996-1997 and 2006-2007 (annual averages, in percentage of GDP)



Source: Bank of Portugal

Figure 36 shows that the negative change in the 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*; this is the main culprit for the negative change in net primary income (see Table 7);

(ii) *the growth of imports of goods*; the increase in the imports of goods in percentage of GDP clearly overshadowed the (modest) increase in exports; in contrast, export of services grew faster GDP than did imports, resulting in a positive contribution of services to the Portuguese external accounts (2/3 of which is related to tourism and air transport) during the period under analysis;

(iii) *the decrease in net current and capital transfers from the EU*[36], which became visible from the end of the 2nd Community Support Framework (1994-1999); and finally

(iv) *the decrease in remittances from emigrants* (in percentage of GDP); note that this was by far more relevant than the growth in remittances by foreigners living in Portugal to foreign countries, in spite of the growth in immigration flows during the period[37].

The decrease in remittances from emigrants (in percentage of GDP) can be accounted for by two main factors: first, the historically diminishing trend in Portuguese emigration, associated with the improvement of real wages and living conditions in recent decades[38]; and, second, the strong exchange rate appreciation of the euro against the US dollar since 2002 (Figure 37), which led to a decrease in the euro value of remittances from outside the euro area (Cabral, 2011).

In turn, the decrease in EU transfers is common to all former EU 'cohesion countries' (Ireland, Greece, Spain, and Portugal), and mainly results from the growth in GDP per capita of these countries during the 1990s, as well as from the EU's 2004 enlargement – both implying a reduction of structural funds allocated to these countries (Figure 38).[39]

[36] EU fund transfers are registered as capital transfers when they are used for physical investment expenditures and as current transfers when used for other purposes (such as training, education, scientific research, etc.).

[37] The number of foreigners legally registered as residents increased from 168,316 in 1995 to 401,612 in 2007.

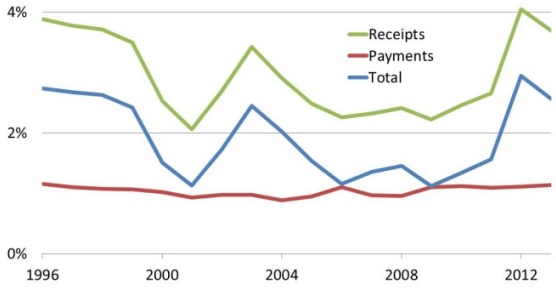
[38] This trend was reversed in recent years, as a result of the enduring recession in Portugal.

[39] The growth of transfers from the EU in percentages of GDP since 2011 is explained both by delays in implanting the funds for the 2007-2013 period and the drop in GDP since 2011.

Figure 37 – Exchange rate of the euro against the US dollar ($/€), 1999-2014

Source: PACIFIC Exchange Rate Service

Figure 38 – Transfers between Portugal and the EU, 1996-2013 (% of GDP)

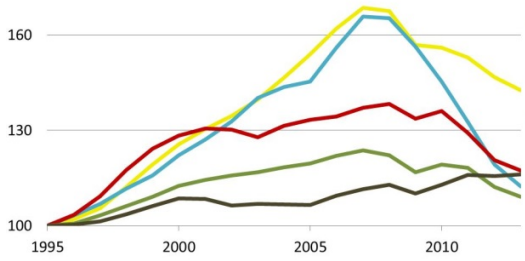


Source: AMECO

In sum, the two factors aforementioned – the decrease in remittances from emigrants and in EU transfers – are essentially explained by institutional, demographic, and international exchange rate phenomena. That is, these 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, cannot be directly associated with the financialisation of the Portuguese economy.

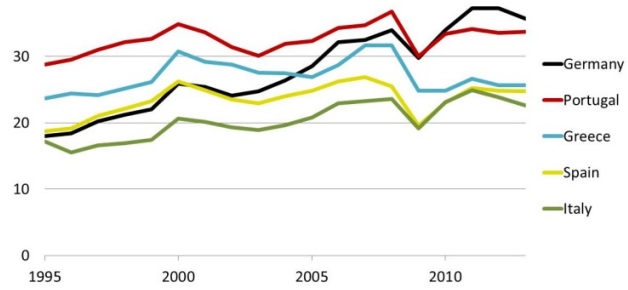
As regards the determinants of the increase in imports of goods in Portugal after 1995, one should distinguish between different periods. As discussed in section II, domestic demand experienced strong growth in the second half of the 1990s (Figure 39), fostered by the rapid expansion of credit to households (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 (Figure 40).

Figure 39 – Domestic demand, 1995-2012 (1995=100)



Source: AMECO

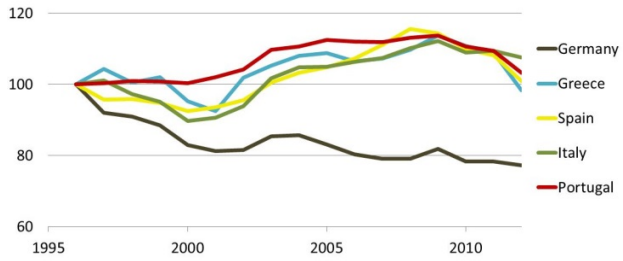
Figure 40 – Imports of goods, 1995-2012 (% of GDP)



Source: AMECO

With the slowdown of economic growth around the turn of the century, imports of goods decreased in percentage of GDP until 2003, a trend that was common across the euro area. Between 2003 and 2007 imports of goods grew much faster than GDP, even though the growth of domestic demand in this period was rather modest. An explanation for this fact can be found in the 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 (Figure 41), 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), as well as a dismal export performance in the period.

Figure 41 – Real effective exchange rates, based on unit labour costs (1996=100)



Source: AMECO

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. To a lesser extent, it was also influenced by the negative change in net direct investment income[40]. 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 middle 1990s (see Section II)[41].

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.

[40] 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.

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

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, 2008b). 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).

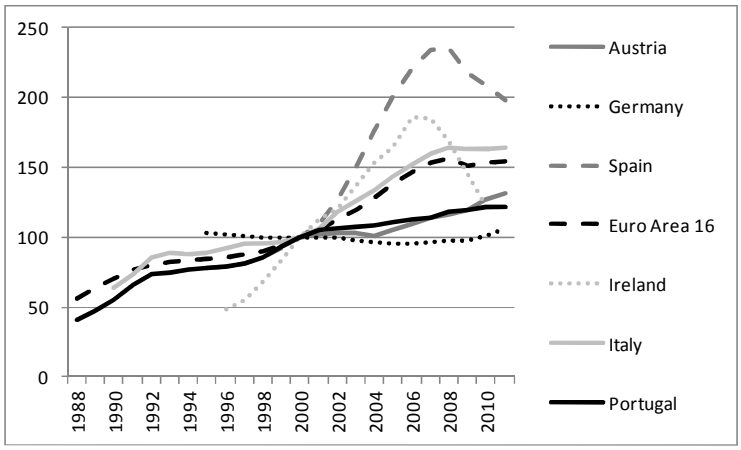
According to the Bank of Portugal (2008), there are other marked differences between the mortgage market in the US and Portugal. First of all, the percentage of households with mortgage credit is substantially lower in Portugal (30%) than in the US (45%). That percentage is also lower than in the Netherlands (38%) or in the UK (40%). On the other hand, Portugal has one of the lowest ratios of credit instalments to income (around 14%) among the euro area countries[42]. Finally, Portugal also exhibited a relatively low loan-to-value ratio.

Moreover, in Portugal house prices had a modest increase when compared to other countries, such as the US, the UK, Ireland or Spain (Bank of Portugal, 2008). Nominal house prices in Portugal increased much less than the euro area average between 2000 and 2011 (Figure 42). Additionally, real and nominal house prices did not increase or decrease more than 10%annually between December 1998 and December 2011, a value which normally is taken as a threshold for the creation or burst of a bubble in the real estate market. Lagoa et al. (2004) review other papers and data indicating that the growth of Portuguese house prices is explained by fundamental factors, such as the increase in household income, the decrease in nominal and real interest rates and the small dimension of the rental market for housing

[42] This ratio indicates the financial effort of the household associated with its debt.

purposes. From the second half of the 1990s, the increase in the supply of new houses prevented a surge in house prices.

Figure 42 – Evolution of nominal house prices (2000=100)



Source: ECB

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 difficulty faced by Portuguese banks in the immediate aftermath of the subprime crisis was the difficulty in obtaining funding in international financial markets. Note that the interbank interest rates (EURIBOR) have surged to record levels, and the risk premium between them and the nominal rate fixed by the ECB jumped substantially, reflecting the high degree of mistrust between banks.

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. The ECB also 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.

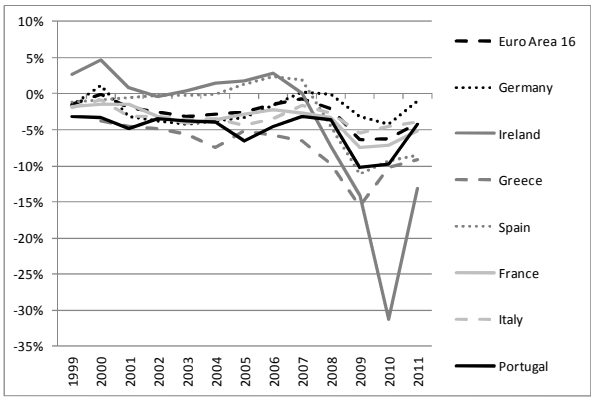
Yet the increase in perceived credit risk led Portuguese banks to increase interest rate spreads in credit, which implied a considerable negative impact on private consumption and gross fixed capital formation. According to the Bank of Portugal (2010), Portuguese households also decreased their investment 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

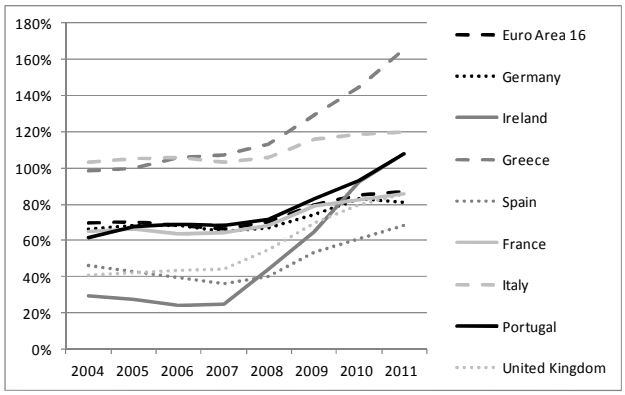
during 2009[43]. However, this led to an increase in the public deficit that was more pronounced than the euro area average (Figure 43). This took place in a country that struggled to maintain the public deficit below 3% between 2001 and 2008. As a consequence, Portuguese public debt increased to levels considerably above the euro area average in 2010 and 2011, when it was close to that average in 2009 (Figure 44).

Figure 43 – Public deficit (% of GDP)



Source: Eurostat

Figure 44 – Public debt (% of GDP)



Source: Eurostat

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

[43] 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).

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.

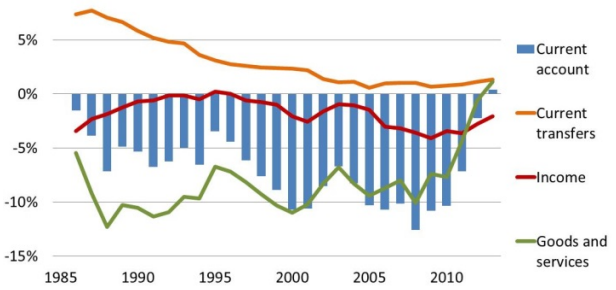
In general, the adjustment programme implemented in Portugal between May 2011 and May 2014 did not represent a dramatic break with the recent past with regard to the measures relating to public finances. Several policy initiatives in this field had been adopted in previous years, including the following: 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

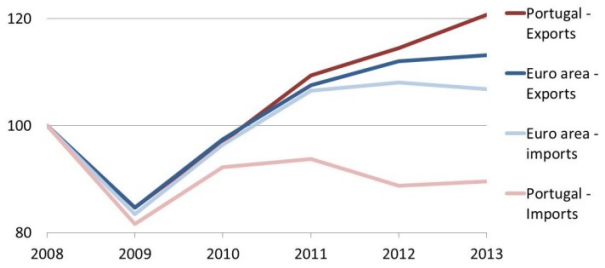
an impressive result was expected to accrue from the combined effects of low wage growth and reforms to the labour market (namely, easing dismissal restrictions, restricting the scope of collective agreements, reducing the duration and amount of unemployment benefits, etc.), which, it was expected, would help to restore the competitiveness of the Portuguese economy. In fact, the Portuguese current account became slightly positive in 2013 (Figure 45). This, however, is largely explained by the steep decrease in imports (Figure 46), 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.

Figure 45 – The Portuguese current account and its components



Sources: AMECO

Figure 46 – Import and exports in Portugal and in the euro area (2008=100)



Source: AMECO

V. Summary and conclusions

Contrary to what occurred in Greece, Ireland, and Spain, the dismal performance of the Portuguese economy is not solely a post-subprime crisis phenomenon. Portugal's GDP nearly stalled 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 bleak performance of the Portuguese economy after 2000 contrasts with the strong GDP growth experienced between the mid-1980s and 2000. In the latter period, Portugal 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.

The sharp discontinuity in GDP growth around the turn of the century is a distinctive feature of Portugal in the EU context and cannot be ignored in analysing the development of the Portuguese economy in recent decades. In this report we have tried to show that, although several factors account for this discontinuity, the process of financialisation of the Portuguese economy is an essential part of that explanation.

The second half of the 1980s was a highly favourable period for European economies, namely as a result of declining oil prices and the implementation of the European Single Market program. 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, 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). 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.

The improvement in growth prospects and in real wages led to an increase in the demand for credit by domestic firms and households. Several institutional developments in the Portuguese financial system made it possible for the demand for credit to be met by supply. These institutional changes, which started gradually in the mid-1980s (after a period of stringent financial repression) and accelerated after the mid-1990s, included a far-reaching process of privatisation, the deregulation of the financial system, the liberalisation of capital movements, and the policy priority attached to nominal convergence as a

result of the decision to participate in the EMU since its inception. The combination of these demand- and supply-side factors translated into a wide availability of credit at historically low levels of interest rates, giving rise to an exponential growth of credit to the private sector, especially in the second half of the 1990s.

The growth of credit-led indebtedness in the private sector has been a common feature across many countries of the euro area in recent decades. 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).

In this report we have argued that the slow growth of credit in the first years of the new millennium was determined by two decisive factors. First, the high levels of private indebtedness, which were already evident at the turn of the century, and which limited the capacity of Portuguese corporations and households to obtain new credit. Second, the growth of credit was also conditioned by the weak aggregate performance of the Portuguese economy in the following years.

In fact, after 2000 the Portuguese economy experienced a succession of shocks: interest rate rises; negative exchange rate developments; pro-cyclical, contractionary fiscal policies; growing competition from the emerging economies; the peak in oil and commodity prices in 2008 and, finally, the Great Recession. Not only was the Portuguese economy more exposed to these shocks than were those of most EU Members States, but also the vulnerability of the Portuguese private sector was higher given the prevailing levels of indebtedness.

Having exhausted the potential for domestic demand-led growth at an early stage (largely due to accumulated indebtedness), and unable to replace it by export-led growth (given the structural weaknesses of the productive fabric, the growth of real wages during the boom years, and heightened competition from the emerging economies), the Portuguese economy slowed down sharply, with increasingly negative consequences for public finances. On the other hand, being part of the European single currency, the Portuguese economy was able to keep financing its external deficits with foreign capital until the end of the 2000s, at the cost of increasingly unsustainable levels of external debt. The high levels of public and private indebtedness in the Portuguese economy were a decisive factor behind

the steep rise in interest rates on sovereign bonds between 2010 and 2012. Ultimately, this led to the need to resort to international financial assistance and to the implementation of an adjustment programme based on fierce austerity measures, which fostered an unprecedented growth in unemployment and emigration.

In sum, 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 (due to the reasons discussed above). 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, financialization 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).

VI. References

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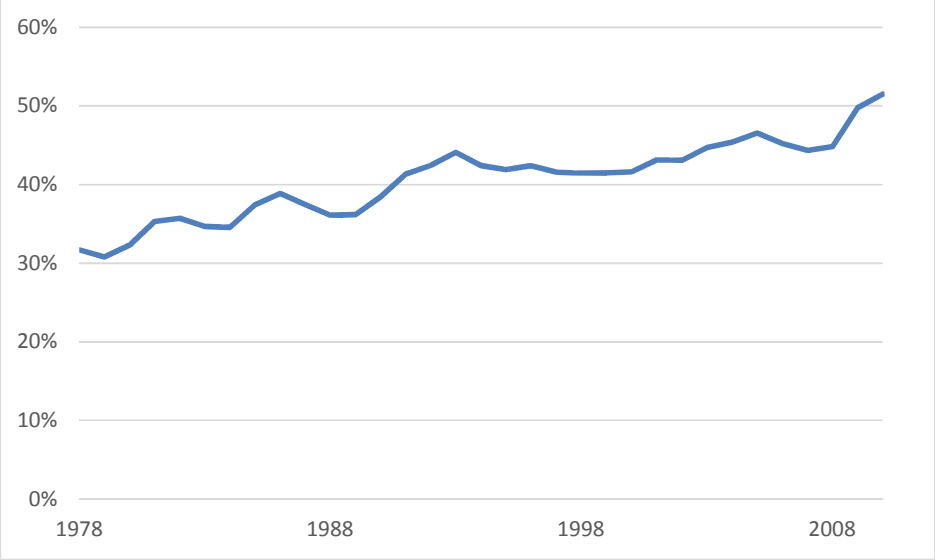
VII. Appendix

Figure 47 – Property income and its counterparties since 1995 (in proportion of *net* national income)

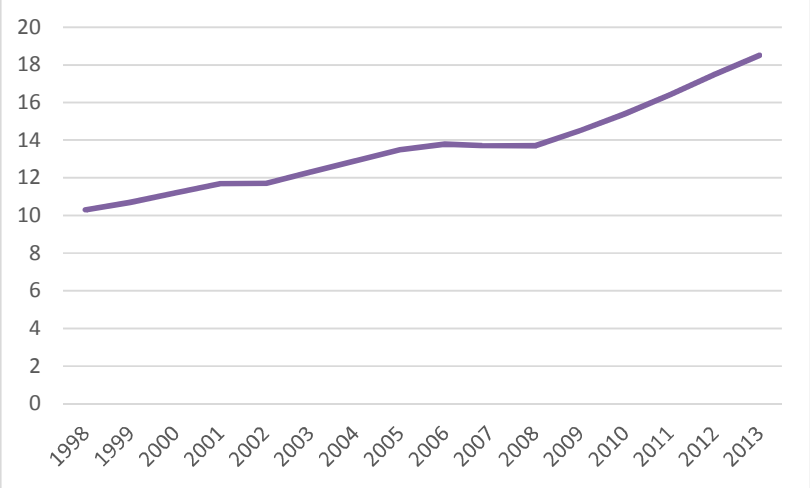
Source: INE - Contas Nacionais (up to 1994) and Eurostat (from 1995)

Figure 48 – Total Expenditure of General Government (% of GDP)



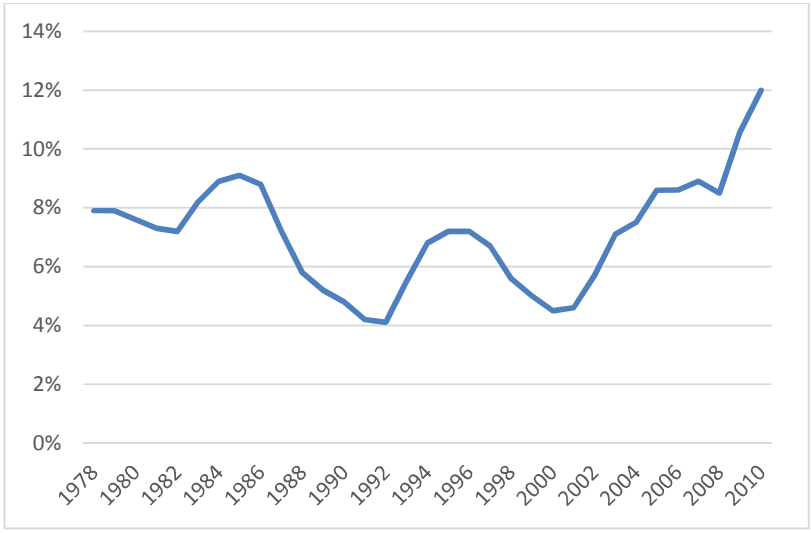
Source: AMECO

Figure 49 – Population with secondary schooling (% of the resident population aged over 15 years)



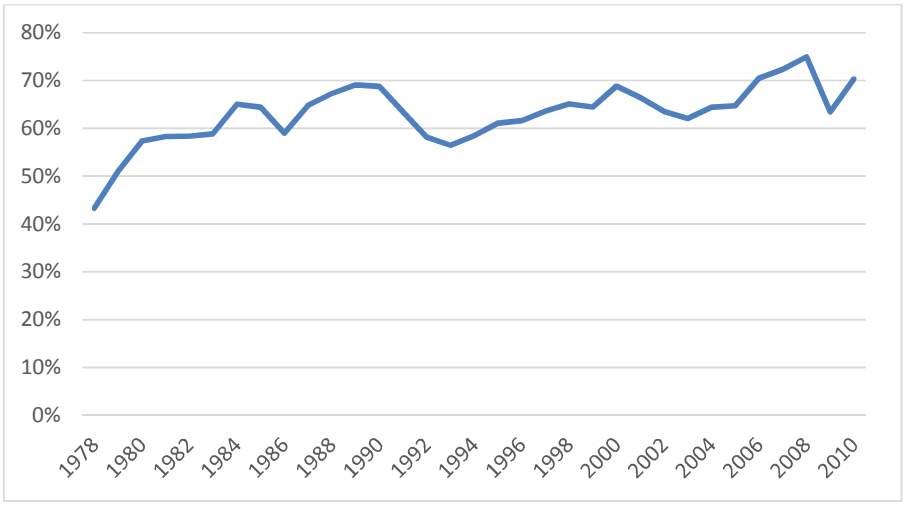
Source: Pordata and INE

Figure 50 – Unemployment rate



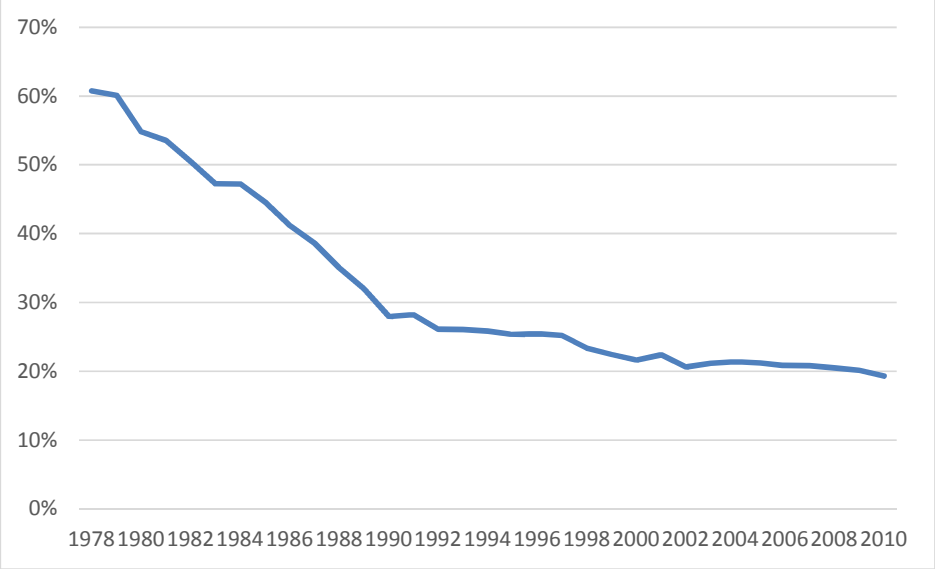
Source: AMECO

Figure 51 – Degree of openness of the economy (export+imports/GDP)



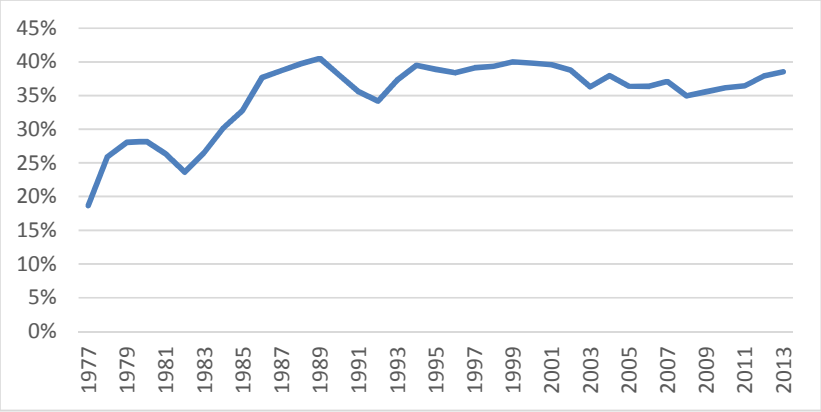
Source: Bank of Portugal

Figure 52 – Union membership rate



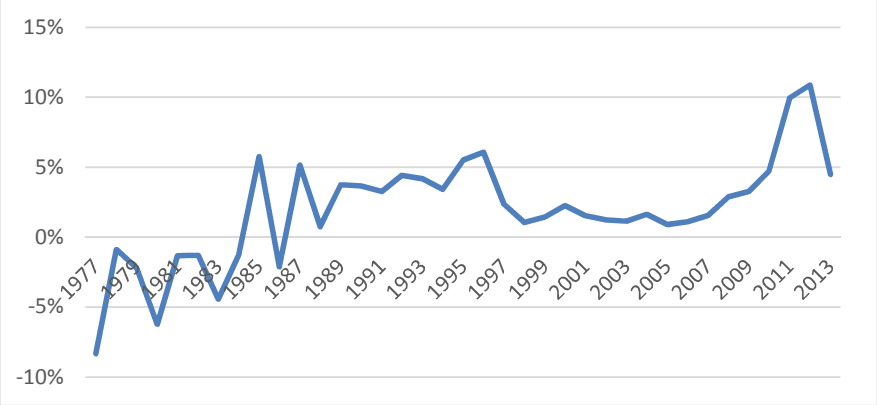
Source: Labour Force Statistics, OECD

Figure 53 – GOS to Value added for NFC



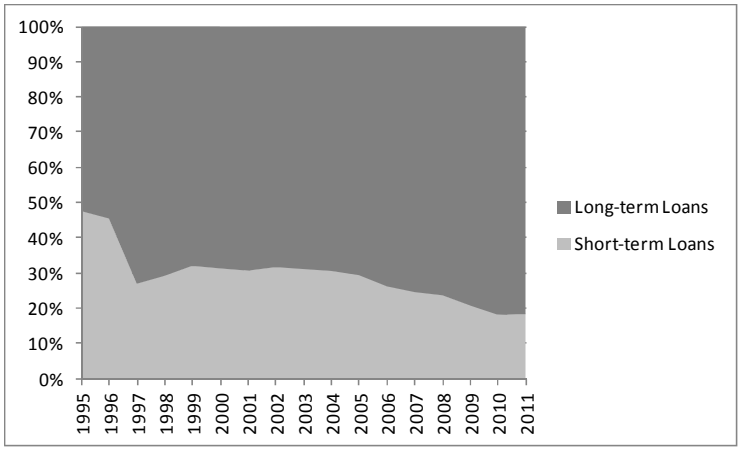
Source: Portuguese National Accounts (at current prices and in millions of euros) from INE

Figure 54 – Real interest rate



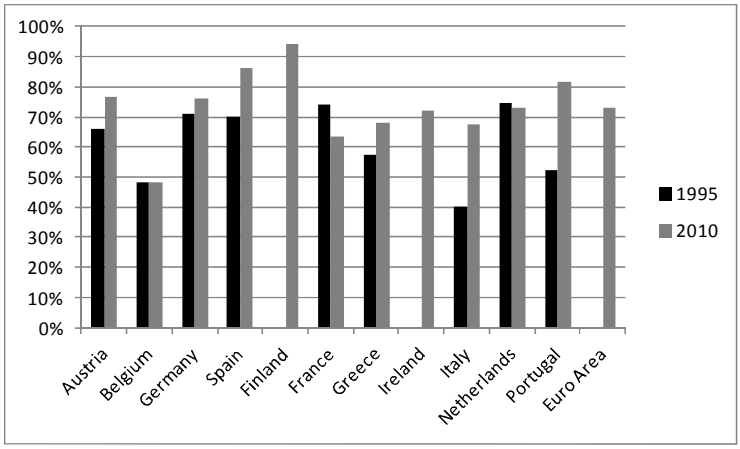
Notes: inflation computed using the GDP deflator. We use the short-term real interest rate between 1977 and 1984 and the long-term real interest rate in the following years, because the long-term real interest rate is only available in the period of 1985 and thereafter. Source: AMECO

Figure 55 – Short and long term loans to non-financial corporations in Portugal (% of total loans to firms, including non-bank loans)



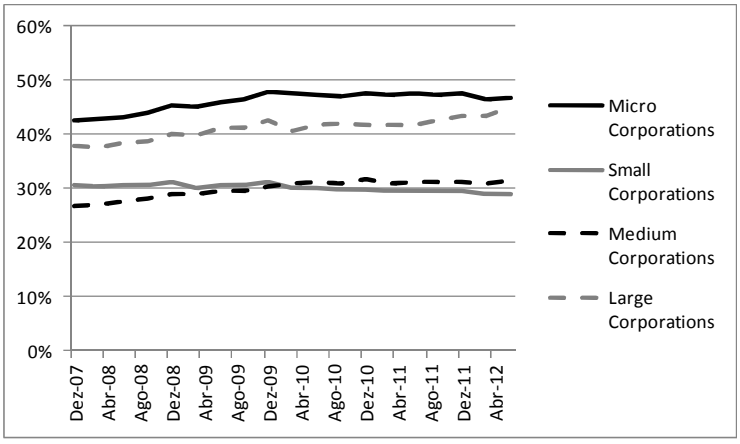
Source: Eurostat

Figure 56 – Long term loans to non-financial corporations in the euro area (% of total loans to firms)



Source: Eurostat

Figure 57 – Debt of non-financial private corporations by firm size (% of GDP)



Note: Non-Financial Holdings are not included. Source: Bank of Portugal (Debt of Non-Financial Sector)