This project is funded by the European Union under
the 7th Research Framework programme (theme SSH)
Grant Agreement nr 266800

FESSUD

FINANCIALISATION, ECONOMY, SOCIETY AND SUSTAINABLE DEVELOPMENT

Studies in Financial Systems

No 9

Report on the financial system in Portugal

Sérgio Lagoa, Emanuel Leão, Ricardo Paes Mamede, and Ricardo Barradas

Dinâmia'CET, ISCTE – University Institute of Lisbon

Report on the financial system in Portugal

Sérgio Lagoa [1], Emanuel Leão, Ricardo Paes Mamede, and Ricardo Barradas

Dinâmia'CET, ISCTE – University Institute of Lisbon

Key words: E00, G01, O11, O16, O52, P16.

Journal of Economic Literature classification: E44, E65, G21, G28.

Contact details: [1] corresponding author: sergio.lagoa@iscte.pt. ISCTE – University Institute of LIsbon, Avenida das Forças Armadas, 1649-026 Lisboa, Portugal. tel: +351213903436, fax: +351217903933.

Acknowledgments: The research leading to these results has received funding from the European Union Seventh Framework Programme (FP7/2007-2013) under grant agreement n° 266800.

We thank the comments of the Leeds' FESSUD team, namely David Spencer and Andrew Brown, and also the comments of Ana Santos, Nuno Teles, and the participants in the FESSUD seminar held in Berlin and the participants in the seminar held in the Centro de Estudos Sociais, University of Coimbra. The usual disclaimer applies.

ISSN: 2052-8027

Website: www.fessud.eu

This project is funded by the European Union under
the 7th Research Framework programme (theme SSH)
Grant Agreement nr 266800

Contents

Introduction 13

PART I – General background 20

1. Historical, political, economic and international background 20

1.1. 1945-1974: dictatorship, industrialization, colonial war, and international economic integration 20

1.2. 1974-1985: revolutionary upheaval, international crises, and adjustment 22

1.3. 1986-1999: accession to the EEC, growth and liberalization, and preparing for the EMU 24

1.4. 2000-2008: dismal growth and loss of competitiveness within the EMU 28

1.5. Since 2008: crises and adjustment programs with no guarantee of success 30

PART II – The Portuguese financial sector 34

2. Regulatory framework 34

2.1. Nationalization of banks after 1974 34

2.2. The re-privatization and deregulation of the banking system . 35

2.3. European integration and the banking system 39

2.4. Changes in regulation in response to the 2008 financial crisis40

2.5. Concluding remarks 44

3. The growth in finance and its role in the decades of financialisation 46
3.1. Output and employment in the financial sector 46
3.2. Other measures of financialisation 52
3.3. Financialisation and real investment 62
3.4. Securities markets 64
3.5. The assets side of households 69
3.6. Volume of loans from banks 79
3.7. Households' debt 84
3.8. Corporations' debt 89
3.9. Non-Performing Loans 92
3.10. Government Debt 96
3.11. Net lending/borrowing 103
3.12. Concluding remarks 105
4. Structure of financial sector by forms of organization 109
4.1. Structure of the financial system 109
4.2. Importance of foreign, public and non-for-profit banks 115
4.3. Securitisation of credit 120
4.4. Derivatives and off-balance sheet operations 124
4.5. Other Financial Institutions 125
4.6. Venture capital 128
4.7. Concluding remarks 130
5. Availability and source of funds 132
5.1. Institutional investors 132

5.2. Financial groups ... 137

5.3. Concluding remarks ... 140

6. The nature and degree of competition between financial institutions 141

6.1. Concentration and mergers and acquisitions ... 141

6.2. Innovation: payment systems and channels of contact with customers ... 147

6.3. Concluding remarks ... 152

7. Profitability of the financial system ... 154

7.1. Financial margin, commissions and other non-interest income ... 154

7.2. Intermediation Margin ... 158

7.3. Cost-to-income ... 160

7.4. Studies on banking efficiency ... 161

7.5. Return-on-Assets and Return-on-Equity ... 163

7.6. Taxes ... 166

7.7. Capital adequacy and funding structure ... 169

7.8. Concluding remarks ... 173

PART III – The interaction between the financial and other sectors ... 175

8. Real Estate sector ... 175

8.1. Real estate loans ... 176

8.2. Weight of housing in investment and production ... 180

8.3. Characteristics of housing loans ... 185

8.4. Equity withdrawals ... 188

8.5. Foreclosure of mortgages with negative equity ... 191

8.6. Early repayment of the mortgage 192
8.7. Wealth effect in Portugal 193
8.8. Concluding remarks 194
9. Source of funds for business investment 196
9.1. Firms' financing structure 198
9.2. Interest rates 206
9.3. Credit conditions from the banks' perspective 214
9.4. Investment survey: firms' perspectives 219
9.5. Survey on the Access to Finance 223
9.6. Concluding remarks 228
10. Involvement of financial sector in restructuring NFCs 230
10.1. M&A in the non-financial sector 230
10.2. Portuguese deindustrialization 234
10.3. Concluding remarks 245
11. The process of privatization 248
12. Culture, inequality, and households finance 254
12.1. Cultural and institutional aspects 254
12.2. Non-Profit Institutions 257
12.3. The health sector and private interests 258
12.4. Growth of credit to consumption 261
12.5. Concluding remarks 261
13. Inequality, poverty and financialisation 264
13.1. Financial inclusion 264
13.2. Poverty and inequality 267

13.3. Concluding remarks 273

PART IV – International integration and the Portuguese financial system....... 274

14. Impact of financial globalization on the national financial system 274

14.1. Major impacts of globalization in the Portuguese economy.. 274

14.2. Internationalization of Portuguese Banks............................ 277

14.3. Concluding remarks 281

15. Impact of European integration on the Portuguese financial system 283

15.1. Major macroeconomic steps in the European integration..... 283

15.2. Free movement of capital at the European level 285

15.3. The Portuguese strategy of convergence to the euro: achievements and difficulties 287

15.4. Major impacts of European integration in the Portuguese economy 291

15.5. How the monetary policy of the ECB affects banks' interest rates 294

15.6. Concluding remarks 296

16. The integration of the national financial system in the international capital markets 299

16.1. Financial account 299

16.2. International Investment Positions 302

16.3. Banks foreign Currency denominated loans and liabilities... 305

16.4. Evolution of the Portuguese Inflation Rate 306

16.5. Evolution of the Portuguese real interest rates..................... 309

16.6. Evolution of the Portuguese real exchange rate.................... 311

16.7. Concluding remarks 313

Part V – The financial crisis in Portugal..... 316

17. The nature and impact of the (2007-?) financial crisis in Portugal 316

17.1. The effect of the Subprime and Sovereign Debt Crisis in Portugal..... 316

17.2. The subprime market in Portugal and the exposure of banks to the Subprime Crisis 318

17.3. From the Subprime Crisis to the Sovereign Debt Crisis..... 322

17.4. The impact of the crisis on key variables 326

17.5. Financial rescue of Portugal..... 330

17.6. Concluding remarks 334

Conclusion 336

References..... 347

Annexes 358

Executive summary

This Report assesses the extent, nature, and effects of financialisation in Portugal. It also discusses the contribution of financialisation for the crisis that presently affects the Portuguese economy.

In the second half of the 1970s and in the 1980s high inflation, monetary financing of the fiscal deficit, and strong regulation of the banking system were the main characteristics of the macroeconomic environment. From 1984 the banking sector was gradually liberalised, leading to an increase in competition, a wave of takeovers, entrance of foreign banks, modernization of the payment system and channels of contact with customers, and a larger supply of credit.

The strong reduction in the level and volatility of inflation and interest rates, as well as an easier access to external financing by banks, caused an increase in credit to the non-financial private sector, giving rise to a period of strong economic growth. Credit to households to buy houses was the credit segment that grew the most, but the growth of credit for non-financial corporation was also remarkable. The rapid growth in credit, together with the dismal performance of the Portuguese economy since 2000 (and especially after 2008), implied that in 2011 both Portuguese households and firms were among the most indebted of the EA, making them particularly vulnerable to an economic slowdown.

The liberalization of the banking sector, the easier access to international financial markets, and the growth of credit fostered the development of the Portuguese financial sector. In 2011, the importance of this sector in terms of value added was one of the highest in the EA, and between 1995 and 2011 its growth was one of the fastest. This indicates a process of financialisation of the economy, which is confirmed by other indicators, namely: the level and

efficiency of investment declined; the Gross Operational Surplus (GOS) of financial institutions has grown faster than the GOS of non-financial corporations; financial assets in proportion of GDP are high and they have grown rapidly between 1995 and 2010; financial corporations registered the fastest growth of financial assets amongst the domestic agents; and non-financial firms became more involved in financial operations.

Another feature of the financialisation of the Portuguese economy is the increasing role of financial interests in the health sector and in the construction of public infra-structures.

Banks responded to the new economic environment by building up large financial groups, increasing concentration, reducing costs, and internationalising their activities. Banks have made use of market mechanisms, such as securitisation, to prosper and have increased their dominance in the financial system.

The growth of the banking sector was accompanied by the emergence of three main risks: large dependence of foreign market financing, strong decrease in capital adequacy ratios, and significant vulnerability to house prices fluctuations (real estate loans represented around 60% of the loans portfolio).

Banks did not treat firms uniformly. On the one hand, compared with large firms, SME paid larger interest rates and received less credit in periods of credit tightening. On the other hand, between 1998 and 2011, manufacturing and construction (after 2004) faced greater difficulties in obtaining credit than other industries. The slow growth of credit to manufacturing is probably both a result and a cause of the slow growth of its output. Since 1995, manufacturing has lost importance in terms of value added, with the fall being larger in Portugal than in the average of the EA.

The growth of credit created the economic boom and the conditions for the bust. The high growth of aggregate demand, fed by credit and helped by a pro-cyclical expansionary fiscal policy in some occasions, led to one of the highest average inflation rates of the EA, which implied a reduction in the competitiveness of Portuguese firms. Around 2002, high inflation, the inevitable slowdown of credit growth (given the increasing levels of indebtedness), the liberalization of worldwide trade, and the vulnerability of the Portuguese export structure to the appreciation of the euro against the US dollar, among other factors, translated into a long period of slow economic growth, resulting in increasing pressure on public finance. During the 2000s the Portuguese economy had one of the worst economic growth performances of the EA, with a high current account deficit financed abroad by banks and the Government.

Therefore, when the Subprime crisis occurred, the Portuguese economy was already in a dismal condition. During this crisis, banks had difficulties in obtaining financing in the international markets. After the Sovereign debt crisis begun in late 2009, this and other factors – namely, liquidity problems of banks, increase in uncertainty, rise of regulatory capital requirements, and the increase in non-performing loans – help to explain the sharp worsening of the conditions faced by firms non-financial in obtaining credit.

As a result of the Subprime crises and its subsequent developments, the fiscal position of the Portuguese government deteriorated fast, both as a result of the ‘ automatic stabilizers’ and, to a lesser extent, to the expansionary fiscal policy followed by the government (according to the guidelines agreed at the EU level). International investors (the main buyers of Portuguese public debt) started to raise doubts regarding the capacity of households, corporations and the government to pay their debts. Interest rates on government’s long term bonds increased noticeably, forcing the country to resort to international financial help. Since 2009 the current account deficit has decreased sharply, a result of

both the international credit rationing, and the substantial drop in internal consumption and investment (both public and private).

In sum, several indicators suggest that the Portuguese economy has gone through a process of financialisation since the early 1990s, namely the large growth of private debt, the growth of the financial sector, the deregulation of financial markets, and the diffusion of market mechanisms to new areas. This process has contributed to create the conditions for the emergence of the Sovereign Debt crisis in Portugal from 2010 onwards.

Introduction

In most developed countries, the financial sector has been growing in importance in terms of both employment and GDP. The Portuguese economy is no exception.

The great importance of finance in the economy nowadays leads us to the concept of financialisation. Although there is no unique definition of financialisation, one of the broadest accounts of the term suggests that *"financialisation refers to the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operations of the economy and its governing institutions, both at the national and international level"* (Epstein, 2001, p. 1).

Many transformations in the structure of the economy reflect the process of financialisation. These include a significant increase in financial transactions, the rise of real interest rates, higher profitability of financial corporations in relation to non-financial corporations, among others (Epstein, 2005).

Menkhoff and Tolksdorf (2001) highlight the growing relative importance of stock markets, capital flows and international financial transactions (visible in the volume of foreign exchange market transactions) during the last three decades, particularly in comparison with corporations' capital stock or the real national product. These authors add that there has been a change in the role of the financial sector during the last decades. They advocate that, in the past, the financial sector supported and stimulated economic growth ("optimistic view"), through a "supportive relationship". However, this relation changed significantly in the last ten to twenty years, as events in the financial sphere started to follow their own logic and the real economy had to adjust to that logic. There was a growing "decoupling" between the financial sector and the real economy.

Palley (2007) argues that the process of financialisation produces a downward trend of real economic growth, a transfer of income from the real sector to the financial sector, and an increase in income inequality and wage stagnation.

Financialisation is, thus, a broad and complex concept. In order to delimit the analysis done in this report, we adopt the definition of FESSUD project, according to which financialisation includes eight features: (i) large development of financial markets, (ii) de-regulation of the financial system and of the economy in general, (iii) the emergence of new financial institutions and markets, (iv) a dominance of finance over industry in terms of investment and production, (v) rising inequality due to the work of market mechanisms and explicit public policies, (vi) growth of consumption based on credit financing, (vii) the diffusion of market and financial logic in economic and social areas previously not affected by these logics, (viii) and the emergence of a culture oriented to the individual, the market and rationalism.

In the light of mainstream economics, "financialisation" is in general a positive phenomenon. According to this view, financial markets are efficient in processing information, which can be used to guide the allocation of resources. Market mechanisms will improve efficiency in all areas of human activity, as long as market failures and externalities are correctly addressed.

Especially after the 2008 financial crisis, this *wonderland*'s view has been contested by many new and less novel theories, mainly referring to the following issues:

- Financialisation reduces the level and efficacy of real investment, as funds are diverted to financial activities.
- Firms aim to maximize their financial value, normally in the short-run, overlooking their long-run survival and other social values.

- Economic and social public policies are pushed to accept market mechanisms in all areas of economic and social life, sometimes with deleterious consequences in terms of efficiency and equity.
- Growing areas of economic and social life are exposed to volatility and crises, which often characterise financial markets.

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

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

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

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

However, a few works analyse the specificities of the process of financialisation in peripheral economies. Leiva and Malinowitz (2007) suggest that the process of financialisation had a negative impact on economic performance both in the North and South, due to the decline of productive investments. Other consequences of that phenomenon include the deregulation of labor-capital relations, the intensification of mergers and acquisitions to boost shareholder value, the reduction of the room of manoeuvre of public policies, and rising income inequality.

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

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

Orsi and Solari (2010) analysed the changes in the financial systems of Southern European economies in the last 15 years. According to these authors, these financial systems are bank-based, with banks controlling all credit, the stock exchange and investment in shares by acting as advisers, mediators, issuers, treasurers and investors. Thus, in such countries, universal banks are able to decide who can invest, where can invest, who makes profits and who loses.

These authors also consider that the most evident sign of financialisation of these economies comes from the strong importance of banks, which sustains the dynamism of the economy granting high levels of credit, especially for durable goods.

Although affecting many countries around the world, financialisation is not a homogeneous phenomenon across space and time. According to Peck and Theodore's (2007) notion of "variegated capitalism", capitalism develops across time and space in heterogeneous way. An important distinction is between market-based and bank-based financial systems. In the literature on varieties of capitalism (Hall and Soskice, 2001), bank-based financial systems are connected to co-ordinated economic systems and market-based are linked to liberal models. Naturally this distinction is a matter of degree, since all financial systems have financial markets and banks. Both systems have their supporters, arguing that one system is better than the other in processing information, allocating capital and managing risk (Levine, 2002).

However, both the market- and bank-based systems are affected by rationing and instability. As is well- known, equity rationing is a pervasive phenomenon, with many firms in developed countries getting a very small fraction of capital from the stock market (Stiglitz and Greenwald, 2003). Credit rationing by banks emerges due to asymmetric information that inherently characterizes financial transactions. As such, an important goal of our work is to discuss whether credit rationing exists in the Portuguese context, how it works, and who is affected by it. It is also interesting to understand if banks use equity participation in firms to better monitor them.

In the bank-based system, instability may come from excessive credit provision, leading to default of firms and households due to excess leverage in periods of downturn and fall in house prices. In the market-based system, financial instability is associated to asset price bubbles, with prices deviating strongly

from their fundamental values. These bubbles sometimes are supported by the provision of credit by banks. In other situations, banks are involved in the creation and investment in new financial products (as CDOs), which create instability in the markets.

Minsky (1994) argues that financial markets oscillate between regimes of stability and instability. Periods of prolonged prosperity may create conditions for the economy to move from a stable system to an unstable system.

Allen and Gale (2001) suggest that the recent past and the present time are characterized by a trend towards liberal and thus market-based financial systems. New developments, as the securitization and the involvement of banks in the trading of financial products, indicate even a change of the character of banks in direction to more market oriented mechanisms.

Either in bank- or market-based financial systems, the State plays a central role. Firstly, its role is central in protecting property rights, in creating regulations, and in liberalizing and developing markets (e.g. the stock market). Secondly, the State has an important role in bailing out the financial sector in periods of crisis. The creation of this safety net allows saving the financial system and the whole economy from collapse, but it creates an incentive for excessive risk taking by financial agents. Giving the centrality of the State for the financial sector, we usually observe financial institutions to exert strong influence over the State, and often having great influence over crucial policy decisions.

Having in mind the definition of financialisation and its many facets, this Report aims to assess the extent, nature and effects of financialisation in Portugal. The interest of studying Portugal is twofold. Firstly, Portugal is currently (in 2013) in a deep economic crisis, and so it is relevant to ask what was the contribution of financialisation for this situation. Secondly, as Becker et al. (2010) sustain, the literature on financialisation process is focused on the most advanced

economies, particularly, on the US economy, often neglecting the peculiarities and dynamics of the process in the countries located in the periphery.

The full range of financial institutions and markets will be evaluated taking into account their interactions with the real economy. The analysis starts in 1980, the moment usually taken as a reference for the acceleration of the process of financialisation.

The report is organized as follows. It starts with an overview of the historical, political and economic development of the Portuguese economy and society. Part II is dedicated to the evolution of the Portuguese financial sector. First, it deals with the evolution of the regulatory framework (Section 2), followed by the growth in finance and its role in the decades of financialisation is described in Section 3. Taking into account the growth in the financial sector, we study the change in the structure and forms of organisation (Section 4), the availability and source of funds (Section 5), the competition between financial institutions (Section 6), and profitability of financial institutions (Section 7).

Part III discusses the interaction between the financial and other sectors, namely the behaviour of the real estate sector (Section 8), the source of funds for business investment (Section 9), the involvement of the financial sector in restructuring non-financial firms (Section 10), the process of privatization (Section 11), and cultural and inequality issues (Section 12).

Part IV assesses the importance of the international context in the Portuguese financial system, with particular attention to the impact of financial globalization (Section 14), European integration (Section 15), and international flows of capital (Section 16).

In Part V we discuss the nature and impact of the financial crisis in Portugal. Finally we draw some general conclusion on the financialisation process in Portugal.

PART I – General background

1. Historical, political, economic and international background [1]

The history of the Portuguese economy and society since the end of World War II can be broadly divided into five periods: 1945-1974, 1974-1985, 1986-1999, 2000-2008, and from 2008 onwards. In what follows, we briefly present the main aspects in the socio-economic history of the country for each of those periods.

1.1. 1945-1974: dictatorship, industrialization, colonial war, and international economic integration

Like most Western countries, Portugal experienced a period of strong economic growth in the quarter century that followed the end of World War II. Although Portugal did not take part in the war (the dictatorial regime, in place since 1926, adopted a neutral position between the traditional English ally and the politically closer Nazi regime), the conflict was all but irrelevant for the evolution of the domestic political economy. Economically, the war fostered the accumulation of financial and political capital amongst part of the local industrial bourgeoisie, tilting the balance of power against the rural interests, which had held great influence within the regime up to then. Politically, the defeat of the Axis Powers helped to convince the conservative dictatorship to embrace the economic development of the country, as a means to minimize the risks of major internal upheavals. Electrification and other major infrastructural programs, together with the active promotion of selected industries, were part of the development strategy adopted in that context.

[1] Point 1b and 17 of the terms of reference.

The evolution of the Portuguese economy and society was further influenced by two major events that took place in the beginning of the 1960s: the participation of Portugal as a founding member of the European Free Trade Agreement (EFTA), and the beginning of the colonial war.

The membership of EFTA was seen by the regime as necessary to avoid international isolation and, at the same time, to take advantage of the opening of international flows of trade and investment which was developing fast in Europe during this period. Portugal's membership of the recently formed EEC was not feasible due to the Portuguese Government's intention to maintain privileged relations with the colonies. In contrast, participation in EFTA gave Portugal greater autonomy in the implementation of its colonial policy. It also helped to protect national agriculture from external competition, allowing a gradual tariff disarmament in manufacturing products. Notwithstanding, by being the single poor country in a club of rich economies (Austria, Denmark, Norway, the UK, Sweden and Switzerland), Portugal was able to attract substantial amounts of FDI from other EFTA countries. This was decisive for the acceleration of industrialization, technological development, productivity growth, and international economic integration.

In the same vein, the colonial war (1961-1974) had multiple implications for the evolution of the Portuguese economy and society. On one hand, the war effort forced the development of several domestic industries. On the other hand, the young male population was largely mobilized for the military action in the African colonies, or escaped the country to avoid the war. As a consequence, the female participation in the workforce increased rapidly, and the scarcity in the supply of labour translated into faster increases in real wages, favouring the slow emergency of a middle class. Moreover, the significant increase in emigration flows led to the increase in remittances, which helped cover the deficit in the balance of goods and services, leading to a substantial

accumulation of reserves since the middle 1960s. Finally, by this time, the colonial war began pressuring public accounts, imposing the need to increase tax revenue, in spite of the fast pace of economic growth. This gradual transformation of the tax system contributed to the ulterior development of social spending.

1.2. 1974-1985: revolutionary upheaval, international crises, and adjustment

At the international level, the period of strong growth that marked the post-war period was interrupted by the collapse of the international monetary system (after the declaration of inconvertibility of the dollar into gold in 1971) and rising oil prices imposed by OPEC in 1973-4.

It was in the midst of the resulting international economic crisis that the Carnation Revolution (25th of April, 1974) took place. Putting an end to 48 years of conservative dictatorship and 13 years of colonial war, the revolutionary process was thus characterized by great social, economic and political instability. In addition to the difficulties driven by the international crisis, several country-specific factors contributed to a sharp disruption in economic activities, including: the abrupt de-colonization process (leading to the arrival of 700 thousand people in less than one year, in a country with less than 10 million inhabitants), the social pressure for fast improvements in living conditions (translating into higher real wages, higher public spending, and inflationary pressures), the conflict between the emerging regime and prevailing business and financial groups (ultimately leading to massive nationalizations in several sectors of activity – electricity, gas, water, rail, sea and air, part of the road network, banking and insurance), and the inherent uncertainty concerning the denouement of the revolutionary process.

Substantial capital flight, significant drops in remittances and foreign investment, disruptions in production (related to labour unrest), the loss of colonial markets, real appreciation in the exchange rate (partially associated with real wage increases), weak external demand, all contributed to increasing difficulties in the balance of payments and the budget balance, ultimately leading to Portugal's recourse to external financial support.

A US-led international loan was granted in 1977 under the condition of an agreement with the IMF, which was signed the next year. The associated stabilization program included as key elements: the adoption of a crawling-peg exchange rate regime (with regular and pre-announced devaluations of the currency), credit limits aiming to control aggregate demand and the external deficit, the direct control of credit growth, administrative restraints on interest rates, and the liberalization of foreign trade. Strong restrictions on the movement of capital were in place since 1977.

However, the efforts to adjust the external balance were jeopardised by the advent of the second oil crisis, leading to the need to resort once more to foreign aid. A second IMF adjustment program was introduced between 1983 and 1985, adding a tighter control on the public enterprises' debt to the ingredients already present in the first program. Overall, the decade that followed the 1974 revolution was marked by slow economic growth and high unemployment.

The nationalizations that took place after the 1974 revolution and the agreements with the IMF account for the late liberalization of the Portuguese economy, in particular the financial sector, in comparison with other European countries. While in other European countries the private sector dominated the banking system, public banks were the norm in Portugal in the in the early 1980s. During this period, public banks typically financed the public sector at interest rates which were below market values, reducing banks' profits and

capital. Banks' management was subject to political influence and competition was essentially absent from the sector – banks could not compete on price, quantity, or location. This situation has significantly changed in the following period.

1.3. 1986-1999: accession to the EEC, growth and liberalization, and preparing for the EMU

By the end of the period of the second IMF intervention, the international economic context was becoming more favourable to the Portuguese economy, due to the appreciation of the US dollar, the substantial drop in oil prices, and the rate of economic growth of Portugal's main trading partners. It was in this favourable context that Portugal joined the EEC (on the 1st of January, 1986), benefiting in the following years from a substantial transfer of structural funds, access to loans from the European Investment Bank, as well as from the significant inflows of FDI (fostered, in particular, by the single market program). This period was also characterized by the political stabilization of the country and the liberalization of the Portuguese economy – in particular, the financial sector (see Table 1).

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

Date	Measure
February 1984	Start of the removal of barriers to the entry of new banking institutions and the removal of restrictions on the expansion of the network of bank branches
June 1984	Liberalisation of deposit rates, excluding the rate on deposits with a maturity of 180 days up to 1 year
August 1985	Liberalisation of lending rates[2], excluding those on operations with a maturity from 90 to 180 days, 2 years to 5 years and over 5 years, for which a ceiling was set
1986	Start of the removal of capital controls (allowing for FDI and portfolio investment)
September 1988	Liberalisation of lending rates, excluding those related to loans for house purchase
March 1989	Start of the privatisation process and elimination of ceilings on all lending rates
March 1990	Suspension of the compulsory credit ceiling system
During 1990	New legal framework for Bank of Portugal
October 1990	Crawling peg ends
January 1991	Elimination of compulsory or indicative quantitative credit limits, replaced by open market operations
April 1992	Escudo joins the European Monetary System
May 1992	Liberalisation of all deposit rates
Dec. 1992	Conclusion of the process international capital movements liberalisation

Source: Based on Castro (2007)

In the first six years following the accession to the EEC, Portugal's GDP per capita (in purchasing power parities) rapidly converged with the EU15 average, from 54% in 1986 of that average to 68% in 1992. This process of catching-up was interrupted during the crisis of the European Monetary System (EMS) in 1992-1993. The adverse international context, however, is only part of the explanation for the falling output and rising unemployment experienced during this period.

[2] Liberalization means that banks become free to set interest rates.

Since 1990 Portuguese economic policy has been committed to the nominal convergence strategy that was inherent to the process of monetary integration in the EU. In the early 1990s, the Portuguese government implemented a strategy of 'competitive disinflation', characterised by restrictive monetary and fiscal policies aimed at reducing the external deficit and inflation, and seeking output and employment growth via the reduction in real wages, increased price competitiveness, exchange rate stability and credibility of policies. The crawling peg was then abandoned and the escudo was pegged to a basket of European currencies dominated by the German mark – thereby anticipating, in essence, the accession to the Exchange Rate Mechanism of the European Monetary System planned for 1992. At the end of this year all restrictions on the free movement of capital were abolished. The conjunction of the disinflationary strategy and the international recession, as well as the financial instability within the EMS, led to the first recession of Portugal's new European age in 1993.

In the remaining years of the 20th century the Portuguese economy benefitted from the improved performance of the international economy and from the sharp reduction in real interest rates since the mid-1990s – real long-term interest rates fell from an average of 4.8% in 1993-1996 to 1.8% in 1997-2000. Such a drop in interest rates was a result of the aforementioned 'nominal convergence' (in anticipation of the EMU), the liberalization of the banking sector, and the free movement of capital within the European single market (improving the domestic banks' access to international financing, via interbank lending, debt market, and securitization of credits). Banks have thus ensured the financing of the economy, borrowing money internationally and lending it internally. In sum, the participation of the Portuguese economy in the process leading to the EMU increased significantly the availability of credit.

Such developments had a decisive impact on public and private decisions, since economic agents were then able to obtain a substantially higher volume of credit without increasing significantly their future financial obligations. Accordingly, public and private (firms and household') investment increased at a fast pace during this period, feeding – and being fed by – economic growth.

The increase in domestic investment coincided with a period of low oil prices and favourable exchange rate developments (with the appreciation of the dollar against the euro), all of which had a positive impact on economic activity. Thus, after a dismal performance in 1993-1994, the Portuguese economy regained momentum, with GDP growing at an annual average of 4.3% (in real terms) between 1995 and 2000, and the unemployment rate dropping from 7.1% to 3.9%.

Such economic growth was to some extent translated into long-awaited improvements in social welfare. For example, between 1990 and 2000, the minimum old age pension increased from 163€ to 202€ per month, while the minimum unemployment allowances increased from 257€ to 334€ (all values at 2006 prices), while access to health and education services for the population at large improved substantially. When the decade drew to a close, government expenditures as a percentage of GDP had grown to 41.1% (from 38.5%) – still below the EU15 average of 44.9%, but much closer than in 1990. Concurrently, public investment grew rapidly over the period, reaching 5.3% of GDP in 1997 and remaining over 4% until 2002.

Notwithstanding the increase in social expenditures and public investment, Government finances seemed at the time to remain in a healthy shape. In fact, national public debt decreased by more than 10 percentage points of GDP in the second half of the 1990, from 59.2% in 1995 to 48.5% in 2000; the Government budget deficit dropped from -5.4% to -3.3%.

In other words, during the second half of the 1990s, a fairly expansionary fiscal policy was compatible with a positive evolution of public finances. Four main reasons account for this: the rapid pace of economic growth, the low levels of real interest rates, the (re)privatization of large public firms in several industries (including telecoms, energy, transport, banking and insurance, among others), and the substantial inflows of European structural funds (corresponding to more than 2% of GDP each year).

1.4. 2000-2008: dismal growth and loss of competitiveness within the EMU

By the turn of the millennium, the Portuguese economy and society were in seemingly promising conditions – and the participation in the founding group of the euro area was just another expression of this optimistic outlook.

However, the evolution of the Portuguese economy was rather different afterwards, with GDP growth between 2000 and 2005 dropping to an annual average of 0.8%. A number of events account for this dramatic change of course. Soon after the inception of the euro, in reaction to what appeared to be signs of overheating in the euro zone, the ECB started to tighten its monetary policy, leading the Euribor 6-month rate to double from its lowest 1999 value of 2.6% to 5.2% in late 2000. Given the high rates of public and private investment in the preceding years, essentially financed through bank credit, the steep increase in the interest rates had a significant impact on the levels of available income and, consequently, in domestic demand. In the meantime, the busting of the 'dot.com bubble' (starting in March 2000 and lasting through 2001) triggered the first international economic crisis of the new millennium. These two events are largely accountable for the increase of the Portuguese public deficit to 4.3% of GDP in 2001, making Portugal the first country in the euro area to break the

Stability and Growth Pact's (SGP) 3% limit. In the following couple of years, the Portuguese authorities were committed to comply with the SGP rules, following pro-cyclical, contractionary fiscal policies, which led to a 1% drop in GDP in 2003 – starting a decade-long period of divergence in average incomes with the EU.

While the levels of public and private indebtedness looked relatively sustainable during the second half of the 1990s (when GDP was growing at an average annual rate of nearly 5%), a sequence of years of dreary GDP growth translated into rising debt ratios of firms and households, which increasingly translated into lower investment and, consequently, even lower growth.

By the early 2000s, the Portuguese economy was facing the consequences of the aforementioned combination of structural weaknesses and international developments. In particular, the growing competition from Asian emerging economies (partly as a result of the agreements reached by the EU in the WTO and other forums) had a substantial impact on a number of traditional industries (namely, textiles, wearing apparel, footwear, wood and paper, metal products and non-metallic minerals), which were responsible for a significant part of the manufacturing work force. Moreover, anticipating the EU's Eastern enlargement in 2004, many 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).

In short, steep increases in the interest rates (after a prolonged period of public and private investment), international crisis, pro-cyclical (restrictive) fiscal policies, increasingly fierce competition from emerging economies, and a loss of policy instruments to address such problems was the context in which the Portuguese economy entered the new millennium. When subsequent external shocks hit the international economy – namely the successive increases in

ECB's 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 characterized by low economic growth, rising unemployment rates (from nearly full-employment in 2000 – 3.9% – up to 7.7% in 2006) 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).

1.5. Since 2008: crises and adjustment programs with no guarantee of success

With a record of dismal GDP growth since 2000, a rapid increase in public debt after 2008 (as a result of the international crisis and the counter-cyclical measures undertaken in line with the European Economic Recovery Plan), and high levels of indebtedness of both firms and households, 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 help to the European Financial Stability Facility (EFSF) 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 International Monetary Fund – which established the terms of the adjustment program that would accompany the EFSF's loan – fixed as main objectives the rebalancing of Portuguese public finances (by reducing public deficit from 9,8% of GDP in 2010 to under 3% in 2013) and the adoption of a number of measures to strengthen the competitiveness of the Portuguese economy.

In general, the adjustment program that is being implemented in Portugal since May 2011 does not represent a dramatic break with the recent past with regard to the measures related to public finances. As was partly mentioned before, several policy initiatives in this field have been adopted in previous years, including reducing the number of civil servants and their real wages; reducing the number of public agencies and managers; cutting back social expenditures; downsizing public investment programs; privatizing state-owned firms; decreasing tax benefits for household expenditures with education and healthcare; decreasing tax benefits for higher pensions; increasing the VAT rate (now at 23%); increasing the maximum marginal rate in personal income tax (now at 45%); 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 program essentially emphasizes 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 to social benefits, greater cuts in public investment, and a stricter control of the budgetary process at all levels – central and local administration, quasi-public agencies and state-owned firms).

As expected, such austerity measures have resulted in a steep decrease in economic activity and employment. For 2012, the Portuguese government expects a drop in GDP of 3% (after -1.8% in 2011) and an increase of the unemployment rate to 15.5% (for 2013, the government's forecasts for GDP and unemployment are -1% and 16.4%, respectively). More recent forecasts by the OECD and the European Commission are even drearier.

The contractionary implications of the adjustment program, in the context of a decelerating European economy (largely due to the austerity programs being adopted in other EU countries), have already led to the need to adopt new

measures in the fiscal area – the most relevant of which was a cut of nearly 12% in civil servants' wages in 2012 (adding to an average cut of 5% that had been previously decided) and the announcement of overarching tax increases in 2013. The fact that the government had to introduce an additional, and substantial, cut of civil servants wages and increase general taxes is not only a sign that the recessive impact of the austerity measures is greater than initially expected – it also suggests that the possibility to obtain significant improvements of the budgetary situation by cutting down superfluous expenditures, or by increasing revenues from unexplored sources, is entering into rapid decreasing returns.

In other words, given the measures that were already in place (some of which for several years), the Portuguese adjustment program seems to be mostly about forcing the reduction of the public deficit in the short term (in order to meet the goals set at the EU level) – and an internal devaluation in the medium term – rather than radically changing fiscal management practices in the country. The aim to achieve a drastic reduction of the deficit is leading to a deep recession, which makes it even more difficult to achieve the desired goals in the fiscal front.

The capacity to achieve the deficit targets seems now to depend on a rapid return of the Portuguese economy to a growth trajectory. This, however, at the present juncture appears to be ever more distant. The adjustment program does not include significant measures to counter the recessionary implications of expenditure cuts and tax increases. During the adjustment period all sources of growth are expected to come from net exports. But the deterioration of the European economy is certainly not a cause for optimism at this level.

For the medium- and long-term, the adjustment program assumes that low wage growth, a decrease in government's expenditures, the control of public debt, together with a number of so-called 'structural reforms' in the labour and

product markets, will help to restore the competitiveness of the Portuguese economy and put it back on a growth track.

However, returning to a sustainable growth path represents a major challenge for the Portuguese economy. More important than the imperfections in the labour and product markets, Portugal presents a number of structural weaknesses that are particularly hard to overcome. The most relevant constraints to development in the present context are: (i) the low levels of education of the labour force, (ii) the profile of economic specialisation (which is still dominated by industries with low value-added and highly exposed to competition from Eastern European and emerging economies), and (iii) the peripheral position of the Portuguese economy in relation to the main European and world markets (which entails relevant cost disadvantages). While being part of a monetary area (the EMU) and a common market (the EU) whose rules and policies are designed for the whole bloc, and which are short of mechanisms to address asymmetric developments among the composing economies, Portugal will probably face a long and painful macroeconomic adjustment in the coming years.

PART II – The Portuguese financial sector

2. Regulatory framework[3]

Since the beginning of the 1980s, there was a worldwide trend to liberalize and privatize the banking system, and eliminate the restrictions to international capital flows. At the EU level this was associated with the creation of the European Single Market.

Even though such a trend reached Portugal with some delay, the liberalization of the financial system followed a similar path to other EU countries. To understand the reasons for this delay in Portugal, one has to go back to the 1974 Revolution and the subsequent nationalization of the banking system.

2.1. Nationalization of banks after 1974

Until the 1974's revolution all banks operating in Portugal were private, with the exception of Caixa Geral de Depósitos (which remained public to the present day). The banks that could issue currency (Banco de Portugal, Banco Nacional Ultramarino, and Banco de Angola) also had a private status.

The provisory Governments in the aftermath of the 1974 Revolution, aiming to prevent capital flight and to have control in the development of the economy, nationalized the issuing banks in September 1974. In March of 1975 the other financial institutions (including non-monetary institutions) were nationalized[4], with the exception of mutual or cooperative institutions (Caixas Económicas, Crédito Agrícola Mútuo) and foreign banks (Crédit Franco-Portugais from Crédit

[3] Point 6 of the terms of reference

[4] According to the Decree-Law 132/75 of 14 March.

Lyonnais, Bank of London & South America from Lloyds Bank, and Banco do Brasil).

In 1976 the new Portuguese Constitution stipulated the irreversibility of the nationalizations and the prohibition of the banking activity to private agents. Concurrently, state owned banks were restructured[5], increasing the concentration of the industry.

In the beginning of the 1980s, the largest part of the banking system was state owned. The system was under the direct control of the Government and there were restrictive regulations. There were restrictions on the amount of credit and on interest rates, and commercial and investment banks were legally separated. The scope of activity of commercial banks was also restricted. There was no real competition, and innovation and efficiency were limited (Caixa Geral de Depósitos, 2010). In sum, the financial system was repressed.

2.2. The re-privatization and deregulation of the banking system

After Portugal joined the European Economic Community in 1986, the gradual integration of the Portuguese economy into the European Common Market required a gradual dismantling of the constraints on the financial system, namely the State ownership of banks. This process had already begun in 1983 with the reopening of banking and insurance activities to private enterprise[6]. The new regulatory framework allowed the creation of new private credit institutions thenceforth, clearing the way for national and international

[5] Banco Pinto & Sotto Mayor absorbed Banco Intercontinental Português, Banco Português do Atlântico absorbed Banco Fernando Magalhães and Banco do Algarve, Banco Fonsecas & Burnay integrated Banco do Alentejo, Crédito Predial Português absorbed Banco Agrícola e Industrial Viseense, and União de Bancos Português was created as a result of the merger between Banco de Angola, Banco da Agricultura and Banco Pinto de Magalhães.

[6] Decree-Law 406/83 dated November 19th and the Decree-Law 51/84 dated February 11th.

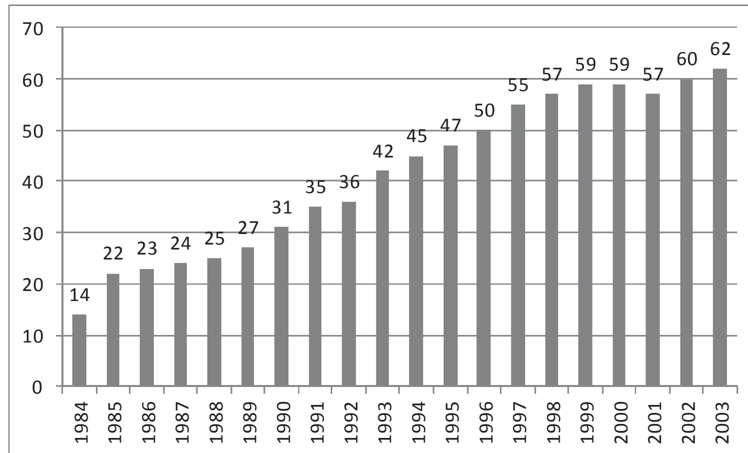
investors to create new private banks (with a minimum of 1.5 million escudos of capital).

Furthermore, a new set of measures was taken later in the decade, including the gradual elimination of administrative limits on interest rates, credit growth, and the number and localization of bank branches. Explicit restrictions on the composition of bank's assets were also removed, namely the compulsory investment in national sovereign debt. Mostly, these measures removed the restrictions that had been implemented as part of the two agreements with the IMF (in 1977 and 1983), aiming to contain the growth of money supply.

In this context, a number of foreign banks opened activity in Portugal from 1985 onwards, including Barclays, Banque National de Paris, Chase Manhattan, Citibank, Manufacturers Hanover Bank. Foreign banks were important to the modernization of the Portuguese financial sector, being carriers of innovation and efficiency in baking practices, in particular they brought new methods for assessing credit risk (credit scoring models), new products and services and new technology (Honohan, 1999). Simultaneously, a new set of domestic banks were created, being typically focused in specific market segments (such as investment activities).

The number of domestic and international banks rose dramatically after then. Between 1984 and 1994, the number of banks (excluding savings and co-operative banks) jumped from 14 to 45 (Figure 1). This trend persisted during the following years, led by the arrival of foreign banks to the Portuguese market, even though although foreigners continued to account for a relatively small share of the domestic banking market. Honohan (1999) suggests that the new foreign banks, many focusing on retail banking, were unsuccessful in the first years mainly due to high levels of non-performing loans.

Figure 1 – Number of banks operating in Portugal



Source: Bank of Portugal's Annual Reports, several years

In 1989 a new Constitution abolished the principle of irreversibility of nationalizations that had been included in the 1976 Constitution. At the end of that year, the privatization process began[7], and the barriers to the entry of new financial institutions into the Portuguese financial sector were abolished.

The privatization process represented an important milestone, enhancing competition and innovation in the banking sector. Since privatizations were carried out mainly through public offers, they contributed to increases in the depth of capital markets and led to greater diversification in investors' portfolio, particularly in the case of households and corporations. The promotion of 'popular capitalism' was by then a *moto*. Commercial banks facilitated and profited from this process by giving credit to small investors wishing to buy stocks.

[7] This happened after the publication of the Decree-Law 84/89 of 20 July. Banco Totta & Açores, Banco Espírito Santo e Comercial and Banco Português do Atlântico were the first institutions to be privatized in 1991. In 1992, the privatization process continued with Banco Fonsecas & Burnay, Banco Internacional do Funchal and Crédito Predial Português. In 1994, Banco Pinto & Sotto Mayor, União de Bancos Portugueses, Banco Fomento do Exterior, Banco Borges & Irmão and Banco Totta & Açores followed (see Table 1, in Annex).

As a consequence of the competition from foreign banks and the efforts for rationalization, several waves of takeovers subsequently took place, especially after 1994. In many cases, the institutions involved in these operations did not actually merge, but rather formed banking conglomerates, only a few disappearing completely as a result. In any case, such reorganization led to the increase in market concentration (Figure 73).

In order to prevent banks from exerting their market power over clients and to avoid excess indebtedness in such a liberalized market, some regulations have been approved to protect consumers. Among the most important, limits to the commissions charged by banks in the case of anticipated payment of the mortgage were established, facilitating the mobility of clients across banks and, therefore, fostering competition among banks. Moreover, banks were forced to disclose comprehensive pre-contractual information to their clients. In the case of mortgages, banks were now expected to provide their clients with simulations of the impact of increases in the interest rate on the monthly instalment.

Finally, in some countries the liberalization of the banking system has caused banking crisis. This succession of events has not occurred in Portugal, in spite of the default of some small banks with no systemic impact.

In sum, and following Honohan (1999), the liberalization of the Portuguese financial system has gone through three stages. The first stage is associated with the possibility of the creation of new banks since 1983, after the revision of the Constitution in the previous year. The second phase starts in 1989 with the privatization of the banks which had been nationalized in 1975. The third stage is related to the elimination of interest rate controls (controls on lending interest rates were removed in 1988, while controls on deposits interest rates were eliminated only in 1992), the abolishment of credit ceilings (in 1990) and other State controls on the number of branches and new products and services.

2.3. European integration and the banking system

The adoption of European regulation has contributed in a decisive way to the liberalization and deregulation of the Portuguese banking system. An important step was taken in late 1992, when the Second Banking Coordination Directive[8] (which extended the single market to financial services) was transposed to the Portuguese law[9]. Thereby, a financial institution allowed to operate in any member state could establish new branches and provide financial services across borders throughout the EU, obtaining the so-called "EU-passport". Hence, any bank based in the EU obtained automatic access to a much wider market, broadening the relevant market in geographic terms, reducing national borders, and removing restrictions on the range of financial activities allowed (with the exception of insurance activity).

This new regulatory framework also established the principle of universal banking, eliminating the legal imposition of segmentation of banking activities. Until the publication of this legal framework, the banking system was segmented into different activities: commercial banks, savings banks, and investment banks. After 1992 all banks were able to perform the whole range of bank activities and the banking system was no longer divided into banks specialized in certain operations with particular maturities. Banks also started to offer other specialized products that are not strictly banking products, such as factoring or leasing. Moreover, banks seized the opportunity to start internationalizing, by opening branches in other countries.

In order to develop the internal market, one of the main concerns of the EU was to harmonize the procedures and regulations across member states, including

---

[8] Directive 89/646/EEC of 15 December.
[9] Law 298/92 of 31 December.

the implementation of the European Union Capital Adequacy Directive[10]. Following the recommendations of the 1988 Basel Committee, such a Directive aimed to establish uniform capital requirements for both banks and non-bank securities firms. The Basel I rules for capital adequacy were implemented in Portugal in 1993. The rules of the common market for insurance and investment services were also adopted in Portugal.

2.4. Changes in regulation in response to the 2008 financial crisis

The 2008 financial crisis evolved rapidly from a situation of financial turbulence associated with sub-prime mortgages in the US, to a serious global financial and economic crisis. In response, the majority of international authorities put in place coordinated actions, involving the adoption of emergency policy measures by central banks, supervisory authorities, governments and supranational entities.

One of the major concerns was to reinforce the future resilience of banks by increasing their capital. In this line, the new Basel III agreement, starting in 2013 and with full implementation expected in 2019, imposes more demanding capital ratios (the Tier I ratio goes from 6% to 7%).

The European Commission has adopted a plan recommending member States to guarantee debt emissions by banks, to soften securities' accounting rules, and to recapitalize banks in difficulty through public money (European Commission, 2008). Measures were taken to improve the regulation of rating agencies, as for example the prohibition of selling consulting services, the obligation to publish models and methodologies, the requirement to include independent members in the administrations. The EU also proposed the

---

[10] Directive 93/6/EEC and the corresponding amendment in Directive 98/31/EEC.

limitation of bonus to banks' managers. The UK and France created a special 50% income tax on bonuses for all high earners.

In line with European guidelines, the Portuguese authorities adopted a pro-active stance, approving measures to support the robustness of the financial system and to mitigate the negative effects of the crisis on the real economy (Bank of Portugal, 2007, p. 39).

Thus, in October 2008 the Portuguese government created State guarantees for issues of securitized debt by banks, to a maximum of 20 000 million € for all banks. These guarantees were designed for all credit institutions with the head office registered in Portugal, which were facing temporary liquidity constraints due to the difficulty in accessing the interbank market and in issuing debt with medium term maturities. Banks had to pay a commission of 50 basis points (b.p.) for the guarantee of a debt emission with maturity less than a year (or 50 b.p. plus the premium on the bank's own credit default swap at 5 years in the case of a debt emission with maturity larger than a year).

On the 2th of November 2008, the Portuguese government announced a recapitalization plan for credit institutions, up to a total of 4 000 M€. The main aim of this recapitalization plan was to guarantee that banks were able to improve their solvency ratios, in a context of strong difficulties in wholesale debt markets and according to the Recommendation of the Bank of Portugal[11] that the Tier I capital ratio should be above 8% from September 2009.

At the beginning of April 2011, the Bank of Portugal switched from a recommendation to a requirement that the minimum limit of the Core Tier I ratio should be 8%. It is worth noticing that the Core Tier I ratio was defined on the basis of Basel III rules, applicable for the definition of Common Equity I in 2013.

---

[11] Circular 83/2008/DSB.

In May 2011 Portugal signed the Economic and Financial Assistance Program (EFAP) with the ECB, European Commission and IMF, as a counterpart of an international loan amounting 78 000 M€. The EFAP established four main goals regarding financial stability (Bank of Portugal, 2012: 17): to improve the solvency of the banking sector, to promote the deleveraging of banks and ensure their stable funding, to strengthen the supervision of the banking system, and to improve the regulation of banks.

In order to reinforce the solvency of the banking system, in May 2011 the minimum for Core Tier I was revised from 8% to 9%, to be complied until the end of 2011, and to 10% by the end of 2012[12]. In order to prevent situations in which banks would be unable to meet this required capital levels selling capital on the markets, part of the international loan (12 000 M€) was allocated to bank recapitalization (the Bank Solvency Support Facility). Yet, only a restricted number of banking institutions are expected to use this fund (Bank of Portugal, 2012: 18), probably because they can obtain capital in the market or are not interested in having the State as a shareholder.

To reduce the leverage of banks the EFAP also included an indicative target for the credit-to-deposits ratio of the eight main banking groups, which was set at 120% by the end of 2014. In the same vein, a stable funding structure for banks was based on the reinforcement of the assets that could be used as collateral for loans from the ECB. This source of finance was still very important for banks in 2011, when the access to international debt markets was virtually blocked. The emission of bonds by banks with government guarantee was important to facilitate the access to ECB's financing, since those bonds could be used as collateral in the ECB. Another important line of action was the increase in banks' deposits (in order to improve the ratio credit-to-deposits), which has occurred at a good pace in 2011. The demand for deposits augmented in

[12] Notice 3/2011.

response to the increase of interest rates and due to higher risk aversion. The competition between banks for deposits was so fierce that the Bank of Portugal decided to create a rule penalizing banks' capital if they paid very high deposits interest rates.

More recently, the Bank of Portugal ruled that 21% of the nominal value of the exposures to Greek public debt should be deducted from the Core Tier I capital of the Portuguese financial institutions, due to the strong deterioration of Greece's fiscal situation and in line with the decision of the European Summit to involve the private sector in the bailout. After that, the European Council's meeting of 26 October 2011 decided a haircut of 50 per cent of the nominal amount of Greek debt held by private investors (the terms and conditions of which have yet to be clarified).

In order to reinforce the confidence of depositors, the Portuguese government also increased the maximum cover for the deposit guarantee fund, from 25 000 to 100 000 euros per depositor and per institution[13].

In addition, there was a substantial reduction in the legally defined period for redemption of deposits and other measures were taken to reinforce the duties of financial institutions in terms of information and transparency. Simultaneously, the Securities Market Commission banned temporarily the short-selling of shares issued by financial institutions.

Furthermore, the Bank of Portugal put in place amendments to its prudential supervisory framework. Changes were made to the treatment of unrealized gains and losses on securities classified as available-for-sale assets, which had a positive impact on bank's capital. On the other hand, in order to improve the supervision of the banking system (in line with the EFAP), the Bank of Portugal requested more frequent and detailed reports on prudential information

[13] Law 211-A/2008.

(liquidity and solvency). There was also a reinforcement of the methodology to assess the solvency and deleveraging process of the banking system (including the realization of *stress tests* on the eight major banking groups), the publication of a new non-performing loans ratio, the development of further indicators to evaluate the level of indebtedness of households and corporations, and the creation of the Special on-site Inspections Program for banks.

Besides these general measures, the Portuguese authorities had to deal with the complications which arose in two banks. The problems in the Banco Português de Negócios (BPN) led to its nationalization in early November 2008 to protect depositors. The other problematic bank was Banco Privado Português (BPP), where the first move was to set up a private solution through a loan from six Portuguese banks backed by State guarantees.

Given the fragilities of the Portuguese banking system in 2012, it can be asked if the supervision of the Bank of Portugal has failed in some aspect. In accordance with the European Commission (2004) banking regulation has involved measures to restrict the lending behaviour of banks, namely: higher capital requirements for mortgage loans with high loan-to-value ratio; acceleration of provisions for non-performing loans (in 2003); and indications for banks to increase capital and extend financing maturities. On the negative side, we can argue that in the BPN and BPP cases there are indications that more could have been done to detect timely fraudulent management's acts.

2.5. Concluding remarks

In the aftermath of the 1974 Revolution, most of the Portuguese banking system was nationalized. Together with the Balance of Payments problems and the related agreements with the IMF (in 1977 and 1983), this implied that the process of liberalization of the financial system in Portugal was somewhat delayed in comparison with other European countries.

In the second half of the 1970s and for most of the 1980s the Portuguese banking system was mainly dominated by public banks and it was subjected to strong regulation, with low levels of competition and innovation. The liberalization of the banking sector started in 1984, with the authorization of private banks, followed by the elimination of many restrictions no banks' activity, privatizations, the free entry of EU banks into the domestic market, and the adoption of capital requirements. This process resulted in the substantial increase in the number of banks (especially foreign-owned ones), an increase in competition, a wave of takeovers, and a larger supply of credit. Despite the liberalization process, no financial crisis has occurred for two decades. Only in 2008, as a result of the international crisis, the Government and the bank of Portugal were compelled to take measures to ensure the stability of the financial system, guaranteeing banks' debt, recapitalizing banks, and re-enforcing the regulatory framework. Such concerns have increased in the context of the adjustment program associated with the international loan obtained by Portugal in 2011.

3. The growth in finance and its role in the decades of financialisation [14]

As in many countries, the growth of the financial sector and of debt has been a distinctive feature in the recent evolution of the Portuguese economy. In this section we start by assessing the importance of the financial sector in terms of output, employment and financial assets in Portugal, as well as the evolution of securities' markets, including the stock and debt markets. Then, we discuss the evolution in the allocation of households' wealth across securities, the saving rate, the volume and composition of deposits, the volume of loans, the level of debt of households and corporations, the level of non-performing loans, and Government's contribution to the increase in debt. We conclude with the analysis of the contribution of households, firms and Government for the external debt.

3.1. Output and employment in the financial sector

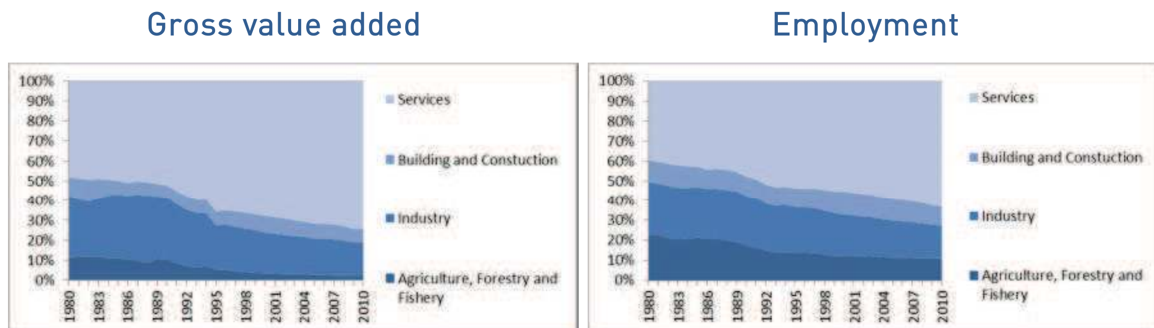
In the recent decades, the sectorial structure of the Portuguese economy has experienced a deep transformation, with the importance of service sector increasing in terms of production and employment (see Figure 4). In the 1990s the weight of agriculture and industry in the total value added of the economy started declining and the weight of services started to increase significantly. In 1990 the shares of agriculture, industry and services in total value added was 10%, 31% and 52%, respectively, whereas in 2010, the corresponding values were 2%, 17%, and 74%. This phenomenon of tertiarisation of the economy was common to other developed economies, although the decrease of primary and secondary sectors' activities over this period was particularly pronounced in Portugal. Since productivity tends to grow at a slower rate in services than in

[14] Point 2 of the Terms of Reference.

manufacturing, the growth of services may have contributed to a reduction in overall productivity growth.

Figure 2 – Sectorial structure of the Portuguese economy, 1980-2010

Gross value added | **Employment**



Source: Bank of Portugal (historical series) and INE

Since 1995 non-tradable goods sectors have grown faster than the average economy (see Section 10.2 for more details). Several factors account for the increasing weight of non-tradable sectors in the Portuguese economy, including the following:

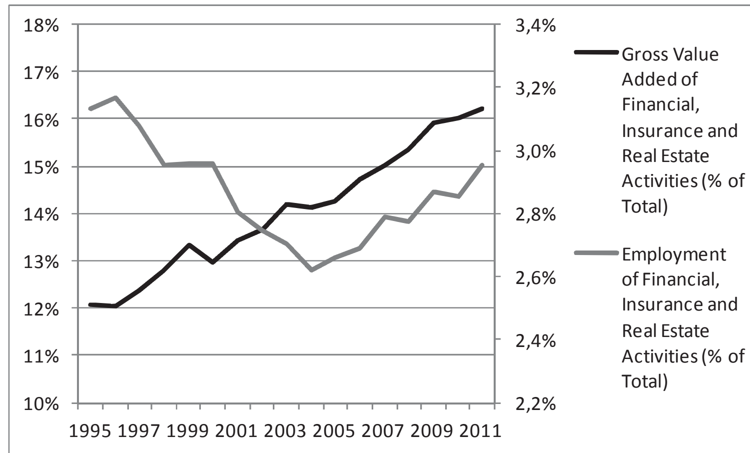
- the growth in public expenditure (mostly in physical infrastructure and in education and training);
- the easier access to credit (fostering the expansion of construction, real estate activities, and financial services);
- the appreciation of the real effective exchange rate (before and after the inception of the euro), the trade agreements between EU and emerging economies, and the EU's Easter enlargement – all of which undermined the competitiveness of Portuguese exports and discourage investment in activities exposed to international competition;
- EU's agriculture and fisheries policies, which favoured the destruction of productive capacity and disinvestment in these sectors (both of which are producers of tradable goods with significant weight in the Portuguese economy until the early 1990s);

- the privatization of large companies in sectors producing mainly for the domestic market (energy, telecommunications, transport, financial services, etc.), in conjunction with regulatory privileges granted to privatized companies (diverting both financial and human resources from the rest of the economy, including the tradable sectors);
- the bargaining power the largest Portuguese business groups – most of which base their activity on non-tradable sectors, such as financial services and retailing – in relation to much of the remaining economic actors (in particular SMEs). These groups used their power to influence political decisions in favour of non-tradable sectors.

Financial services (defined in a broad sense: including financial services and real estate) were among the sectors which benefited the most from these trends: between 1986 and 2010, their weight in terms of total value added grew from 10% to 15% (see Figure 3). It is worth noting that the larger increase in the importance of the financial sector occurred in the five years after the reopening of this sector to private actors. The proportional growth in importance of financial sector in terms of value added was rather similar to the growth of the overall service sector: over the same period, the weight of the whole service sector in the total value added of the economy also increased by a half, from 51% to 74%.

In contrast, financial activities registered a marginal decrease in importance in terms of employment, from 3.1% in 1995 to 3% in 2011. Since its share in terms of value added has increased, while its share in employment has remained constant, the financial sector's apparent productivity of labour has grown faster than the average.

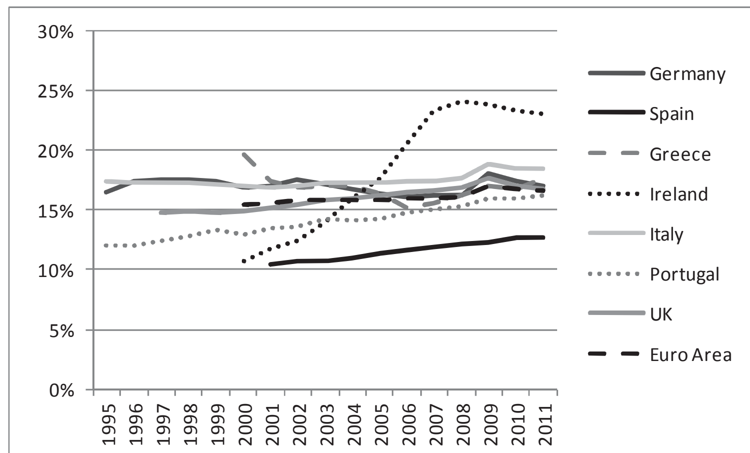
Figure 3 – The importance of the financial sector (% of gross value added and employment)



Source: Eurostat

Comparing the importance of financial activities in terms of total value added with the euro area partners, we conclude that in 1995 the Portuguese financial sector was one of the smallest (Figure 4). However, from 1995 to 2011 the relevance of the financial sector in the overall GDP has grown faster in Portugal than in the Euro area, with its pace of growth being only supplanted by Ireland's. By 2011 the weight of the financial sector in the Portuguese economy in terms of value added had converged to the Euro area's average, although remaining below the latter.

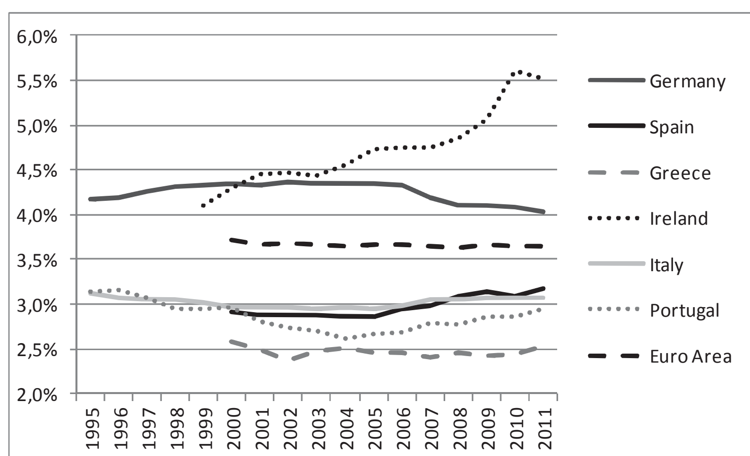
Figure 4 – The importance of the financial sector in broad sense in the EA (% of gross value added)



Source: Eurostat

Similarly, in terms of employment, the financial sector was less important in Portugal than in the Euro area in 2010. As in many other Euro Area countries (with the noticeable exception of Ireland), the weight of the financial sector in total employment in Portugal has remained relatively stable in the period under analysis.

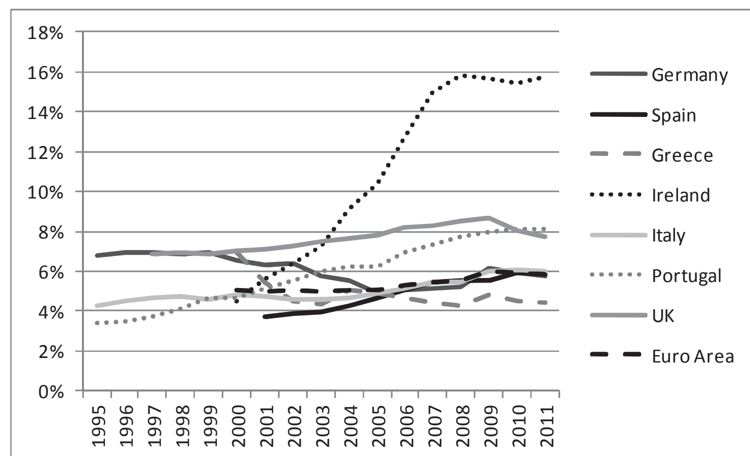
Figure 5 – The importance of the financial sector in broad sense in the EA (% of employment)



Source: Eurostat

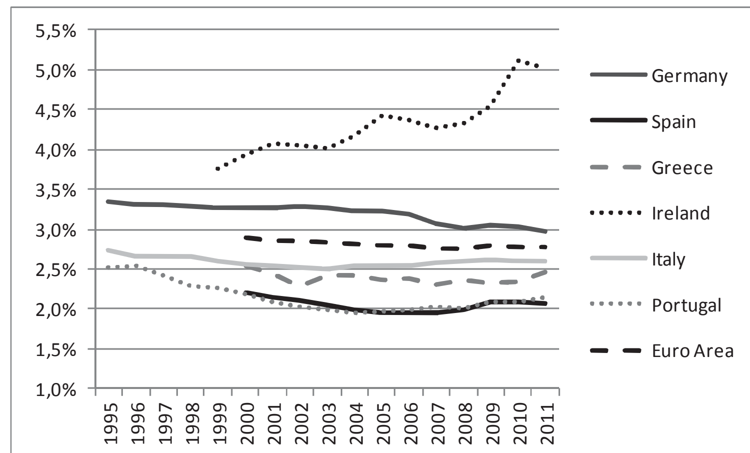
However, a very different picture is obtained when we adopt a more restrictive definition of financial activities (i.e., considering only financial activities, *i.e.*, the activities classified under the category K according to Eurostat's NACE classification). In this case the weight of financial activities in total value added in Portugal was among the highest in the Euro Area in 2011 (Figure 6), and its growth between 1995 and 2011 was outstanding (Figure 6). Still, the importance of financial activities in terms of employment in 2011 was below the EA average, and followed a downward trend since 1995 (Figure 7).

Figure 6 – The importance of the financial sector in strict sense in the EA (% of gross value added)



Source: Eurostat

Figure 7 – The importance of the financial sector in strict sense in the EA (% of employment)



Source: Eurostat

3.2. Other measures of financialisation

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

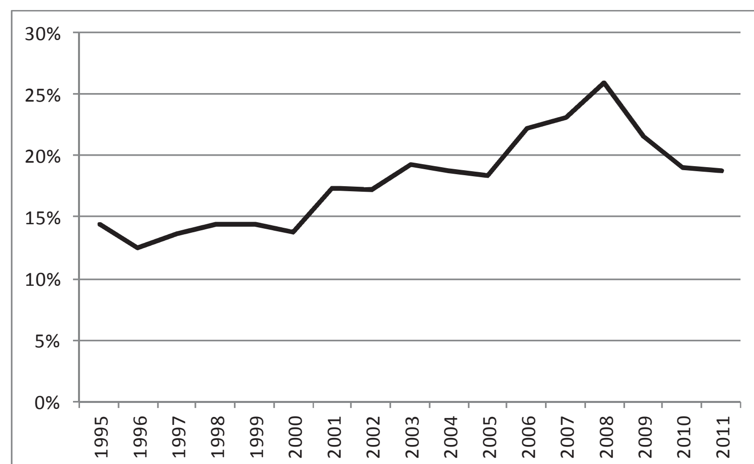
In order to measure those implications of financialisation we can use two indicators. For the first consequence we can use as a proxy the gross operating surplus (GOS) of financial corporations in comparison to GOS of non-financial corporations. The GOS synthetises the remuneration of capital (rents, interests and profits)[15]. This indicator tells us from which sector capital is taking its remuneration. Regarding the second effect of financialisation, we look at the

[15] "At the level of national accounts, gross operating surplus can be defined as a balancing item in the generation of income account representing the excess amount of money generated by incorporated enterprises' operating activities after paying labour input costs. In other words, gross operating surplus is the capital available to financial and non-financial corporations which allows them to repay their creditors, to pay taxes and eventually to finance all or part of their investment." (Eurostat)

weight of financial revenues from sales or net profit for non-financial firms, obtained from a representative sample of firms [16]. As a complement, we look at the data from National Accounts on property income (interest, rents, and dividends)[17] of non-financial corporations in comparison to production.

Regarding the first indicator, from 1995 to 2008, the proportion of GOS of financial corporations to non-financial corporations grew by 10 p.p., from 15% to 25%, a sign of the on-going process of financialisation in the period (Figure 8). From 2009 to 2011, in the context of the financial crisis, that indicator decreased approximately 6 p.p.

Figure 8 – Gross operating surplus of financial corporations (% of gross operating surplus of non-financial corporations)



Note: The values for 2010 and 2011 are forecasts.

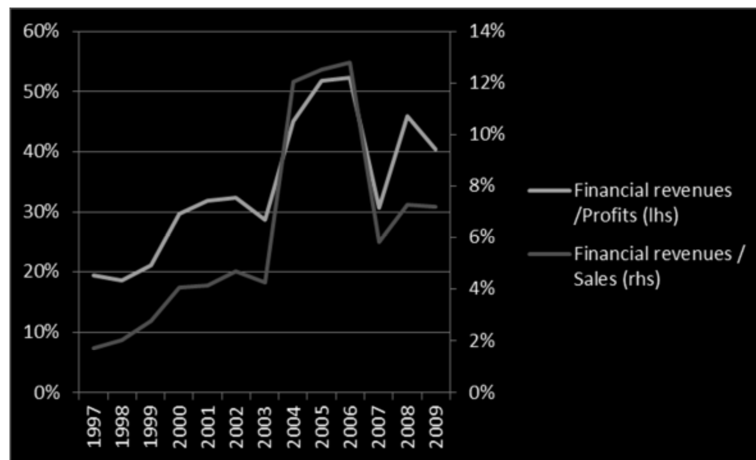
Source: INE (National Institutional Accounts)

Concerning the second indicator, since 1997 there was a rise in financial revenues (interests, dividends, and capital gains on financial investments) of non-financial corporations in percentage of total sales (or total net profit), with a particularly strong increase in the period 2003 and 2007 (Figure 9). A

[16] Source: Sistemas de Contas Integradas de Empresas em Portugal, INE.
[17] It excludes capital gains in financial transactions.

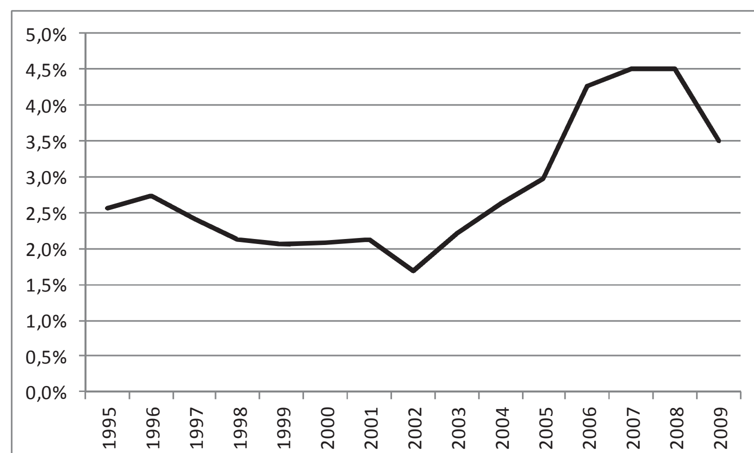
complementary indicator, the ratio property income to production also increased, but only since 2003. [18]

Figure 9 – Financial revenues of non-financial corporations (% of sales and net profit)



Note: The sample comprises the non-financial corporations with over 20 employees until 2003 and the total of non-financial corporations thereafter.
Source: INE (*Sistemas de Contas Integradas de Empresas em Portugal*)

Figure 10 – Property income of non-financial corporations(% of production)



Note: The values for 2010 and 2011 are forecasts.

Source: INE (National Institutional Accounts)

[18] See the definition of property income above.

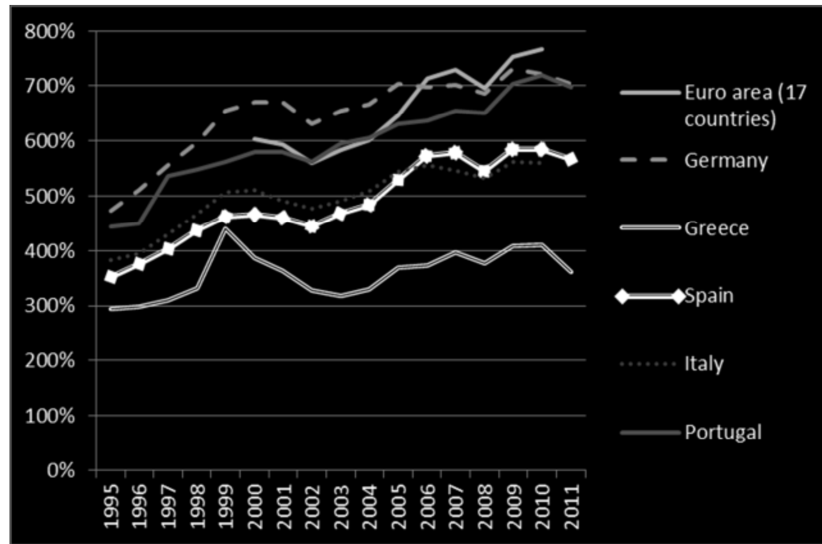
Financial assets

Another way of looking at financialisation is by analysing financial assets, namely how they are distributed across institutional sectors (financial firms, non-financial firms, households and the Government). In Portugal, financial assets accounted for around 720% of the GDP in 2010, which is smaller than the EA17 average of 767%[19]. In this indicator Portugal is close to Germany (722%) and has a larger value than countries of larger GDP per capita, as Austria (633%), Finland (684%), Italy (560%), and Spain (586%).

In Portugal, as well as in most European countries, financial assets have been increasing as a percentage of GDP (see Figure 11 and Table 2). In the period 1995-2010 the ratio of financial assets to GDP increased 274 p.p. in Portugal, which is the third largest increase in the EA9[20], only supplanted by Finland (369%) and France (320%).

[19] Financial assets include currency and deposits, securities and other shares, loans, shares and other equity, insurance technical reserves and other accounts receivable/payable (Eurostat). The values for Ireland and Netherlands are not shown in the graph because they were very high and would distort the graph.
[20] We exclude Ireland, Luxembourg, and Netherlands because they are outliers in this indicator.

Figure 11 – Financial assets of the total economy (% of GDP)



Note: Consolidated Figures. Source: Eurostat (Annual Sector Accounts)

Table 2 – Change in financial assets of the economy (in p.p.)

Country	1995	2000	2010	Change 1995-2010 (p.p.)	Change 2000-2010 (p.p.)
Euro Area 17	n.a	603%	767%	n.a.	164
Belgium	639%	797%	877%	238	80
Germany	474%	670%	722%	249	52
Ireland	n.a.	1148%	2542%	n.a.	1394
Greece	294%	387%	410%	116	23
Spain	353%	467%	586%	232	119
France	435%	598%	754%	320	156
Italy	383%	510%	560%	177	50
Netherlands	847%	1091%	1447%	600	357
Austria	384%	469%	633%	249	165
Portugal	445%	579%	719%	274	140
Finland	316%	402%	684%	369	282

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

Source: Eurostat (Annual Sector Accounts)

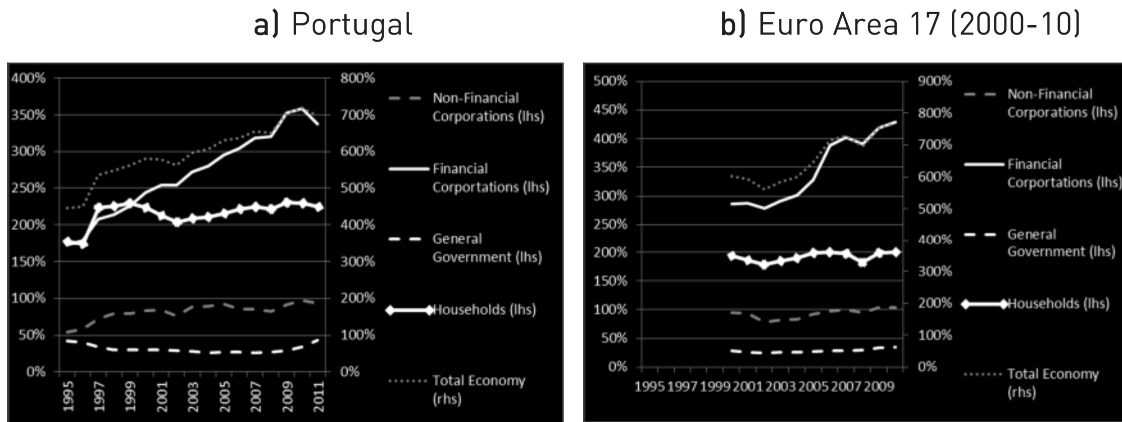
This upward trend in financial assets could be interpreted as an indicator of financial development. It gives us also an indication of the relative speed at which financial stocks and productive revenues have developed over time and, therefore, measuring indirectly "financial rents" accumulated (Cingolani, 2012). According to Aglietta (1998) and Toporowski (2010), the growing importance of financial assets as a percentage of GDP in most European countries could be a symptom of asset price inflation. Indeed, even if one discount future gains, it is relatively unlikely that the value of accumulated financial assets should grow much faster than GDP.

Looking at which sectors own financial assets, in 2011 most of the financial assets (337% of GDP) were owned by financial corporations (the central bank, banks and other non-monetary financial institutions), which is similar to the EA17 (

Figure 12). However from 1995 to 2011, there was a structural change in Portugal, with the very fast growth of financial assets owned by financial corporations. In order to illustrate this change we compare financial corporations with households. In 1995, financial assets owned by households and financial corporations both represented each around 175% of GDP. In 2011, financial corporations basically doubled their assets holdings to 337% of GDP and households increased their assets only to 224% of GDP. In reality, the growth of financial corporations' assets represented a convergence of Portugal with the EA in terms of distribution of assets by institutional sectors.

Figure 12 – Financial assets by institutional sector (% of GDP)

a) Portugal b) Euro Area 17 (2000-10)



Note: Consolidated Figures. The total of the economy is the sum of the four institutional sectors. Households includes Non-Profit Institutions

Source: Eurostat (Annual Sector Accounts)

Other way of looking at the rise of the importance of financial corporations is by looking at the weight of financial corporations' assets on the sum of the total assets of non-financial corporations, government and households (Table 3). Even though in 2010 Portugal had a position below average on that indicator (100% for Portugal and 127% for the EA17), the country had one of the largest increases of the EA11 in terms of financial corporations assets relative to other institutional sectors: it increased from 63% in 1995 to 100% in 2010. Only Ireland and the Netherlands had a larger growth of that indicator.

The rapid growth of financial assets held by financial corporations may reflect a transfer of real wealth from productive sectors (Non-Financial Corporations, Households and Non-Profit Institutions) to the financial sector (Cingolani, 2012).

In principle, financial assets should have a residual importance for non-financial firms. If a large increase in the financial assets owned by non-financial firms is observed, this is an indication that firms are diverting resources from productive applications to financial accumulation, distorting their main goal. Financial assets owned by non-financial corporations also denoted an upward

rise of 42.4 p.p. in Portugal from 55% in 1995 to 93% of the GDP in 2011. This increase was not very large when compared with other EA countries and the ratio in 2010 was marginally smaller in Portugal than in the EA17 (Table 4).

Table 3 – Ratio between the financial assets of Financial Institutions and the sum of Non-financial Corporations, Government and Households (%)

Country	1995	2000	2010	Change 1995-2010 (p.p.)
Euro Area 17		90.6	127.0	
Belgium	88.9	72.8	78.1	-10.8
Germany	99.8	113.2	126.4	26.5
Ireland	0.0	0.0	394.0	
Greece	89.6	70.7	120.2	30.5
Spain	76.4	82.2	101.4	25.0
France	84.3	83.0	109.7	25.5
Italy	59.1	56.4	79.2	20.1
Netherlands	126.8	132.1	169.5	42.7
Austria	94.3	104.4	100.8	6.5
Portugal	63.3	72.6	99.7	36.4
Finland	63.3	53.5	88.4	25.1

Note: Consolidated Figures. The data for Ireland relates to 2001.

Source: Eurostat (Annual Sector Accounts)

Table 4 – Change in financial assets of non-financial corporations (in p.p.)

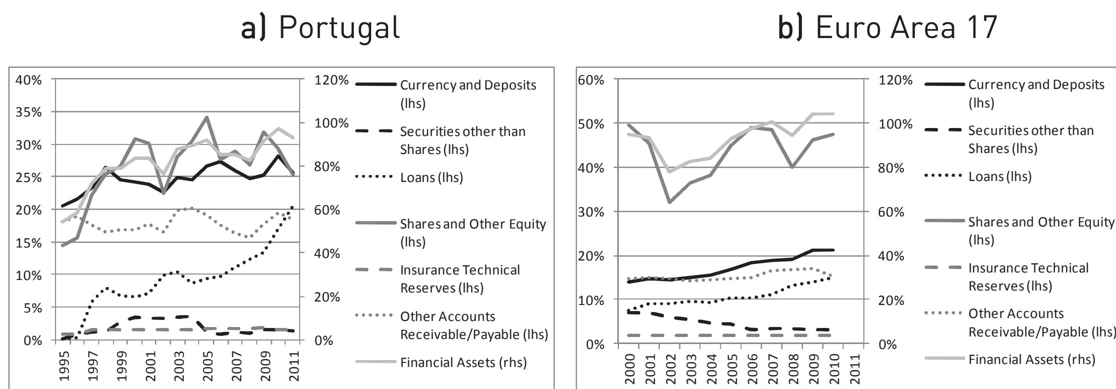
Country	1995	2000	2010	Change 1995-2010	Change 2000-2010
Euro Area 17	n.a	95%	104%	n.a.	9%
Belgium	69%	125%	219%	151%	95%
Germany	72%	116%	97%	25%	-19%
Ireland	n.a	n.a	274%	n.a.	147%
Greece	19%	31%	33%	14%	2%
Spain	40%	67%	95%	54%	27%
France	63%	117%	115%	52%	-2%
Italy	40%	57%	59%	19%	1%
Netherlands	97%	138%	199%	103%	61%
Austria	33%	48%	105%	72%	57%
Portugal	**55%**	**83%**	**97%**	**42%**	**14%**
Finland	45%	69%	104%	59%	36%

Note: Consolidated Figures. The change for Ireland is for 2001 to 2010

Source: Eurostat (Annual Sector Accounts)

Regarding the distribution of financial instruments owned by non-financial corporations, in 2010 they owned essentially shares and other equity (29% of GDP), currency and deposits (28% of GDP), other accounts receivable (19% of GDP) and loans (17% of GDP). [21] The more speculative category (securities other than shares) had a minor importance (2% of GDP). Loans was the item that grew the most in 1995-2011, but growth was also significant in shares, and currency and deposits. The growth of loans was also very large when compared with the EA17. In 2010, it is worth mentioning that shares and other equity had a smaller importance in Portugal than in the EA17 (48% of GDP and 25% of GDP for the EA17 and Portugal, respectively). This probably is an indication of the lower importance of inter-firm equity participations, reflecting the lower presence of large business groups in the Portuguese economy.

Figure 13 – Financial assets owned by non-financial corporations (% of GDP)



Note: Consolidated Figures. Households includes Non-Profit Institutions

Source: Eurostat (Annual Sector Accounts)

[21] Shares refer basically to participations in other firms; currency and deposits is liquidity for conducting transactions; other accounts and receivable is the financing of the activity by the suppliers; and loans typically refer to loans between non-financial firms belonging to the same business group.

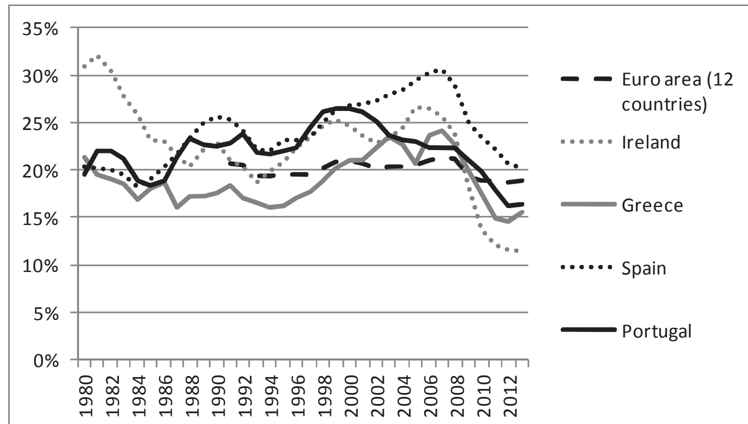
3.3. Financialisation and real investment

One negative consequence of financialisation is that financial activities crowd-out real investment, reducing its level and efficacy.

Portugal has had since 1980 and up to 2008 high levels of investment to GDP (private and public investment). These levels were above the EA12 average and were also quite high even among the cohesion countries (Greece, Ireland, Spain, and Portugal) – see Figure 14. The reasons for the high investment in Portugal can be found in the fact that initially, between 1980 and 2000, Portugal was a country with high needs of private and public investment, due to poor public infrastructures and the need to modernize firms' technology. Investment was also fostered by the reduction in nominal and real interest rates during the convergence process to the EA, and also by the EU structural funds. The rapid growth of credit to firms was also a factor supporting levels of investment above the EA average.

From 2001 up to 2008 the share of investment in GDP declined in Portugal, whereas in the EA it remained essentially constant. This reflected the conjunction of factors such as: low growth prospects (associated with the dismal performance of the domestic economy and the increasing competition from outside the EU – see Section 1), growing levels of indebtedness, increases in interest rates, and also the satisfaction of investment needs in earlier periods (specially, with regard to public infrastructure). After 2008, the importance of investment in GDP also declined in the EA, but at a smaller rate than in Portugal. In 2011, the importance of investment in GDP has become smaller in Portugal than in the EA. The rapid decline in investment after 2008 in Portugal can be attributed to the international crisis of 2008 and 2009 and, later, the Sovereign debt crisis starting in 2010, which implied a strong reduction in credit and even drearier prospects of economic growth.

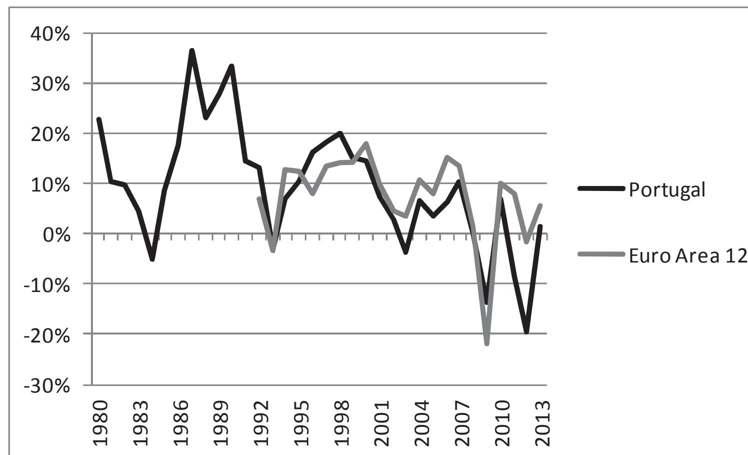
Figure 14 – Gross fixed capital formation at 2005 prices (% of GDP)



Source: AMECO

Despite the high level of investment, there are some doubts about its quality and real efficiency. In Portugal, the marginal efficiency of capital since 1986 was followed a strong downward tendency (Figure 15). [22] Nevertheless, this downward trend worsened after the creation of the single currency, when the Portuguese marginal efficiency of capital slipped below the level in the EA.

Figure 15 – Marginal efficiency of capital



Note: The values for 2012 and 2013 are forecasts.

Source: Ameco

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

Between 1992 and 1998 the Portuguese marginal efficiency of capital was larger than in the EA: 0.117 and 0.091 respectively. After the creation of the euro, the picture changed dramatically, with the efficiency of investment in Portugal becoming one of the lowest in the EA (Table 5).

3.4. Securities markets

In Portugal, the stock market capitalisation as a proportion of GDP increased 11 p.p. from 1989 to 2011 (from 16% to 27%). This indicator includes not only the number of shares outstanding, but also their prices. That upward tendency hides some large oscillations in line with the evolution of the world's stock markets (Figure 16). From 1989 to 1999 there was a large increase in the capitalisation of the Portuguese stock market, due to the privatisation process, the entrance of foreign investors via the development of the Portuguese market, and the boom of the dot.com firms after 1995. After 1999 there was a decline in market capitalisation due to the bursting of the dot.com bubble. After 2002, market capitalisation recovered until 2007, and then fell again afterwards as a result of the Subprime crisis. Since 2010 the Sovereign debt crisis caused a further and strong decline in the stock market, an evolution which was also observed in Greece and Spain.

Table 5 - Marginal efficiency of capital (periods' averages)

Country	Mean 1992-1998	Mean 1999-2012
Austria	0.09	0.09
Belgium	0.10	0.08
Germany	0.07	0.07
Spain	0.10	0.07
Finland	0.14	0.11
France	0.10	0.08
Greece	0.10	0.04
Ireland	0.33	0.12
Italy	0.07	0.03
Netherlands	0.15	0.08
Portugal	**0.12**	**0.02**
Euro Area 12	0.09	0.07
UK	0.18	0.11

Note: The value for 2012 is a forecast.

Source: Ameco.

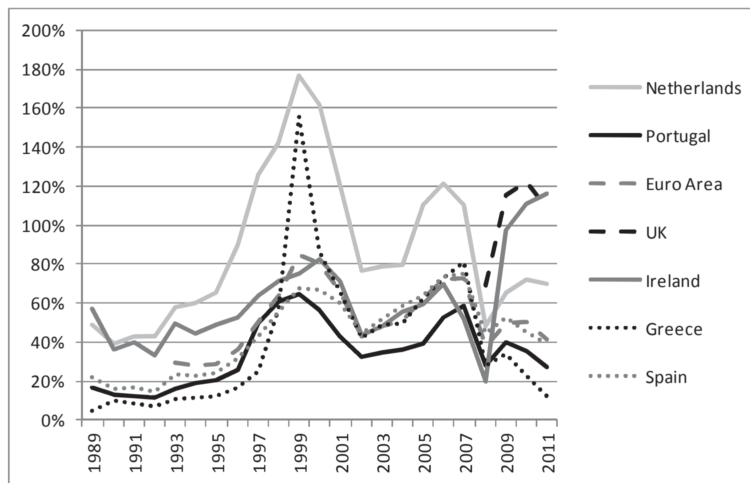
In 2011, Portugal had a stock market capitalisation corresponding to 21% of the GDP, which was much lower than the Euro area average of 41%. The underdevelopment of the stock market in Portugal is a structural characteristic, being also reflected in the reduced number of firms listed in the market, the strong concentration of the stock market in the top 10 firms (IMF, 2006:24) and the decisive importance that banks have on the financing of firms. The corporate sector in Portugal is largely dominated by SMEs, which mostly rely on banks for financing.

Furthermore, between 1993 and 2011, the increase in the Portuguese stock market capitalisation was well below the Euro area average: 11 p.p. and 41 p.p., respectively. During this period Portuguese firms have privileged debt over equity, which largely accounts for such divergence. The large prevalence of SME in Portugal also creates obstacles to the development of the stock market.

Regarding the weight of financial firms' capitalisation (monetary and non-monetary firms) in stock market capitalisation, from 1989 to 2003, this was larger in Portugal than in the EA (Figure 17). That was especially true in the period 1990-1996, because the first privatisations were done on the financial

sector. However, after 2004 Portuguese financial companies had a representation in the stock market smaller than in the EA. Since 2010, this results from the fact that Portuguese financial firms have been more affected by the Euro Sovereign debt crisis than EA's firms.

Figure 16 – Stock market capitalization of quoted shares (proportion of GDP)

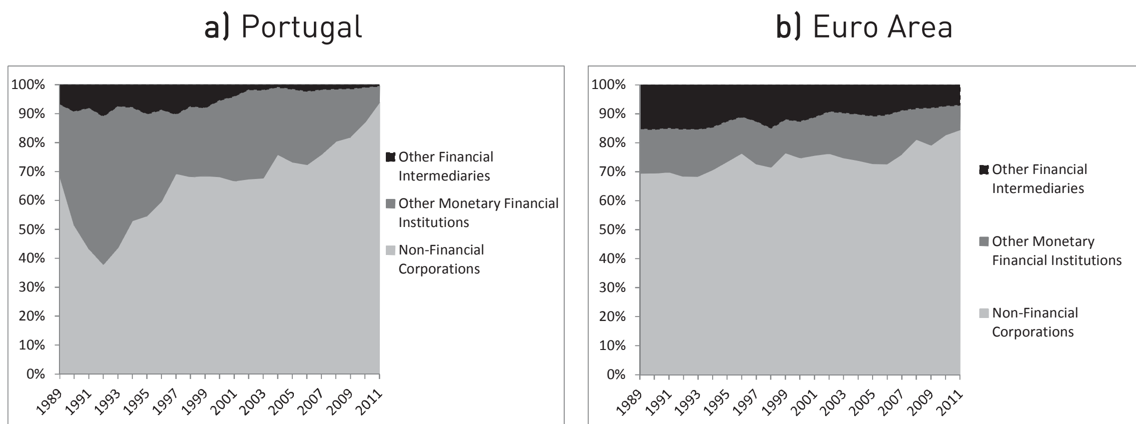


Source: AMECO and ECB

Figure 17 –Market capitalization by institutional sector

a) Portugal

b) Euro Area

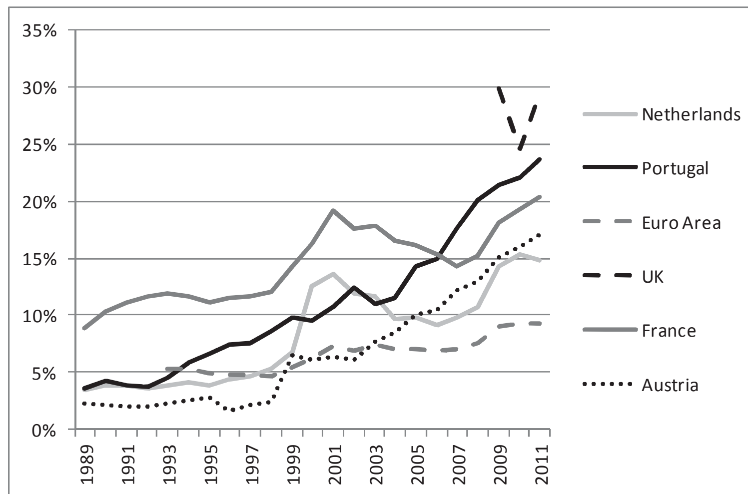


Source: ECB (Payments and Settlement Systems Statistics)

Looking inside the financial sector, the other financial intermediaries have a much lower importance in Portugal than in the euro area in terms of stock capitalisation, and since 1989 they have been losing importance, reaching an almost null representation in 2011. This is related with the fact that the other financial intermediaries are integrated into financial groups.

In terms of debt securities (bonds and commercial paper, for example) issued by non-financial firms the situation is quite different. In Portugal the total outstanding amounts were 5% of GDP in 1993, a value similar to the euro area average (Figure 18). From 1989 to 2011 debt has increased substantially and achieved 24% of GDP, the highest value among the euro area countries and quite close to the UK. In this comparison, we use nominal values and include also securities not traded in markets, such as commercial paper, which is an important source of financing for Portuguese firms. The large increase in the amount of debt represented by securities resulted from the process of leveraging of Portuguese firms. Particularly, since 2005 bank loans have become less important in the financing of firms in favour of debt securities (See Section 9.1).

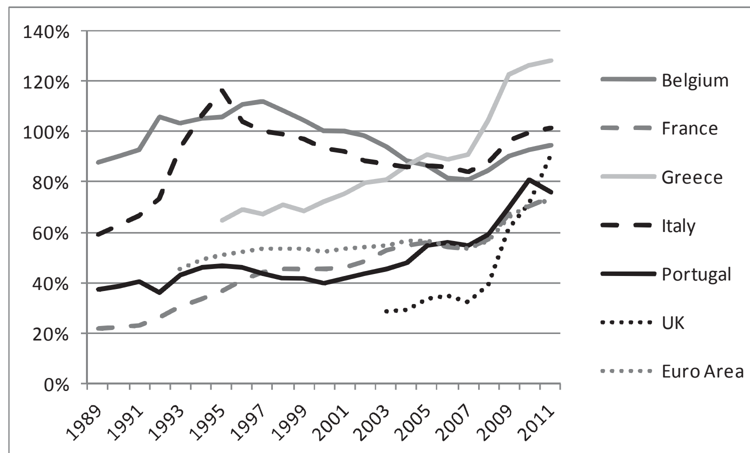
Figure 18 –Market capitalisation of securities other than shares issued by non-financial corporations (*proportion* of GDP)



Source: AMECO and ECB

Regarding the issue of debt securities by the General Government, these represented 76% of GDP in 2011, much more than the value of debt securities of non-financial firms (Figure 19). Since 1989, there was an increasing trend in the value of Government securities, mirroring the evolution of Public Debt (see Section 3.10). Such evolution implied that the weight of Government securities on GDP risen above the Euro average since 2006.

Figure 19 –Market capitalisation of securities other than shares issued by the general government (proportion of GDP)



Source: AMECO and ECB

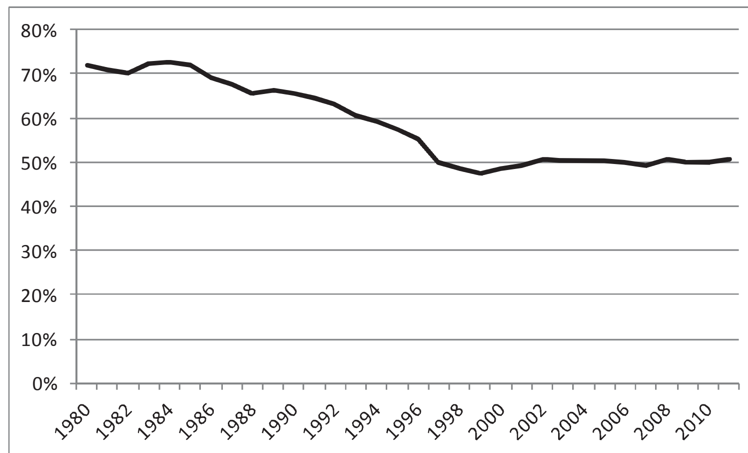
3.5. The assets side of households

In this section we study the composition of households' wealth to understand the propensity of households to fund banks and other firms through the acquisition of shares, other securities and deposits.

In 1980 the importance of dwelling in households' wealth was 72.1% [23] – see Figure 20. From 1980 to 1996 this value decreased substantially, reaching 55.3% in 1996. From 1997 to 2011 the proportion of wealth (already including loans) invested in dwelling remained around 50%. One reason for such a large proportion of wealth being invested in dwellings is the large proportion of houses occupied by the owner. Due to the malfunctioning of the rental market, households tend to buy the house in which they live. This issue is further discussed in Section 3.7 below.

[23] Here, we measure the importance of the value of houses in total wealth (financial plus houses). From 1980 to 1996 the data on wealth excludes loans, which are included after 1996.

Figure 20 – The importance of houses in households' wealth (% of total)



Source: Bank of Portugal (Economic Bulletin)

In 2008 the value of dwellings to disposable income was smaller in Portugal than in other European countries (Spain, France, Italy, Finland and UK), being comparable to German (Bank of Portugal, 2009). One reason for this is the weak growth of house prices in Portugal in recent years (Figure 164).

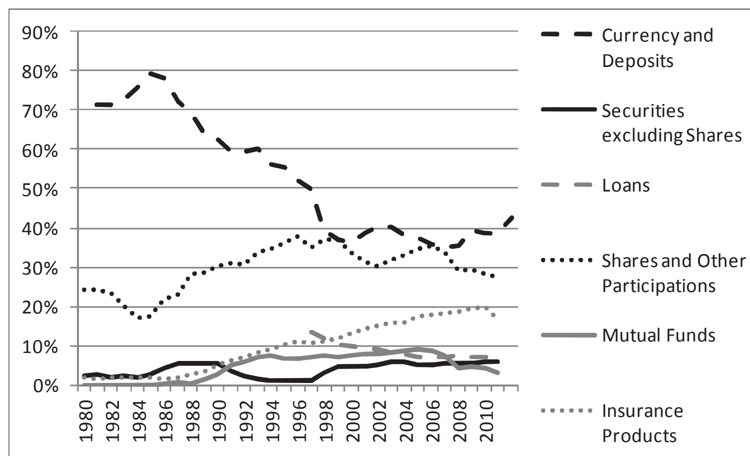
In contrast, financial wealth's importance on total wealth has grown and its composition has exhibited substantial changes (Figure 21).[24] Currency and deposits were the main financial investment of families over the period 1980-2011. This is in accordance with the liquidity preference theory, which argues that households prefer to invest in more liquid assets in order to be able to consume promptly. However, their importance has declined remarkably: currency and deposits represented 71% of total financial wealth in 1980, decreasing to 50% in 1996. From 1997 to 2010 their weight remained around 39% despite some fluctuations. One major reason why deposits became less attractive for households up to 2010 is related with the decrease in their return, leading investors to seek higher returns in more risky assets. The supply of such assets has increased with the growth of mutual funds during the 90s and

[24] Financial wealth includes currency and deposits, securities (including shares), loans, mutual funds and insurance products.

insurance companies (especially in the life segment) during the 80s and 90s, and with the development of the stock market fed by the privatisation process.

In 2011 there was an increase in 4 p.p. in the investment in deposits and currency, explained by the increase in deposits' interest rates, due to the increasing competition for deposits among banks. Another factor contributing to the increase of deposits was the crisis in stock and bond markets associated with the Euro sovereign debt crisis, leading people to seek refuge in more safe assets.

Figure 21 – Structure of households' financial wealth (%)



Note: before 1997 there is no information on loans.

Source: Bank of Portugal (Economic Bulletin)

In fact, mutual funds' importance in households' wealth[25] increased especially in the first years after 1989. From 2000 to 2006 there was again a slight increase in the investment in mutual funds. After that the decline was quite strong reflecting the reduction in prices but mainly the disinvestment in this asset (Antão et al, 2009: 487).

[25] The stock of mutual funds and quoted shares depends both on the market price and on the outstanding amount.

In turn, the importance of insurance products, mainly life and pension funds, has grown steadily from 1% of the financial wealth in 1989 to 16% in 2011. On the one hand, retirement savings plans were fostered through tax benefits, as well as by fears that the public pension system would not be able to meet its responsibilities in the future. On the other hand, closed pension funds were created for workers of the financial sector, as well as of large public and private companies. Ultimately, almost all these pension funds have been integrated in the public pension system (See Section 5.1).

The importance of shares and other participations (hereafter shares) as a proportion of households' wealth has increased substantially from 24% in 1980 to 38% in 1996, largely as a result of the privatization process (see Section 11). After 1996 the importance of shares ceased to increase and has fluctuated with the evolution of the stock market, with a strong decline in 2001 and 2008. The tendency for decline in the preference of households for shares after 1999 meant a larger difficulty for firms in issuing shares.

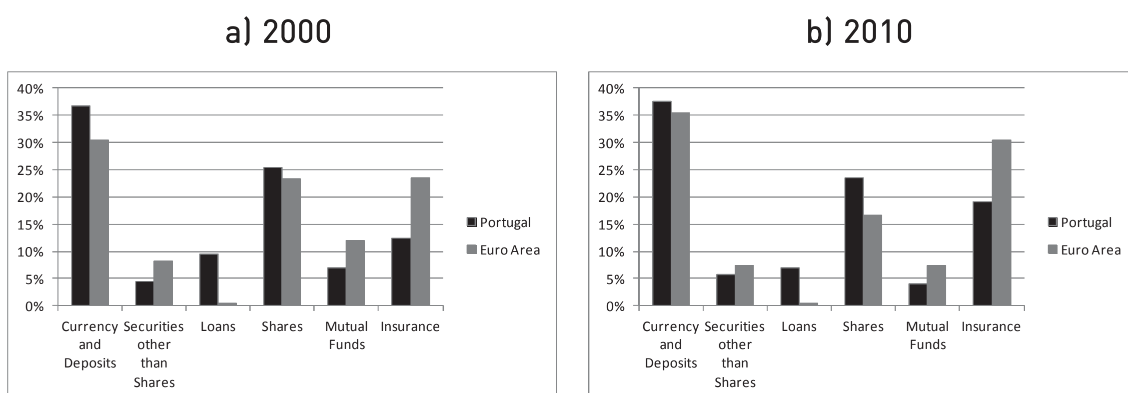
The evolution of the importance of securities excluding shares (hereafter debt securities) was opposite to the evolution of the importance of shares, translating a probable substitution between the two classes of assets in accordance with markets fluctuations. Comparing 1980 and 1996, we conclude that debt securities have basically maintained a residual importance in households' wealth, around 1-2%. But in the period 1986-1991 their importance increased to around 4%-5% and decreased afterwards. From 1998, the importance of debt securities has increased steadily up to 6% of financial wealth in 2011. This increase has created a demand for the large amount of debt securities issued by firms in that period.

When we compare the structure of the financial wealth of Portuguese and European households in 2010, it stands out that in Portugal there was a smaller proportion of wealth invested in quoted shares, mutual funds and insurance

(Figure 22). But the proportion of wealth invested in equity (quoted and *unquoted* shares and other equity) was larger in Portugal (23.4%) than in the euro area (16.6%) in 2010. The larger importance of equity in households' wealth in Portugal compared with the euro area is explained by the components unquoted shares and other equity, which in 2010 represented 21.2% in the former and 12.3% in the latter. This indicates that in Portugal firms have a considerable demand for their equity from households. However, the component shares and other equity in proportion of GDP had a downward tendency since 1995 (Figure 23), meaning that the demand for equity by households has not accompanied the growth of corporations' assets, which constitutes a factor explaining the increase in the debt-to-equity ratio of corporations during that period.

Another conclusion that we can draw is that the development of the stock market could be improved with the right education of households for the advantages of *quoted* shares, since household already have a large interest in *unquoted* shares and other equity.

Figure 22 – The structure of households' financial wealth (% of total)

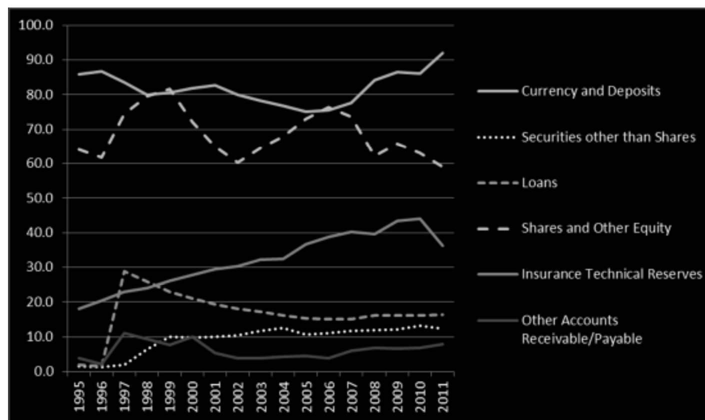


Note: Shares includes quoted shares, unquoted shares and other equity

Source: Eurostat, Sectorial Accounts

Furthermore, in 2010 the share of wealth invested in deposits was similar in Portugal and in the Euro area, while in 2000 Portuguese households invested more in deposits than their euro area counterparts. Between 2000 and 2010, Euro area households have increased the proportion of wealth invested in deposits in response to the financial crisis.

Figure 23 –Households' financial wealth (% of GDP)



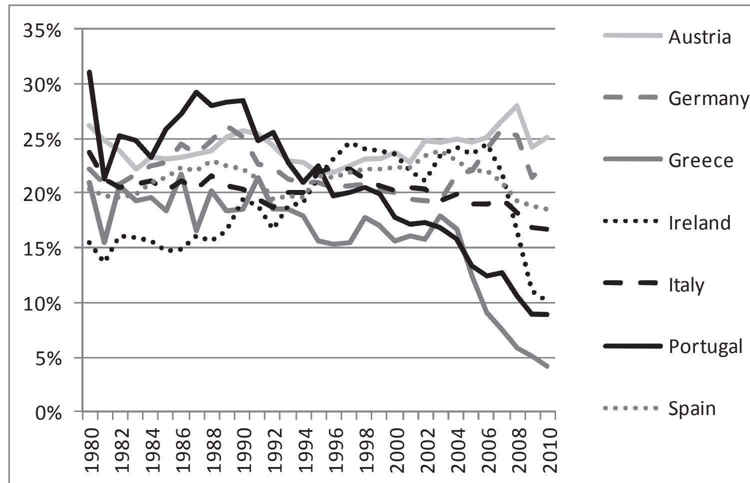
Source: Eurostat, Sectorial Accounts

Savings

During the 1980s Portugal was one of the Euro area countries with highest gross national saving rate [26] (Figure 26). In the run-up to the euro, the national saving rate decreased and in 1998 Portugal was among the euro area countries with the lowest saving rates, with a saving rate near 20% of GDP. After joining the euro, the saving rate decreased rapidly and reached values around 9% of GDP in the period 2009-2010, which was a value significantly smaller than the euro area average.

[26] Includes savings of households, corporations and government.

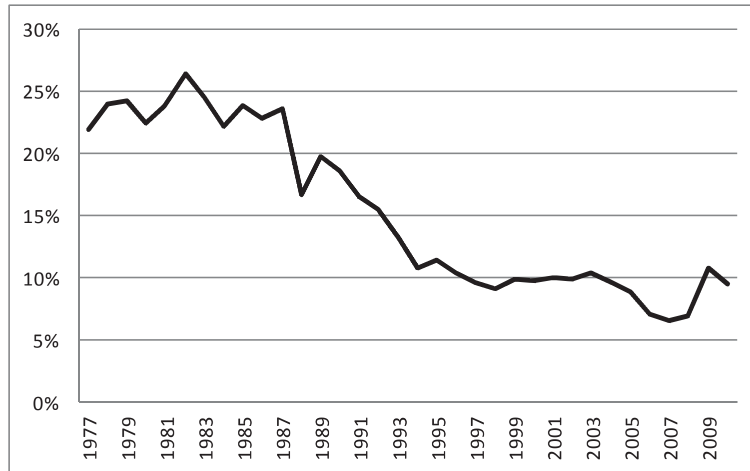
Figure 24 –Gross national savings (% of GDP)



Source: IMF (World Economic Outlook Database)

Households saving rate followed a similar pattern to the overall saving rate (see Figure 25). In the period 1989-1998 households' savings as a proportion of disposable income felt more than 10 p.p., from 19.7% in 1989 to 9.2% in 1998. The decline in the saving rate was explained by the reduction in interest rates and the increase in private consumption in a favourable macroeconomic environment, where precautionary saving made less sense. The development of the banking sector, which offered large amounts of cheap credit, together with the development of the social state, where also important factors explaining the decline in households saving rate (Alexandre el at., 2011). In 2004-2007 there was a further decline in the saving rate, but after the Subprime crisis there was a recovery.

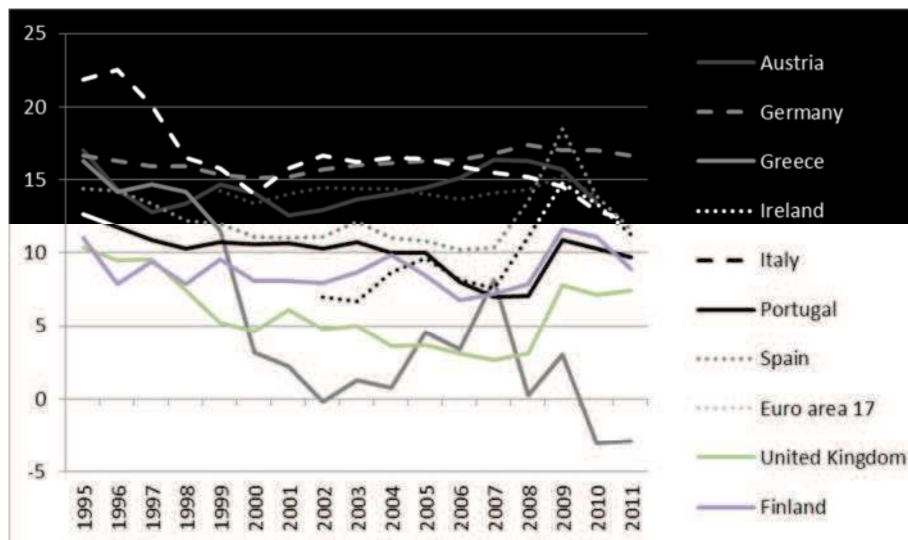
Figure 25 – The Portuguese saving rate (% of disposable income)



Source: Bank of Portugal (Economic Bulletin)

That evolution put Portuguese households among the ones with the lowest saving rate in the period 1995-2010, only above Finland, the UK and Greece (after 1999) (see Figure 26).

Figure 26 – Households saving rate (% of disposable income)

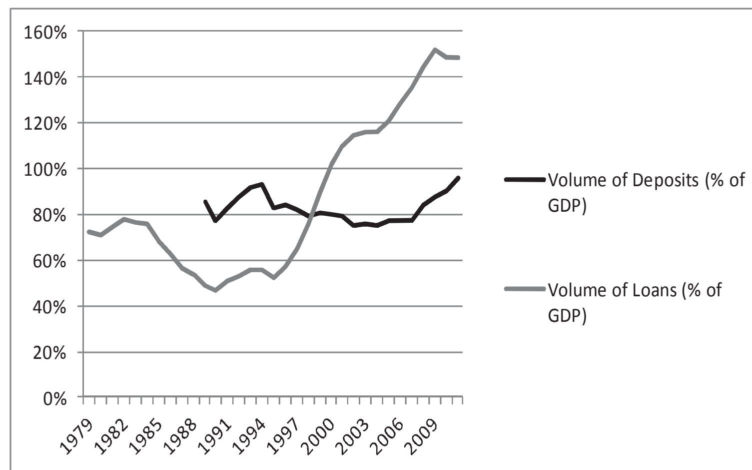


Source: AMECO

Volume of Deposits

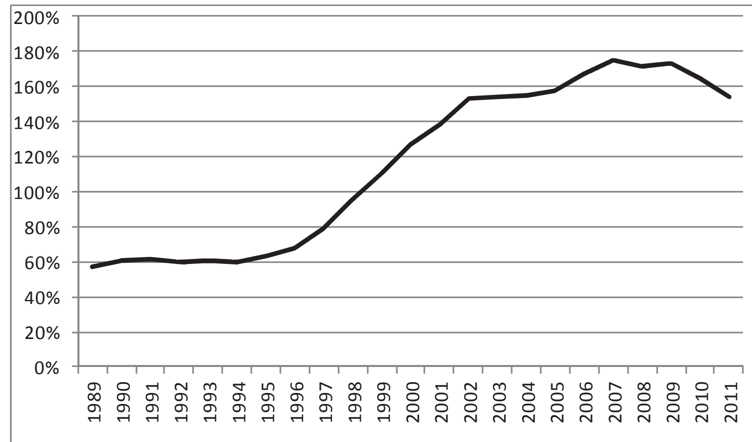
The strong growth in bank credit after 1995 was not matched by a growth in deposits of households and firms. In fact, the importance of deposits decreased from 93% of GDP in 1994 to 77% of GDP in 2007 (Figure 27). This resulted not only from a decline in the saving rate of households, but also from the emergence of other financial instruments that competed with deposits. As a result the ratio loans to deposits went from 60% in 1994 to 175% in 2007 (Figure 28).

Figure 27 – Volume of deposits and loans (% of GDP)



Source: Bank of Portugal and INE

Figure 28 – Ratio of loans to deposits (%)



Source: Bank of Portugal

From 2007 to 2011, the share of deposits in GDP has increased from 77% to 96%, reflecting the increase in deposits' interest rates, a slight increase in households' saving rate, and an increase in risk aversion as a result of the crisis. This has occurred in a context in which banks had more difficulty in getting finance in the financial markets, and thus have been competing more for deposits. This allowed banks to reduce the ratio loans to deposits to 155% in 2011.

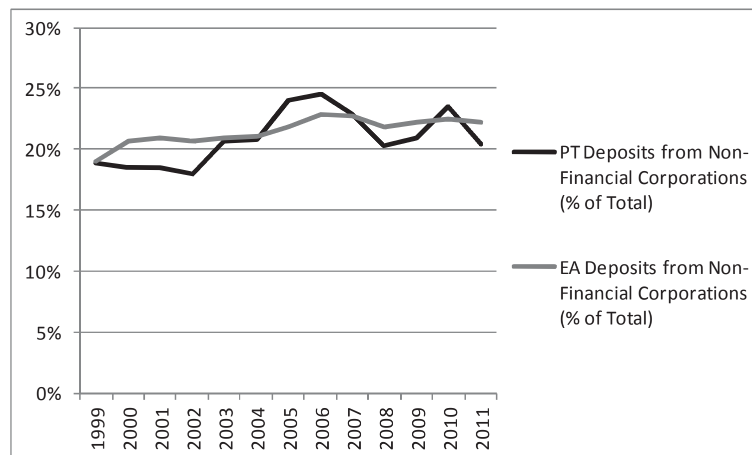
Deposits of firms

Regarding firms, deposits were in the 2000s still the main component of non-financial corporations' portfolios, despite the growing importance of shares and other securities (Antão et al, 2009)

In Portugal and in the euro area, deposits from non-financial firms have accounted for about 20 per cent of total deposits (households plus firms) in the last decade (see Figure 29). In both cases, there was a slight increase in the

share of non-financial corporations' deposits. Such an increase indicates that firms, more than households, have increased their preference for liquidity.

Figure 29 – Volume of Deposits from non-financial corporations (% of total).



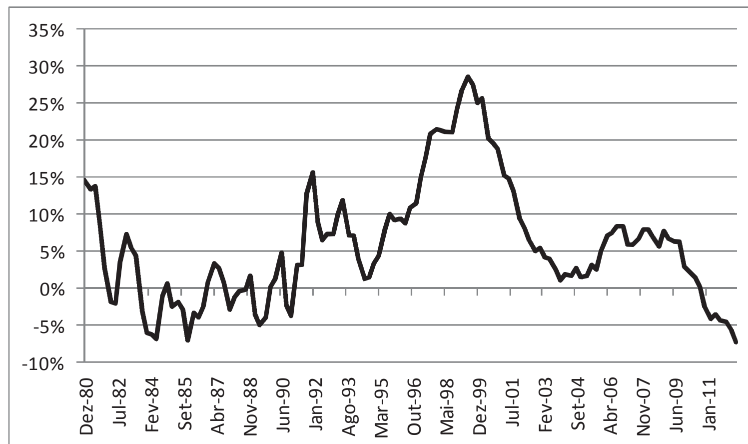
Source: Bank of Portugal and European Central Bank

3.6. Volume of loans from banks [27]

During the 1980s, the real growth of credit (nominal growth minus CPI inflation rate) was very low and in many years negative (Figure 30).[28] This is explained by the low economic growth, nominal instability and the IMF intervention in Portugal. From 1991 up to 1993 there was a short cycle of high credit growth, which was interrupted by the economic slowdown. In 1995 a cycle of very strong growth of credit started, reaching more than 25%/year in 1999. Afterwards, credit growth declined reaching negative values en 2011. Explanations for these cycles will be done below.

[27] Excludes financial non-monetary institutions.
[28] Excludes securitised credit.

Figure 30 – Total loans (annual real growth rate)



Source: Bank of Portugal

Another way of looking at the evolution of credit is to analyse the ratio of credit-to-nominal GDP (Figure 27). [29] From 1980 to 1995, that ratio declined from 71% to 53%, showing a decline in financial development in the period. From 1995 to 2009, there was a notable increase of 100 p.p. in that indicator, from 53% to 152%. In 2010 and 2011, there was a slight decrease in the ratio to 148% in 2011. The strong growth of credit in the period 1995-2009 was undoubtedly associated with the Portugal joining the euro, which affected both the demand and supply of credit.

On the demand side, the participation in the EMU increased current and expected output growth and led to a sharp decline in nominal and real interest rates. As a result, the unemployment rate decreased considerably during the nineties. Initially these changes were seen as permanent by most economic agents, favouring a substantial increase in credit demand.

On the supply side, the greater competition between banks also increased the availability, sophistication and diversification of financial products and services, particularly in the credit segment. This process was clearly facilitated by the

[29] It includes bank credit to non-financial firms and households.

use of international financial markets, which occurred even before the arrival of the euro, with the elimination of capital controls and an expressive reduction in the exchange risk of the escudo. After Portugal joined the euro, the exchange risk disappeared completely and the access to the European financial markets was opened up. Portuguese banks began to access to those markets, diversifying their funding sources, selling government bonds from their portfolios and borrowing on the euro interbank and bond markets, or directly to the ECB, making them less dependent on customers deposits.

Securitization also allowed banks to gradually change the structure of their balance sheets, adjusting risk, cost and liquidity. Since 1997, Portuguese banks have been undertaking securitization operations, mainly in the segment of credit to households. The first operations were done on international markets more familiar with these kind of operations, but in 1999 a new legal framework was approved authorizing the creation in Portugal of institutions specialized in the acquisition or transformation of credits. The amounts involved in securitization operations have been increasing during the last years, representing an important additional funding source (See Section 4.3).

The easier financing allowed banks to satisfy the demand for credit, feeding the expenditure of households and the investment of firms. Consequently, the indebtedness of most Portuguese economic agents increased substantially, which led after some time to a natural reduction of credit growth. In fact, from 1999 to 2002 there was a decline in the real growth of credit to values slightly above 5%/year. The decline in the loans' growth was also associated with the perception that the potential growth of the Portuguese economy had decreased substantially, which was made clear by an actual recession in 2003. After this year, credit growth increased again, but never above 10%/year. In 2008, the financial and economic crisis caused the beginning of a new downward tendency, culminating in 2011 with a negative real growth of loans.

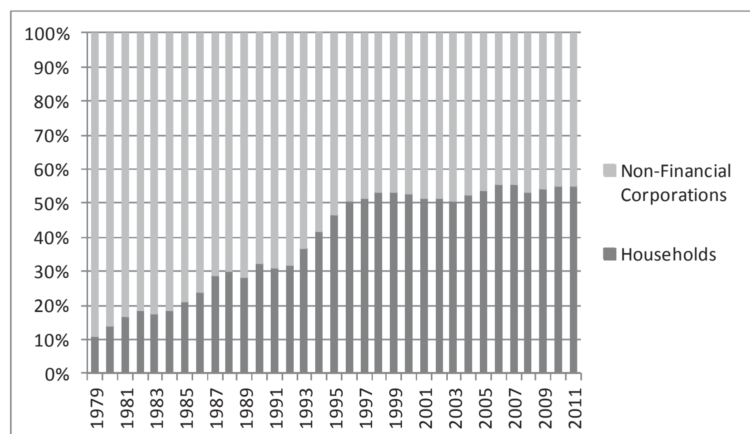
Regarding the credit to households and non-financial corporations (NFC), between 1980 and 2007 the former grew systematically at higher rates than the latter (Table 6), and in 2007-11 both types of credit grew at approximately the same rate. Between 1980 and 1998, loans to households increased from 14% to 53% of total loans (households and NFC) (Figure 31). After 1998, the share of loans to households has essentially stabilized.

Table 6 – Credit to households and to non-financial corporations (annualized growth rates)

	Total Loans	Loans to Household	Loans to Non-Financial Corporations
1980-1993	17,2%	28,0%	14,4%
1994-2002	17,4%	21,9%	14,0%
2003-2007	7,3%	8,9%	5,4%
2008-2011	2,6%	2,3%	2,9%

Note: Securitized credit not included. Source: Bank of Portugal

Figure 31 – Volume of loans to NFC and households (% of total)



Source: Bank of Portugal

Looking at the three types of household credit (housing, consumption and other purposes)[30], it is clear that, between 1993 and 2011 the loans for housing

[30] Credit to other purposes is a residual category, including for example credit to students and to small entrepreneurs.

purchase grew at a much faster rate than loans for consumption and other purposes (Table 7). Housing credit represented in 2011 around 80% of total credit to households, and this proportion has grown in the last 20 years from a value of 64% in 1980 (Figure 32).

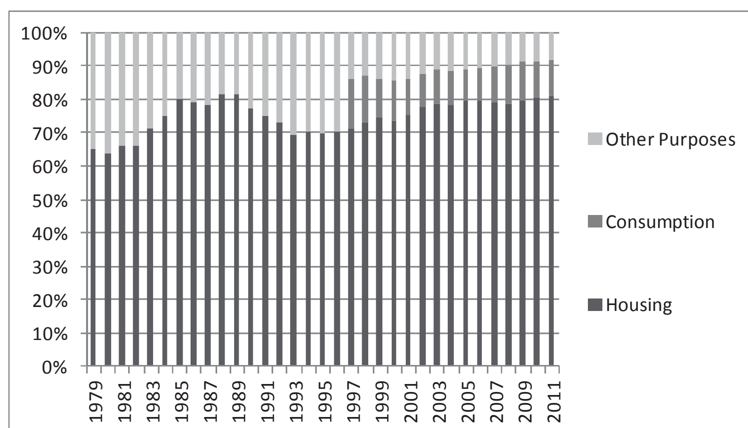
Table 7 – Loans to households by purpose (annualized growth rate)

	Total	Housing	Consumption	Other Purposes
1979-1992	27,9%	29,1%	n.a.	25,3%
1993-1998	26,5%	26,5%	n.a.	12,5%
1999-2007	12,4%	13,4%	9,3%	9,2%
2008-2011	2,3%	3,0%	2,1%	-2,6%

Note: From 1979 to 1998 credit for other purposes included credit to consumption.

Source: Bank of Portugal

Figure 32 – Volume of loans to households by purpose (% of total)

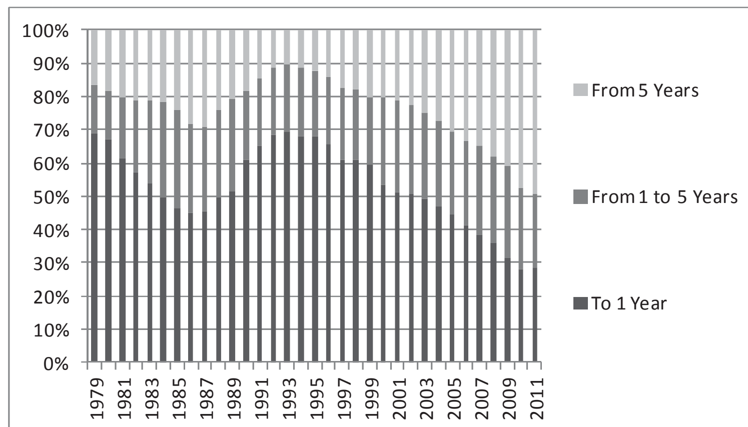


Source: Bank of Portugal

In terms of loans to NFC, an important element is their maturity structure. Long maturities are riskier for banks, but are essential for firms to finance medium and long term investments. From 1980 to 1987 loans with maturity larger than one year increased from 33% to 55% of total loans (Figure 33). From 1987 to 1993 that tendency was inverted, and in 1993 the medium/long term loans

returned to around 30% of loans to NFC. From 1994 up to 2011 the medium/long term loans gained importance and in 2011 they represented 72% of total loans. This evolution in the Portuguese banking system was quite notable, showing that banks were able to take more risk (naturally with a larger return) in order to finance medium and long term investments. Even though they were assuming larger risks by lending with larger maturities, banks may have reduced risk by using collateral or because the financial situation of firms and the business cycle had a better outlook.

Figure 33 – Volume of loans to non-financial corporations by maturity (% of total)



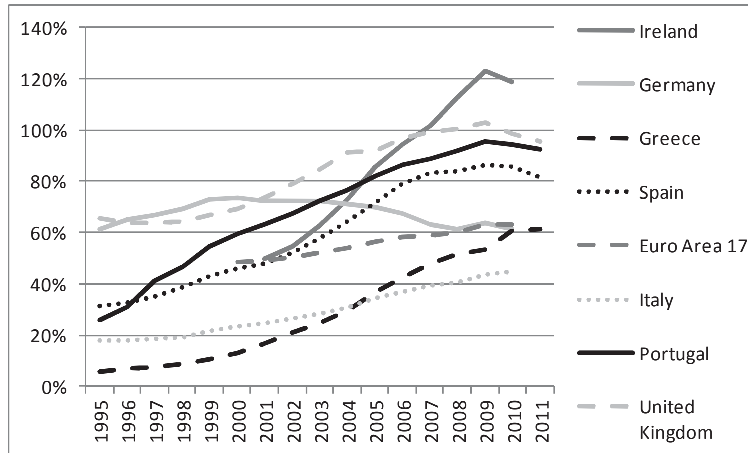
Source: Bank of Portugal

3.7. Households' debt

In Portugal, the indebtedness of households grew quickly from 1993 up to 2009, and declined slightly afterwards (Figure 34). In 1995, Portugal had one of the lowest levels of households' debts of the EA, at 26.1% of GDP. By then, only Italy and Greece presented lower levels of households' debt. After a period of fast growth, in 2009 households' debt in Portugal represented 95.4% of GDP, which compares with 63.2% for the EA16. The level of debt in Portugal was one of the

highest of the EA, being supplanted only by the Netherlands (127.7%) and Ireland (123.2%). Portuguese households' debt level was close to the UK.

Figure 34 – Household's debt (% of GDP)



Source: Eurostat

Both demand and supply factors contributed to the increase in households debt levels as we have seen in the previous section. Since the beginnings of the 1990s, liquidity constraints have been attenuated for a large number of families (mainly due to the reduction of nominal interest rates) facilitating the access to credit, mostly for house purchase. In the previous section it became clear that the most important component of households' credit is the credit for house purchase.

It was precisely on mortgage credit that financial liberalization led to more intense competition, with a significant reduction of interest rates, increase in credit supply and emergence of new products. As a result, the spread in

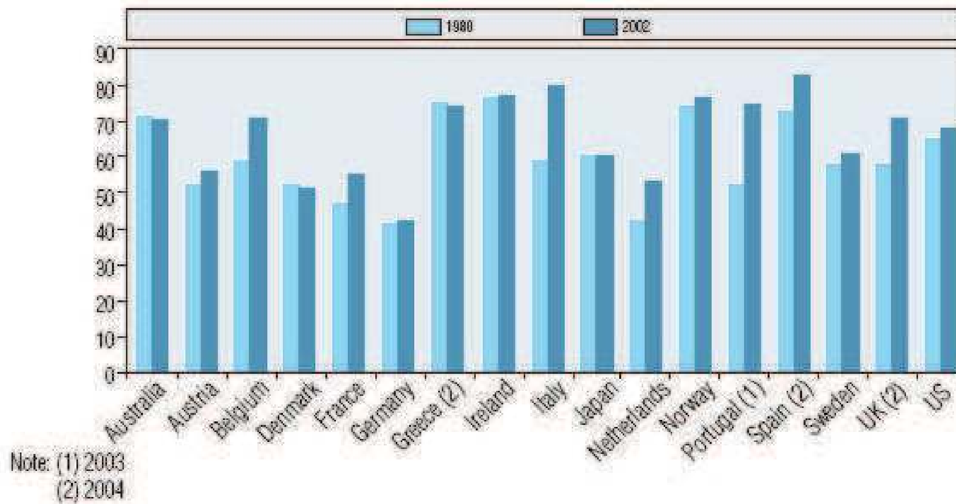
housing credit has been smaller in Portugal than in the EA, whereas for other credit's types the opposite occurs (See Section 9.2). [31]

The high growth and importance of housing credit in Portugal was related with households buying houses, with around 3/4 of households living in houses of their own in 2010. Notice that in the period 1980-2002 the growth of owners occupancy rate in Portugal was one of the largest in Europe (Figure 35). Additionally, the percentage of households that own a second house has increased substantially since 1995.

One of the main reasons for the high proportion of households owning a house is related to the malfunctioning of the rental market. Legislation from the late forties limited the increase of rents for the oldest contracts. This implied that many tenants still in 2011 paid rents below the market value. This regulatory framework has been responsible for a low supply of houses to rent, as well as for the high value of rents in recent contracts. Although rents of new contracts can be set freely, the supply of new houses for renting has been small. One explanation for that is the slowness of courts on the resolution of rental contracts' disputes.

[31] The spread is the difference between the credit interest rate and the interbank interest rate.

Figure 35 – Home Owners (owners occupancy rate, %)



Source: OECD,
http://www.oecdobserver.org/news/archivestory.php/aid/1996/Owning_up.html

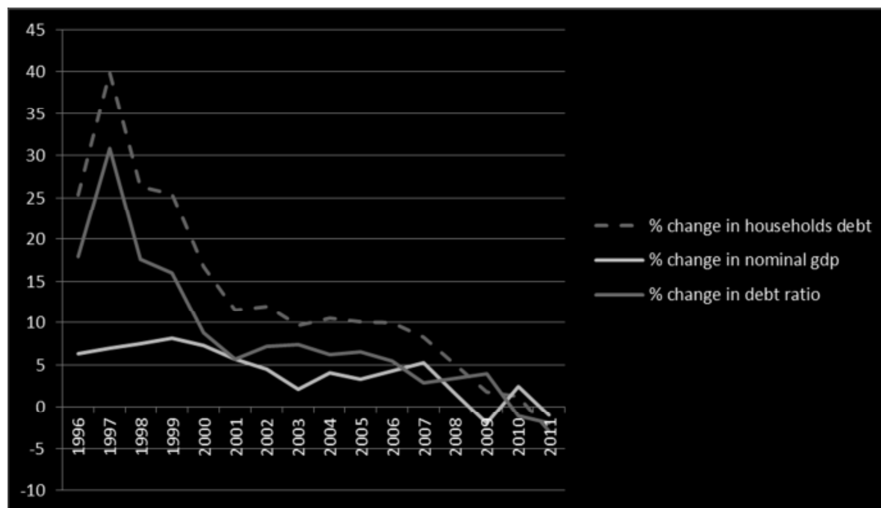
The demand for houses was also stimulated by several policy measures, namely through tax benefits to loans by the Portuguese government that lasted until September 2002.

Similarly, since the early nineties there was a rapid increase in credit for consumption, which was used to satisfy the demand for durable goods, like cars, appliances, and furniture. As a consequence, the growth rate of private consumption has been relatively higher than the growth rate of GDP.

A negative consequence of the increase in families' indebtedness is that they become more vulnerable to shocks. Obviously, they are more susceptible to any increase in the interest rate, especially in Portugal where flexible interest rates are dominant. Additionally, since a large share of their monthly income is devoted to the payment of the debt service, any decrease in disposable income, especially caused by unemployment, cannot be easily accommodated.

The boom in credit to households, with credit growing at more than 10% per year, lasted until 2002 (the same for firms). Afterwards, credit and indebtedness continued to grow but at a slower rate (the percentage change in debt ratio can be seen in Figure 36), which was not enough to sustain economic growth at high levels.

Figure 36 – Percentage change in households debt ratio



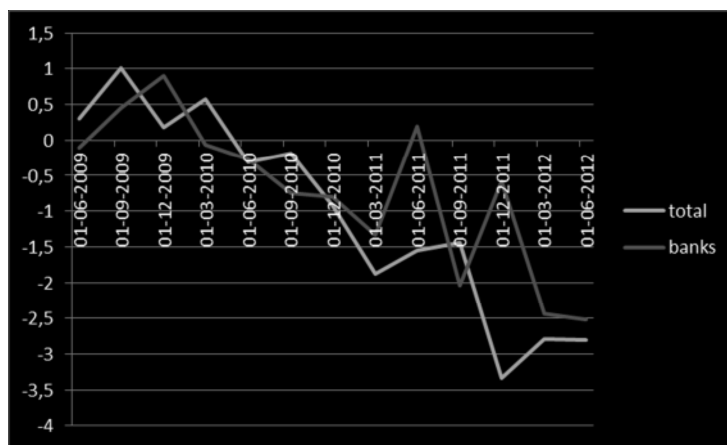
Note: % change in debt ratio equals the % change in households debt minus the % change in nominal GDP. Source: Eurostat

The debt that we referred to above includes loans from banks and non-monetary institutions, as credit-purchase financing firms. In terms of credit to households for consumption and other purposes, *non*-monetary financial institutions were responsible for 13.4% of total credit in 2011. [32] Regarding the evolution since June 2009, it is worth noting the credit from banks has grown at a higher rate than the credit from other financial institutions (Figure 37). In

[32] The credit from banks was obtained from the Monetary and Financial Statistics of Bank of Portugal (does not include securitized credit). The total credit to households, including monetary and non-monetary credit, was obtained from the *Central de Responsabilidades de Crédito* of Bank of Portugal (includes securitized credit). Notice that the fact that one source of data does not include securitized credit while the other source includes it, does not constitute a major problem, because we are interested in credit to consumption and other purposes, which very rarely has been securitized by banks.

June 2009, credit from non-monetary financial institutions represented 16.5% of the total credit to households for consumption and other purposes, and in June 2012 represented only 12.8%. This is an indicator that banks did not adopt a more restrictive attitude on credit to households than other non-monetary institutions.

Figure 37 – Quarterly growth rate of loans to households for consumption and other purposes (from all financial institutions and banks) - %



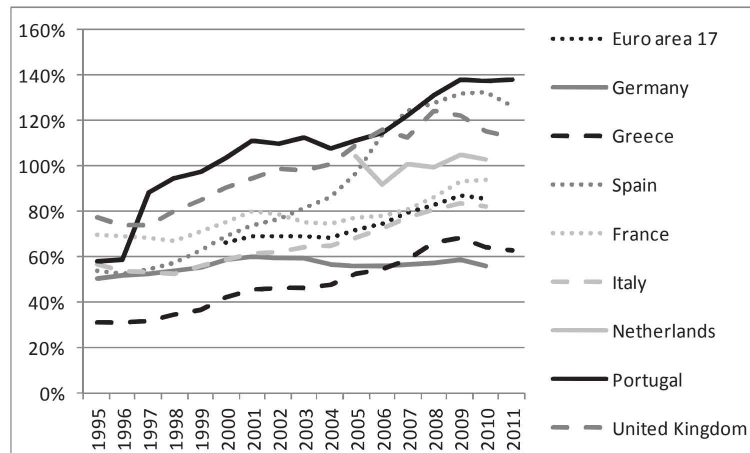
Source: Bank of Portugal

3.8. Corporations' debt

Between 1995 and 2000, the robustness of the Portuguese economy stimulated investment by the corporate sector, which stimulated further economic growth. In a context of declining interest rates and increasing bank competition, corporations financed investment mainly through bank credit, but used also debt securities. This evolution implied a strong increase in firms' total debt (loans, debt securities and trade credit) – Figure 38. In 1995 this debt represented 58% of GDP, a value which was not a high value in the EA context. As a term of reference, the unweighted average of that indicator for Germany, France, Spain and Italy was 57.7% in 1995. Between 1995 and 2010, non-financial corporations' debt increased rapidly in Portugal, and in 2010 it

represented 137.2% of GDP, a value that is much higher than the EA average of 85.3%. The Portuguese indicator was even larger than the UK's indicator.

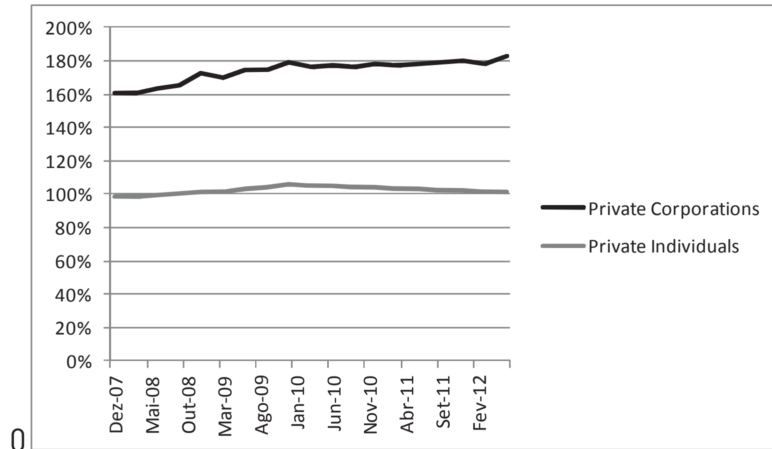
Figure 38 – Corporations' debt (% of GDP)



Note: debt includes loans, securities other than shares, and trade credit.
Source: Eurostat

The level of debt has been considerably higher for private corporations than for households: 183% of GDP and 101% of GDP in June 2012, respectively (Figure 39). Since 2007, households' debt as a percentage of GDP had a small growth of 3 p.p., while firms' debt in percentage of GDP grew 22 p.p. This suggests that during the crisis firms have been probably using credit to support their financial obligations.

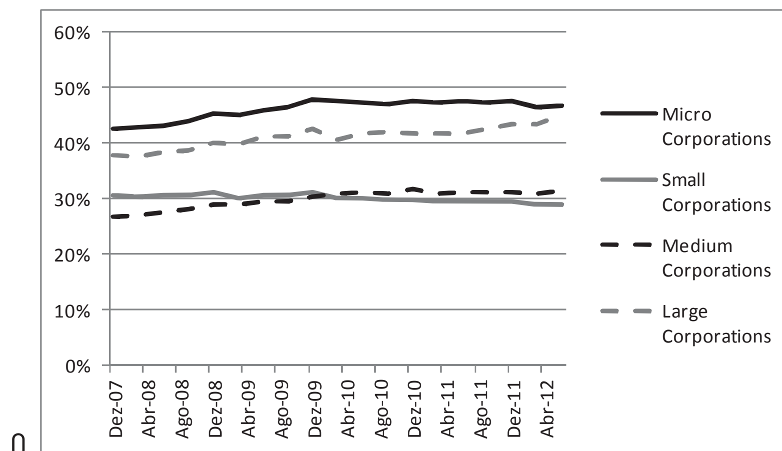
Figure 39 – Debt of non-financial private sector (% of GDP)



Source: Bank of Portugal (Debt of Non-Financial Sector)

When we study which firms were increasing their debt between 2007 and June 2012, we realise that micro and small firms had a much smaller increase (2 p.p.) than medium (5 p.p.) and large firms (7 p.p.) - Figure 40. Even though we cannot be conclusive, this may be a symptom of credit rationing in relation to micro and small firms. It can also be argued that micro and small firms were more affected by the recession than medium and large firms.

Figure 40 – Debt of non-financial private corporations by firm size (% of GDP)

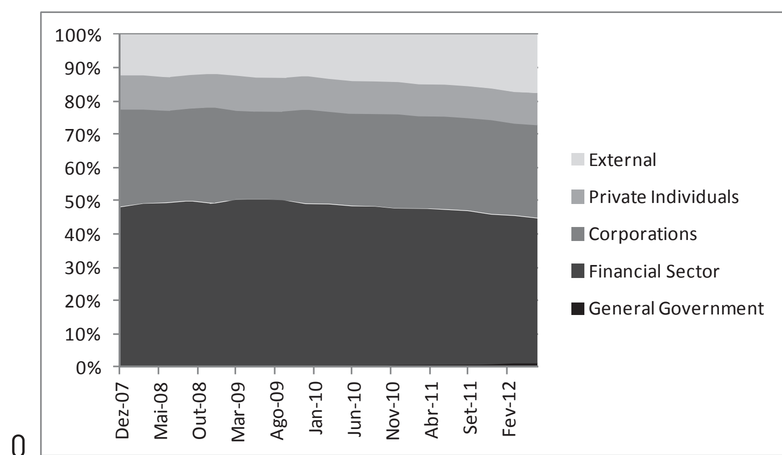


Note: Non-Financial Holdings are not included

Source: Bank of Portugal (Debt of Non-Financial Sector)

Non-financial private corporations have been financed mainly by the financial sector (Figure 41). Still, the importance of the financial sector has decreased slightly in the last two years (-4.9 p.p.), in favour of the Rest of the World (+4.3 p.p.), probably reflecting reduced credit supply by domestic banks.

Figure 41 – Private corporations by financing sector (% of total)



0

Source: Bank of Portugal (Debt of Non-Financial Sector)

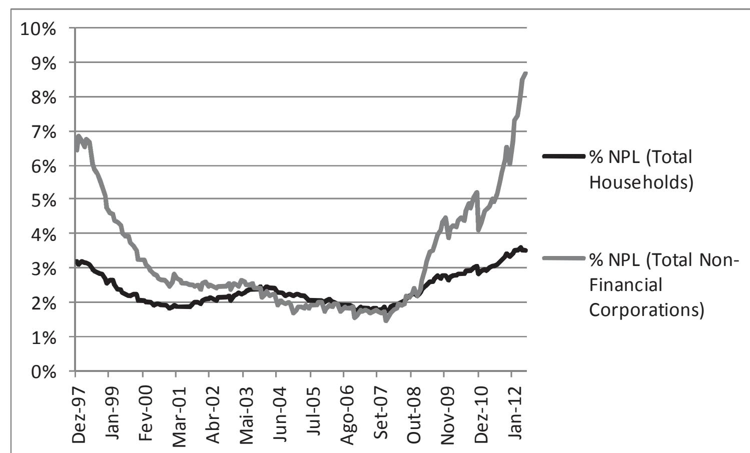
3.9. Non-Performing Loans

We observed that households' and corporations' banking debt increased remarkably since 1995. One interesting question is whether that increase was sustainable. If that was the case, we should not observe a large increase in non-performing loans.

Between 1997 and mid-2001, there was a notable decline in non-performing loans (NPL) ratio both for households and non-financial corporations (see

Figure 42) [33]. Even though at a slower rate, the decline in the ratio of loans in default for non-financial corporations continued up to 2007. In contrast, for households that ratio has remained relatively stable between 2001 and 2007. After 2007, the increase in NPL ratios was very fast for households and especially for firms, surpassing in 2011 the values that the ratios had in 1997. This increase was explained by the strong deterioration in Portuguese economic activity after 2007, with an increase in unemployment, the reduction in firms' profitability, and increase in the bankruptcy of non-financial corporations. In addition, Antão et al (2009) highlights that the rise of non-performing loans has been common to firms of all sizes (small, medium and large).

Figure 42 – The evolution of non-performing loans of households and non-financial corporations



Source: Bank of Portugal

Nonetheless, in 2011 the level of non-performing loans was differentiated across sectors (see Table 8): the sectors with a rate of default above the average were manufacturing, construction, real estate, and trade. From 2007 to

[33] It includes credit and interest overdue for more than 90 days and other uncertain loans. This ratio incorporates a more restrictive understanding of NPL than the NPL ratio calculated by the Bank of Portugal.

2011 the sectors with an increase of non-performing loans larger than average were trade, construction and real estate, which shows the difficulties existing in these sectors.

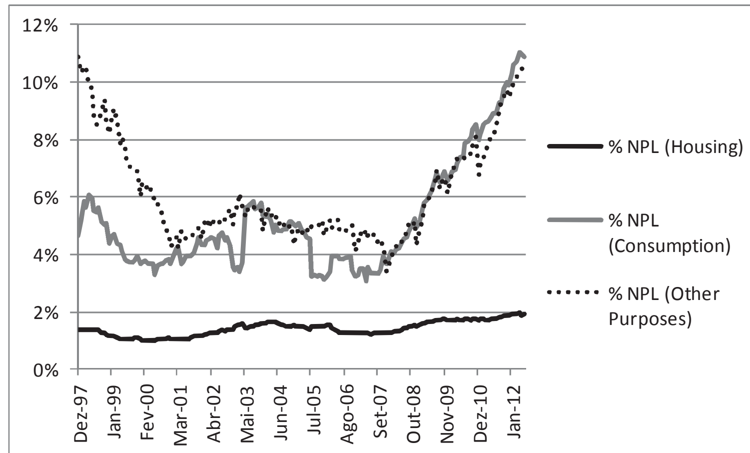
Table 8 – Non-performing loans of non-financial firms by sector

	Agriculture, Forestry and Fishering	Mining and Quarrying	Manufacturing	Electricity, Gas, Water, Sewerage, Remediation	Construction	Trade and Repair of Vehicles	Transportation and Storage	Accommodation and Food Service Activities	Information and Communication	Real Estate	Professional, Techonological Services, Support Services	Education, Health and Social Work Activities	Total Non-Financial Corporations
1997	11,9%	5,9%	10,7%	0,2%	6,4%	5,4%	2,5%	7,3%	3,7%	6,4%	2,3%	4,5%	6,4%
2003	6,3%	2,3%	4,0%	0,2%	2,2%	3,4%	0,6%	2,0%	1,5%	1,0%	1,0%	1,8%	2,1%
2007	1,2%	1,3%	2,5%	0,2%	1,8%	2,2%	0,6%	1,2%	2,4%	1,0%	0,7%	1,0%	1,5%
2011	3,5%	4,6%	6,2%	0,3%	11,0%	7,7%	1,8%	5,3%	2,4%	7,2%	3,3%	2,5%	6,0%
Change 2007-11	2,3%	3,3%	3,7%	0,1%	9,2%	5,5%	1,1%	4,1%	0,0%	6,2%	2,6%	1,4%	4,6%

Source: Bank of Portugal

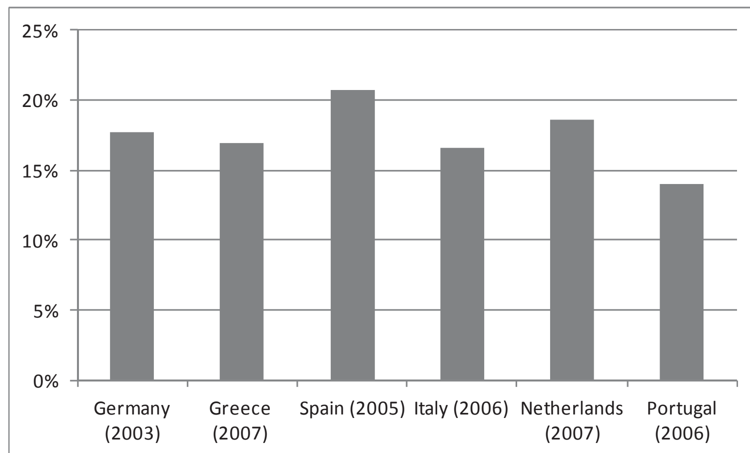
In terms of segments, the non-performing loans of households have increased very rapidly in the loans to consumption and other purposes (see Figure 43), with the ratio of loans in default reaching a value of around 10% in 2011. This increase was not particularly worrying for banks because many credits in this segment had collaterals, such as cars. In contrast, the increase in non-performing loans in the housing segment has been very mild, and the ratio was less than 2% in 2011. The small rate of default in the housing segment can be explained by the low level of Euribor, especially from mid-2009 (Figure 122), the existence of real and parental collateral, the practice of long maturities for this type of loans (which allows low instalments), and the low values of debt service to income ratio (Figure 44).

Figure 43 – The evolution of non-performing loans of households by purpose



Source: Bank of Portugal

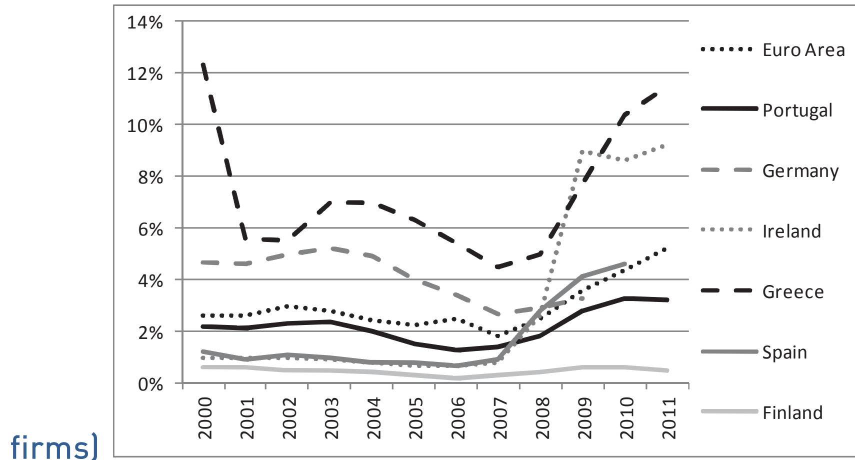
Figure 44 – Debt service to income for households (median values of the ratios)



Source: Household surveys from ECB (2009), *Housing finance*, Occasional paper 101.

Despite the increase in non-performing loans for households and firms, the scale of the problem is still below the euro average. In other words, the credit risk in the Portuguese banking system was in 2011 at a low level.

Figure 45 – Nonperforming loans to total gross loans (households and firms)



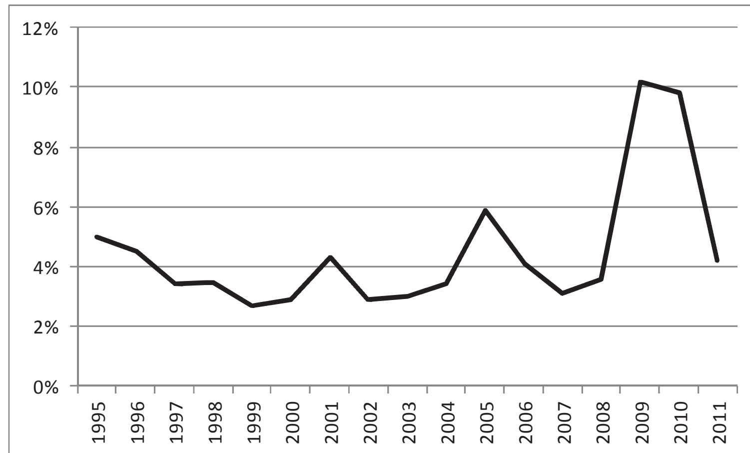
Source: World Bank.

Note: The loan amount recorded as nonperforming is the gross value of the loan as recorded on the balance sheet, not just the amount that is overdue.

3.10. Government Debt

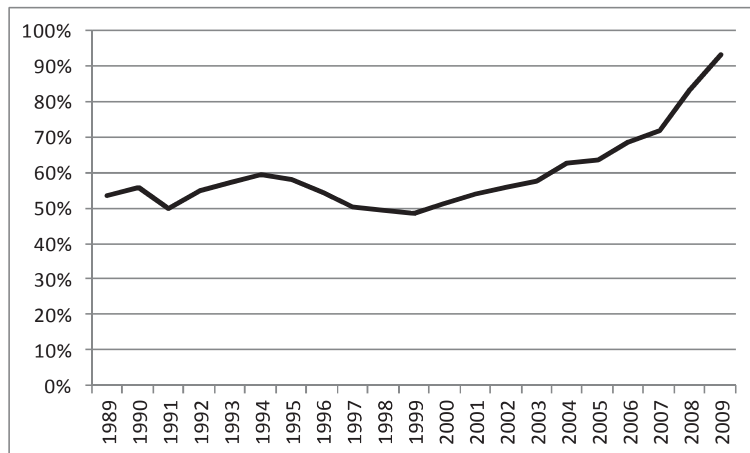
The favourable business cycle evolution, the sharp decline in interest rates, and the privatization process caused a reduction of the government deficit and public debt between 1995 and 1999, in accordance with the Maastricht criteria (Figure 46 and Figure 47). The government deficit decreased during the second half of the 1990s from 5% of GDP, in 1995, to 3%, in 2000. This effort allowed the participation of Portugal in Stage Three of the EMU.

Figure 46 – The Portuguese public deficit (% of GDP)



Source: Bank of Portugal

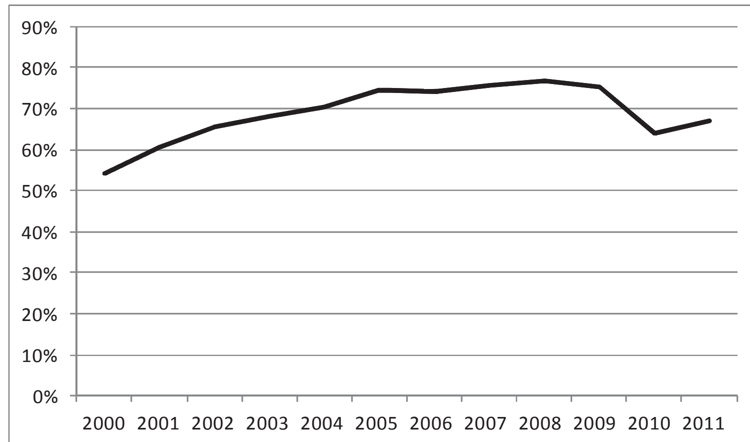
Figure 47 – The Portuguese gross general government's debt (% of GDP)



Source: World Bank New Database

Financial integration, the reduction of exchange rate risk, and the development of pan-European negotiation platforms led to an increase of the proportion of public debt owned by foreigners: in 2000 it was 54% and in 2008 increased to 78% (Figure 48). This process was already under way since 1993, with the General government issuing almost exclusively fixed rate bonds with long maturities.

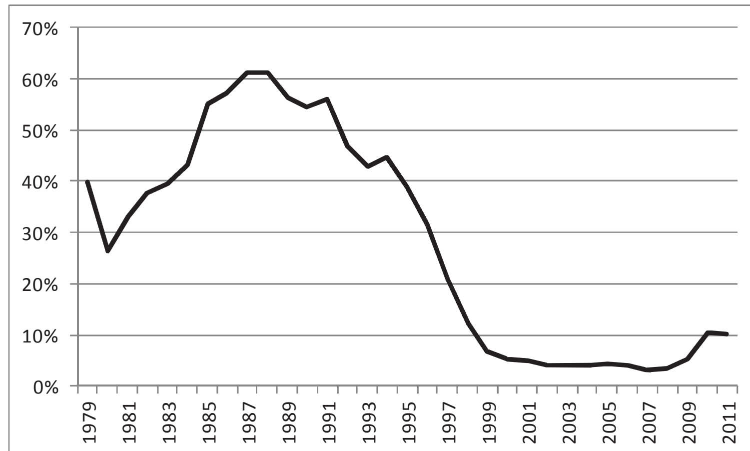
Figure 48 – Percentage of total public debt owned by non-residents



Source: Bank of Portugal, Annual Report 2011

As foreigners bought more public debt, domestic banks withdraw slowly from that market, allowing them to concentrate on the provision of credit to households and firms, which was more profitable. Credit granted the State in proportion of the total credit to the private sector decreased remarkably from 60% in 1987 to around 5% in 2001 (Figure 49). This decrease was possible because at the end of the second half of the 1980s the compulsory obligation to buy public debt was withdrawn. When in the second half of the 1990s the private credit grew at high rates, banks even sold Government bonds as a way of financing. Only in 2010 and 2011 the credit granted to the State in proportion of total private credit increased to a level near 10%, because national banks bought public debt as the yields increased and foreign investors took flight from domestic public debt.

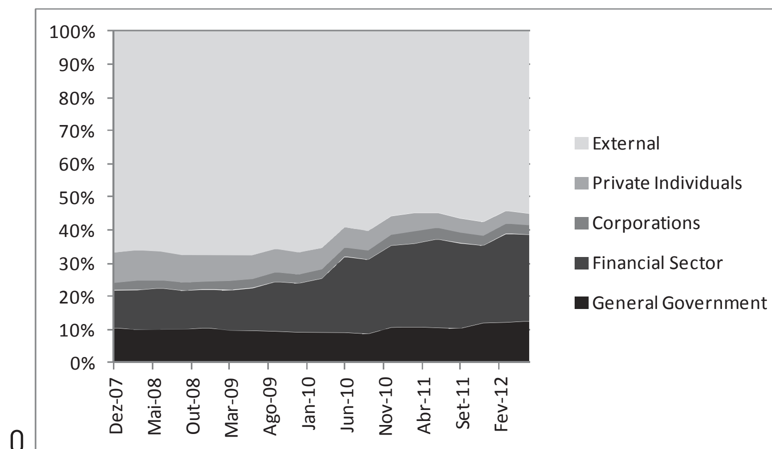
Figure 49 – Credit granted to the State (% total internal credit without the State)



Source: Bank of Portugal

Since 2007, there is information on all the financers of the General Government.[34] We observe a growing importance of the financial sector in the last two years, due to the purchase of public debt on large scale by banks (Figure 50).

Figure 50 – Financer sector of the General Government (% of total)



Source: Bank of Portugal (Debt of Non-Financial Sector)

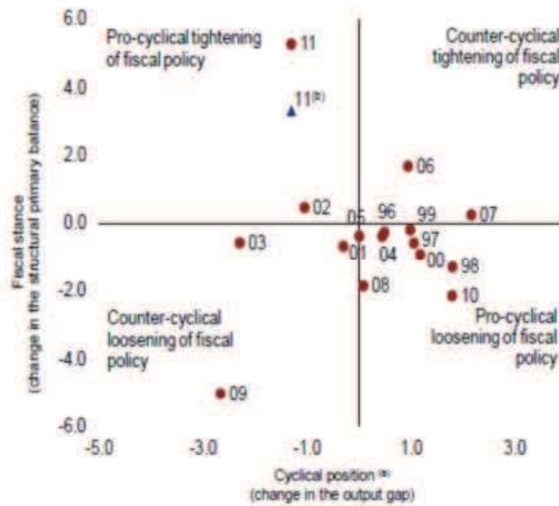
[34] Financers are banks granting credit to the State and essentially buyers of public debt.

After 2000, Portugal started to struggle to maintain the budget deficit under 3% of GDP. Portugal was one of the first countries to violate the Stability and Growth Pact in 2001. One reason for that was the decline in economic growth after Portugal joined the Euro. As a result, the Public debt started to increase steadily, and after 2004 was already above the 60% limit of the Growth and Stability Pact.

Some authors argue that in the years around 2000, when the economy was near full employment, the budget deficit should have been smaller, in order to allow more room for a counter-cyclical policy in periods of economic slowdown (see for example Abreu, 2006). Between 1996 and 2000 the fiscal policy was expansionary and pro-cyclical - Figure 51. This meant that the output gap increased while the fiscal balance (structural primary balance) increased. In the years 1998 and 2000 the pro-cyclicality of fiscal policy was particularly accentuated. Later on, in 2002 in a period of economic slowdown, the constraints of the SGP forced the government to follow a pro-cyclical tightening of the fiscal policy.

The situation of the public finances became much worse in 2009 and 2010 with the impact of the economic crisis. The deficit reached in 2009 and 2010 values close to 10% of GDP. This proved to be dreary signs for foreigner public debt investors, eventually leading to a sovereign debt crisis and the need to resort on international institutions for Government financing.

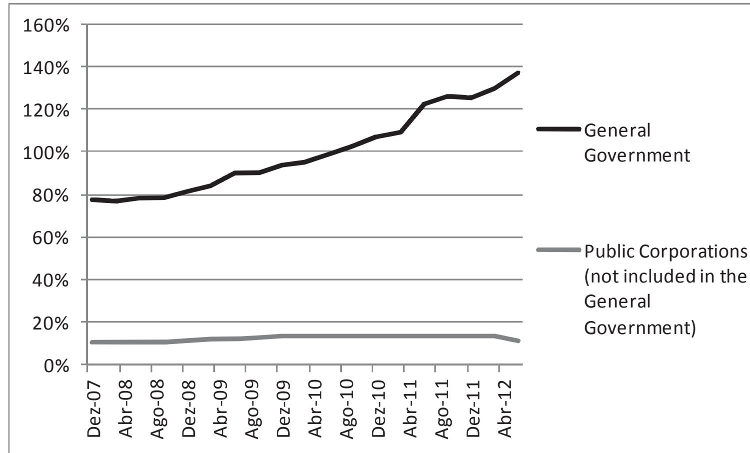
Figure 51 – Fiscal policy and the business cycle



Source: From Bank of Portugal, Annual Report 2011, pp. 96

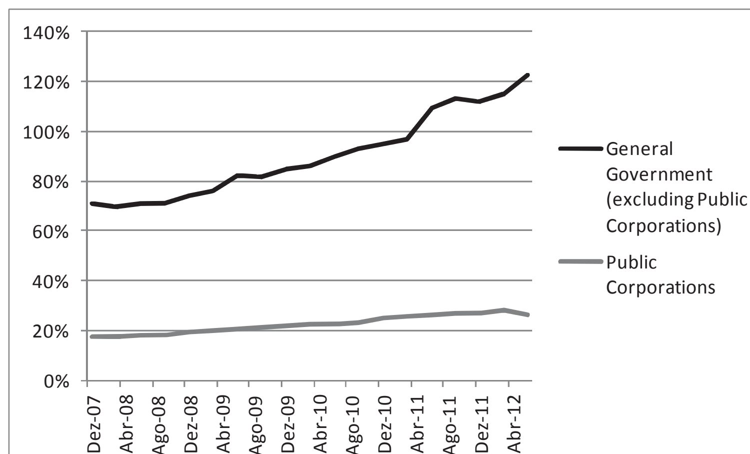
The total public debt includes the debt of the general government and the debt of public firms not included in the general government. In June 2012, the debt of those public corporations represented 11% of GDP (Figure 52). In order to have an idea of the total debt of public firms we have to look at the ones included and at the ones excluded from the perimeter of General Government. In total, public corporations' debt was in June 2012 26% of GDP, which represented 17.5% of total public debt. Between 2007 and June 2012, the increase of public sector debt was also explained by the rise in the debt of public corporations (+9 p.p.), but the major increase was in the debt of the General Government excluding public firms (52 p.p.) (Figure 53).

Figure 52 – Debt of both the General Government and public corporations not included in the General Government (% of GDP)



Source: Bank of Portugal

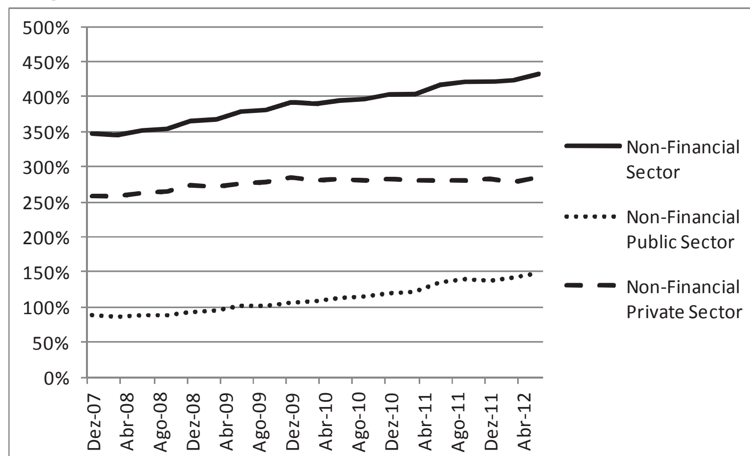
Figure 53 – Total debt of public corporation (% of GDP)



Source: Bank of Portugal

To place public and private debt in perspective, in June 2011, the overall debt of the non-financial sector of the Portuguese economy was 432%, with around a third being the responsibility of the Public Sector (Figure 54). Since 2007, the debt of the public sector has increased more than the debt of the private sector, mainly due to the adoption of countercyclical policy measures after the 2008 crisis and the increase in interest rates of the public debt due to the Euro sovereign debt crisis.

Figure 54 – Total debt of the economy (% of GDP)



Source: Bank of Portugal

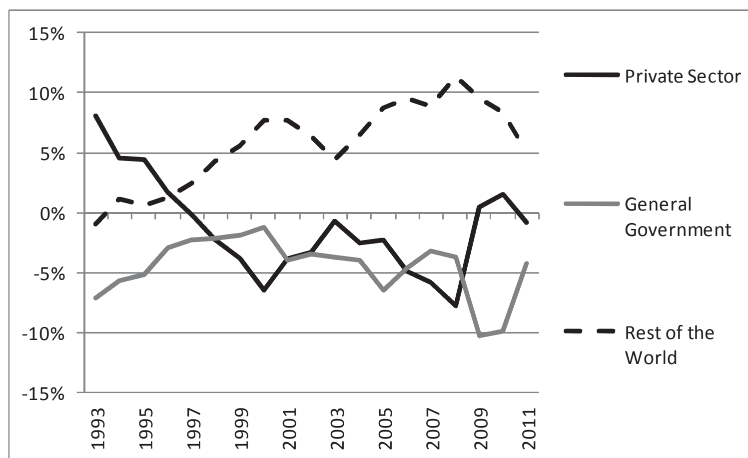
3.11. Net lending/borrowing

The net lending/borrowing of each institutional sector corresponds to the difference between current savings (plus capital transfers) and investment of each sector. Current savings are obtained by the difference between income and consumption. Net lending/borrowing corresponds to the financial saving of the sector, which is the difference between financial investments made and financial liabilities acquired in the period.

From 1993 to 2000, the private sector went from a lending position 8% to a borrowing position of 6.5% (Figure 55). The improving of the borrowing position of the Government during that period was not enough to avoid a deterioration of

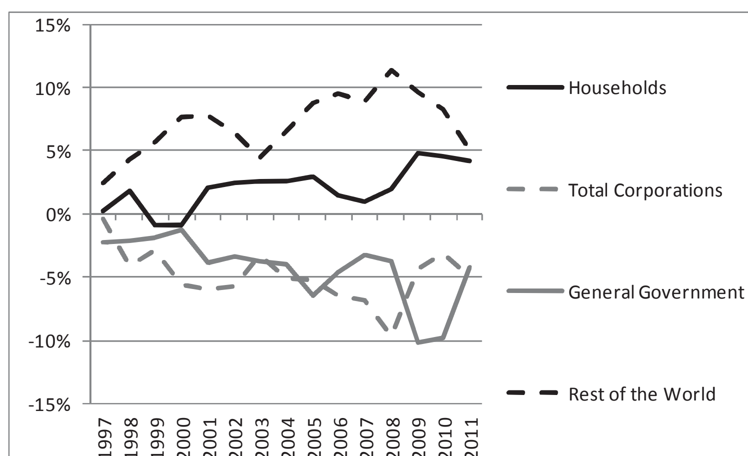
the borrowing position of the economy vis-à-vis the rest of the World. The evolution of the positions of the private sector and of the government was conditioned by the integration in the euro, which caused a reduction in interest rates and was associated with the increase in credit and the improvement in the budget deficit. In this period, both families and corporations suffered a decline in their net lending/borrowing position (Figure 56).

Figure 55 – Net lending/borrowing position by sector (% of GDP)



Source: Bank of Portugal, Several Annual Reports and Financial Stability Reports

Figure 56 – Net lending/borrowing position of households, Corporations, General Government and Rest of World (% of GDP)



Note: Total corporations includes financial and non-financial corporations

Source: Bank of Portugal, Several Annual Reports and Financial Stability Reports

From 2001 to 2008, the borrowing positions of the Government and the private sector remained high, causing high borrowing from the Rest of the World. On the private sector side, corporations had the highest increase in the borrowing position, while households maintained their lending position at an almost constant level.

After 2008, the tendency was for a reduction of the borrowing from the Rest of the World, due to a strong reduction in the borrowing position of the Private sector, which was accompanied by the public sector only in 2011. The recovery in the private sector was accomplished by an improvement of net lending/borrowing position of both families and corporations.

3.12. Concluding remarks

In this section we reviewed the growth of finance and several dimensions of the financialisation process. In 2011, the importance in terms of production of the financial sector (using a strict definition) in Portugal was one of the highest in the EA, and the growth between 1995 and 2011 was one of the fastest.

From 1995 to 2010, the financial sector has financed a high level of real investment in Portugal. Nevertheless, since 2001 there was a decline on the level and efficiency of investment. The Gross Operational Surplus (GOS) of financial institutions has grown faster than the GOS of non-financial corporations.

In Portugal, financial assets as a proportion of GDP are high and they have grown fast between 1995 and 2010, indicating an accumulation of financial rents during the period. The institutional sector with the fastest growth of financial

assets was financial corporations, probably translating a transfer of wealth to the financial sector.

Non-financial firms were also more involved in financial operations, which were increasingly more important in terms of revenues. Accordingly, financial assets owned by non-financial corporations have grown since 1995 slightly more than in the EA, but they are not very large in terms of GDP. The growth was especially large in the item loans.

One financial area where Portugal is underdeveloped is the stock market, and the tendency since 1993 has been for a divergence with the EA in terms of stock market capitalization. In contrast, Portuguese firms are among the ones of the EA that most issue debt securities, which had a fast growth since 1993.

The growth of the financial sector has been accompanied by a less conservative attitude of households in terms of investment, with a decrease in the investment in deposits and an increase in the investment in shares, debt securities and above all insurance products. Portuguese households have less preference than EA's households for quoted shares, but on the overall they have more preference for shares (quoted and unquoted). This means that the large preference of Portuguese firms for debt is not explained by a low demand for equity from households.

Households' saving rate decreased considerably before Portugal joined the euro, with the decline starting in the 1980s. In 1995-2010, Portugal was one of the euro area countries with one of the lowest households' saving rate.

As a result the growth of deposits did not accompany the growth of credit, leading banks to search for other sources of financing.

Borrowing from abroad and using credit securitization, banks were able to finance a strong cycle of credit growth, initiated in 1995 and ended in 2001/02, and induced by both demand and supply conditions. Credit to households grew

much faster than credit to firms, especially in 1994-2002, despite the fact that the latter is more important for economic growth than the former. The segment of credit to households that grew most was credit for housing, and in 2011, 80% of the credit to households was for that purpose. The credit for firms with medium/long term maturities increased considerably, allowing firms to do more long term investments. Finally, there are indications that SME were less favoured than large firms in in the recent period of credit tightening.

The rapid growth in credit from 1995 to 2002 contributed to the high growth of GDP in the period. Since the economy in 2001 was already near full employment, the inflationary pressures were also considerable. After 2002, credit continued to growth but at slower rates, which was not enough to sustain high levels of economic growth, especially because other forces were pushing it down: nominal exchange rate appreciation and high inflation implied a loss of external competitiveness, the efficiency of the investment has been decreasing, and the competition from Asian and Eastern European countries accentuated.

The growth in credit implied that in 2011 both Portuguese households and firms were among the most indebted of the EA, making them vulnerable to an economic slowdown. Indeed, since 2008 non-performing loans have increased considerably, especially for some sectors of activity and households' credit segments. This constitutes an indication of the difficulties brought by the growth of indebtedness, but on the overall the problem is still controlled.

Government finances had a good performance from 1995 to 1999 and a worse performance since 1999, mainly due to the slow economic growth of the Portuguese economy. Between 1996 and 2000 the Government followed a pro-cyclical expansionary policy, which, with the benefit of hindsight, can be pointed as imprudent. In 2002 the constraints of the Stability and Growth Pact obliged the Government to adopt a pro-cyclical tightening of the fiscal policy. In 2009 and 2010 the fiscal deficit reached almost 10% of GDP. This moved foreign

investors away from Portuguese public debt, in a context marked by high uncertainty in the euro area. Since they were the main buyers of public debt, this ultimately led to Sovereign debt crisis.

One reason for the crisis was the high level of foreign borrowing of the economy as whole to finance current account deficit, with the Government representing a third of the debt of the non-financial sector. From 1993 to 2000, the increase in borrowing from the rest of the world was due to the private sector, while Government reduced borrowing. From 2001, the increase in borrowing from the Rest of the World was due to an increase in borrowing of corporations and the Government, with households not contributing for this increase.

4. Structure of financial sector by forms of organization [35]

In this chapter we analyse the structure of the financial sector. The importance of the different financial institutions is assessed (Section 4.1), including a description of the importance of foreign and public banks (Section 4.2). Next, we study how banks have used the securitization of credits to spur their growth (Section 4.3). The use of derivatives and off-balance sheet items is also taken into consideration (Section 4.4). The way other financial institutions have evolved is studied in Section 4.5. Finally, the role of venture capital in financing innovative investment is the topic of Section 4.6.

4.1. Structure of the financial system

In Portugal, financial liberalization and economic growth caused an increase in the importance of the financial system: the assets of the CB (namely foreign reserves, credit to banks, and securities), other monetary institutions, insurance corporations and pension funds, and other financial intermediaries as a proportion of GDP increased 240 p.p. from 1995 to 2010 (see Table 9 and Figure 57).[36] This phenomenon was observed in other OECD countries as well.

Between 1995 and 2011, the importance of banks and of CB's assets in terms of GDP basically doubled, while the importance of insurance corporations and pension funds increased 2.5 times. Finally, the weight of other financial intermediaries has almost trebled (Table 9 and Figure 57).

[35] Point 3 of the Terms of Reference.

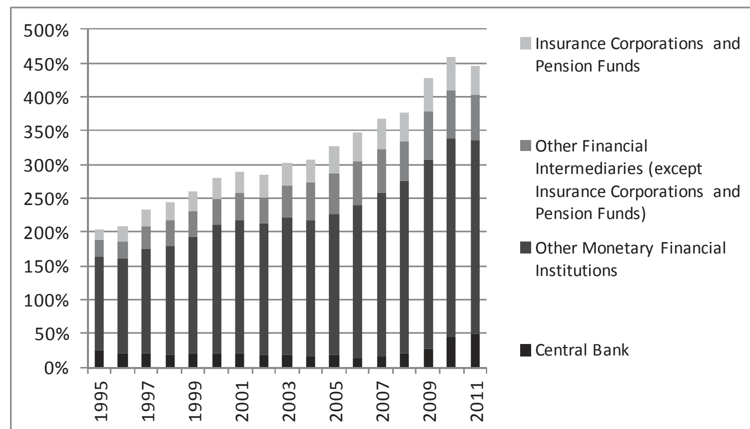
[36] In this section the total of financial corporations is non-consolidated.

Table 9 – Financial assets (% of GDP)

Financial Assets	1995	2011	Change 1995-2011 (p.p.)
Central Bank	24,1%	49,1%	25,0
Other Monetary Financial Institutions	140,4%	287,2%	146,8
Other Financial Intermediaries (except Insurance Corporations and Pension Funds)	23,0%	67,1%	44,1
Insurance Corporations and Pension Funds	17,5%	42,4%	24,9
Total	**205,0%**	**445,8%**	**240,8**
Financial Auxiliaries	0,3%	2,3%	2,0

Source: Eurostat

Figure 57 – The structure of the Portuguese financial system (% of GDP)



Source: Eurostat

Regarding the relative importance of each financial institution, between 1995 and 2011, the weight of banks (including the CB) in the financial system decreased: it was around 80% of total financial assets of the financial system in 1995 and decreased to 75% in 2011 (see Table 10 and Figure 58). The decline was not larger because the importance of the CB has increased between 2008 and 2011, due to the massive financing of banks by the CB. In contrast, other financial institutions, insurance companies and pension funds increased their importance in the financial system. Investment funds increased their role in system until 1998, but after that there was a reduction of their importance (Antão et al, 2009).

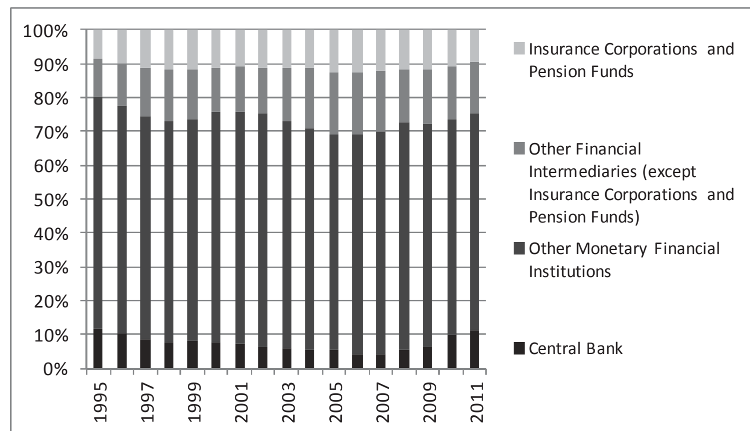
The reported tendency for the loosing of importance of banks among financial intermediaries was observed in other European countries. The size of the disintermediation in Portugal was very similar to Spain and Finland, and much less than in Belgium, France and Austria (see Table 11).

Table 10 – Financial assets of financial institutions (% of Total)

Financial Assets	1995	2011	Change 1995-2011 (p.p.)
Central Bank	11,8%	11,0%	-0,8
Other Monetary Financial Institutions	68,5%	64,4%	-4,1
Other Financial Intermediaries (except Insurance Corporations and Pension Funds)	11,2%	15,1%	3,9
Insurance Corporations and Pension Funds	8,5%	9,5%	1,0

Source: Eurostat

Figure 58 – The structure of the Portuguese financial system (in proportion of the total)



Source: Eurostat

Table 11 – Financial assets of other monetary financial institutions (% of Total)

Country	1995	2007	2010	Change 1995-2010 (p.p.)	Change 2007-2010 (p.p.)
Euro Area 17	n.a.	44,8%	42,9%	n.a.	-1,9
Belgium	79,0%	65,1%	61,2%	-17,7	-3,8
Germany	n.a.	n.a.	n.a.	n.a.	n.a
Ireland	n.a.	n.a.	n.a.	n.a.	n.a.
Greece	68,9%	81,9%	73,5%	4,7	-8,3
Spain	74,0%	67,3%	68,8%	-5,2	1,5
France	68,5%	59,8%	59,4%	-9,1	-0,4
Italy	n.a.	n.a.	n.a.	n.a.	n.a.
Netherlands	32,0%	36,2%	33,4%	1,4	-2,8
Austria	75,1%	65,1%	64,2%	-10,9	-0,9
Portugal	**68,5%**	**65,6%**	**63,8%**	**-4,7**	**-1,8**
Slovenia	n.a.	62,5%	66,7%	n.a.	4,1
Finland	75,2%	67,0%	72,4%	-2,8	5,3

Source: Eurostat

Despite their declining share of total financial assets, other monetary financial institutions continue to be the main financial institutions in Portugal, similar to other Continental European countries. In 2010, the importance of banks in the Portuguese financial system was above the EA17 average, but was still below the largest values of Finland, Greece and Spain (Table 11). The characterization of the Portuguese financial system as a bank-based system is perfectly valid in 2010.

More generally, other authors talk about the rise of the importance of financial markets over financial intermediaries, which they call disintermediation. In Portugal, we only observe such a tendency in the securities debt market, but not in the stock market (Table 12). But in 2011 the difference between the assets of financial intermediaries and debt securities market capitalisation is still huge. Anyway, this tendency has to be interpreted with caution, since a large part of the debt market of non-financial firms is "controlled" by banks, in the sense that they buy directly the debt or sell it through their branches.

Table 12 – Financial intermediaries versus financial markets

	Stock market capitalisation (% GDP)	Debt market capitalisation (% GDP)	Financial assets of financial intermediaries (% GDP)
1995	20	7	205
2011	27	24	446
% change 1995-2011	35%	269%	117%

Source: Eurostat and ECB

Accompanying the development of the financial system between 1995 and 2010, the assets of financial auxiliaries have also increased from 0.3% of the PIB to 2.3% (see Table 9). [37]

Compared to other European countries, the growth of the financial sector on the economy between 1995 and 2010 was high (see Table 13). In 2010 the importance of the financial system was below the Euro area average, but was a high value among the countries of similar development.

A rather interesting issue is that if instead of using consolidated data for the financial system we use unconsolidated data, the Portuguese financial system appears as the second largest of euro area, with a dimension very similar to the French system. [38] This indicates that there are many financial operations between the major sub-sectors (central bank, OMFI, other financial intermediaries, and insurance companies and pension funds) that compose the financial system.

[37] Financial auxiliaries are institutions that serve financial intermediaries and clients but do not finance the economy. This category includes for example dealers, stock market exchanges, exchange rate agencies, and rating agencies.
[38] The unconsolidated data corresponds to the sum of the financial assets of the diverse sectors composing the financial system.

Table 13 – Financial assets of the financial system (% of GDP)

Country	1995	2007	2010	Change 1995-2010 (p.p.)
Euro area (16 countries)	n.a	403,2%	429,6%	n.a.
Belgium	300,6%	459,6%	384,6%	84
Germany	236,7%	388,7%	403,2%	167
Ireland	n.a	1493,2%	2027,7%	n.a.
Greece	139,0%	178,9%	223,6%	85
Spain	153,1%	284,4%	294,9%	142
France	198,7%	380,3%	394,6%	196
Italy	141,9%	227,3%	248,9%	107
Netherlands	473,6%	870,1%	910,3%	437
Austria	186,4%	318,5%	317,8%	131
Portugal	172,5%	318,7%	359,0%	187
Finland	122,3%	207,9%	320,9%	199

Note: the financial system includes the Central Bank, other monetary financial institutions, other financial intermediaries, and insurance corporations, pension funds, and financial auxiliaries. In this table the financial system is on consolidated terms. Source: Eurostat (Annual Sector Accounts)

Table 14 – Financial assets of the financial system – unconsolidated data (% of GDP)

Country	1995	2007	2010	Change 1995-2010 (p.p.)
Euro Area 17	n.a.	349,7%	378,7%	n.a.
Belgium	313,1%	547,9%	452,7%	139,6
Germany	n.a.	n.a.	n.a.	n.a.
Ireland	n.a.	n.a.	n.a.	n.a.
Greece	149,6%	197,0%	281,5%	131,9
Spain	179,7%	379,4%	414,5%	234,8
France	222,2%	445,1%	460,9%	238,7
Italy	n.a.	n.a.	n.a.	n.a.
Netherlands	523,8%	1017,3%	1116,0%	592,2
Austria	215,4%	395,0%	398,8%	183,4
Portugal	**205,0%**	**367,9%**	**460,0%**	**255,0**
Slovenia	n.a.	191,0%	200,6%	n.a.
Finland	142,7%	230,2%	347.4%	n.a.

Note: the financial system includes the Central Bank, other monetary financial institutions, other financial intermediaries, and insurance corporations, pension funds, and financial auxiliaries.

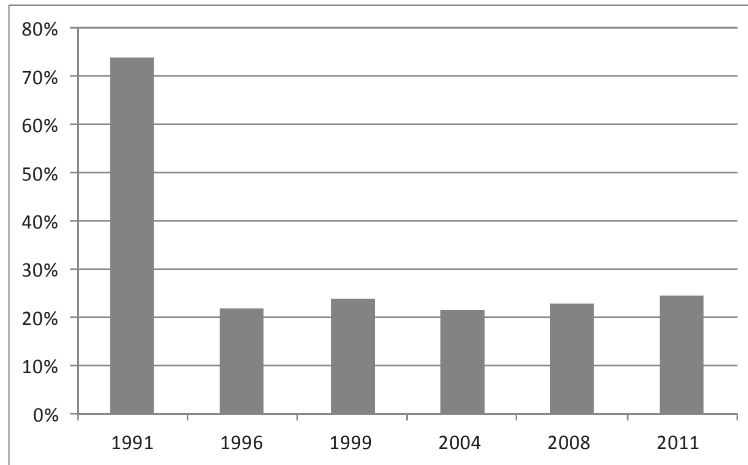
Source: Eurostat (Annual Sector Accounts)

4.2. Importance of foreign, public and non-for-profit banks

In the first years of the 1990s there was a radical change in the Portuguese banking system, with the transformation of a mainly public system into a system were the public bank has a minority role. In 1991, the system was dominated by State-owned banks with around 74% of the assets (Figure 59). In 1996, after the privatization of banks, only one State-owned bank (*Caixa Geral de Depósitos* - CGD) was left with 22% of banks' assets. Ever since, the state bank has been among the five largest banks operating in Portugal, and in 2012 was still state-owned and maintained basically the same market share of assets.

The existence of CGD as a public bank has been subject of discussion in Portugal. The same type of polemic exists in other countries and in the economic literature. There are several arguments favouring the existence of public banks, namely the stabilizing role in credit supply, the role in solving problems of insolvent banks, and the correction of asymmetric information. Moreover, public banks have a special role in supporting small and medium enterprises, providing services to residents of isolated areas, and funding socially desirable projects but financially unprofitable.

Figure 59 – Weight of public banks in the banking system



Source: Bank of Portugal (Banking System Statistics), Associação Portuguesa de Bancos and Antão et al (2009)

In contrast, other authors advocate that public banks may have undesirable effects, due to their inefficiency, the political influence on management, the distortion of competition, and the limited effect on economic growth.

In Portugal, CGD has been crucial in mitigating the recession after the Subprime crisis. Mortágua (2011) highlights that CGD had a counter-cyclical lending behaviour raising credit in the period 2009-11, contrary to most of the Portuguese private banks. CGD was also used by the Portuguese Government to bailout the private bank BPN after the crisis.

Barros and Modesto (1997) developed a model using panel data of seventeen commercial Portuguese banks over the period between 1990 and 1995, in order to evaluate the existence of a regulatory intervention in the Portuguese banking sector by public banks (at that time there were several public banks). They constructed a simple oligopoly model, where a public bank competes (through the level of interest rates) with several private banks. All private banks aim to maximize their profits, although the public bank is instructed by public authorities to maximize an objective function (in order to promote the welfare state) that depends on its profits and its revenues from deposits and loans. They

find evidence of regulatory intervention of public banks in the loans market, which aimed at decreasing the equilibrium interest rates paid for loans. Nevertheless, their empirical results do not support the hypothesis of the existence of internal regulatory devices in the deposits market.

Against this backdrop, the possibility of creating a new development bank owned by the Portuguese state is currently under discussion. The goal of the new bank would be to finance investment projects with very low interest rates, countering the strong recessionary effects arising from the current effort towards fiscal consolidation. The new bank may or may not be inserted in the group CGD.

Other banks similar to the public bank in the non-profit orientation are co-operative or mutual banks. There are two of such banks operating in Portugal: Crédito Agrícola and Montepio Geral. Even though these two banks have a small proportion of the total banking activity, they have distinctive characteristics because their prime goal in not to maximize profits with the aim of distributing them to their owners (Barradas et al, 2011). These authors emphasize that both banks have modernized in the last years, offering a set of financial products and services similar to any standard bank. Nevertheless, they find important differences between the co-operative and mutual banks and commercial banks, namely in the way funds are raised (both banks are not listed in the stock market, so they only raise capital through the injection of funds by new or existing members and by retaining profits), governance criteria (they are customer owned entities with a democratic control by their members), tax regime (Caixa Económica Montepio Geral has benefited from an exemption of Income Tax[39]), application of profits (they use profits essentially to increase

[39] According to the Article 8 of the Decree-Law 119/83, dated February 25th; Article 1 of the Law 151/99, dated September 14th; and Article 10 of the Corporate Income Tax Code. Crédito Agrícola has already lost most of the fiscal benefits and tax exemptions.

their capital base and promote social activities), and behavior towards profits and social development (they maximize members/customer value and not exclusively profits and contribute to the social and economic development of regions where they operate).

On the other hand, Crédito Agrícola is mainly designed to support primary sector and SME and is local in nature, whilst the mutual institution is more focused in households and, particularly, in credit concession for housing purposes. Thus, both banks are slightly more specialized than the other commercial banks in domestic retail banking.

According to the European Association of Co-operative Banks, at a European level the specific business model of co-operative banks has proved to be more resilient to the crisis, since they had a better performance than standard commercial banks during the financial crisis started in 2008. Besides, co-operative banks have not been included in any nationalization program or declared bankruptcy.

Regarding foreign banks, they were already operating in Portugal in 1991, although with a residual importance (around 3% of the assets). They were mainly branches and subsidiaries of large foreign banks operating in other European markets. Since then, the market share of foreign banks has increased and in 1999 they represented 12.7% of banking assets (Bank of Portugal, 2000). These banks are subsidiaries or branches of large European banks. In 2000, the importance of foreign banks experienced a large increase to around 22% of assets, when Santander bought the Banco Totta e Açores and became one of the largest banking groups operating in Portugal. The increase in the importance of foreign banks was a tendency that occurred also in the Euro area (Figure 60), and has contributed to the increase in diversity and competition in the market. After that large takeover, the importance of foreign banks stabilized and started to decline slightly after 2005 (Table 15).

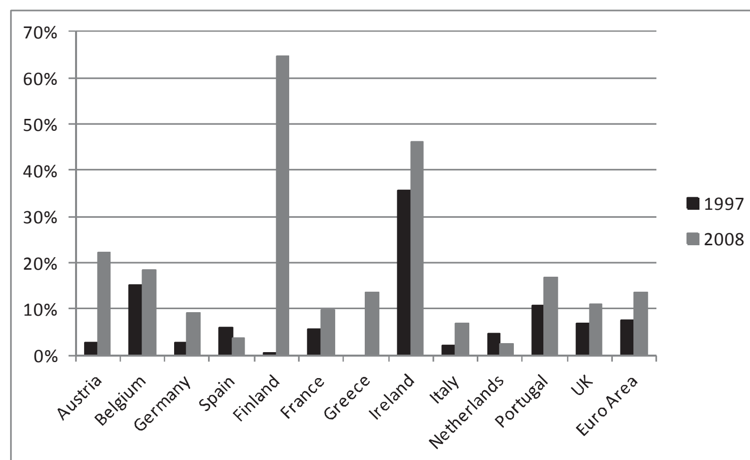
Table 15 – Subsidiaries and branches of foreign banks in proportion of banking system's assets

Period	Mean
1995-1996	8,0%
1997-1999	12,0%
2000-2005	22,7%
2006-2010	17,7%

Source: Annual Reports of BP (before 2000), Bank of Portugal (Banking System Statistics) and ECB (Structural Financial Indicators)

The presence of foreign subsidiaries in Portugal was larger than in the euro area: in 2008 it was 16.9% and 13.7%, respectively (Figure 60). But the importance of foreign subsidiaries was smaller in Portugal than in other medium size countries, such as Austria, Belgium, Finland and Ireland. This may indicate the ability of Portuguese banks to withstand foreign competitors.

Figure 60 – Assets of subsidiaries in percentage of the assets of credit institutions



Note: EA12 between 1997 and 2002, EA13 from 2003 to 2007 and EA16 after 2008

Source: ECB (EU Banking Structures)

4.3. Securitisation of credit

The beginning of the Subprime crisis in the American subprime housing market was strongly linked to the securitization of credit. The system of incentives of banks led them to grant excess credit to households with dubious creditworthiness. Commercial banks granted credit that afterwards was securitized in the form of CDOs, obtaining more financing for continuing to supply credit. In this way they removed credit risk from their balance sheets, creating an incentive for generating more credit independently of its quality.

In Portugal, securitization was used to finance the rapid growth of credit. Securitization allows banks to sell loans and obtain liquidity at a low cost (Bank of Portugal, 2008). Banks used two types of operations: the ones where loans stayed in the balance sheet and the ones where loans went off-balance sheet.

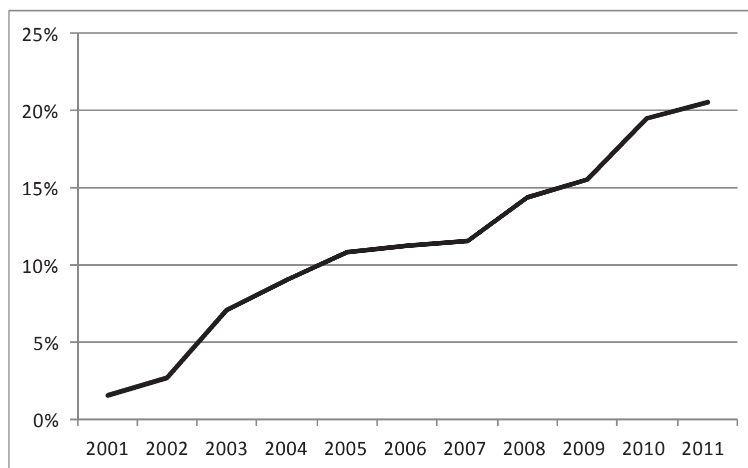
In Portugal and in the Euro area accounting standards hamper the elimination of bank's responsibilities through securitization operations (Antão et al 2009: 503). Besides that, banks are forced to maintain the commercial relationship with the client after the securitization of its credit, charging the amounts in debt and providing other services related with the loan (Antão et al, 2009: 456). Both previous comments indicate that unlike in the US, apparently, the legal framework of securitization operations in Portugal does not incentive banks to take too many risks in credit operations.

In the Portuguese market, securitization operations began in 1997. Before that there was only the issue of mortgage bonds, which had a residual importance. These bonds are instruments that have mortgage credit as collateral. During the first years of the securitization process, the absence of specific legislation implied that securitization operations were made with non-resident special-purpose vehicles. In 2000, specific legislation for securitization operations was created, leading to the rapid development of these operations. Especially after

2002, securitization grew quickly with the use of special-purpose vehicle companies to issue securities. In 2011 securitisation operations represented 20.5% of the total stock of credit to the non-financial private sector (Figure 61). Notice that after 2005 there was a rapid increase in on-balance sheet securitization operations at the expense of off-balance sheet operations (Figure 62).

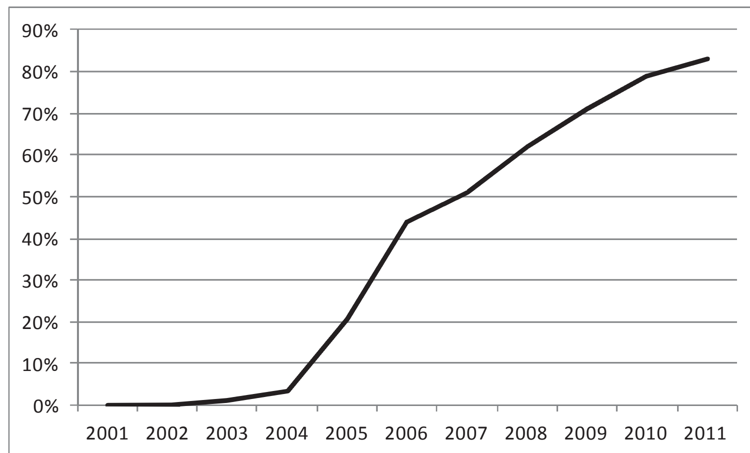
Reflecting the development of securitization operations, securitisation societies and funds had an exponential growth since 2001 and represented 62% of Other Financial Institutions' assets in 2011 (See Section 4.5).

Figure 61 – Loans securitized by OFMI (% of the total credit to the private non-financial sector)



Source: Bank of Portugal (Monetary and Financial Statistics)

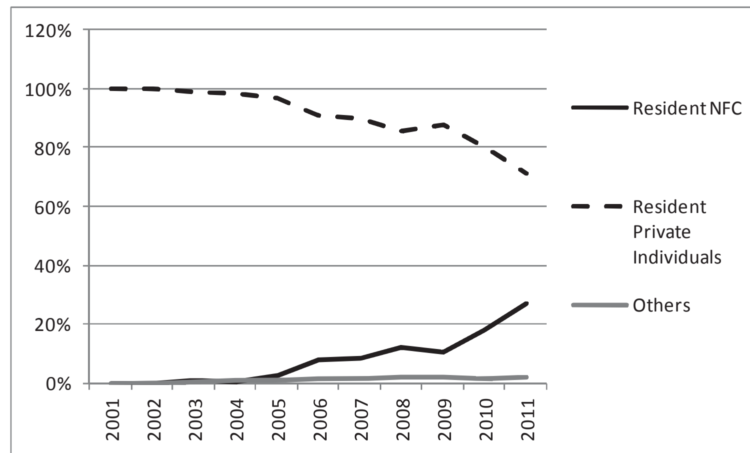
Figure 62 – Securitized credit recognized on the balance sheet (% of total securitized credit)



Source: Bank of Portugal (Monetary and Financial Statistics)

The majority of securitization operations was of mortgage loans (Bank of Portugal, 2008: 9), but it also included consumer loans and SME loans (ECB, 2011: 35). When we look at securitised assets by securitization companies and funds, we conclude that in 2001 there was only securitization of loans to households. Afterwards, the importance of the securitisation of loans to non-financial firms increased and in 2011 it represented 26.8% of the total, while households' loans declined to 71.4% (Figure 63).

Figure 63 – Original debtor of securitized assets by securitization companies and funds (% of total assets securitized)



Source: Bank of Portugal

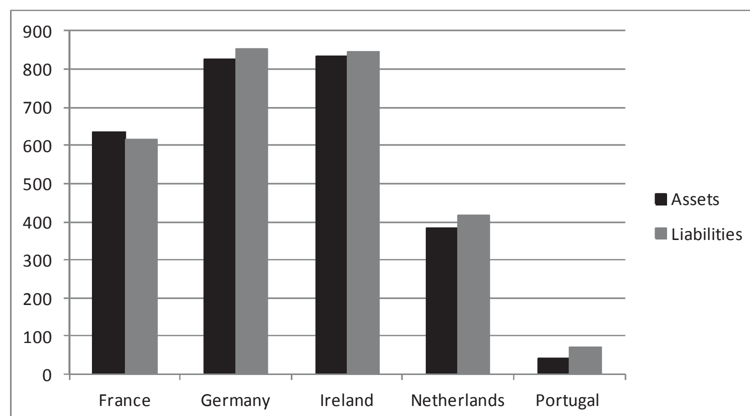
Besides being used for liquidity purposes, securitised products can serve as collateral in the ECB credit operations. Since 2007, Portuguese banks have self-retained new issues for that purpose (ECB, 2011: 35). Banks acquire the securities issued by the special purpose vehicles to use them as collateral in ECB monetary operations. In 2011, there was a slowdown of securitisation due to unfavourable market conditions and to the tightening of the criteria for asset backed securities (ABS) to be accepted as collateral by the ECB. Indeed, in 2011 the central bank started to demand AAA rating at the time of the issue of the ABS, conditions that were loosened in 2012 (Bank of Portugal, 2012: 54).

Notice that, the reduction of capital requirements is not significant in securitisation operations, because normally banks retain on the balance sheet the securities with greater subordination (equity tranche), which have high capital requirements (Bank of Portugal, 2008: 9). The regulatory goal is that securitisation operations should be neutral in terms of capital adequacy requirements (Bank of Portugal, 2001: 206). This means that, if after the operation a bank maintains the same level of risk, the capital requirement should also be maintained.

4.4. Derivatives and off-balance sheet operations

Banks may invest in financial markets to increase profits. A particularly risky way of doing that is using derivatives. In the history of banking and recent financial crises there are some examples of banks loosing large amounts with these instruments. Probably the best known case is Bearings bank that went bankrupted due to derivatives trading. To assess the exposure of banks to derivatives, we look at the ratios between gross asset and liability positions at market value in financial derivatives to total capital. In 2008, these ratios for Portuguese banks were much lower than the ratios of France, Germany, Ireland and Netherlands. In 2008, on average for France, Germany, Ireland and Netherlands the ratio of asset position to capital was 669.1% and for Portugal it was 39.8%, while for liabilities the numbers were 682.4% and 71.1%, respectively (Figure 64). This clearly indicates that Portuguese banks engage much less in derivatives trading than their European counterparts.

Figure 64 – Asset/Liability position in financial derivatives to capital (2008)

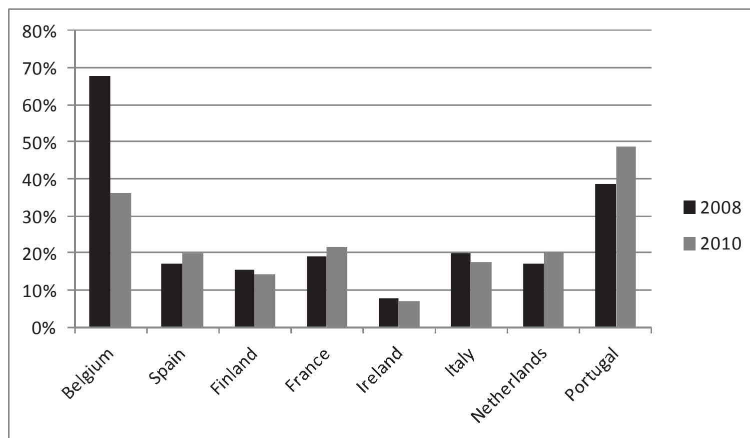


Note: The data for Germany refers to 2007

Source: IMF (Financial Soundness Indicators)

Banks also hold off-balance sheet items such as guarantees and loan commitments. By performing services to firms associated with those accounts, banks charge fees, but they are acquiring future responsibilities that may compromise capital. Looking at the importance of those two off-balance sheet items in proportion to total assets across 8 euro area countries in 2010, we observe that Portugal was the country with the largest indicator, with a value two times larger than the average of the other countries (48.6% and 19.6%, respectively) – Figure 65. Notice that in 2010 in Portugal there was a 10 p.p. increase in the off-balance sheet ratio, while in the group of euro area countries there was a 5 p.p. decline.

Figure 65 – Off-balance sheet commitments (% of total assets)



Source: ECB

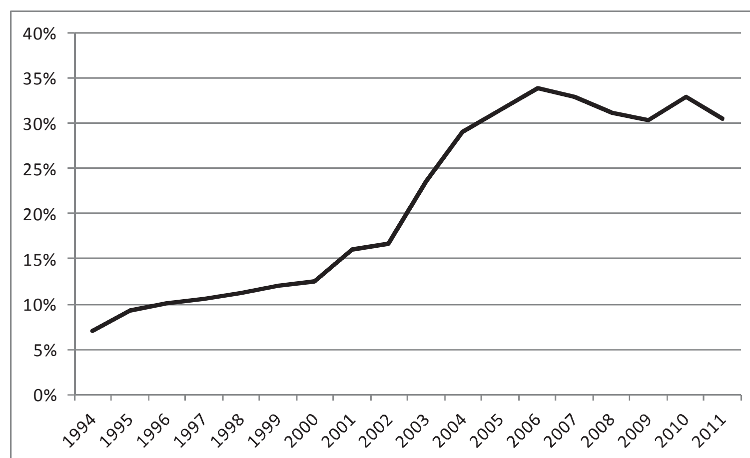
4.5. Other Financial Institutions

Besides monetary institutions, there are other financial institutions (OFI), and some of them are able to finance the economy without creating money. The best known ones are factoring firms, leasing firms, brokers, and credit-purchase financing firms. There are also credit financial institutions, securitisation societies and funds, and financial holding companies. In particular, credit financial institutions are allowed to realize all the banking operations except

receiving deposits. In reality they include many other types of institutions, such as factoring firms, leasing firms, credit-purchase financing firms, consumer credit firms, which prefer to have this legal category. Securitisation societies and funds manage funds of credit titularisation.

On the aggregate, these institutions have grown faster than the monetary sector (central bank and OFMI). In 1994, their assets represented 6.9% of total assets of the CB and OFMI and in 2011 they represented 30.5% (see Figure 66).

Figure 66 – Total assets of OFI (% of monetary assets)

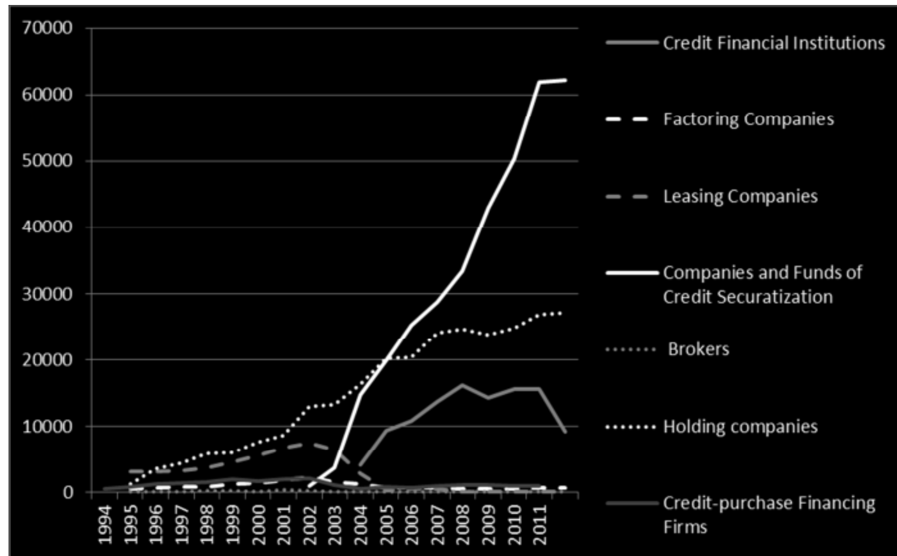


Note: monetary assets are the total of assets of the monetary survey.

Source: Eurostat

Besides the quantitative growth there was a qualitative change in the group of OFI (Figure 67). In 1994, the most important institutions were leasing firms and financial holding companies, followed by credit-purchase financing firms and factoring firms. The two latter types of firms together with leasing firms registered an absolute decrease in their assets after 2001. Notice that this may result from the fact that these types of institutions started to register themselves as credit financial institutions, a category that emerged in 2003 and grew substantially thereafter.

Figure 67 – Total assets of other financial institutions excluding Investment Funds (millions of euro)



Source: Bank of Portugal

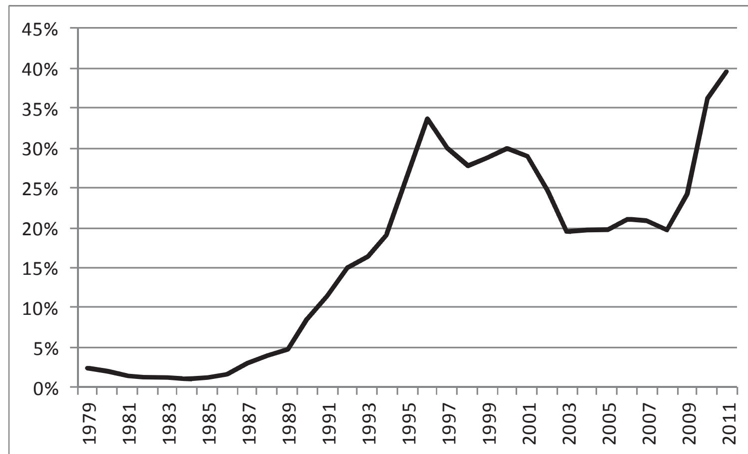
Another structural transformation in the sector was the continuous growth in importance of financial holding companies, reflecting the growing importance of financial groups.

Finally, the major event in the sector was the emergence of securitisation societies and funds in 2001, which registered an exponential growth, and in 2011 represented 62% of the assets of all OFI. This was associated with the growth of securitisation of credit by banks (see Section 4.3).

In addition to granting credit to the non-financial sector, banks also give credit to OFI. From 1980 to 1989 the credit to non-monetary financial institutions (NMFI) as a proportion of credit to non-financial corporations (NFC) was relatively stable and below 5% (Figure 68). After 1989 that indicator registered a remarkable increase, reaching 34% in 1996. From thereon there was a decline in the importance of credit to NMFI, which reached 20% of the credit to NFC in 2003 and remained around that number until 2008. But with the beginning of the sovereign debt crisis the credit to NMFI increased again, and in 2011 it

represented 39.5% of the credit to NFC. Overall, the evolution since 1980 indicates that banks have being devoting a large proportion of their credit capacity to finance other financial institutions.

Figure 68 – Credit to non-monetary financial institutions in proportion of the credit to non-financial firms

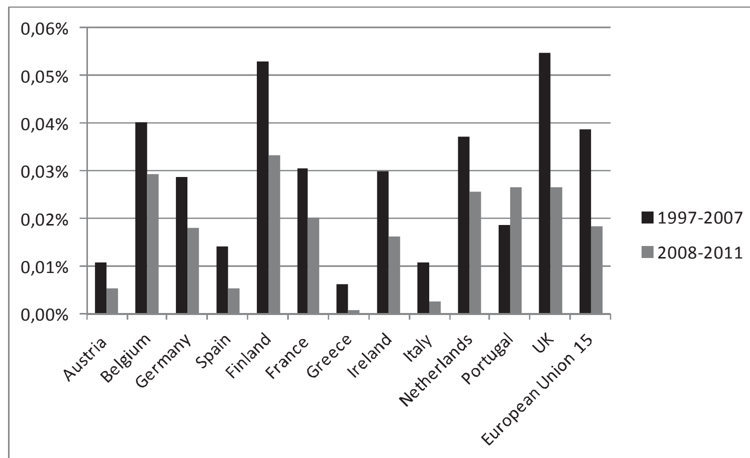


Source: Bank of Portugal

4.6. Venture capital

An important source of financing for innovative firms is Venture Capital (VC), especially in an early stage (seed and start-up). In the period 1997-2007, the importance of this type of financing was smaller in Portugal than in the euro area: 0.019% of GDP and 0.039% of GDP, respectively (see Figure 69). This is an indication that the innovative entrepreneurs obtained less finance of their activities in Portugal. However, in 2008-2011, Portugal has made an effort to increase seed VC, increasing the importance of VC above the Euro area average: 0.027%/GDP and 0.018%/GDP respectively. A significant part of that effort was supported by public funds. Overall either in the euro area or in Portugal, the venture capital represents a very small proportion of GDP.

Figure 69 – Venture capital investment by type of investment stage (early stage, seed and start up) (% of GDP)



Source: Eurostat

The stock market is another important source of financing for innovative firms. As an example one can think of the many dot.com US firms that have already made their IPOs. However, on this regard Portugal presents a less developed stock market than the EA average, implying less financing for innovative firms (See Section 3.4).

Another important activity of VC firms is to finance buyouts. In this case outsiders in conjunction with VC firms take the control of a firm. Through this activity VC facilitate firms' acquisitions. In Portugal, transactions in this segment of VC as a percentage of GDP are clearly below the European average (see Table 16).

Table 16 – Buyouts and venture capital investments (% of GDP)

Country	VC Buyouts (% of GDP)					Total VC (% of GDP)
	2007	2008	2009	2010	Mean 2007-2010	Mean 2007-2010
European Union 15	0,49%	0,32%	0,11%	0,25%	0,29%	0,40%
Belgium	0,16%	0,09%	0,14%	0,06%	0,11%	0,24%
Bulgaria	0,13%	0,00%	0,00%	0,00%	0,03%	0,05%
Czech Republic	0,03%	0,01%	0,04%	0,01%	0,02%	0,04%
Denmark	0,43%	0,13%	0,12%	0,05%	0,18%	0,29%
Germany	0,29%	0,22%	0,06%	0,13%	0,17%	0,23%
Ireland	0,10%	0,01%	0,01%	0,01%	0,03%	0,07%
Greece	0,03%	0,09%	0,01%	0,00%	0,03%	0,04%
Spain	0,15%	0,05%	0,03%	0,18%	0,10%	0,18%
France	0,55%	0,31%	0,07%	0,20%	0,29%	0,39%
Italy	0,08%	0,16%	0,05%	0,04%	0,08%	0,12%
Luxembourg	0,01%	0,11%	0,00%	0,09%	0,05%	0,37%
Hungary	0,04%	0,00%	0,20%	0,02%	0,07%	0,08%
Netherlands	0,51%	0,16%	0,04%	0,12%	0,21%	0,31%
Austria	0,10%	0,05%	0,02%	0,02%	0,05%	0,08%
Poland	0,22%	0,14%	0,13%	0,10%	0,15%	0,19%
Portugal	**0,04%**	**0,16%**	**0,07%**	**0,07%**	**0,09%**	**0,16%**
Romania	0,07%	0,05%	0,02%	0,03%	0,04%	0,09%
Finland	0,34%	0,14%	0,06%	0,11%	0,16%	0,29%
Sweden	0,53%	0,72%	0,23%	0,66%	0,54%	0,77%
United Kingdom	1,41%	0,94%	0,37%	0,86%	0,89%	1,16%
Norway	0,08%	0,12%	0,14%	0,21%	0,14%	0,26%
Switzerland	0,11%	0,17%	0,07%	0,30%	0,16%	0,30%

Source: Eurostat

4.7. Concluding remarks

The growth of the Portuguese financial sector between 1995 and 2010 was high when compared with the EA, but in 2010 its importance in the economy was still below the average of the monetary area, but it was high among countries of similar development. Accompanying this growth there was also a rapid change in terms of the importance of public and foreign banks. In the first half of the 1990s, the financial system went from a system dominated by state-owned banks to a system where only one public bank remained, with around 20% of the market. Since 1991, foreign banks increased their importance in the national banking system, but their penetration was smaller than in other EA countries of similar dimension. This shows the good competitive capacity of domestic banks.

To finance their growth, banks have securitisation, which became an importance source of financing for banks. In this way a bank-based system has used market mechanisms to strength its position. Apparently, credit securitization did not create incentives for banks to take excessive risks in credit granting.

In other areas of risk, Portuguese banks trade much less than euro area banks in derivatives, but they have a much higher level of off-balance sheet items.

Other financial institutions grew faster than banks, especially securitisation societies and funds, which registered an exponential growth. Financial holding companies also grew considerably fast, reflecting the growing importance of financial groups. Banks have been devoting a large proportion of their credit capacity to finance non-monetary financial institutions.

We observe a tendency for disintermediation as the securities debt market grew much faster than financial intermediaries.

Regarding the non-bank financing of innovation, venture capital financing of early stage projects was smaller in Portugal than in the EU from 1997-2007, but from 2008-2011 it was larger in consequence of an important effort of public policy. Additionally, the financing of innovative firms in the stock market is also more limited in Portugal, due to the small dimension of this market.

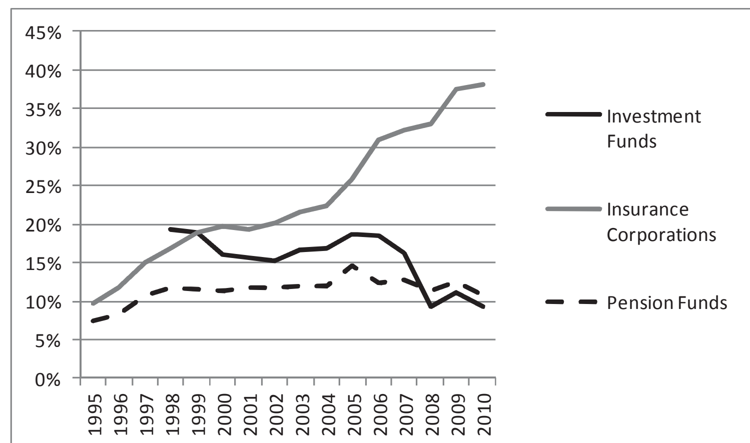
5. Availability and source of funds [40]

This section studies the growth of the several types of institutional investors and their role in the financing of firms (Section 5.1). Some of these financial firms are part of banking groups, which are described in Section 5.2.

5.1. Institutional investors

Institutional investors are financial companies that cannot create money directly, but due to their functions in the economy manage large sums of funds, and therefore are important in the financing of the economy. There are three major institutional investors: insurance companies, pension funds and investment funds. In the period 1995-2010, the institutional investor that grew fastest was insurance companies. In 1995, their assets represented only 9.7% of GDP and in 2010 represented 38.1% of GDP (Figure 70).

Figure 70 – Financial assets of Institutional investors (% of GDP)



Source: OCDE

The fast growth of insurance companies can also be noted by looking at another indicator of insurance: the ratio of direct gross premiums to GDP (Table 17).

[40] Corresponds to point 9 of the terms of reference.

Between 1983 and 2010, the Portuguese insurance market grew significantly. In 1983 the premiums represented 1.8% of GDP, one of the lowest values among Euro area countries.[41] In 1998, before joining the Euro, the importance of insurance premiums to GDP had grown to 4.98%, still below the EU-15 average of 7.4%. The growth of insurance companies continued in the following years and in 2008 the premiums represented 8.69% of GDP, slightly above the EU-15 average and above the majority of euro area countries.

Table 17 – The direct gross premiums (% of GDP)

Country	1983	1998	2010
Austria	n.a.	5,3%	5,8%
Belgium	3,7%	6,4%	8,0%
Finland	4,3%	3,9%	4,8%
France	3,5%	7,9%	10,6%
Germany	2,8%	6,4%	n.a.
Greece	n.a.	1,7%	2,3%
Ireland	6,9%	11,6%	21,7%
Italy	1,7%	4,7%	8,1%
Netherlands	n.a.	9,3%	6,2%
Portugal	1,8%	5,0%	9,0%
Spain	1,6%	4,8%	5,3%
United Kingdom	n.a.	12,6%	n.a.
European Union (15)	2,1%	7,4%	5,0%

Source: OCDE

In the non-life insurance sector, foreign firms have contributed significantly to the growth of the market (see Table 18). In 1983, foreign companies controlled 18.1% of this market segment, which was a reasonably high value in the Euro area context. In 1998, foreign companies already controlled 26.4% of the non-life insurance segment. In the next years, the market share of foreign companies increased slightly and in 2010 they represented 28.3% of the non-life insurance segment.

[41] There is no information for Netherlands and Greece.

Interestingly, in the life insurance segment there has been a decline in the market share of foreign companies. In 1983 they controlled 47.7% of the market, 15.2% in 1998 and 5.8% in 2010 (see Table 18).

Table 18 – Market share of foreign undertakers (% of total business)

Country	1983		1998		2010	
	Life	Non-Life	Life	Non-Life	Life	Non-Life
Austria	n.a.	n.a.	32,5%	50,8%	n.a.	n.a.
Belgium	24,3%	39,1%	3,1%	2,6%	n.a.	n.a.
Finland	0,0%	0,6%	0,0%	0,1%	n.a.	n.a.
France	7,7%	12,1%	1,0%	1,2%	n.a.	0,1%
Germany	3,4%	4,0%	7,7%	12,2%	27,0%	17,1%
Greece	17,0%	20,0%	9,7%	9,8%	57,2%	33,8%
Ireland	47,4%	45,1%	17,2%	16,7%	8,2%	8,9%
Italy	1,2%	4,6%	2,3%	4,8%	30,2%	27,3%
Netherlands	16,6%	26,6%	34,3%	36,7%	25,2%	17,0%
Portugal	47,7%	18,2%	15,2%	26,4%	5,8%	28,3%
Spain	23,5%	21,7%	28,7%	26,7%	10,3%	18,6%
United Kingdom	n.a.	n.a.	26,3%	39,9%	n.a.	n.a.

Source: OCDE

Pension funds had a smaller growth than insurance companies from 7.4% of GDP in 1995 to 14.6% of GDP in 2005. After that their importance declined to 10.8% of GDP in 2010. One reason for this decline is the transference of private pension funds to public social security.

In Portugal, as in many continental European countries, most pensions are provided by public funds. There are some private pension funds for large companies and banks that have gradually been dismantled. Nevertheless, in 2010 the assets controlled by autonomous pension funds as a percentage of GDP represented 11.4%, which is a relatively high value for the euro area if we exclude Finland, Ireland, and Netherlands (Table 19). In the latter three countries private pension funds are disproportionally very important.

Notice that between 2001 and 2010, the tendency in Portugal was for a stabilization of the share of autonomous pensions funds' assets in GDP, while in the other Euro area countries the tendency was for an increase.

As already mentioned, one reason why pension funds have not grown was the transference of some pension funds to Social Security since 1997. The main transferences happened in 1997 (BNU and Territory of Macau, 0.4% of GDP), in 2003 (CTT, 0.9% of GDP), in 2004 (CGD, ANA, Navegação Aérea de Portugal e Imprensa Nacional, 2% of GDP), in 2010 (PT Comunicações, 1.6% of GDP) and in 2011 (various banks, 3.5% of GDP) – Bank of Portugal, 2011).

Table 19 – Assets (including non-financial) of autonomous pension funds (% of GDP)

Country	2001	2005	2010
Austria	2,9%	4,8%	5,3%
Belgium	5,5%	4,4%	3,8%
Finland	49,5%	68,6%	82,1%
France	n.a.	0,0%	0,2%
Germany	3,4%	4,0%	5,2%
Greece	n.a.	n.a.	0,0%
Ireland	43,7%	48,3%	49,0%
Italy	2,2%	2,8%	5,6%
Netherlands	102,6%	121,7%	128,6%
Portugal	11,5%	12,7%	11,4%
Spain	5,8%	7,2%	7,9%
United Kingdom	72,0%	78,6%	88,7%

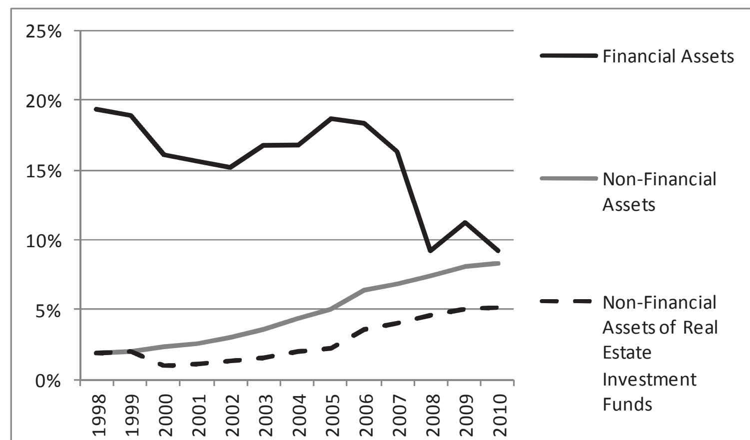
Source: OCDE

Those transferences allowed the temporary reduction of the fiscal deficit, which was very convenient for Governments, because it allowed them to comply with the Growth and Stability Pact. But in the long-run such operations may undermine the fiscal balance if the discounted value of the liabilities assumed by Social Security is inferior to the value of assets transferred. Naturally, this calculus is subject to substantial uncertainty arising from the evolution of wages, financial markets and mortality rates. The EU has highlighted that transfers of pension funds to Social Security have a particularly negative impact on the structural fiscal balance (Banco de Portugal, 2011).

Financial assets of investment funds have lost importance in terms of GDP: from 19.3% of GDP in 1998 they declined to 9.2% in 2010. In contrast, the non-financial assets of investment funds have grown quickly, and in 2010 they represented 8.3% of GDP, almost the same as the financial assets (see Figure 71).

The growth of non-financial assets in investment funds is related to the growth in real estate investment funds. In 1998 they represented 1.9% of GDP and in 2010 they had grown to 5.1% of GDP. Naturally, the growth of these specialised funds has contributed to the increase in investment in real state.

Figure 71 – Assets of investment funds (IF) (proportion of GDP)

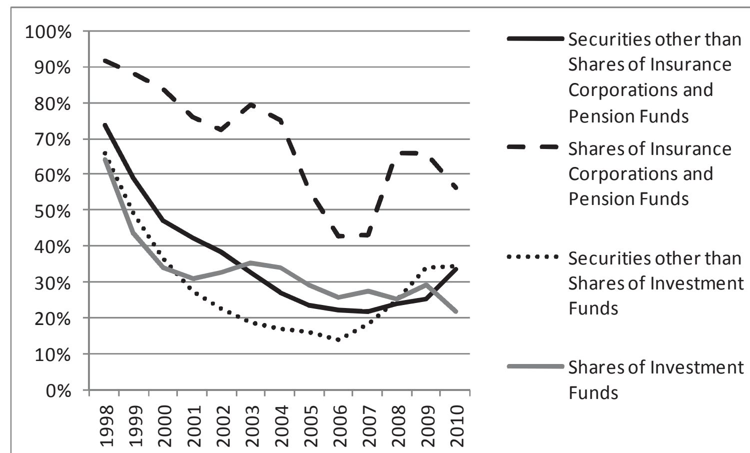


Source: OCDE

The main buyers of securities (debt and shares) are institutional investors (mutual funds, insurance companies and pension funds). In Portugal, financial integration implied a diversification of institutional investors' portfolio towards securities issued by non-residents (Figure 72). The reduction of exchange rate risk was one of the main explanations for the increase in the international diversification of portfolios. In a sense, this implied less demand for the

securities issued by Portuguese firms, probably creating difficulty in the financing of firms.

Figure 72 – Assets issued by residents and owned by institutional investors (in proportion of the total assets owned by each institutional investor in each category)



Source: OCDE

5.2. Financial groups

The process of deregulation and privatization of Portuguese financial system boosted the formation of large financial groups, which typically have a commercial bank as a dominant shareholder.

According to Pinto (1995), this type of strategy has had essentially two goals. Firstly, it has allowed the proliferation and distribution of diverse financial services in a more efficient way, through *cross-selling* or *bundling*. This type of strategy favours the attraction of customers to other financial products less common in commercial banking. Banks can use their clients' base to sell not only deposits and credit, but also mutual funds, insurances, factoring, leasing, among other products. Besides this marketing advantage, there are also synergies in terms of information and production technologies. Secondly, it

prevents a hostile takeover by other financial institutions, due to the large dimension of the financial institution.

The creation of a banking group by diversifying operations to related markets allows for the stabilization of revenues and for taking advantage of growing markets. An example of this is the insurance market in Portugal, which had a rapid growth and where banking groups were present. Another advantage of banking groups is that they facilitate the financing of activities. The commercial bank that can receive deposits and access to the central bank and the interbank market can finance other financial firms lacking such access, as investment banks and other non-monetary credit institutions. Naturally, there are some risks. For example, if an investment bank makes risky investments, it can drag the whole group into a difficult situation. But in Portugal such a scenario was not realized.

Banking groups dominate the Portuguese financial system, offering a wide variety of products and services, in a context of universal banking. Those groups have been created essentially by mergers and acquisitions, but also by internal growth. They have chosen to control specialised firms dedicated to a segment of business. They control and own most of financial companies linked to the provision of other financial activities, like insurance services, factoring, leasing, renting, asset management, investment banking, among others. All companies in the group are overseen by a holding company.

Mainly since the last decade, these financial groups have been following an international expansion's strategy, in an attempt to avoid the deceleration of the Portuguese economy and the maturity of the Portuguese banking market. In most cases, this international strategy has been used to facilitate and to promote exports and direct investment by Portuguese companies.

The continuous growth of financial groups was also detected in Section 4.5, as we noticed that the control of assets by holding companies grew substantially since 1994.

Notice that, together, the five largest banking groups account for around 75% of the Portuguese banking market, either in terms of assets, credit or resources from customers. In Portugal there are 5 large groups: CGD, BCP, BES, Santander and BPI. Only Santander is foreign owned, and the rest are domestically controlled. The largest group is CGD, controlled by the state, and the smallest are Santander and BPI. In terms of market share, Santander has had a very fast growth since 2003, while BCP has lost market share (Table 20). In Annex 0 we describe in more detail the composition of each group.

Table 20 – The importance of banking groups on the Portuguese banking system

	2003	2011
Banking System Total Assets	**100.0%**	**100.0%**
CGD Total Assets	23.4%	24.6%
BCP Total Assets	21.4%	18.1%
BES Total Assets	13.7%	15.5%
Santander Totta Total Assets	1.5%	7.8%
BPI Total Assets (individual)	8.3%	8.3%
C5	**68.3%**	**74.2%**
Banking System Credit to Clients	**100.0%**	**100.0%**
CGD Credit to Clients	22.5%	25.9%
BCP Credit to Clients	24.9%	21.6%
BES Credit to Clients	13.0%	15.6%
Santander Totta Credit to Clients	1.7%	9.0%
BPI Credit to Clients	8.9%	9.0%
C5	**70.9%**	**81.1%**
Banking System Resources from Clients	**100.0%**	**100.0%**
CGD Resources from Clients	28.2%	28.5%
BCP Resources from Clients	19.3%	19.2%
BES Resources from Clients	12.7%	13.8%
Santander Totta Resources from Clients	1.2%	8.0%
BPI Resources from Clients	7.8%	10.0%
C5	**69.2%**	**79.6%**

Source: Based on data from Bank of Portugal and APB

5.3. Concluding remarks

Institutional investors are important in financing the economy. In Portugal, insurance companies were the institutional investor that grew most since 1995. On the other two groups of institutional investors – pension funds and investment funds – there was no progress. Financialisation has stabilized or retreated in terms of pension funds, with many private pension funds transferred to the public domain. This movement had a positive effect on the fiscal deficit in the short run, but in the long run may have had negative effects. The importance of investment funds decreased substantially, but the importance of real estate investment funds increased.

The monetary integration led Portuguese institutional investors to invest more in foreign assets. This may have created difficulties for Portuguese firms to obtain finance in markets.

In the banking sector there was the construction of banking groups through M&A and internal growth. This tendency brought many advantages for banks namely the possibility of cross-selling, easy of financing, costs reductions, technology and information advantages, and creation of barriers to entry. The creation of groups allowed banks to have a universal approach to the business, offering a variety of products and services, many times through their own specialized financial firms. Currently, the 5 largest banking groups control around 75% of the banking system.

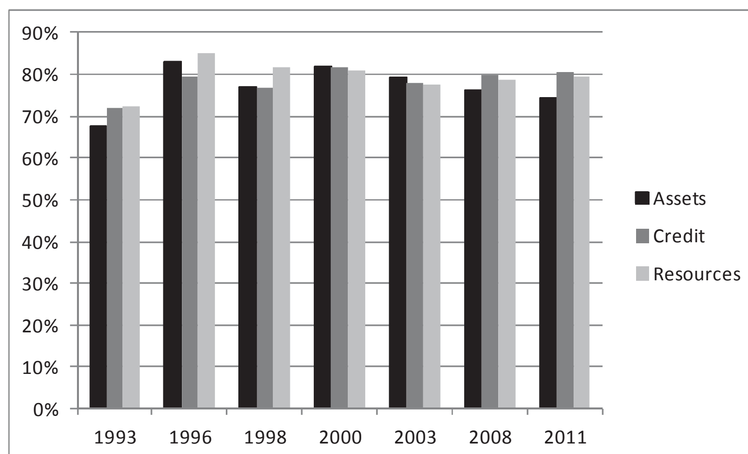
6. The nature and degree of competition between financial institutions[42]

This section describes the evolution of concentration in the Portuguese banking sector, giving particular attention to the impact of Mergers and Acquisitions (Section 6.1). The impact of competition on innovations in the payment system and channels of contacts with clients is the focus of Section 6.2.

6.1. Concentration and mergers and acquisitions

Since 1990, the degree of concentration in the Portuguese banking market has increased significantly in line with global and European tendencies. From 1991 to 1996, the deregulation of the banking market and privatisation of banks originated a consolidation in the sector. The share of assets of the five major banking groups (C5) increased from 67.7% in 1993 to 83% in 1996 (Figure 73).

Figure 73 – Bank concentration (C5)



Note: Non-consolidated data from 1993 to 1998 and consolidated data from 2000.

Source: From 1993 to 2003 data from Bank of Portugal's Annual Reports and from 2004 calculations based on APB and Bank of Portugal.

[42] Corresponds to point 4 of the terms of reference.

The privatization process consolidated the dominance of the five largest banking groups: Caixa Geral de Depósitos, Banco Comercial Português, Banco Espírito Santo, Banco Pinto e Sotto Mayor (latter Santander Totta) and Banco Português de Investimento. These groups are organized to offer a wide variety of products and services, in a context of universal banking. Since the end of banking privatizations, those banking groups have clearly led the Portuguese banking system, in terms of assets, income, credit and deposits. In 1996, they accounted for 83% of the assets, 79.6% of credit, 84.9% of deposits and 93.1% of net income. The fact that their share of net income was larger than their share of assets shows that they were more profitable than the remaining banks in the system. This may result from larger efficiency and/or larger market power.

After the end of the privatization process and up to 2002 there was some significant M&A, with the peak in the year 2000 (Table 21). In that year there were several M&A involving the major banking groups. Two events were of paramount importance. The first was the dismantling of the group Banco Pinto e Sotto Mayor (BPSM), which included Banco Totta e Sotto Mayor Inv (BTSM inv), Banco Totta e Açores (BTA) and Crédito Predial Português (CPP). The BPSM was acquired by Banco Comercial Português, BTSM Inv was acquired by Caixa Geral de Depositos and CPP was acquired by BTA. The second major event occurred in the 2000, when BTA was acquired by the Spanish group Santander, creating the major foreign bank in Portugal. The impact of these M&A movements can be seen in the increase in 2000 of the share of assets owned by the five major groups (Figure 73).

Table 21 – Number of domestic M&A involving credit institutions

Country	1997	1998	1999	2000	2001	2002	2003	2004
Belgium	1	6	1	0	1	1	2	1
Germany	15	12	22	10	9	8	14	11
Greece	1	8	3	4	2	2	3	1
Spain	7	12	9	7	5	3	4	1
France	17	9	7	10	12	12	8	11
Ireland	0	0	0	0	0	0	1	0
Italy	17	16	24	31	24	23	22	13
Netherlands	3	1	1	0	2	2	2	2
Austria	5	2	4	4	1	3	0	1
Portugal	**2**	**3**	**1**	**5**	**2**	**0**	**1**	**0**
Finland	0	0	0	0	0	2	0	0
United Kingdom	4	0	0	1	13	12	10	13
EA 12	68	69	72	71	58	56	57	41
EU	73	69	75	73	93	75	73	60

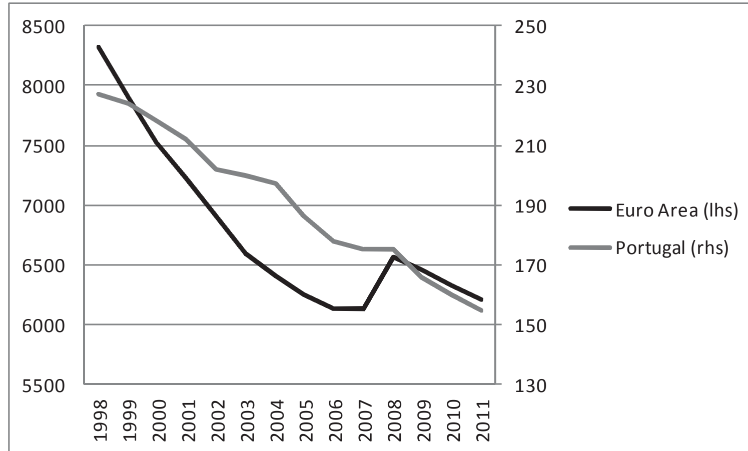
Note: EU 12 (1997-2000) and EU 25 (from 2001)

Source: ECB (EU Banking Structures 2004 and 2005)

After 2001 the M&A activity reduced significantly to one or zero operations a year. Also, after 2000 the tendency was for a decrease in the concentration of the banking market.

Between 1998 and 2010 the number of credit institutions in Portugal decreased by 32% (73 institutions), which compares with a reduction of 26% in the Euro area (Figure 74). Despite large, the decrease in the number of institutions in Portugal corresponds mainly to some minor adjustments in the banking system (Table A , in Annex). A large number of institutions leaving the market are local Agricultural *Caixas* that have merged with other *Caixas*. Moreover, small foreign banks leaving the market, M&A and internal adjustments in banking groups led also to the reduction of the number of banks. The joiners are small foreign banks and internet-based banks. Other banks join the market due to internal re-organizations of large banking groups.

Figure 74 – Number of credit institutions

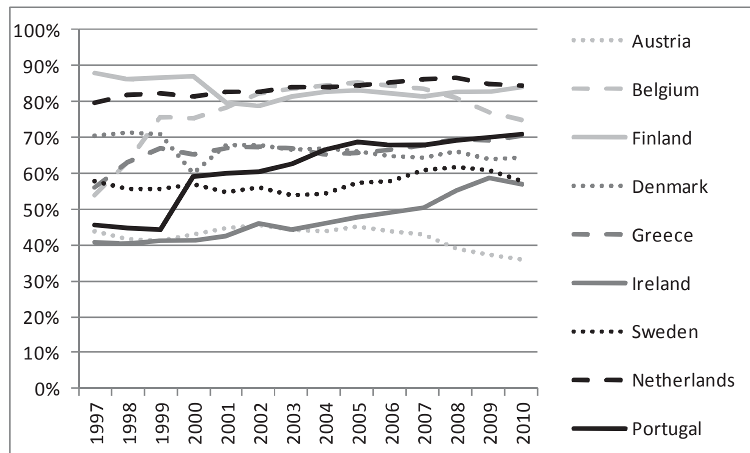


Source: ECB

Regarding concentration, a slightly different picture is obtained by looking at the Credit Institutions[43] on a non-consolidated basis, *i.e.*, excluding other firms of the banking group apart from Credit Institutions. Comparing with the share based with consolidated data, the share of total assets of the five major institutions decreases (Figure 75). But the most important is the analysis of the tendency of the indicator C5, being much clearer the increase in concentration in the credit market after Portugal has joined the Euro. Although in a smaller scale, this tendency also occurred in the Euro area (Figure 75), and also at a global scale (Uhde and Heimeshoff, 2009).

[43] According to the Portuguese law, credit institutions are companies whose business is to receive deposits or other repayable funds in order to apply them by granting credit. It is also considered as credit institutions companies which have as their object issuing means of payment in the form of electronic money. Thus, credit institutions include: banks, savings banks, mutual agricultural credit banks, credit companies, investment companies, leasing companies, factoring companies, mutual guarantee societies, and electronic money institutions.

Figure 75 – Share of the five largest Credit Institutions in total assets (non-consolidated basis)



Source: ECB and for the EA average the *Report on EU Banking Structures* (ECB), several years.

The degree of concentration of assets in the Portuguese banking market is larger than for the majority of Euro area countries (Figure 75). But these data has to be interpreted with caution, since banks grow in size to exploit scale and scope economies and, therefore, it is expected that smaller national markets would be more concentrated. Thus, compared with EU countries of similar dimension as Belgium, Finland and the Netherlands, the level of concentration does not seem large.

The increase in concentration did not mean a decrease of competition. Since 1990, competition between banks increased considerably due to: 1) the privatization of public banks, 2) the authorization of universal banks, 3) the end of credit limits in 1991 and 4) the reduction of the reserve rate from 17% to 2% in 1994 (Alexandre et al, 2011: 34).

As described by the Bank of Portugal (1997), one of the consequences of the rise on banking competition between 1986 and 1997 was the increase of deposits interest rates and a decrease of credit interest rates for low risk

clients. In this way, the financial margin felt considerably after 1991, in detriment of an increase of commissions and other services.

Effectively, Pinho (1999), using a panel data model, concludes that the period of deregulation of the banking activity between 1986 and 1992 implied an increase of price and non-price competition between banks. Additionally, he founds that the smallest banks paid higher interest rates and supported higher levels of advertising and branch expenditures, in order to increase their market share.

Boucinha and Ribeiro (2009) conclude that the Portuguese banking market is close to monopolistic competition in the long-run. Competition was more intense after 1996 and especially after 2000, indicating that the privatization of banks, the liberalization of the market and the euro participation has increased competition, namely in the credit segment.

In general, the effect of M&A has two contradictory effects on the conditions offered to clients. On the one hand, those operations may contribute to an improvement in firms' efficiency, which can be transmitted into lower interest rates and more credit to the non-financial private sector. On the other hand, M&A reinforce the market power of banking groups, leading to worse conditions for clients. Bonfim et al (2011) conclude for Portugal that M&A have contributed to a reduction of interest rates and to an increase of credit to non-financial firms, but has implied a smaller growth of credit to households.

If a merger increases the efficiency of both the acquiring and the acquired institutions, it is expected that the sum of the market value of both institutions increases. In this direction, Silva and Diz (2005) analyse the value creation effects of mergers and acquisitions in the Portuguese banking industry between January of 1995 and September of 2003, using an approach based on event studies. They study the market performance of twenty acquired or absorbed financial institutions (called "targets") and of twenty-two acquiring financial institutions (called bidders).

They note the existence of some gains for the targets, but no gains for the bidders. Nevertheless, if analysed as a combined entity (target plus bidder), they conclude that mergers and acquisitions in the Portuguese banking industry during that period did not create net wealth for shareholders.

6.2. Innovation: payment systems and channels of contact with customers

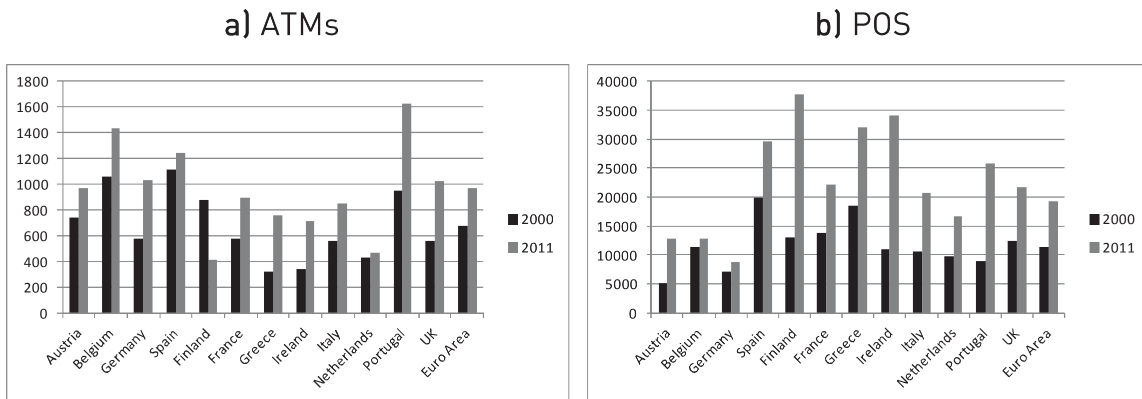
It was just saw that, despite the increase in concentration, the level of competition between Portuguese banks has increased. Some authors argue that competition is associated with innovation. In this section we study how banks innovated in terms of payment systems and ways of contact with customers.

Between 2000 and 2011, there was a strong increase in the number of ATMs and Point of Sales (POS) in Portugal (Figure 76a). In 2011, Portugal had the highest number of ATMs per million inhabitants, as well as the largest set of functionalities since the Portuguese ATM system is one of the most sophisticated in Europe (Antão et al , 2009). At the same time, the number of POS per million inhabitants has also risen, and in 2011 this indicator was larger in Portugal than in the EA, being only smaller than Finland, Ireland, Greece and Spain in 2011 (see Figure 76b).

In Portugal, the ATM system has functioned in a cooperative basis between banks, through the creation of a firm (Sociedade Interbancária de Serviços – SIBS) in 1993, in which each bank with a retail network owns an equity position. Clients from any bank can use the ATM system, with all services free of charge, with the system being mostly funded by advertising.

Figure 76 – Payment terminals per million inhabitants

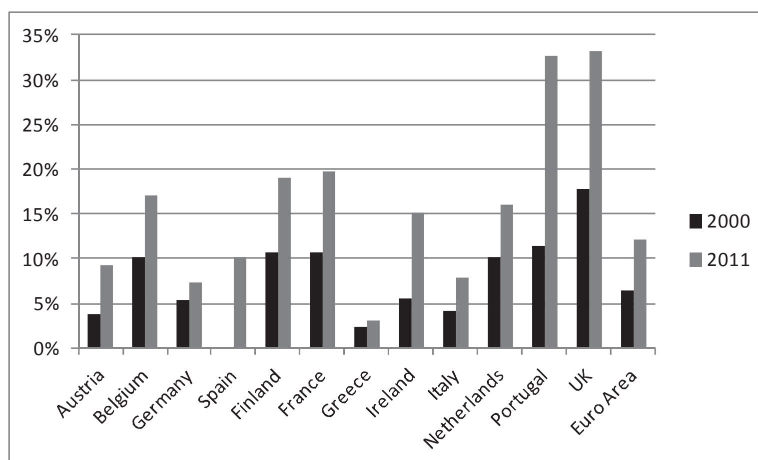
a) ATMs b) POS



Source: ECB (Payments and Settlement Systems Statistics)

In Portugal, the development of payment terminals during the last decade was also associated with the increasing use of debit and credit cards. In fact, in the 2000s, the use of cards as a payment instrument in proportion of GDP had in Portugal the highest jump among EA countries (see Figure 77). In 2011, Portugal had the second highest utilization of cards, only lower than the UK.

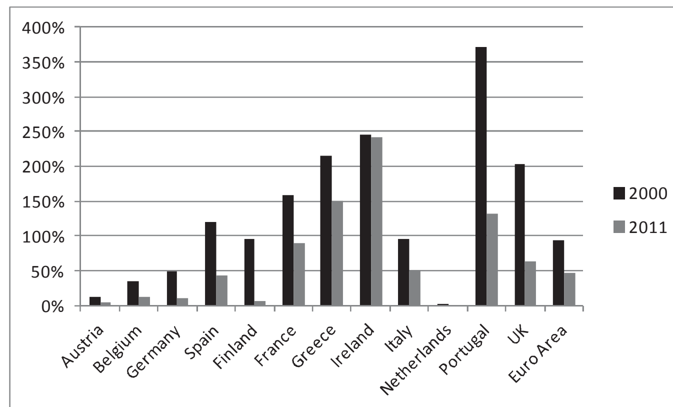
Figure 77 – Utilization of cards issued in the reporting country except e-money function (transaction in % of GDP)



Source: ECB (Payments and Settlement Systems Statistics)

In contrast, the use of chequebooks decreased substantially in the last decade in Portugal, a trend also visible in other European countries. Nevertheless, cheques continued to be used more in Portugal than in other EA countries, with the exception of Ireland and Greece (see Figure 78).

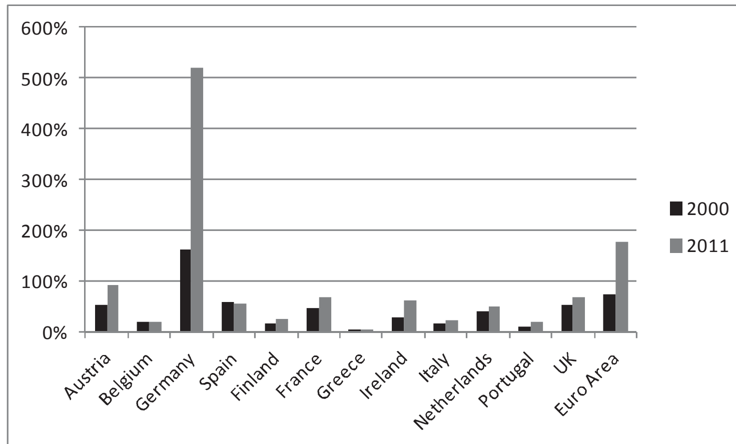
Figure 78 – Utilization of cheques (% GDP)



Source: ECB (Payments and Settlement Systems Statistics)

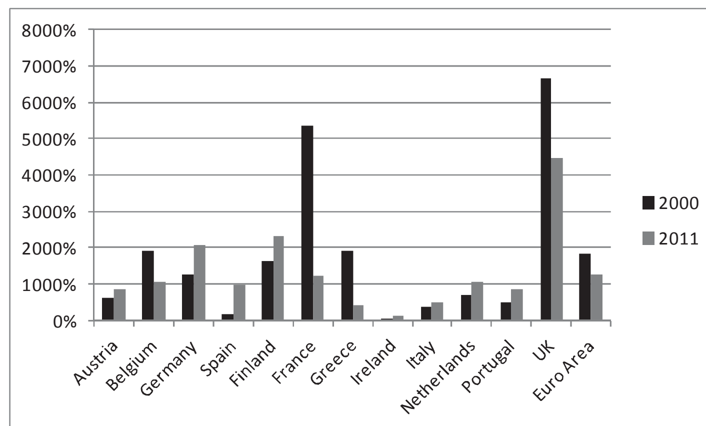
The Portuguese situation is quite different when we analyse direct debts and credit transfers. Despite some convergence since 2000, especially on credit transfers, those payment systems in 2011 were still less used in Portugal than in the EA (Figure 79 and Figure 80). This means that on direct debts and credit transfers, which are the most representative payment methods in other EA countries, Portugal still presents some underdevelopment, implying more transaction costs and less productivity. For example, the lower use of direct debits implies more use of labour input to make recurrent payments.

Figure 79 – Utilization of direct debts (% GDP)



Source: ECB (Payments and Settlement Systems Statistics)

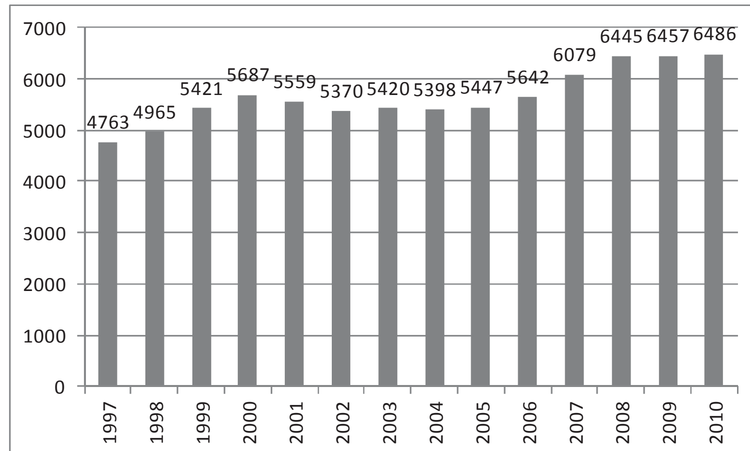
Figure 80 – Utilization of credit transfers (% GDP)



Source: ECB (Payments and Settlement Systems Statistics)

As we saw, the accessibility to banks' services through ATMs has increased notably since 2000. Similarly, the number of branches also rose quite substantially since 1997 (Figure 81), reflecting the abolition of the barriers to the location and opening of new branches in 1993. This process has been accompanied by a geographical dispersion of branches through the territory, in an effort to increase the contact with customers to raise market share.

Figure 81 – The number of bank branches in Portugal

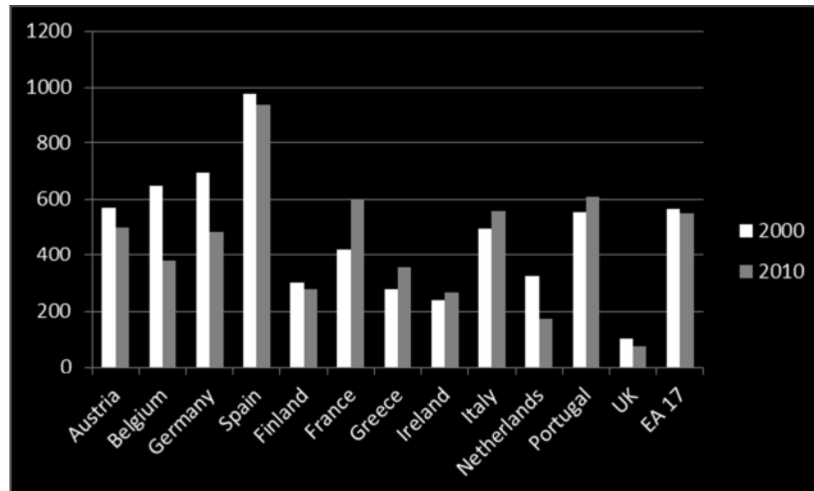


Source: ECB (Structural Financial Indicators)

However, the upward trend in the number of branches reversed between 2001 and 2004, due to the development of new business channels, like homebanking (by fax, phone and especially internet). There was also a reduction in the number of employees *per* branch (Activity Report of APB, several years), mainly in the last few years, in a context where branches are increasingly smaller, more disperse and decentralized. Between 2005 and 2008 there was again an increase in the number of branches, and in 2009 and 2010 the crisis caused the stabilization in the size of the branches' network.

The number of branches per million inhabitants increased in Portugal in the period between 2000 and 2010. This increase went in the opposite direction to the evolution that occurred in the EA. Moreover, in 2010 Portugal had the second highest number of branches per million inhabitants among the European partners (Figure 82).

Figure 82 – The number of bank branches per million inhabitants



Source: ECB (Structural Financial Indicators) and Eurostat

6.3. Concluding remarks

Since 1999 the deregulation of the banking market, the privatisation of banks, and M&A increased considerably concentration in the banking sector. This increase was one of the largest in the euro area. In 2010, the degree of concentration was above the EA average, but it was not very different from other small European countries.

Despite the increase in concentration, competition has increased especially after 2000, causing a reduction of lending interest rates and an increase in credit supply to firms.

Financial integration and the increase in competition led to a modernization of the payment systems and channels of contact with customers. The two areas where more progress was made were ATMs and bank branches. Portugal has one of the largest networks of ATMs, which has also more functionalities than in other countries. The size of the network of bank branches also increased, and in 2010 Portugal had one of the largest networks per million of inhabitant of the EA. Simultaneously, homebanking has also grown substantially.

In other areas the progress was slower. The use of direct debits and credit transfers is quite small in Portugal, while cheques are still very much used, showing evidence of the underdevelopment of parts of the payment system.

7. Profitability of the financial system[44]

In this section we assess the profitability of the financial system. Section 7.1 looks at financial margin, commissions and other non-interest income. As a complement, we describe the evolution of the intermediation margin in Section 7.2. The ratio cost-to-income and a review of studies on banking efficiency are the objects of Sections 7.3 and 7.4, respectively. The overall profitability of the banking system as assessed by the ROA and ROE is reviewed in Section 7.5, which includes also a comparison with the return of non-financial firms. The payment of taxes by banks is seen in Section 7.6. Finally the evolution of capital ratios is studied in Section 7.7. In all these sections we face a significant challenge in terms of the comparison of indicators across time, due to the widening of the group of banking institutions under analysis in the statistics of Bank of Portugal (in 2004 and 2007).

7.1. Financial margin, commissions and other non-interest income

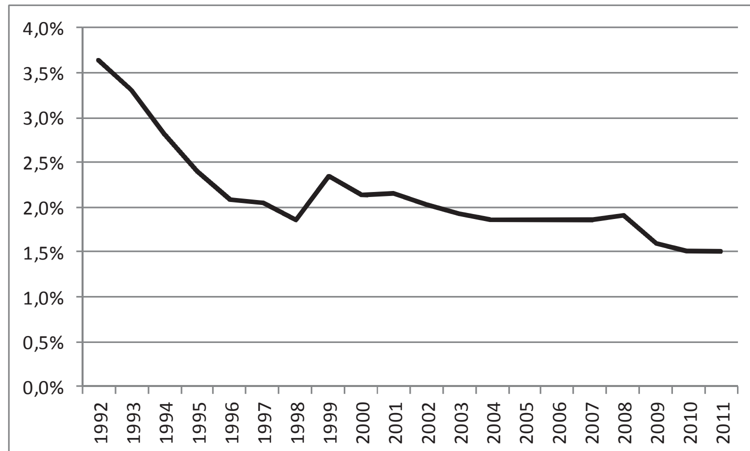
From 1992 to 2010 there was a strong downward tendency the financial margin (the difference between interests received and paid), especially in the period 1992 to 1998 (Figure 83) as a result of an increase in competition, the reduction in interest rates and the improvement in operational efficiency. One of the drivers of the improvement of operational efficiency was technological progress (Antão et al, 2009: 463).

The decline of the financial margin implied an approximation to the European values. In 2010, the Portuguese financial margin was not as high as in Austria, Spain, Greece and Italy, but was close to these high values (Figure 84). Notice

[44] Corresponds to point 5 of the terms of reference.

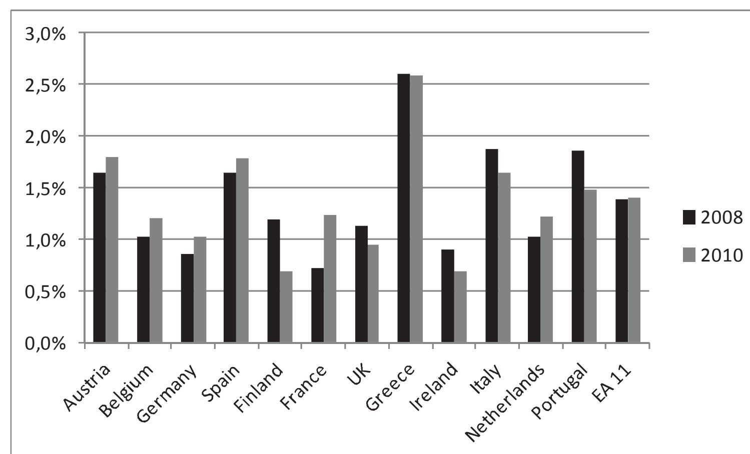
that the comparison between countries should be interpreted with caution, due to differences in balance sheet structures (Antão et al, 2009: 466).

Figure 83 – Financial margin (% of average assets)



Source: Calculations based on data from Bank of Portugal

Figure 84 – Net interest income in several EA's countries (% of total assets)

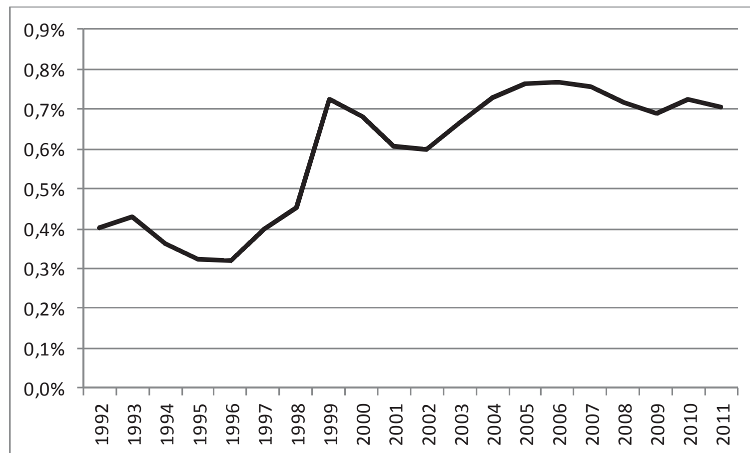


Source: ECB (Statistics on Consolidated Banking Data)

In order to compensate the decrease in the financial margin, the income from services and commissions as percentage of average assets had a tendency to increase between 1997 and 2005 (Figure 85). That occurred because in the

beginning of the 1990s banks' services to clients were not directly charged, with banks being remunerated by high financial margins. As financial margins decreased, banks started to charge explicitly for the services provided. After 2005, there was a small downward tendency in the income from services and commissions.

Figure 85 – Income from services and commissions (% of average assets)



Source: Calculations based on data from Bank of Portugal

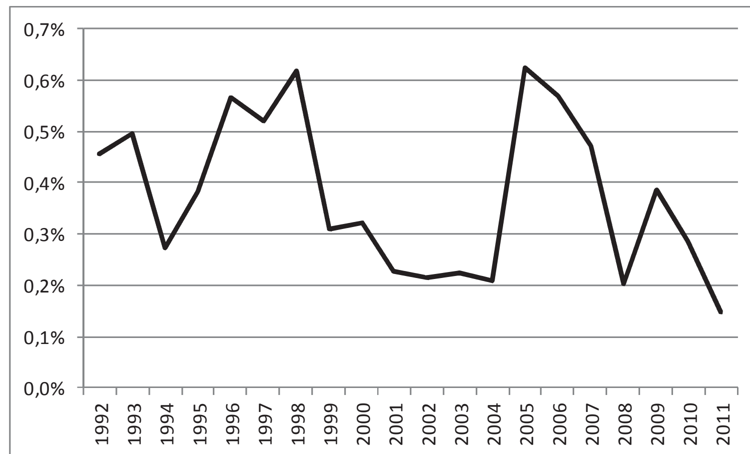
Besides credit and other services provided to clients, banks can invest directly in financial markets. In Portugal, since many banking groups include investment and commercial banks, we may wonder if banks have been dedicating more resources to investment and trading activities. From 1992 to 2011, the income from securities and financial operations did not show any overall trend, fluctuating in accordance with the evolution of the stock market[45] (Figure 86).

However, the investment in securities in proportion of total assets had a clear downward tendency up to 2008, which was particularly strong from 1992 to 2002 (Figure 87). During that period banks dedicated increasing resources to satisfy

[45] Even though there was a certain degree of anticipation of banks' income in relation to the stock market evolution.

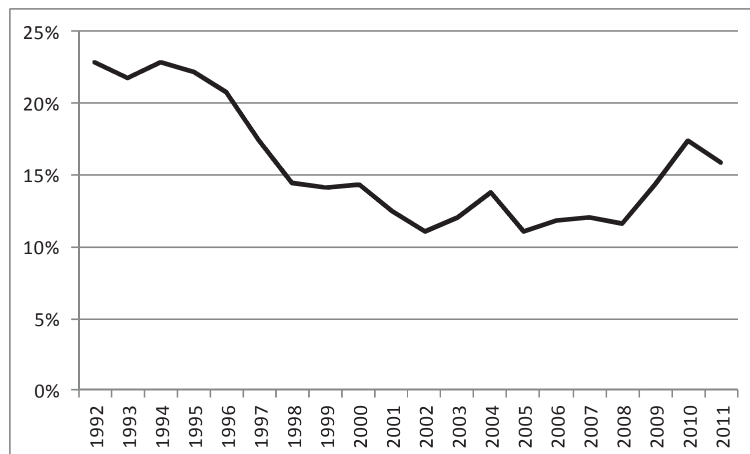
the growth of credit's demand. But after 2008, the investment in securities increased, probably because profit's opportunities in the credit market declined. Also, during that period domestic banks invested in the Portuguese government debt as foreign investors moved away from this market.

Figure 86 – Income from securities and financial operations (% of average assets)



Source: Calculations based on data from Bank of Portugal

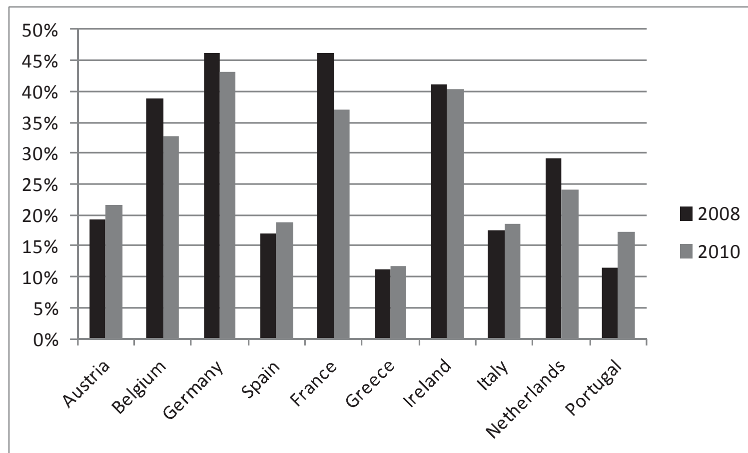
Figure 87 –Investment in securities (% of total assets)



Source: Calculations based on data from Bank of Portugal

The proportion of assets associated with securities and financial operations in total assets was in 2010 smaller in Portugal than in the other Euro area countries, with the exception of Greece (Figure 88). Nevertheless, between 2008 and 2010, in Portugal that proportion suffered the largest increase in the Euro area (7 p.p.), due to the reasons indicated above.

Figure 88 – Trading and investment securities (% of total assets)



Note: Trading and investment in securities includes financial assets held for trading, financial assets designated at fair value through profit or loss, available-for-sale assets, held-to-maturity investments, and derivatives-hedge accounting.

Source: ECB (Statistics on Consolidated Banking Data)

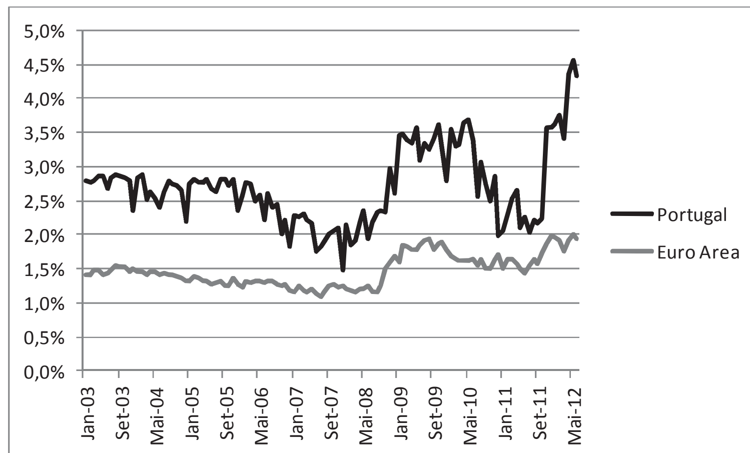
7.2. Intermediation Margin

The intermediation margin, which assesses the gross margin captured by banks, is measured as the difference between active (credit) and passive (deposits) interest rates. The smaller that margin the more efficient banks are in performing financial intermediation. The intermediation margin can be calculated separately for non-financial firms and for households.

Since 2003, the intermediation margin for non-financial corporations was on average 1 p.p. larger in Portugal than in the EA (Figure 89). The difference

between the two margins increased from the end of 2011 to June 2012. Similarly, between January 2003 and June 2012, the average interest rate margin for credit to households for consumption was also 2 p.p. larger in Portugal than in the EA (Figure 90a), but the margin for credit to households for housing was 0.35 p.p. smaller in Portugal than in the EA (Figure 90b).

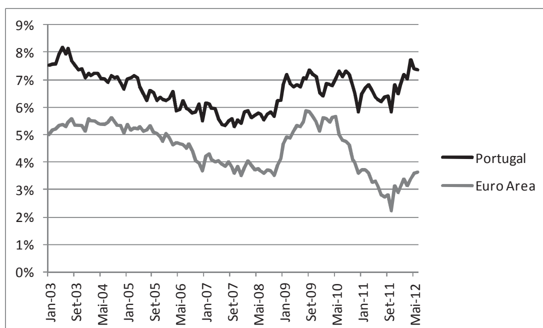
Figure 89 – The intermediation margin for non-financial corporations



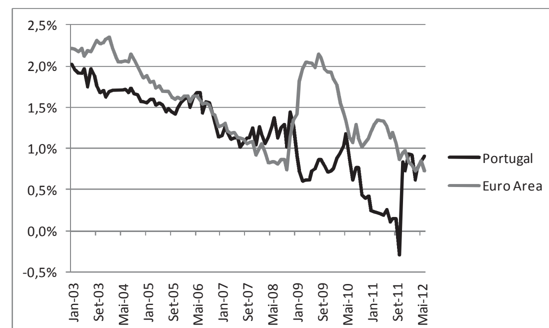
Source: Bank of Portugal

Figure 90 – The intermediation margin for households

a) Credit to consumption



b) Credit for housing

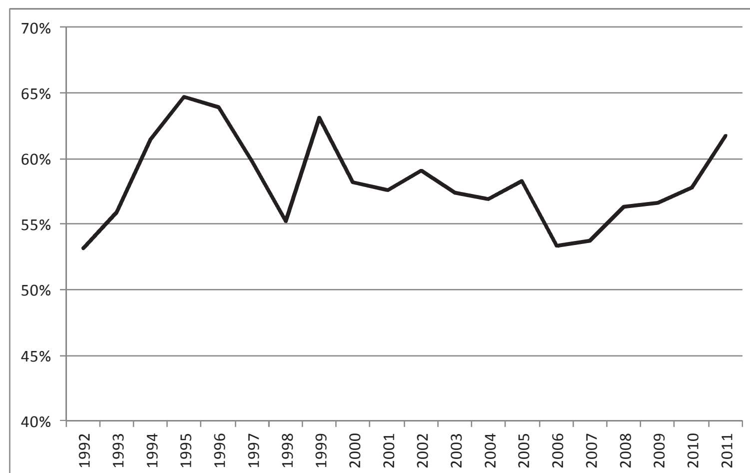


Source: Bank of Portugal

7.3. Cost-to-income

In the beginning of the 1990s the cost-to-income ratio increased, probably due to the reorganization of the main banks after the privatization process (Figure 91). [46] From 1995 to 2006 the cost-to-income ratio followed a downward trend. After 2006, with the beginning of financial turbulence in the markets, the ratio of cost-to-income started to increase at a quick rate, as the crisis reduced banks' income.

Figure 91 – Evolution of the cost-to-income ratio (% of banking product) in Portugal

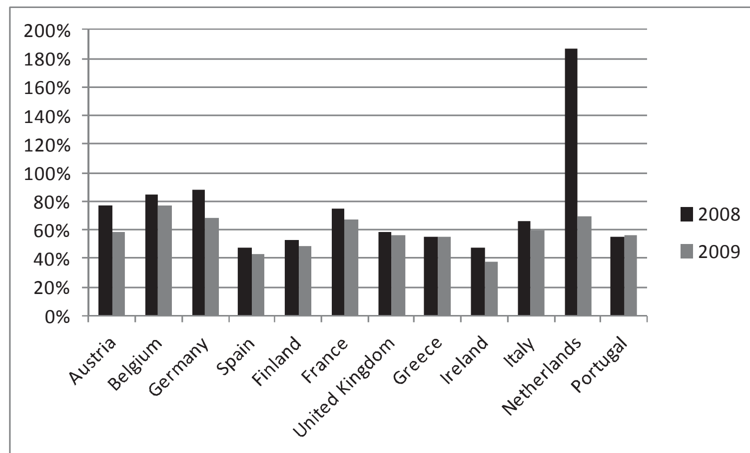


Source: Calculations based on data from Bank of Portugal

Comparing with other Euro area countries, in 2010 the cost-to-income ratio of Portuguese banks was low, with only Spain, Finland and Ireland presenting a lower ratio (Figure 92).

[46] The cost-to-income ratio is the sum of administrative costs, personnel costs and amortizations divided by banking production.

Figure 92 – Cost-to-income ratio (%) in the euro area



Source: ECB (Statistics on Consolidated banking Data)

7.4. Studies on banking efficiency

There are several studies on banking efficiency in Portugal. One of the most recent and complete is Boucinha, Ribeiro and Weyman-Jones (2009), which covers the period 1992-2004 using a stochastic cost function. The study assumes that banks attribute loans using debt and equity to finance them. Banks take into account a comprehensive set of costs in minimising costs: these include labour costs, financial costs, capital costs and external services. All these cost affect the marginal cost. The estimations done show that the reduction in interest rates decreased financial costs and thus the marginal costs of loans. There was also a decrease in marginal costs due to the reduction of the other costs (labour, capital and external services).

The level of cost-inefficiency was only 9% (above the efficient level), which means that on average banks had a cost 9% above the efficient level. This inefficiency may be due to allocative or technical inefficiency. Technical efficiency is the firm's ability to minimize cost for a given level of inputs. In turn, allocative efficiency reflects the ability to use inputs for the optimization of production, given the respective prices and technology. It is interesting to notice

that there is no evidence of an improvement in cost-efficiency over time. But naturally the efficiency varies across banks, from a minimum of 84% to a maximum of 99%. In contrast, there evidence of technological progress that reduces costs at a rate of 2.2% a year, which intensifies at the end of the sample.

The authors also find evidence of scale and scope economies. This may justify the merger and acquisitions that occurred in the Portuguese banking system, where the goal was to create larger and more diversified institutions.

The positive evolution of total factor productivity was mainly determined by scale efficiency and technological progress, with no contribution from technical efficiency. The growth of productivity accelerated after 1999, and was quite slow in the first part of the 1990s, when the liberalization of the banking system was still incipient.

There are other studies on cost efficiency, ones using stochastic cost functions (Mendes e Rebelo, 1999; Pinho, 2001; Ribeiro, 2006; Lima and Pinho, 2008) and another using Data Envelopment Analysis that is a non-parametric approach (Canhoto and Dermine, 2003). Mendes and Rebelo (2000) use both methods. These studies have several theoretical and empirical methodological differences, besides covering different time periods, making it difficult to compare their results. Anyway, all studies except Mendes and Rebelo (1999) find productivity gains in Portuguese banks (Antão et al, 2009: 471).

Studies also find systematic differences in cost efficiency across different types of banks: public banks are less efficient (Pinho, 2001; Mendes and Rebelo, 2000), banks created after 1984 tend to be more efficient than the ones created before (Canhoto and Dermine, 2003), and foreign banks are more efficient than domestic banks (Canhoto and Dermine, 2003). The results of Canhoto and Dermine (2003) indicate that deregulation of the banking system which allowed the entrance of new banks may have contributed to an improvement of average

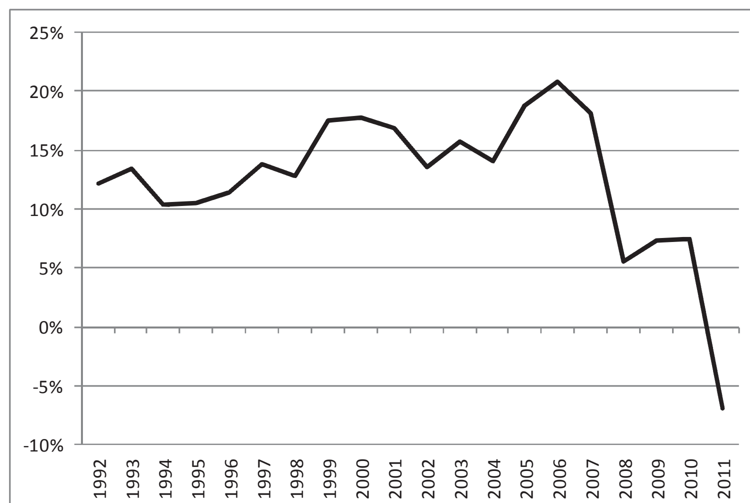
efficiency. Using a simulation exercise, Mendes and Rebelo (2000) found that the mergers and acquisitions may improve banks' efficiency. Ribeiro (2006) found the opposite result. In this direction, Lima and Pinho (2008) indicate that periods of high market concentration are associated with lower cost efficiency.

Barros and Borges (2011), not using a frontier approach, conclude that banks which have constructed stronger capital structures benefit from a larger return on assets.

7.5. Return-on-Assets and Return-on-Equity

Even though the data is not completely comparable across time, the ROE (before taxes and minority interests) of the Portuguese banks has shown a tendency to increase between 1992 and 2006 (Figure 93). After that there was a steep decline in the ROE, which in 2011 became negative. This reduction is explained by the Subprime crisis and the Sovereign debt crisis.

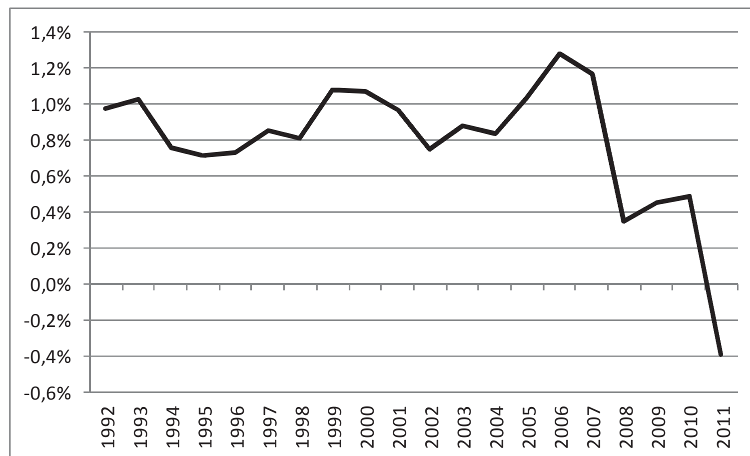
Figure 93 –ROE (before taxes and minority interests) of the Portuguese banks



Source: Calculations based on data from Bank of Portugal

The evolution in terms of ROA (before taxes and minority interests) was slightly different, since between 1992 and 2006 the upward tendency is not so clear, being more visible in 1996-99 and 2003-06 (Figure 94). The difference in the evolution of ROE and ROA reflect an increase in the leverage of the banking system, as we will see in Section 7.7. But the strong decline in ROA after 2007 was similar to the one that occurred in ROE.

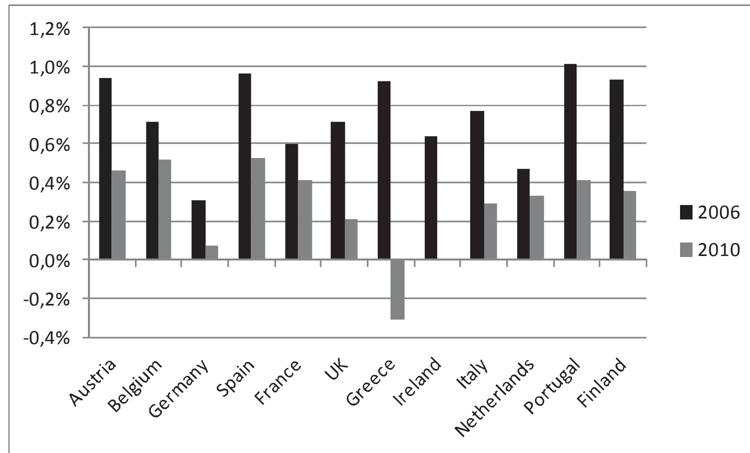
Figure 94 –ROA (before taxes and minority interests) of the Portuguese banks



Source: Calculations based on data from Bank of Portugal

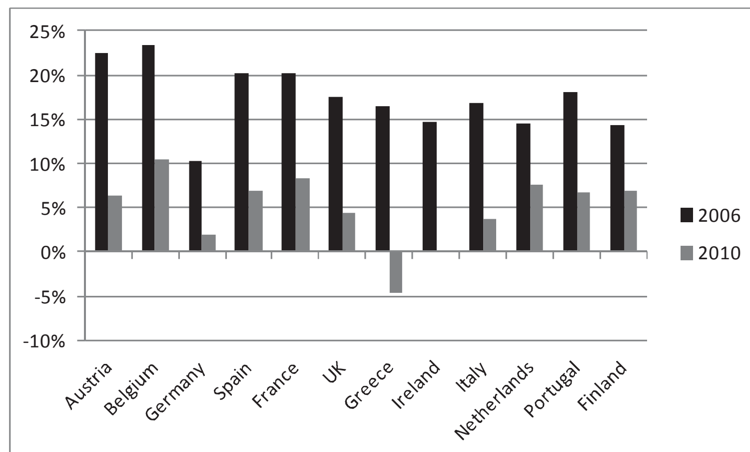
Compared with the EA, the average ROA of Portuguese banks was in 2006 one of the largest (Figure 95). The average ROA of banks was also very large in Greece and Spain, two countries affected latter by the sovereign debt crisis. In 2010, the ROA in Portugal declined to an intermediate position in the EA. In terms of ROE, Portuguese banks had an intermediate position in 2006 and 2010 (Figure 96).

Figure 95 – Banks' ROA of euro area countries (%)



Source: ECB (2007), *European Banking Sector Stability*, Nov; and ECB (Statistics on Consolidated Banking Data)

Figure 96 – Bank's ROE of euro area countries (%)

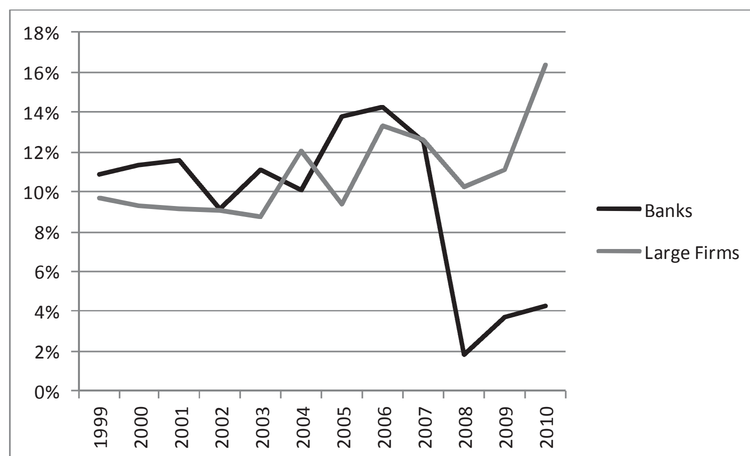


Source: ECB (2007), *European Banking Sector Stability*, Nov; and ECB (Statistics on Consolidated Banking Data)

If the financialisation hypothesis was valid, banks would increase their profits and non-financial firms would suffer a reduction of profits. In Portugal, the ROE (after taxes) of banks in 2001-07 was around 5 p.p. larger than the ROE of non-financial firms: 11.79% and 6.6% respectively. The data for non-financial firms was obtained from the *Central de Balanços* that includes firms of all sizes. It would be more correct to compare banks with large firms. When we compare

only with the mean of large firms (including financial) for the period 1999-2007, we observe that banks have a slightly higher ROE than the average of large firms: 11.63% and 10.37% respectively (Figure 97). After 2007, due to the larger effect of the financial crisis on banks, the situation inverted and the ROE of banks has become smaller than the one of non-financial firms.

Figure 97 – Comparing the ROE (after taxes) of banks and large firms



Note: Large firms have a turnover higher than 50 million euros

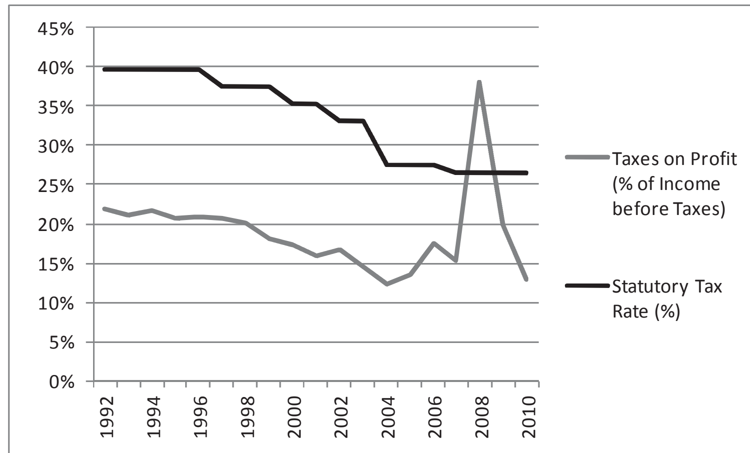
Source: European Sectorial Reference Database for large firms and Bank of Portugal for banks

7.6. Taxes

One contribution of banks to society is through the payment of taxes. Accompanying the fall in the statutory tax rate, taxes on banks' profits as a proportion of income before taxes has decreased from 1992 to 2004 (Figure 98). From 2005 to 2008 that tendency reverted. In 2009 and 2010 tax rate decreased again, probably due to the use for tax purposes of the losses caused by the financial crisis. [47]

[47] Banks can use losses to decrease the tax rate on profits.

Figure 98 – Firms' statutory tax rate and taxes on banks' profits (% of income before taxes)



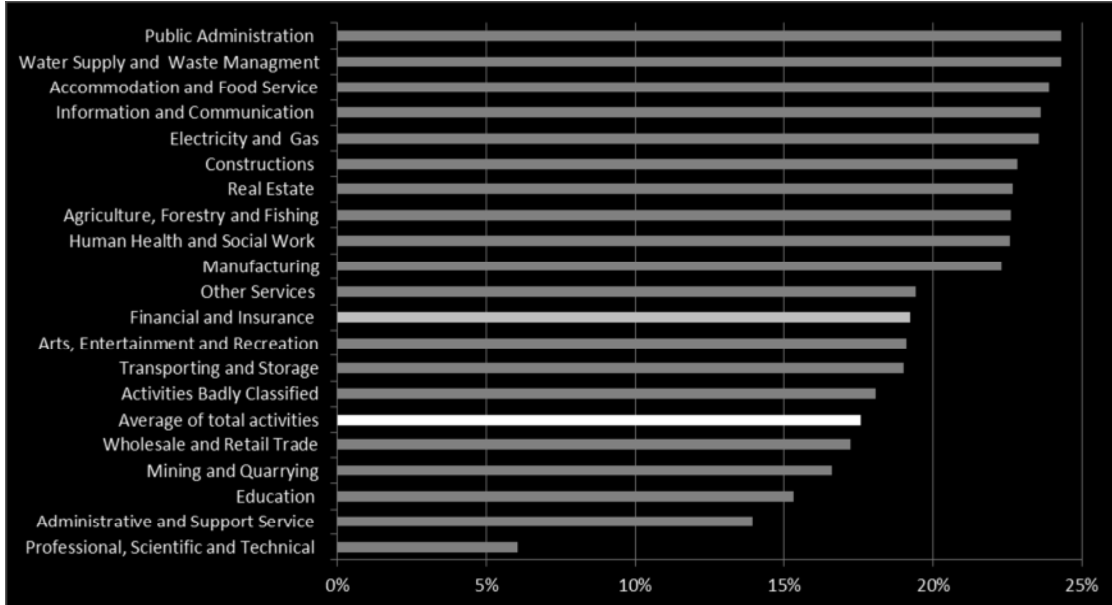
Source: OECD and calculations based on data from Bank of Portugal

If we look to a more precise measure, the effective tax rate computed by the Tax Authority for 2007-2010, it can be noticed that financial and insurance activities pay more tax than the national average (

Figure 99). However the national average tax rate is pushed down by social activities and by activities characterised by a high degree of informality. Therefore, comparing financial and insurance activities with manufacturing industry, real estate activities, or health activities, it stands out that the financial sector has a tax rate 3 to 4 p.p. lower.

Figure 99 – The effective tax rate on profits by activity (% average 2007-2010)

:



Source: INE

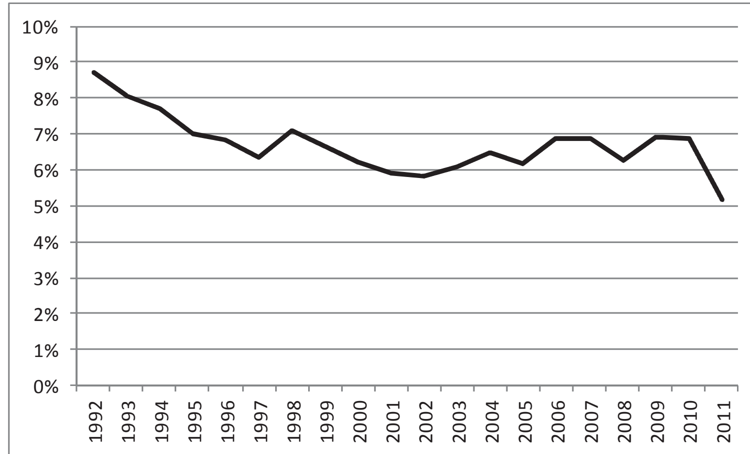
In part, the low average profit tax rate of banks is related with the use of the Madeira's Off-shore (valid up to 2011), which allowed to obtain tax exemption for the profits of banks' subsidiaries located there (up to 15% of the total profit of the credit institution (APB, 2010: 109)). [48] In general, this opportunity was not available for other firms.

7.7. Capital adequacy and funding structure

Between 1992 and 2002, the fact that the ROE increased more than the ROA was due to the decrease of the capital to liabilities ratio (Figure 100). After 2002, that ratio increased slowly, and then decreased again in 2011.

[48] Profits generated by banks on the Madeira's Off-shore are tax exempt. Also, profits obtained elsewhere and transferred to that Off-shore are not subject to taxes.

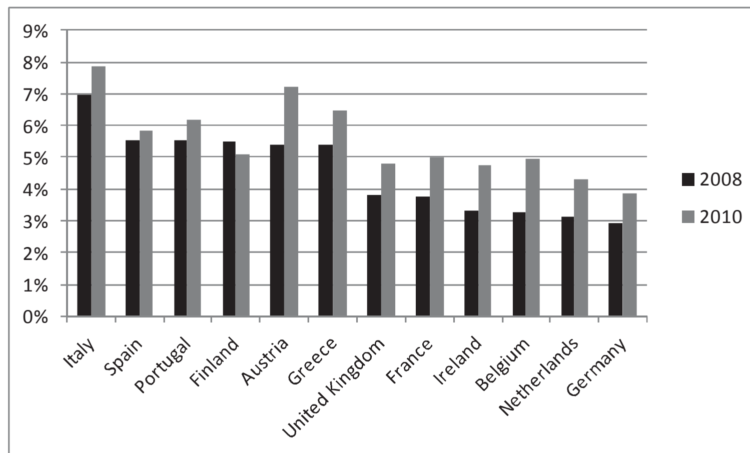
Figure 100 – The capital to liabilities ratio (%)



Source: Calculations based on data from Bank of Portugal

In 2008-10, Portugal was among the Euro area countries with higher equity-to-assets ratio (Figure 101). This explains why the relative profitability of Portuguese banks decreases when assessed in terms of ROE rather than in terms of ROA. But the capital-to-assets ratio does not take into account the risk of assets. For that we have to look at the overall capital adequacy ratio.

Figure 101 – Capital in percentage of total assets

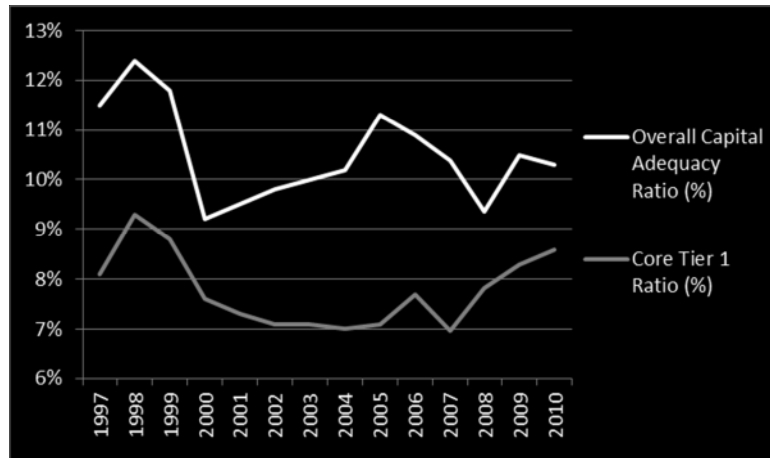


Note: capital includes all the equity on the balance sheet. Source: ECB (Statistics on Consolidated Banking Data)

From 1997 to 2000 the overall capital adequacy ratio has decreased due to the increase in credit (Figure 102). This tendency was already evident since 1994

(Antão et al, 2009: 551). In 2000, the overall capital adequacy ratio was slightly higher than 9%, which is close to the regulatory minimum of 8%. From 2001 to 2005 there was an attempt to prevent the further decline in the capital ratio, which was followed by a new decline after 2005.

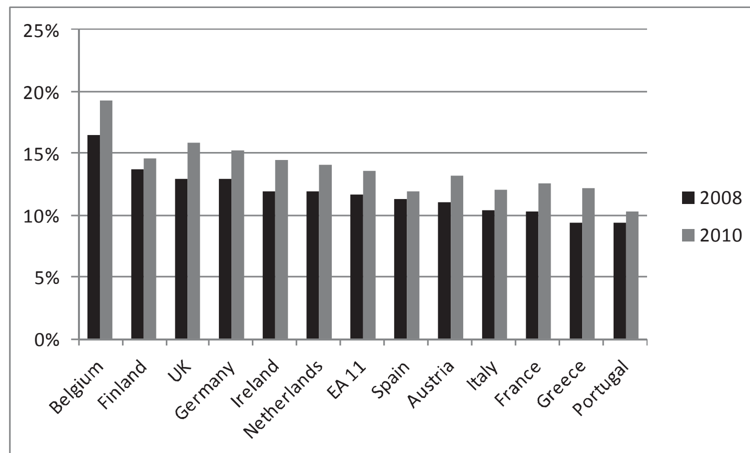
Figure 102 – Capital adequacy ratios (%)



Note: The overall capital adequacy ratio is the regulatory capital ratio. Source: Bank of Portugal's Annual Reports and Financial Stability Reports, several years

Comparing with other EA's countries, in 2008 and 2010 Portugal was the country with the lowest overall solvency ratio (Figure 103). In 2000 and 2004 the picture was essentially the same (Bank of Portugal, 2004: 100).

Figure 103 – Overall capital adequacy ratio (%)

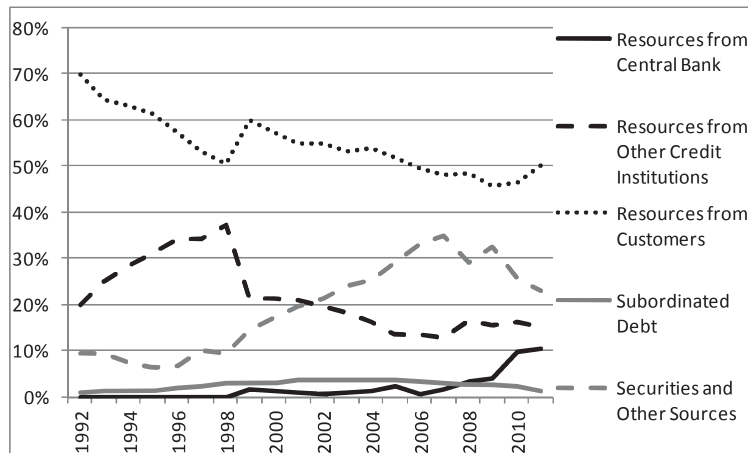


Source: ECB (Statistics on Consolidated Banking Data)

As we just saw in Figure 102, banks have used increasingly liabilities to finance activities. The funding structure of the Portuguese banks has changed significantly since 1992 (Figure 104), with resources from customers loosing importance. In fact, during the nineties the main funding component was related to the resources from customers. In 1992, deposits represented 70% of total liabilities. Higher households saving rate, high interest rates and the absence of other saving products explain the strong importance of deposits during that period. However, since 1992 the tendency has been for a decline of deposits, which in 2009 represented only 47% of liabilities. This is undoubtedly related to the decline of households saving rate.

Up to 1998, deposits were replaced by loans from other European banks. After 1998 and up to 2007, the emission of securities became an increasingly important source of financing. This tendency was interrupted by the Subprime crisis that led banks to gain financing from the ECB and from depositors.

Figure 104 – Funding structure of the Portuguese banks (% liabilities)



Source: Bank of Portugal

7.8. Concluding remarks

The several transformations in the Portuguese banking system (including the increase in competition) have led to a reduction in the financial margin, which however remained above the EA average. In compensation banks have increased income from services and commissions.

Another interesting aspect is that despite universal banking being the rule in Portugal, banks decreased the amount of resources devoted to securities and financial operations, and their level of engagement in these operations is low.

Confirming the results on the financial margin calculated from banks' balance sheets, the intermediation margin obtained directly from interest rates shows that the spread in credit to consumption and to firms is larger in Portugal than in the EA. However, the intermediation margin for credit to households is smaller in Portugal than in the EA.

Banks made a substantial reduction in costs that was interrupted by the financial crisis. In European terms Portuguese banks are relatively efficient. The observed gains in banks' productivity were due to scale efficiency and

technological progress. The effect of M&A on cost efficiency seems to have been negative.

Combining revenues and costs, from 1996 to 2006 the tendency was for an increase in the ROE and ROA of the banking system. Naturally, the financial crisis turned the upward tendency into a steep decline. Before the decline, the ROA of Portuguese banks was among the largest of the EA, but comparing with large firms in Portugal banks do not seem to have had excess profitability.

Financial and insurance activities paid slightly less taxes than other industries, as manufacturing, real estate and health.

From 1997 to 2010, banks have suffered a degradation of capital adequacy ratios. Initially, the decline is explained by the rapid growth of credit, and later by losses due to the crisis and by difficulties in raising capital. Consequently, in 2008 and 2010, Portuguese banks had one of the lowest levels of regulatory capital of the euro area.

With less capital, banks used more liabilities to finance their activity. The structure of funding changed considerably since 1992, with deposits losing importance and loans from European banks and securities gaining importance.

8. Real Estate sector [49]

The real estate sector has an important role in the economy, not only because a large fraction of households' wealth is invested in houses, but also because it represents a significant proportion of GDP. The real estate sector is heterogeneous, with two large divisions being present: residential and commercial real estate. The latter includes buildings related to leisure, retail, office, industry and healthcare. Commercial real estate for the IMF includes loans collateralized by commercial real estate, loans to construction companies, and loans to firms developing real estate.

Given the importance of the real estate sector, the emergence of bubbles in this sector is especially dangerous for macroeconomic stability. Sometimes they occur for reasons not related to fundamentals, while in other circumstances rational elements play an important role, as in the case of low interest rates and large capital availability.

In the boom phase, growing house prices stimulate an unsustainable growth in credit. This stimulus is larger than in the case of stock prices increases. As the price of houses rises, the value of collaterals also increases, leading to a growth in credit. This together with growing house prices incentivizes the expansion of investment in the construction and real estate sectors. The increase in house prices also affect households' consumption, due to the positive effect of wealth on consumption.

[49] Point 7b of the terms of reference.

In the bust phase, decreasing house prices lead some construction firms to default. Banks start accumulating non-performing loans. The default of households may also increase has they do not have means to pay a credit larger than the value of the home (this is especially true in the UK and the US). In an attempt to recover its money, banks start selling houses that were given as collateral, leading to further decline in house prices. As banks accumulate losses, they start decreasing the supply of loans to the economy. Simultaneously, as collaterals' value decreases, households and construction firms have less access to credit. This and the negative effect of declining house prices on consumption imply a fall in aggregate demand, which makes the situation even worse.

The decline in both house prices and aggregate demand may lead to deflation, which increases the real value of debt, initiating a debt-deflation spiral. With decreasing prices, households also postpone consumption, leading to a further fall in aggregate demand.

The distortion in the financial sector can last for decades, as the 1990's Japanese crisis shows.

In this section we start by examining the growth of real estate loans, including loans to households and firms in the industry (Section 8.1). Then, one goes to the analysis of the weight of real estate in investment and production (Section 8.2). After, we study the contractual characteristics of the housing credit market (Sections 8.3 to 8.6). Finally, we review some studies on the impact of wealth on consumption (Section 8.7).

8.1. Real estate loans

In Portugal in the beginnings of the 1980s credit was subject to ceilings, and only some banks could give credit for housing, due to the segmentation of the

banking industry. As a result, credit grew slowly in *real* terms. With the financial deregulation, the supply of credit for the real estate sector increased at a fast rate. However, there was not a boom-bust cycle in house prices (See Section 17.1).

In the periods 1980-88 (before the full liberalization of banking) and 1992-2006 after the liberalization) real estate loans (loans to households for house purchase, and loans to construction and real estate firms) increased faster than the overall credit to the private sector (Table 22).

Table 22– Annual average growth rate of real estate loans and total loans to the non-financial private sector

	1980-88	1988-92	1992-98	1998-2006	2006-2011
1. Households housing	33.4%	14.2%	26.5%	13.9%	4.3%
2. Construction	18.6%	12.5%	24.1%	16.6%	1.3%
3. Real estate activities	18.6%	12.5%	24.1%	19.2%	3.1%
4. Total of real estate loans (includes 1, 2 and 3)	27.9%	13.8%	25.9%	14.8%	3.7%
5. Non-financial firms	14.5%	15.2%	8.9%	11.3%	4.4%
6. Households	29.4%	17.3%	26.5%	12.6%	4.0%
7. Private non-financial sector (includes 5 and 6)	17.5%	15.8%	16.0%	12.0%	4.1%

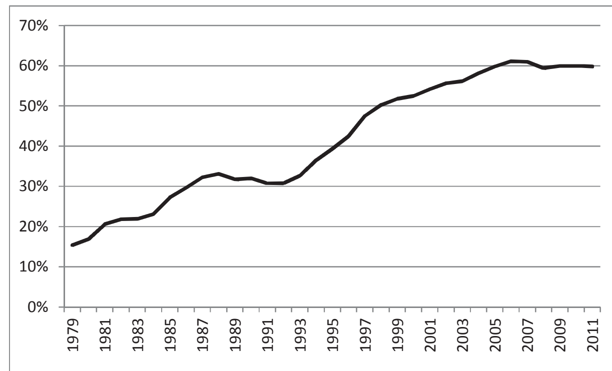
Source: Bank of Portugal

If real estate is very important in the loans' portfolio, it implies that the banking system has a large vulnerability to fluctuations in house prices. A cycle of boom and bust in the real estate sector may reduce credit quality and the value of collaterals, with negative consequences for the financial sector stability. Therefore, we assess next the importance of real estate sector loans.

In Portugal, since 1980, the evolution of real estate loans in the private non-financial sector has had five distinct periods (Figure 105). From 1980 to 1988, there was a rapid growth of the importance of real estate loans, from 16.8% in 1980 to 33.1% in 1988. From 1988 until 1992 there was a slight decrease of real estate loans' share. From 1993 to 1998 the share of real estate grows again quickly from 32.6% to 47.4%. The perspective of joining the euro decreased

interest rates and increased expectations of future GDP growth. These together with the growth of house prices and the small number of households owning a house boosted the demand for houses. The next period, from 1999 until 2006, was a period of slower growth, with the weight of housing loans reaching the maximum of 61.1% of total loans to the private sector. During this period, the slower growth occurred because a large number of households were already owners of a house, house prices' growth started to slowdown, and economic grow was smaller. After 2006, the further reduction in GDP growth and the worsening of the conditions offered by banks (availability of credit and interest rates) implied a period of stabilization of the importance of real state credit around 60%.

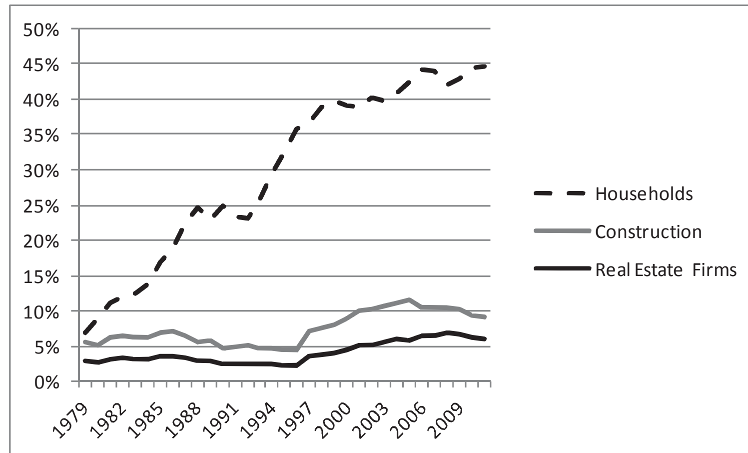
Figure 105 –Real estate loans in % of loans to the private non-financial sector



Source: Bank of Portugal

The growth of each segment of real estate loans was not uniform. The increase in the importance of credit to construction and real estate companies in total credit occurred relatively late in comparison with the increase in credit to households for house purchase (Figure 106). Indeed, such an increase happened only after 1996 and lasted until 2005 for construction firms, and until 2008 for real estate firms. After these periods of expansion, both sectors start losing importance in total credit.

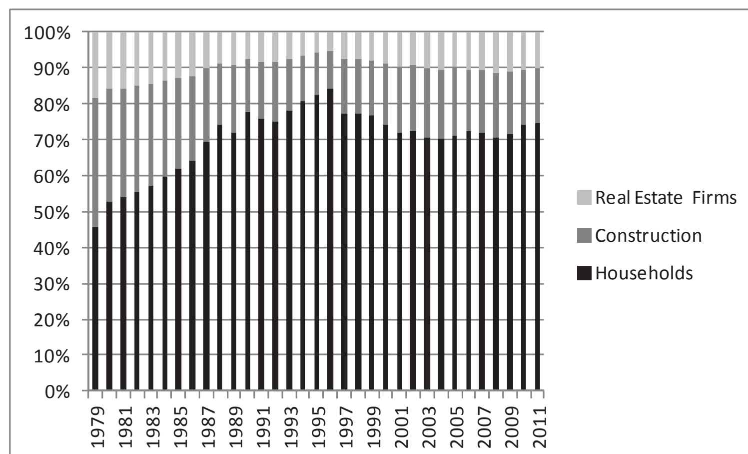
Figure 106 –The weight of the total loans to the private non-financial sector by purpose



Source: Bank of Portugal

When we look at the importance of residential real estate loans in total real estate loans, we observe a sharp increase in the period 1979 to 1996, with an jump from 45.6% to 84.0% (Figure 107). From 1996, the importance of loans for housing decreased to a value slightly above 70%, where it basically remained until 2011, with a small increase to the end of the period.

Figure 107 –The importance of residential real estate loans (% of the total real estate loans)



Source: Bank of Portugal

Comparing with Austria, Germany, Italy and the Netherlands, the importance of residential real estate loans in total loans (including to government and non-residents) was larger in Portugal (Table 23). That was already clear in 1999-2001, when the proportion of households' credit directed to house purchase was 75.4% in Portugal and 63.7% in the euro area (Banco de Espanha, 2002). The same picture exists when we compare the weight of commercial real estate loans on total loans in Portugal with Germany and Italy.

Table 23 – The importance of the residential and the commercial real estate loans

Country		2005	2006	2007	2008	2009	2011
Austria	Residential Real Estate Loans (% of Total Gross Loans)	n.a.	13%	12%	11%	12%	n.a.
Germany	Residential Real Estate Loans (% of Total Gross Loans)	18%	18%	17%	n.a.	n.a.	n.a.
	Commercial Real Estate Loans (% of Total Gross Loans)	6%	6%	5%	n.a.	n.a.	n.a.
	Residential and Commercial Real Estate Loans (% of Total Gross Loans)	24%	24%	22%	n.a.	n.a.	n.a.
	Commercial Real Estate Loans (% of Residential Real Estate Loans)	26%	25%	25%	n.a.	n.a.	n.a.
Italy	Residential Real Estate Loans (% of Total Gross Loans)	n.a.	n.a.	n.a.	n.a.	n.a.	19%
	Commercial Real Estate Loans (% of Total Gross Loans)	n.a.	n.a.	n.a.	n.a.	n.a.	9%
	Residential and Commercial Real Estate Loans (% of Total Gross Loans)	n.a.	n.a.	n.a.	n.a.	n.a.	27%
	Commercial Real Estate Loans (% of Residential Real Estate Loans)	n.a.	n.a.	n.a.	n.a.	n.a.	47%
Netherlands	Residential Real Estate Loans (% of Total Gross Loans)	n.a.	n.a.	n.a.	25%	n.a.	n.a.
Portugal	Residential Real Estate Loans (% of Total Gross Loans)	32%	32%	32%	32%	n.a.	n.a.
	Commercial Real Estate Loans (% of Total Gross Loans)	11%	11%	11%	12%	n.a.	n.a.
	Residential and Commercial Real Estate Loans (% of Total Gross Loans)	43%	43%	43%	44%	n.a.	n.a.
	Commercial Real Estate Loans (% of Residential Real Estate Loans)	34%	34%	35%	37%	n.a.	n.a.

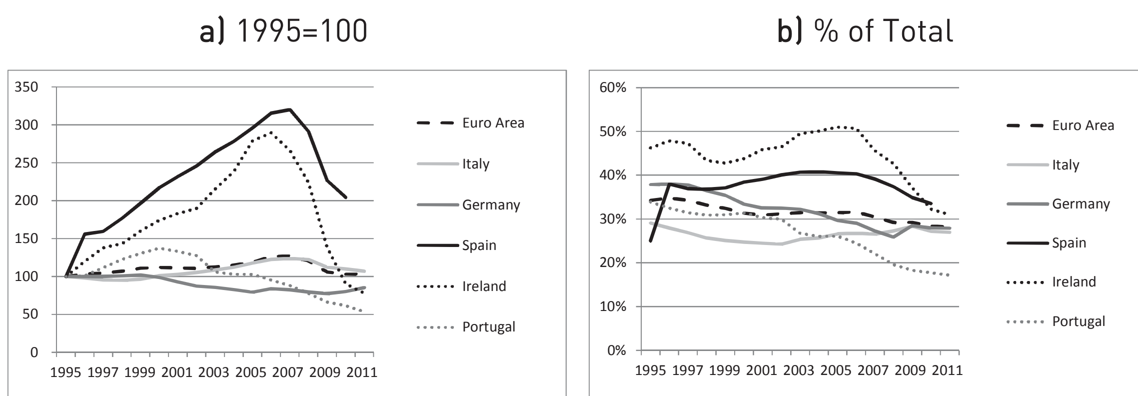
Source: IMF (Financial Soundness Indicators)

8.2. Weight of housing in investment and production

The investment done by all agents in the economy may be divided into investment in dwellings, other buildings and structures, transport equipment, other machinery and equipment, cultivated assets and intangible fixed assets. Now, we are interested particularly in the investment in dwellings. From 1995 to 2007, in the EA the gross fixed capital formation (GFCF) on dwellings has increased moderately, but after 2007 up to 2011 declined, reaching in 2011 the 1995's level. But this average trend hides different national trajectories. In Spain and Ireland, there was a strong growth until 2007 and to levels probably

compatible with the formation of a bubble on the housing market. After 2007, in these two countries there was a movement of strong correction and the GFCF on dwellings slipped, mainly in Ireland where investment returned to levels lower than the 1995's level (see Figure 108).

Figure 108 – The evolution of the gross fixed capital formation on dwellings.

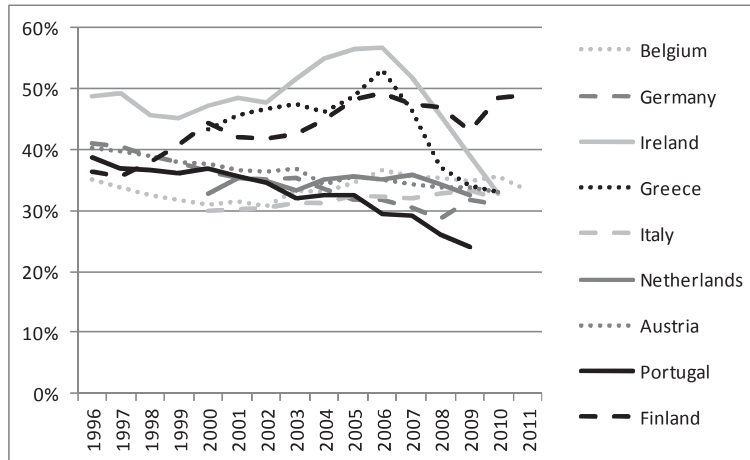


Source: Eurostat

In Portugal, the GFCF on dwellings rose until 2000 at a faster rate than the EA average and after 2000 decreased considerably, in what was one of the largest declines in the EA. In 2011 the investment was 50% of the 1995's level.

The investment in dwellings is related with the investment of real estate and construction sectors, but is not identical to it. Then, it is interesting to analyse the investment of those two sectors in comparison with the investment of all sectors. From Figure 111 we observe a continuous decline in almost all EA's countries, with this trend been more pronounced in Portugal with a fall from 39% in 1996 to 24% in 2011.

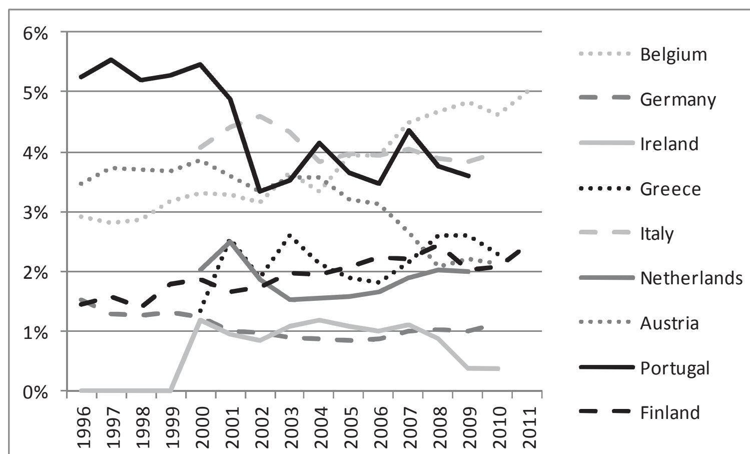
Figure 109 – Gross fixed capital formation of construction and real estate sectors (% of total)



Source: Eurostat

It may be interesting to make a separate analysis of construction and real estate. The importance of investment done by the construction sector in 1996-2011 was very high in the Portuguese economy when compared with other EA countries (Figure 110). After 2000, it experienced a significant decline, but the level of investment continued to be considerably high, situated above 3.5% of total investment.

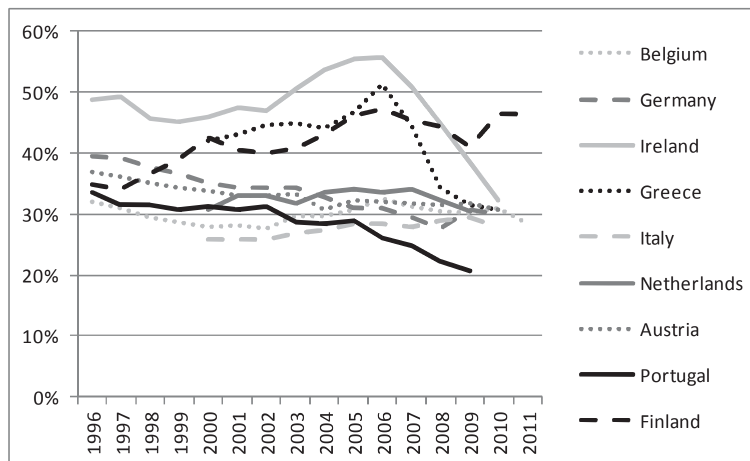
Figure 110 –Investment by the construction industry (% of total investment)



Source: Eurostat

In turn, the investment in real estate was between 1996-2011 lower in Portugal than in the EA and the negative trend has also been more pronounced (Figure 111).

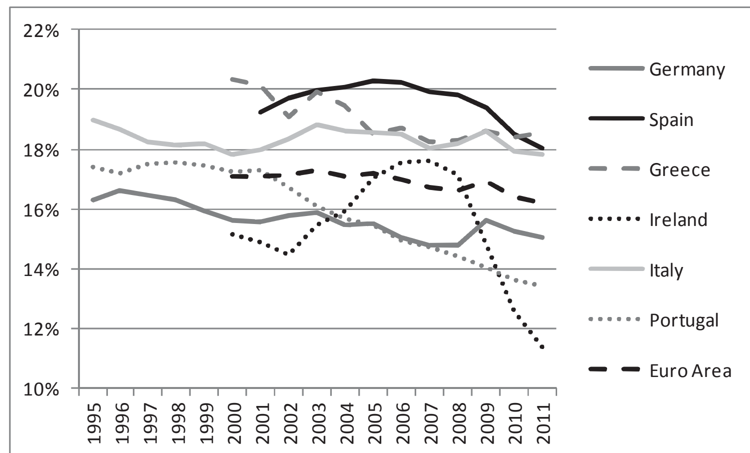
Figure 111 –Investment by the real estate industry (% of total investment)



Source: Eurostat

In the EA the weight of the real estate and the construction activities on the gross value added decreased slightly between 2000 and 2011 (Figure 112). In Portugal the descendent trend was much stronger than in the EA. In 2000 the importance of real estate and construction in Portuguese GDP was around 17.3%, very close to the EA average, but in 2011 those activities only represented 13.4% in Portugal, a value significantly below the EA (16.2%).

Figure 112 – The importance of real estate and construction activities (% of gross value added)

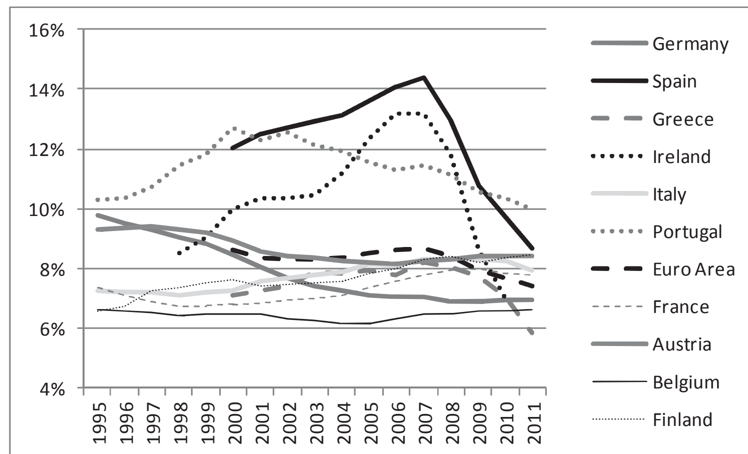


Source: Eurostat

Similarly to production, from 2000 to 2011, in the EA the weight of the real estate and construction on total employment also declined, especially after 2007 (Figure 113). However, the importance of those sectors on employment has increased in Belgium, Finland, France and Italy. Once more, in Portugal the downward trend was stronger than in the EA: in 2000 the real estate and construction represented 12.7% and 8.7% of total employment in Portugal and the EA, respectively, and in 2011 they represented 10% and 7.4%. From these numbers also stands out that in the EA real estate and construction sectors have a larger labour productivity relative to the other sectors of the economy than in Portugal, since they employed a larger proportion of people in Portugal than in the EA, but represent a smaller proportion of the value added than in the EA.

Notice that the strong increase in employment in the real estate and construction sectors in Portugal between 1995 and 2000 was clearly at odds with what happen in the EA, probably with the exception of Spain and Ireland for which we do not have data for that years. And most notably that increase of importance in terms of employment did not translate in an increase in terms of value added.

Figure 113 – The importance of the real estate and the construction activities (% of total employment)



Source: Eurostat

8.3. Characteristics of housing loans

According to the ECB (2009), the interest rate characteristics of housing loans vary considerably from country to country. In most euro area countries, housing loans are granted at variable interest rates (Ireland, Greece, Spain, Italy, Cyprus, Luxembourg, Malta, Austria, Portugal, Slovenia and Finland). In these countries, interest rates are adjusted to the Euribor on a monthly, quarterly, half-yearly or yearly basis. In some countries other reference interest rates are used, like the Treasury Bills in Belgium or the ECB main refinancing rate in Ireland, Greece, Malta and Luxembourg. In a minority of countries (Belgium, Germany, France and the Netherlands) housing loans are granted using fixed interest rates normally for a period over five or ten years.

In Portugal, the share of variable rate loans in new loans for house purchase reached ninety nine per cent in 2007, with the six-month EURIBOR as the main index for variable interest rates. Indexed real estate credits make the real estate sector and families' income more dependent of interest rate's changes.

Besides, in Portugal housing loans are granted on average with a maturity between thirty and forty years, which represents a maturity quite large when compared with other countries.

In relation to the loan-to-value ratio (LTV ratio)[50], the typical ratio for new housing loans was about eighty per cent in the euro area in 2007 (ECB, 2009). In Portugal, the typical LTV was slightly lower, around seventy per cent, which is quite similar to Germany, Greece and Spain. This is an indication that in Portugal there were not very aggressive practices in housing credit, on average.

Despite that, ECB (2009) notes that in 2000-08 were granted loans for housing purposes with high LTV ratios (from 80% to 100%) in some countries, especially in Ireland, Greece, Italy and Portugal. These loans usually require a large maturity in order to keep then affordable for most households. This note implies that in Portugal credit practices have become more aggressive in the years before 2009.

In addition, the percentage of total dwellings that is occupied by its owner was around 62.3% in the euro area in 2007 (Table 24). Portugal presented one of the highest levels (74.5% in 2001) among the euro area countries, just below the levels exhibited by Ireland, Greece and Spain. In order to be able to buy a house, households have to have a mortgage. In Portugal the proportion of households with a mortgage is reasonably high when compared with a group of 7 EA countries, as shown in Table 25.

The high percentage of homes occupied by the owner in Portugal is the result of a highly regulated and distorted rental market, the slowness of courts in the resolution of rental contract' disputes, and of several policy measures which incentivized the purchase of homes. The high proportion of home owners in

[50] The loan-to-value ratio is the ratio of the amount borrowed to the appraisal or market value of the underlying collateral.

Portugal makes it difficult for workers to move around the country. Especially the unemployed have difficulty in accepting an employment far away from their homes, because of the difficulty in selling their house. The result may be a higher structural unemployment rate.

Table 24 – The percentage of total dwellings that is occupied by its owner

Country	Owner-Occupancy Rate
Belgium	71,3%
Germany	43,0%
Ireland	74,7%
Greece	79,6%
Spain	86,3%
France	57,2%
Italy	69,1%
Cyprus	84,9%
Luxembourg	74,7%
Malta	75,2%
Netherlands	56,6%
Austria	58,0%
Portugal	**74,5%**
Slovenia	81,1%
Finland	65,1%
Euro Area	62,3%

Note: Data refers to 2007, except for Belgium, Germany, Greece, Italy, Cyprus (2006), Spain, France, Malta, Slovenia (2005) and Portugal (2001). Source: ECB (2009)

Table 25 – Households with a mortgage (% of total)

Country		Share of All Households with Mortgage
Germany	2003	26,5%
Ireland	1995	36,1%
	2000	35,0%
	2005	35,9%
Greece	2007	16,6%
Spain	2002	20,9%
	2005	25,3%
France	2004	29,7%
Italy	1995	13,0%
	2000	9,0%
	2006	11,9%
Netherlands	2007	38,5%
Portugal	2006	29,6%

Source: ECB (2009)

8.4. Equity withdrawals

Equity withdraws from a real estate loan occur when the value of the house is larger than the value of the mortgage (the equity is positive) and the debtor can obtain further financing giving the home equity as collateral. This financing can be used for consumption spending, buying other assets or paying other debts. The debtor has the advantage of contracting additional debt in this way instead of using unsecured consumption credit because the interest rate is lower. Equity withdrawals occur especially when house prices increase and they are quite common in the US and the UK, and less common but growing in the euro area (ECB, 2009).

Mortgage equity withdrawals have contributed to a larger housing wealth effect on consumption in the UK and the US than in the euro area (IMF, 2008). This effect may amplify the pro-cyclical effect of house prices.

The survey done by the ECB (2009) on banks shows that the *proportion of new mortgage loans* that were used for purposes other than financing a home was 20% in 2007 in Portugal, much higher than the 5% average of the euro area and one of the highest values in the sample. The report suggests that the high value in Portugal may be related to the financing of the down payment or of transaction costs.

Table 26 – The percentage of new mortgage loans that are used for purposes other than financing a home

Country	Mortgages for Purposes other than Financing a New Home (% of New Housing Loans)
Belgium	1%
Germany	1%-2%
Ireland	13%
Greece	30%
Spain	5%
France	1%
Italy	1%
Cyprus	n.a.
Luxembourg	<1%
Malta	9%
Netherlands	3%
Austria	2%
Portugal	**20%**
Slovenia	11%
Finland	12%
Euro Area	5%

Source: ECB (2009)

In terms of the *volume* of the outstanding loans to households with real estate collateral that were used for other purposes than the acquisition of the main residence, Portugal also had higher values than the euro area (

Table 27).

Table 27 – Outstanding loans to households with real estate collateral that were used for other purposes than the acquisition of a principal residence

	Portugal		Euro Area	
% of All Mortgage Loans	Purchase of Second Homes or Homes for Investment Purposes ("Buy to Let")	Other Purposes*	Purchase of Second Homes or Homes for Investment Purposes ("Buy to Let")	Other Purposes*
Minor (0% to 10%)	100%	80%	49%	64%
Significant (10% to 20%)	0%	20%	27%	8%
Considerable (more than 20%)	0%	0%	12%	5%
Not Applicable	0%	0%	13%	23%

Note: * This category covers, for example, consumption , financial investment and redemption of debts, as well as the situation in which a parent borrows a mortgage for the purpose of transferring the funds to a son or daughter for the purchase of house.

Source: Bank Lending Survey Bank of Portugal, October 2006. Bank Lending Survey ECB, July 2006

8.5. Foreclosure of mortgages with negative equity

In the US, a borrower with a negative equity on his or her mortgage has a strong incentive to walk away from the house, since by delivering the house he or she puts an end to the debt contract with no further obligations.

In the euro area, personal insolvency rules state that a borrower with a negative equity cannot simple delivery the house to end the debt contract. The debtor continues to be responsible for the difference between the debt and the value of the dwelling, and banks can still claim other assets and/or income flows from the client. This implies that borrowers do not have an incentive to walk away from the mortgage in such circumstances. Comparatively to the US, this has contributed to a smaller decline of house prices in the euro area, because borrowers are less prone to abandon their houses in the euro area than in the US. This implies that there are fewer houses for sale and therefore house prices decrease less in the euro area.

However, in Portugal a new law was passed in 2012 characterizing the situations in which a household can deliver the house to cease the debt. The new law only applies to low income families and does not allow them to walk away from a home with negative equity, but facilitates the process of delivering a house to the bank. This new proposal enables that the delivery of a house can extinguish the debt *(i)* whenever the sum of the current value and the amortized capital equals the amount of capital initially borrowed or (*ii)* if the current value of the property is equal or larger than the outstanding capital.

If one of these two requirements is met, banks are required to accept the respective house. If the home's value is insufficient to settle the debt, the capital portion in debt remains, but the debt associated with future interest extinguished.

Nonetheless, this proposal continues to have many restrictions, namely the requirement that at least one element of the household is unemployed or had suffered a reduction in wages of of least 35%. In addition, the gross monthly income of the household (two elements) cannot exceed twice the minimum wage, in order to benefit from this new regime (this value can be increased by 50% of the minimum wage by each minor child). Finally, the value of the dwelling is also limited to 90, 105 and 120 thousands euros, depending on the location of the house.

8.6. Early repayment of the mortgage

As in other euro area countries, the partial or total early repayment of the mortgage is allowed, but in general subject to a fee. The early repayment is often associated with the client changing to another bank that offers better interest rate conditions. Therefore the fees charged may be an important deterrent to bank competition in the mortgage market. In Portugal, usually these fees are paid by the new lender (ECB, 2009). By law, the maximum fee for

variable interest rate contracts is 0.5% of the paid capital and for fixed interest rate contracts is 2%. Other credit contracts also covered by the house mortgage are subject to the same fees. Insurance contracts associated with the mortgage remain valid as long as risk conditions do not change. Notice that in several euro area countries early repayment is free of charge for variable interest rate contracts (ECB, 2009).

8.7. Wealth effect in Portugal

The wealth effect refers to the increase in consumer spending that accompanies an increase in wealth. Most of empirical studies confirm the existence of such relationship. In the Portuguese case, the main references are Castro (2008) and Farinha (2009).

Castro (2008) estimated the wealth effect on non-durable consumption of households, using aggregated time series data between 1980 and 2005, concluding that in Portugal the marginal propensity to consume out of wealth was about 0.03. This means that an increase of one euro in wealth implies an increase in consumption of 3 cents. The marginal propensity to consume out of disposable income was 0.48. At the same time, she observes that this result is similar both for financial and housing wealth. Besides, Castro (2008) notes that after the financial liberalization the wealth effect on consumption increased, because liquidity constraints faced by Portuguese households decreased.

On the other hand, Farinha (2009) studies the wealth effect using micro data from the *Inquérito ao Património e Endividamento das Famílias*, realized by INE and Bank of Portugal. He concludes that in Portugal the marginal propensity to consume out of wealth was between 0.04 and 0.05, which is quite similar to other European countries and the US. Farinha (2009) observes also that the wealth effect is stronger for housing wealth than for financial wealth. This is

consistent with the fact that households use their houses as collateral to obtain more credit to consume (Section 8.7).

8.8. Concluding remarks

In terms of prices there was not a boom-bust cycle in real estate in Portugal. Despite this, the weight of real estate loans in total loans has increased substantially since 1980, especially the credit for households to buy houses. In 2011 total real estate loans represented around 60% of the loans portfolio. This weight seems to be larger than in some EA countries, making Portuguese banks particularly vulnerable to house price fluctuations. The risk is mitigated because credit practices in housing loans do not seem to have been very aggressive, as shown by the fact that the average LTV ratio is lower in Portugal than in the EA. Moreover, the non-performing loans on real estate are not a problem at the level of households. But non-performing loans of construction firms increased much more than the average of all industries (See Section 3.9).

In terms of interest rate risk, a large part of the risk is on the household's side, since almost all housing loans are at adjustable rates.

The large importance and growth of credit for households to buy houses led to a large percentage of dwellings occupied by their owners. This is related to the malfunctioning of the rental market, but also with policy measures that favoured the buying of houses. The large proportion of workers that are homeowners difficults the mobility of workers and may increase structural unemployment rate.

The growth in credit was only possible due to high capital inflows and an increase in foreign debt. But the debt was obtained in euros, and there was no currency mismatch that could make banks and borrowers vulnerable to exchange rate changes.

A part of the credit to buy houses was indeed directed to consumption and other purposes. Equity withdrawal from mortgages seems to have been a more significant phenomenon in Portugal than in the EA.

One element that has prevented larger declines in house prices is the fact that in Portugal a client with a negative equity on his or her mortgage cannot simply walk away from the house.

The growth in credit for housing allowed the investment in dwellings to rose faster in Portugal than in the EA between 1997 and 2000, but after 2000 the investment in Portugal started a downward tendency much stronger than in the EA.

Since 1995, construction and real estate industries have lost importance in terms of value added and investment at a faster rate than in the EA. In 2011, those industries were less important in terms of production than in the EA, but in terms of employment they were still very important.

The wealth effect in Portugal has a size similar to the US and other European countries. Financial liberalization has increased that effect because it reduced liquidity constraints faced by households. Housing wealth has a larger effect than financial wealth on consumption, which indicates that households use mortgage loans to finance consume.

9. Source of funds for business investment[51]

In this point we detail the source of funds of the business sector. Section 9.1 studies the financing structure of firms in terms of equity and types of debt. In Section 9.2 we look at the interest rate charged in Portugal, comparing small and large firms, and looking at the rates practiced in the EA. Finally, Sections 9.3, 9.4 and 9.5 analyse how banks and firms see the financing of firms and the evolution of the degree of restrictiveness of bank credit.

An important point in this section is to analyse the extent to which banks have restricted credit to firms after the 2008 crisis. Situations of credit rationing or in more extreme cases of credit crunch are usual in severe crises as the Great Recession. During periods of economic slowdown, demand and supply factors lead to a slower growth of banking credit. On the one hand, the fall in aggregate demand leads to a decline in credit demand. On the other hand, banks adopt a higher level of credit tightening during these periods, mainly due to the deterioration of expectations regarding the future evolution of economic activity.

Nevertheless, there are some situations marked by a quite aggressive cut of credit to the non-financial sector, which is called a “credit crunch”. In these circumstances, credit tightening extends to all segments, even for those economic agents with good collateral. Credit crunch is originated in the supply side and it results from the unwillingness of banks to lend more money or the lack of ability to do it.

This credit rationing could be produced by several factors. Firstly, it can be originated by a more stringent interpretation of the rules by the regulatory

[51] Point 10 in the terms of reference.

authority, forcing banks to mobilize more capital to cover the increase of non-performing loans and to have more caution regarding the risk of new loans.

Secondly, it can result from the introduction of new capital requirements, which originate a decline in the relative level of banks' capital. With less capital, banks are forced to cut back credit. In many circumstances, banks are not willing to get more capital, in order not to injure shareholders' interests or due to asymmetric information. This asymmetry becomes larger in periods of crisis as bank management try to hide problems in loans portfolio. Therefore, the market will assume that only banks with bad loans will be willing to dilute the property in exchange for more capital. Thus, the issuer will have to issue capital at a very low price. This problem of lack of capital is not easily solved by an action of authorities, unless they are willing to inject capital into banks.

Thirdly, credit rationing may also derive from the lack of liquidity, the rise in bankers' risk aversion and the impact of poor quality loans in banks' capital levels. In particular, in periods of high uncertainty, where losses are potentially high, banks prefer liquidity and they do not grant credit. As predicted by Keynes' theory of liquidity-preference in moments of great pessimism and uncertainty, agents prefer the safety and flexibility of liquid assets instead of the illiquidity and uncertainty of other assets.

Finally, the phenomenon of credit crunch could be originated by a strong fall in the prices of financial or real estate assets, after a speculative bubble or after an expressive rise of prices. In this case, there is an increase in non-performing loans, a fall in the value of collaterals and the rise of banks' losses on their investments. Notice that these factors will motivate a sudden decrease in credit, which will deepen further the fall of asset prices.

The economic crisis in the UK and Scandinavian countries in the beginning of the nineties was clearly associated with sudden reduction in house prices, in a

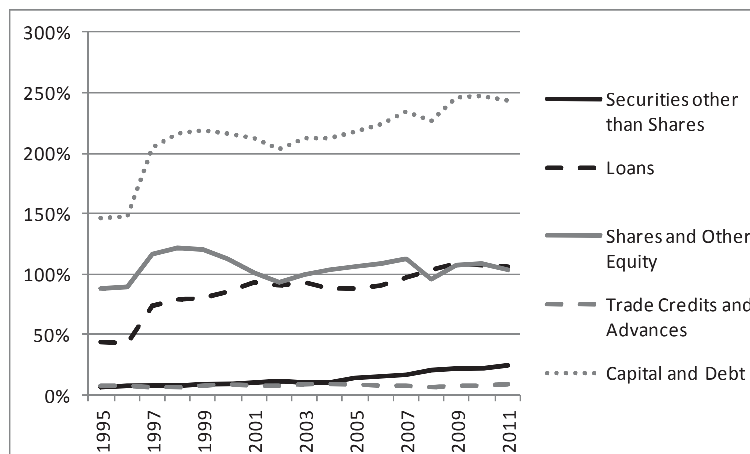
context of an over-indebted of private sector and a deregulated financial system.

After the 2008 crisis, in Portugal there were some factors that could have led to a strong slowdown of credit supply, namely the lack of liquidity of banks, the increase in uncertainty, the rise in capital requirements and the lack of capital in some banks, and the increase in non-performing loans.

9.1. Firms' financing structure

In this point we study how Portuguese firms finance their activities. Between 1995 and 2011, the assets of NFC as a percentage of GDP increased 96.9 p.p., with two-thirds of this increase (62.2 p.p.) being financed by loans, and the remaining third being financed in almost equal parts by debt securities (17.5 p.p.) and equity (15.8 p.p.) – Figure 114.

Figure 114 – Sources of financing for non-financial corporations (% of GDP)



Note: Based on consolidated data

Source: Eurostat

In 2011, a year of crisis, debt securities increased their importance as a source of financing (+2.1 p.p.), while loans as a proportion of GDP decreased 1.3 p.p.

During this year banks had difficulty in obtaining financing in the markets, which probably led them to limit finance to firms.

In 2011, the financing of Portuguese firms was essentially through loans (43.5% of assets) and shares and other equity (42.8%), with debt securities having a minor importance (10.0%). In accordance with the evolution described above, the importance of banks' loans in financing firms' assets has increased substantially between 1995 and 2011, from 29.8% to 43.5% of total assets (Figure 115). Securities other than shares also increased from 4.7% in 1995 to 10.0% in 2011, but they remained with a residual importance, as firms prefer to use banks instead of financial markets to raise debt. In general, only a small number of corporations is 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. SMEs account for around 99% of the number of non-financial corporations and more than 80% of total employment. The importance of SMEs in the Portuguese economy is larger than in French or German economies, and slightly less than in Italy or Spain (

Table 28).

SMEs depend more than large firms on banks for financing, since in general they do not have access to the markets for debt and equity financing, due to their size, low visibility and small transparency. Consequently, a reduction in bank credit affects more SMEs. As a result, the reduction in credit by banks will have a bigger effect in Portugal than on other European countries. Therefore, the shortage of credit may be one factor explaining the large upward trend of the Portuguese unemployment rate in 2010-12. Naturally other factors explain the increase in unemployment, namely the reduction of fiscal balance.

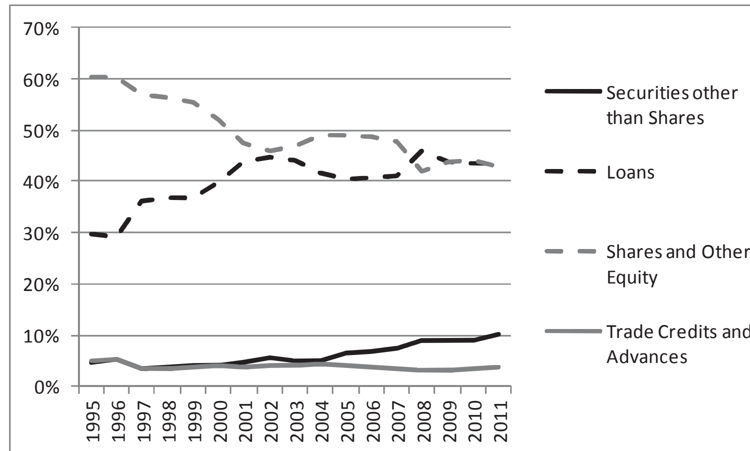
Table 28 – SME in Portugal and other European countries

		Portugal	German	France	Spain	Italy
Number of Firms	Micro	95.7	83.3	93.2	93.1	94.4
	Small	3.7	13.8	5.7	6.0	5.0
	Medium	0.5	2.4	0.8	0.7	0.5
	Large	0.1	0.5	0.2	0.1	0.1
Employment	Micro	41.6	19.2	24.3	38.9	47.3
	Small	22.9	21.8	20.4	23.3	21.8
	Medium	16.4	20.0	15.6	14.0	12.3
	Large	19.1	39.9	39.7	23.7	18.6
Investment	Micro	24.0	18.9	42.1	27.0	68.4
	Small	20.7	15.8	10.2	30.4	13.5
	Medium	22.3	18.6	12.5	20.2	8.4
	Large	33.0	46.6	35.2	22.4	9.7
Added Value	Micro	23.8	16.3	22.4	27.7	32.2
	Small	22.4	17.1	18.9	22.6	23.6
	Medium	20.8	20.2	14.7	17.4	15.4
	Large	33.0	46.3	44.0	32.2	28.8

Source: Eurostat

Portuguese firms have been more dependent on banks' loans than the average of EA16 firms (Figure 116 and Figure 115) and they have less equity.

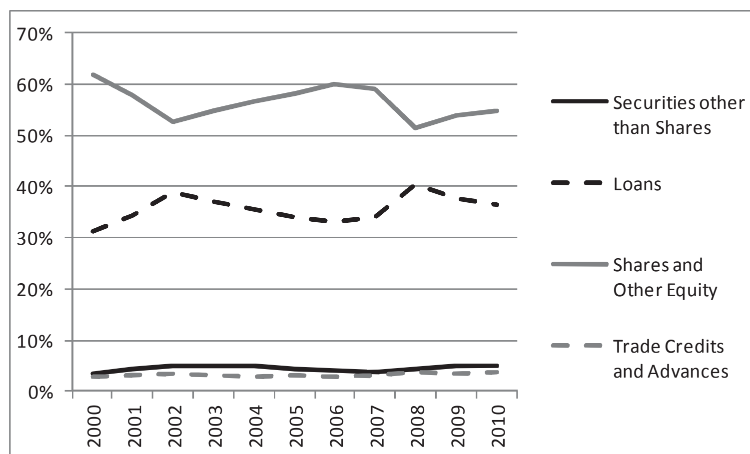
Figure 115 – Financing structure of Portuguese firms (% of assets)



Note: Based on consolidated data

Source: Eurostat

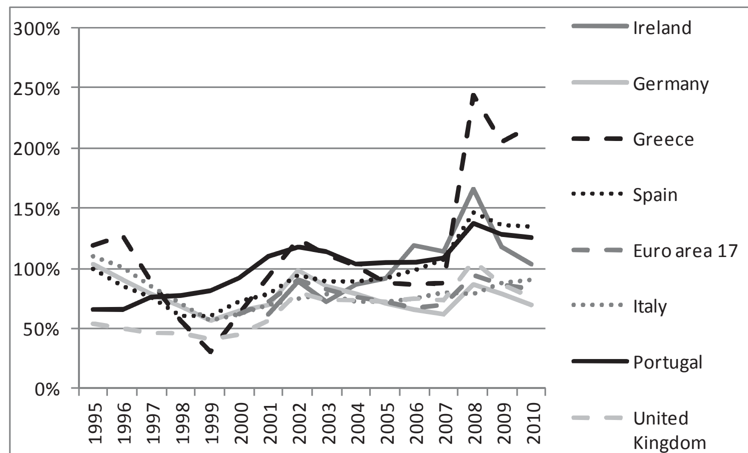
Figure 116 – Financing structure of EA16 firms (%)



Source: Eurostat

Since Portuguese firms have been relying more on debt, the ratio of debt-to-equity has more than doubled between 1995 and 2010, from 0.66 to 1.26 (Figure 117). Notice that this ratio depends also on the fluctuations of shares prices. This explains why the ratio increased substantially in 2001 and 2008, which were years of large falls in the equity markets.

Figure 117 – Debt to equity ratio of several European countries



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

Source: Eurostat

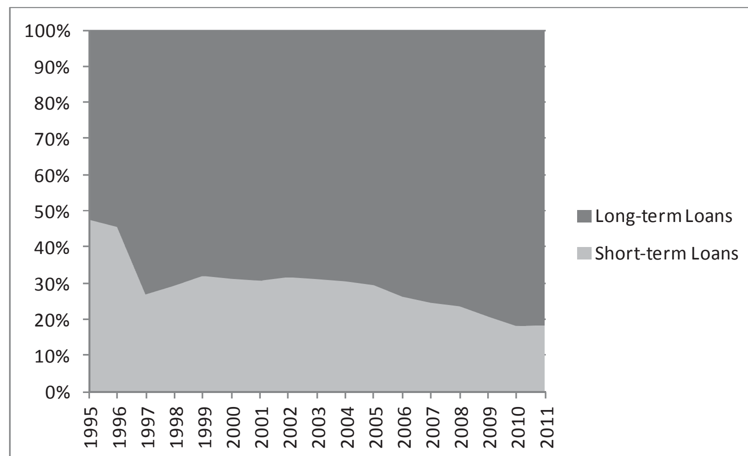
The rise in firms' debt can be explained by the same arguments that explain the increase in households' debt: reduction in the level and volatility of interest rates, increase of GDP growth, greater competition between banks, and easier access of banks to foreign financing. The adoption by banks of new methods to assess credit risk also contributed to the increase in the availability of credit to firms. The growth in credit was essentially due to credit concession to firms that previously did not have access to credit (Antão et al, 2009: 526).

The growth in firms' debt was related to the quick growth of investment between 1995 and 2000 (Figure 14). The decision to invest may not be independent of the financial situation of the firm. Several studies on firms' liquidity restrictions conclude that investment and financial situation are related, especially for small firms (Antão et al, 2009: 525). As a result, firms with larger access to credit can invest more.

In 2010, the ratio of debt-to-equity of non-financial corporations in Portugal was one of the highest of the Euro area, being larger only in Greece and Spain. In Portugal, Spain and Greece the debt-to-equity ratio has increased substantially after 2007 (Figure 117).

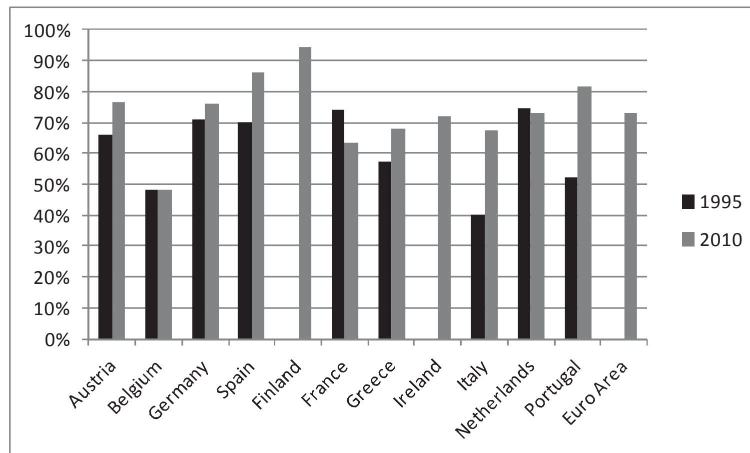
When we look at the partition of loans by long term and short term, in 1995 Portugal had 48% of the loans concentrated in short term maturities (Figure 118). This value was clearly larger than the EA average (Figure 119), and probably implied that Portuguese firms had difficulty in financing long-term investments. However, between 1995 and 2010 the proportion of long term loans increased substantially, and in 2010 82% of the loans to firms were long-term loans, which was even larger than the EA. We conclude that there was a large increase in banks' willingness to lend money with long term maturities.

Figure 118 – Short and long term bank' loans to non-financial corporations in Portugal (% of total loans to firms)



Source: Eurostat

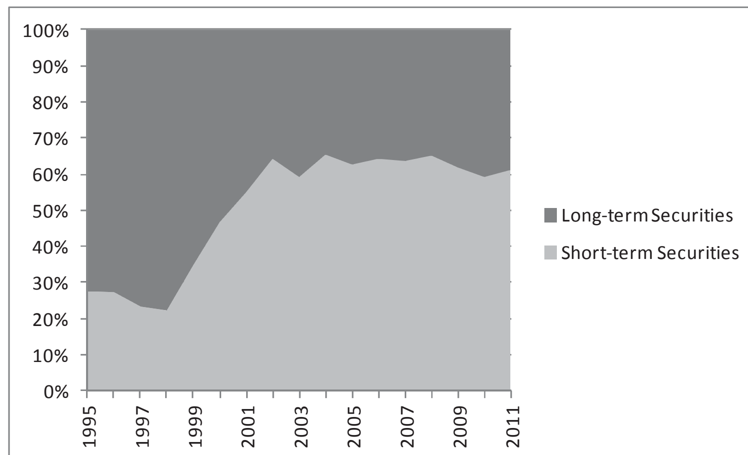
Figure 119 – Long term loans to non-financial corporations in the euro area (% of total loans to firms)



Source: Eurostat

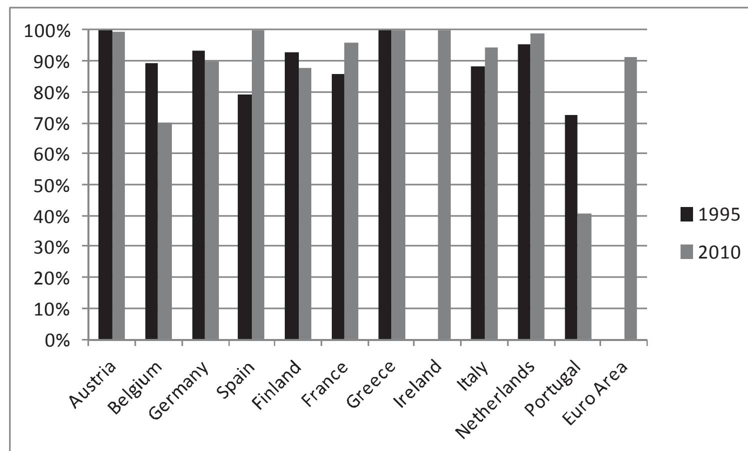
Regarding debt securities issued by NFC, in 1995 the proportion of short term debt and long term debt was 27% and 71%, respectively (Figure 121). The proportion of long term debt was among the lowest in the EA, being similar to Spain. During the period up to 2010, the importance of short term debt has grown even more and in 2010 it represented 59% of total debt securities. This value was clearly an exception in the Euro area, where short term debt only represented 9% of total debt. As a proportion of GDP, long term debt securities represented 8.9%, which is similar to the euro average of 8.5%. It is on the short term debt that Portuguese firms depart from 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.

Figure 120 – Short and long term debt securities of non-financial corporations in Portugal (of % total)



Source: Eurostat

Figure 121 – Long term debt securities of non-financial corporations in the euro area (% of total debt securities)

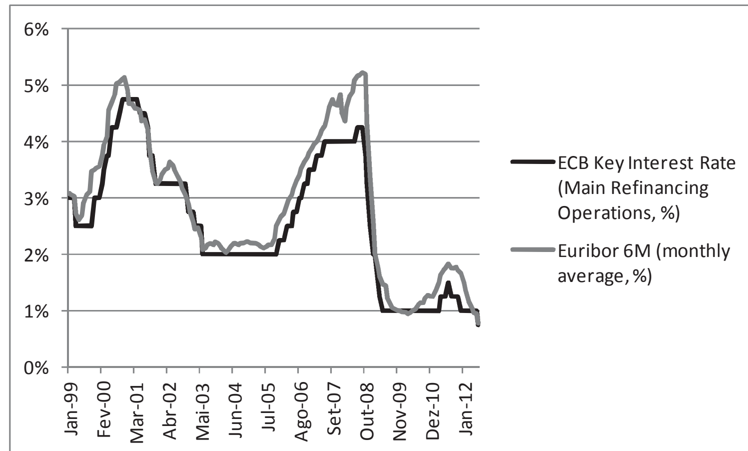


Source: Eurostat

9.2. Interest rates

The active or passive interest rates reflect the evolution of Euribor and banks' spreads. In turn, Euribor is determined by the present and future evolution of the ECB refinancing rate. The co-movement of both interest rates can be seen in Figure 122.

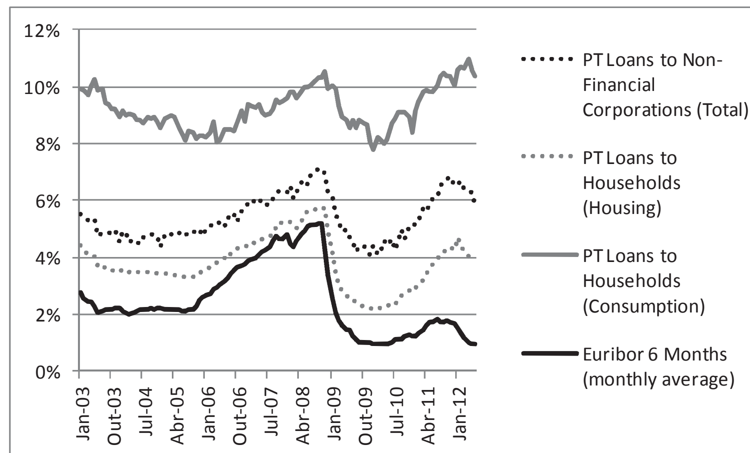
Figure 122 – ECB Main refinancing rate and Euribor 6 months



Source: Bank of Portugal

The Portuguese and the euro area active interest rates have increased between 2005 and 2008, due to the tightening of monetary policy by the ECB, in a context of economic dynamism and inflation pressures (see Figure 123). At the end of 2008, this upward trend reverted, reflecting several cuts on the ECB key interest rates in order to mitigate the shortage of liquidity and the downside risks on the business cycle arising from the Subprime crisis. From the beginnings of 2010 onwards, the level of interest rates has increased again. At the end of 2011, active interest rates decreased in response to a decline in key ECB interest rates, making an important contribution for the economic recovery in the Portuguese economy.

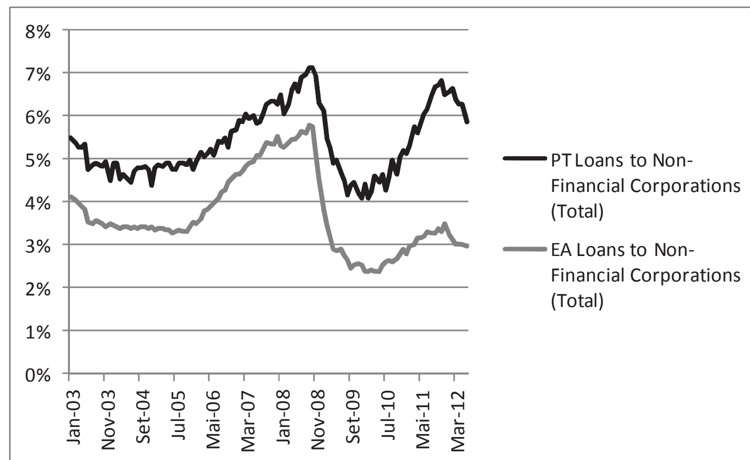
Figure 123 – The evolution of the Portuguese and the euro area interest rates



Source: Bank of Portugal

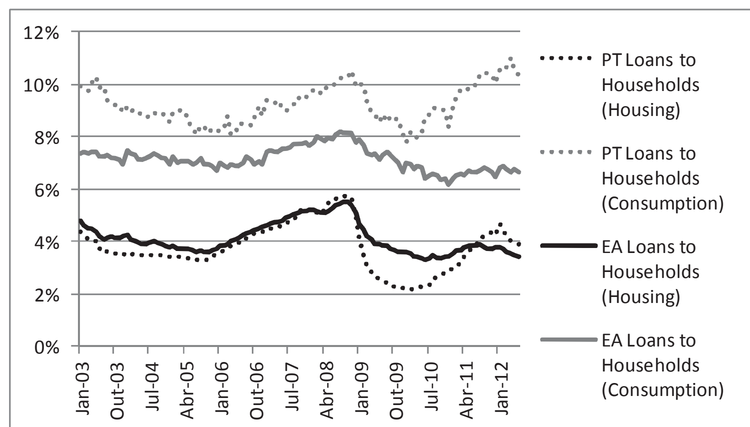
From 2003 to 2012, interest rates for credit to corporations and to consumption were higher in Portugal than in the euro area, probably due to higher risk premiums (see Figure 124 and Figure 125). For credit to corporations, that difference has increased since the beginning of 2009, while for credit to consumption that difference only increased substantially in 2010. The fact that interest rates are becoming increasingly higher in Portugal since 2009 reflects difficulties in banks' financing and increase of clients' risk premiums. Interestingly, the interest rate for credit to housing has been smaller in Portugal than in the EA, a situation that reverted only in mid-2011. The low interest rates to housing in Portugal can be explained partially by the fact that this credit is done with flexible interest rates, which transfer all the risk to the debtor, while in many EA's countries fixed interest rates are used.

Figure 124 – The evolution of interest rates for credit to non-financial corporations



Source: Bank of Portugal

Figure 125 – The evolution of interest rates for credit to consumption

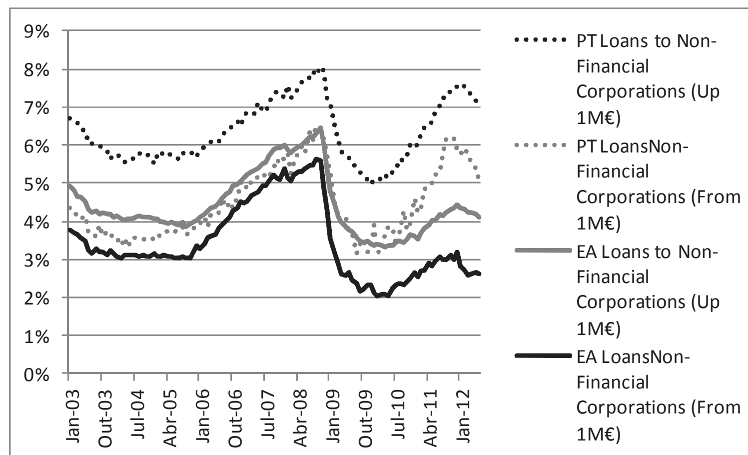


Source: Bank of Portugal

Interest rates charged to non-financial corporations vary substantially with the size of the loan. Usually banks do not treat all firms in the same way, with size being a key variable of differentiation. Normally, SME have worse credit conditions because they are more risky and have less bargaining power towards banks. Looking at the interest rates charged, firms with loans up to €1 million paid 1 to 1.5 p.p. more than firms with loans larger than €1 million (see Figure 126). The difference of interest rates according to the size of the loan has been larger in Portugal than in the EA.

Since 2009, the evolution of credit also shows an asymmetry across firms. From 2009 to 2011, the credit to SME has registered a much larger reduction than the credit to large firms, -5.3% and -0.5% respectively.[52] In the same period, exporting firms have benefited from a 3.1% increase in credit, which can be explained by the good performance of exports since 2009 (and also by the favourable treatment granted to exporting firms in public support mechanisms to enterprise investment).

Figure 126 – The evolution of interest rates for credit to non-financial corporations by size of loan



Source: Bank of Portugal

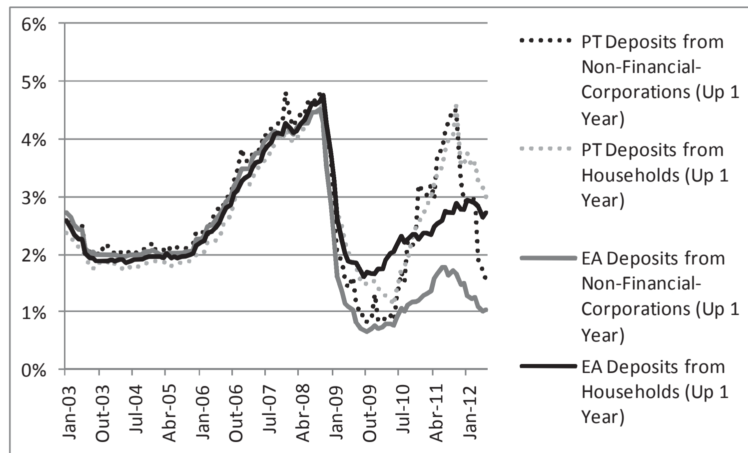
In addition, contrary to what happens in the euro area, in Portugal the interest rates for loans to households for housing purposes was smaller than the interest rate for non-financial corporations up to one million euros. This may be an indication that Portuguese financial institutions gave some priority to the funding of housing at the expense of funding of investment.

Turning now to deposits, banks in Portugal and in the EA have paid almost the same interest rates on deposits from firms and from households between 2003 and 2008 (Figure 127). From 2009, this situation reversed with banks paying, on

[52] Data from Bank of Portugal.

average, more to households than to firms, in an attempt to capture households' savings.

Figure 127 – The evolution of interest rates for deposits



Source: Bank of Portugal

From 2003 to mid-2010, Portuguese banks have paid larger interest rates in deposits from firms than EA's banks, while paying lower interest rates to households. Yet, these differences were relatively low. After mid-2010, deposit interest rates both for households and firms have become larger in Portugal than in the EA.

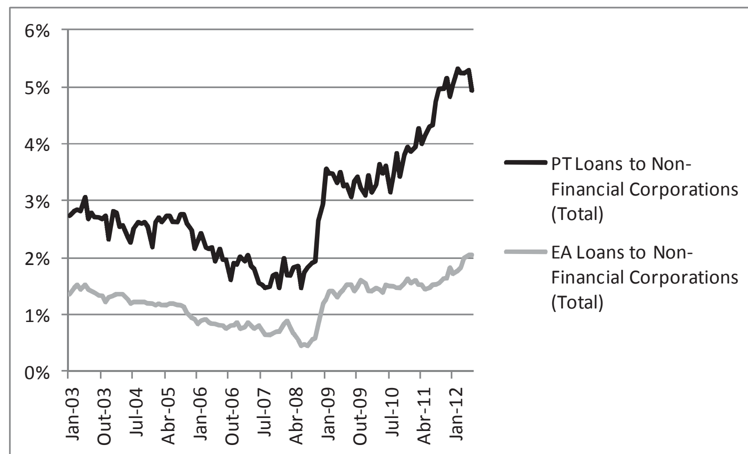
From mid-2010 to mid-2011 there was a much larger increase in deposit interest rates in Portugal than in the EA. This was the result of the strategy of attracting deposits adopted by most Portuguese financial institutions, in the wave of deleveraging process imposed by Troika and the difficulties in obtaining financing in the international markets.

Spreads:

As it stands out from the previous analysis, the differentials between active interest rates and the interbank interest rate are larger in Portugal than in the EA, with the exception of credit to housing.

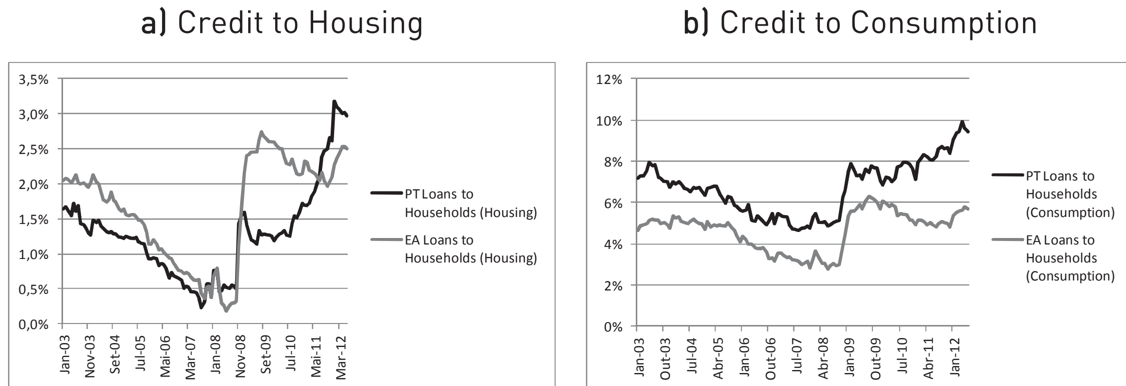
In Portugal and in the EA, a remarkable event was the substantial increase in active spreads at the end of 2008 (see Figure 128 and Figure 129). Afterwards and up to the beginning of 2010, there was a stabilization or even a decline of spreads. From the beginning of 2010, spreads started to increase substantially in Portugal, while they remaining relatively stable in the EA. Only from the mid-2011 spreads started to increase also in the EA. A clear indication of the new regime was that, in 2011, the spread for credit to housing has become larger in Portugal than in the EA, when between 2003 and 2010 had always been smaller.

Figure 128 – The evolution of spreads for the credit to non-financial corporations.



Source: Bank of Portugal

Figure 129 – The evolution of spreads for the credit to consumption.



Source: Bank of Portugal

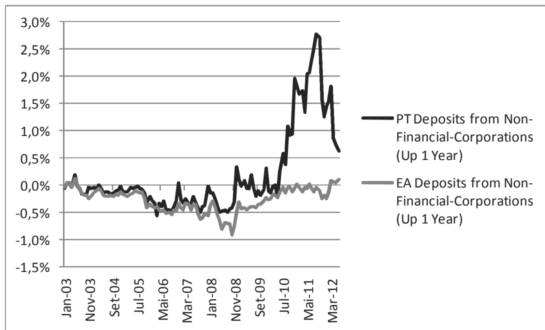
From June 2008 to June 2012, the spread has increased 4.5 p.p. for loans to consumption, 7 p.p. for loans to housing and 3.2 p.p. for loans to corporations. Small firms had an increase in spread of 3.6 p.p., while large firms had only an increase of 3 p.p.

Concerning deposits interest rates to households, in the end of 2008 they started to be larger than the Euribor 6 months, due to competition for funds among banks in a context of very acute financing difficulties in both the interbank and securities market (see Figure 130a). Afterwards, the increase in passive rates continued, with the increase being more pronounced in Portugal than in the EA.

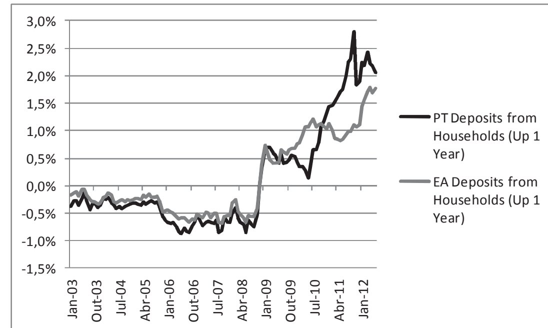
From the end 2008, there was also a tendency for an increase in the deposits interest rate for corporations. However, in the euro area that interest rate never was, in a sustained way, larger than the Euribor 6 Months (see Figure 130b). But in Portugal the deposits interest rate to corporations have increased to values much larger than Euribor 6 Months.

Figure 130 – The evolution of spreads on deposits.

a) Deposits from non-financial corporations



b) Deposits from households



Source: Bank of Portugal

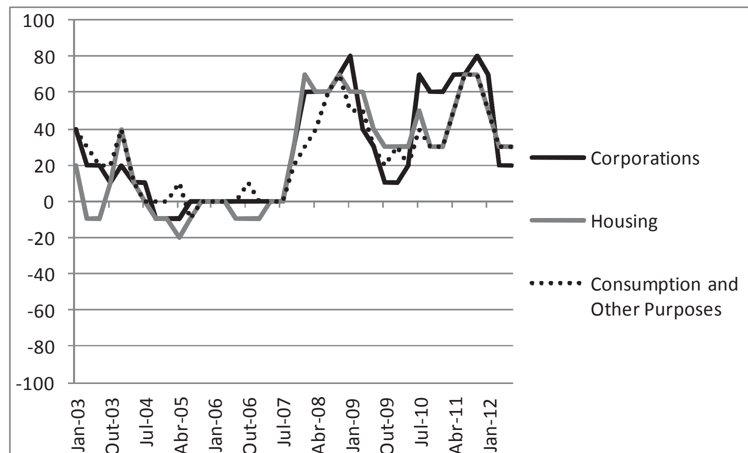
9.3. Credit conditions from the banks' perspective

The bank lending survey questions large banks on the conditions they impose in credit concession[53]. From July 2007, the Portuguese banks have tightened credit conditions for all credit segments, as illustrated by the respective diffusion index[54] (see Figure 131). Credit conditions tightened considerably for both households and corporations mainly due to pessimist expectations regarding the evolution of economic activity, creditworthiness of consumers and housing market prospects; difficulty in banks getting market financing; and balance sheet constraints (see Table 29).

[53] The bank lending survey is an inquiry made by the central banks integrating the Eurosystem. Bank of Portugal reports the results of a sample composed by the five largest banking groups, whilst the European Central Bank aggregates a sample of the one hundred thirty-one largest banks in the euro area.

[54] The diffusion index is defined as the net percentage weighted according to the intensity of the response, using a scale from -100% to 100% to aggregate individual replies, where 0% corresponds to "remained basically unchanged". Values of less than 0% mean a loosening of the credit standards criteria and, in turn, values exceeding 0% point to an increase in the level of restrictiveness. The survey results report to the conditions existing in the previous three months.

Figure 131 – The Portuguese diffusion index for credit to households and corporations



Source: Bank of Portugal

Table 29 – Factors behind the tightening of credit conditions

	Jan-03		Jan-05		Jul-08		Jan-09		Oct-09		Apr-2011		Jul-12	
	PT	EA	PT	EA	PT	EA	PT	EA	PT	EA	PT	EA	PT	EA
Corporations														
Bank Competition	0	1	-40	-10	0	2	0	3	0	-2	10	-3	0	-2
Capital Position	50	21	0	2	40	10	50	17	30	4	50	2	40	6
Expectations Regarding General Economic Activity	80	47	0	6	30	28	80	45	40	15	70	3	40	11
Industry or Firm Specific Outlook	60	50	10	7	30	30	70	44	50	21	40	3	40	13
Liquidity Position	10	8	0	0	10	9	20	13	0	-5	60	4	0	1
Ability to Access Market Financing	30	11	-10	-1	60	13	60	22	20	-2	80	5	20	3
Market Financing Competition	0	11	-10	-1	10	13	0	22	0	-2	-10	5	0	3
Non-Bank Competition	0	-2	-10	-1	0	2	0	2	0	0	0	0	0	0
Risk on the Collateral Demanded	30	30	-10	2	20	11	30	24	40	10	20	2	30	5
Households (Housing)														
Bank Competition	10	-7	-20	-7	0	-4	0	3	0	0	0	-1	0	0
Funds and Balance Sheets Constraints	10	3	0	0	40	9	50	16	10	2	90	8	40	7
Expectations Regarding General Economic Activity	40	21	10	2	60	20	80	29	20	10	90	6	50	6
Housing Market Prospects	40	15	0	4	50	20	80	30	30	7	80	4	50	5
Non-Bank Competition	0	1	0	-2	0	0	0	5	0	1	10	0	0	0
Households (Consumption)														
Bank Competition	0	-5	-10	-5	0	-1	0	0	0	1	10	-1	0	-1
Funds abd Balance Sheets Constraints	30	2	-10	0	40	7	40	10	20	2	80	6	30	5
Creditworthiness of Consumers	50	19	10	5	60	16	80	23	60	10	70	4	60	4
Expectations Regarding General Economic Activity	40	19	10	2	50	15	80	24	40	10	80	4	40	4
Non-Bank Competition	0	-2	0	-3	0	0	0	3	0	1	0	0	0	0
Risk on the Collateral Demanded	30	7	10	1	30	12	40	14	20	4	50	2	40	2

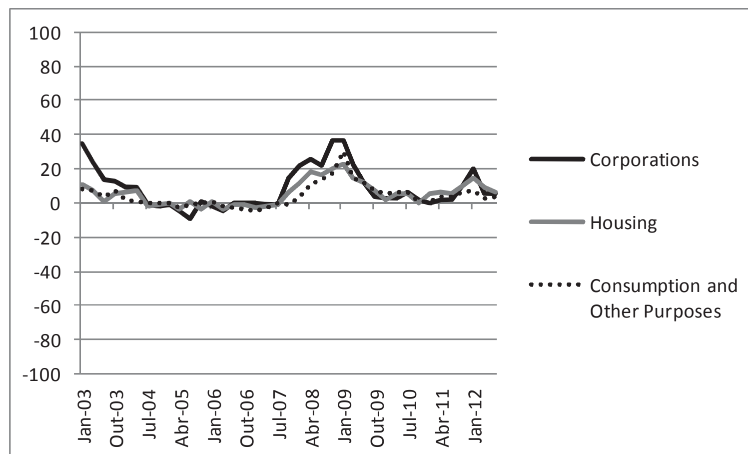
Source: Bank of Portugal and Bank of Portugal

Credit conditions for households and corporations have also became tighter in the euro area after July 2007, but they returned to a more neutral position after July 2009 (see Figure 132). Furthermore, since July 2007 the level of restrictiveness of credit conditions as measured by the diffusion index has been higher in Portugal than in euro area banks, due to demand conditions, as the

evolution of economic activity, risk of collaterals and housing market prospects, as well as supply conditions, like the access to market financing and funds, solvability levels, and balance sheet constraints.

Looking at the period before July 2007, from October 2004 to July 2007, credit conditions in the EA and in Portugal remained basically unchanged. But from January 2003 to July 2004 the restrictiveness of credit standards increased both in the EA and Portugal, with the increase being larger in the latter country.

Figure 132 – The euro area diffusion index for credit to households and corporations



Source: European Central Bank

After July 2007, Portuguese and the European banks have applied more stringent contractual terms and conditions for all type of loans, which has been visible in the widening of margins (spread and commissions), especially for riskier loans, in the decrease of loans' maturity, namely for corporations, the strengthening of collateral requirements, and the decrease of loan to value ratio (see Table 30).

Additionally, the bank lending survey from the Bank of Portugal highlights that the tightening of credit conditions has been more aggressive in the case of long-term loans (see Figure 133a). At the same time, the level of tightness of

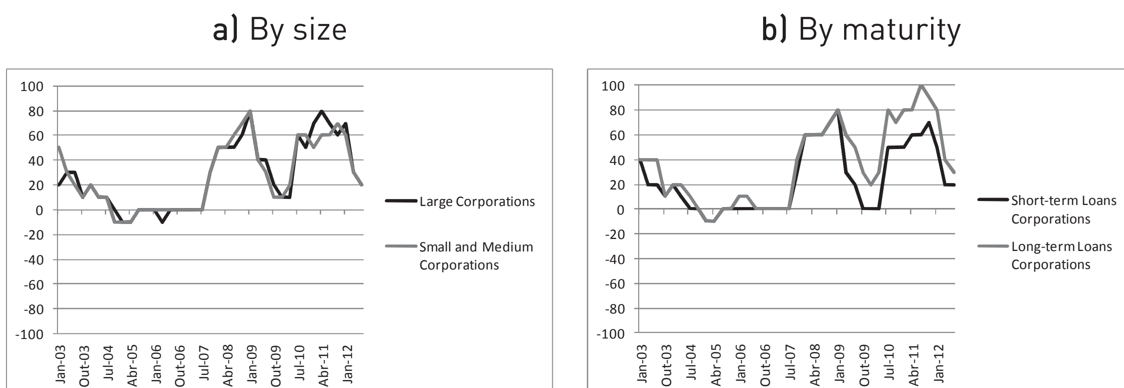
credit conditions has been similar for large and small and medium corporations (see Figure 133b).

Table 30 – Terms and Conditions for type of loan

	Jan-03		Jan-05		Jul-08		Jan-09		Oct-09		Apr-2011		Jul-12	
	PT	EA	PT	EA	PT	EA	PT	EA	PT	EA	PT	EA	PT	EA
Corporations														
Collateral Requirements	60	31	-10	0	20	18	20	23	20	10	30	1	40	5
Loan Covenants	30	22	0	3	20	14	20	17	10	7	10	0	40	4
Margin on Average Loans	40	36	-20	-1	40	29	70	35	50	7	60	-1	20	13
Margin on Riskier Loans	70	60	30	9	40	41	80	49	70	21	80	11	40	17
Maturity	40	23	-10	0	30	13	60	20	30	5	50	2	40	6
Non Interest Rate Charges	40	16	-10	1	10	9	20	13	10	4	40	0	20	4
Size of Loans	20	27	-10	1	20	16	40	23	0	7	30	0	30	4
Households (Housing)														
Collateral Requirements	0	9	0	1	20	10	30	17	0	3	20	1	10	1
Impact of Loan to Value Ratio	40	8	0	-2	50	16	40	21	20	7	70	5	20	3
Margin on Average Loans	20	11	-10	-10	40	11	70	24	30	4	50	6	10	7
Margin on Riskier Loans	30	27	10	1	70	17	90	30	60	13	80	11	50	12
Maturity	-30	1	-20	-4	20	5	0	10	0	1	30	3	0	2
Non Interest Rate Charges	10	3	10	-2	10	1	0	6	10	0	40	1	10	0
Households (Consumption)														
Collateral Requirements	50	10	0	-1	20	7	10	11	20	6	40	1	30	1
Margin on Average Loans	10	9	-10	-8	40	11	50	16	50	9	50	3	20	6
Margin on Riskier Loans	30	21	30	3	60	19	60	19	60	14	60	6	40	8
Maturity	30	1	-10	0	40	4	20	11	10	5	20	1	0	1
Non Interest Rate Charges	10	4	0	-1	30	4	30	6	10	2	10	1	10	0

Source: Bank of Portugal and European Central Bank

Figure 133 – The Portuguese diffusion index for credit to corporations

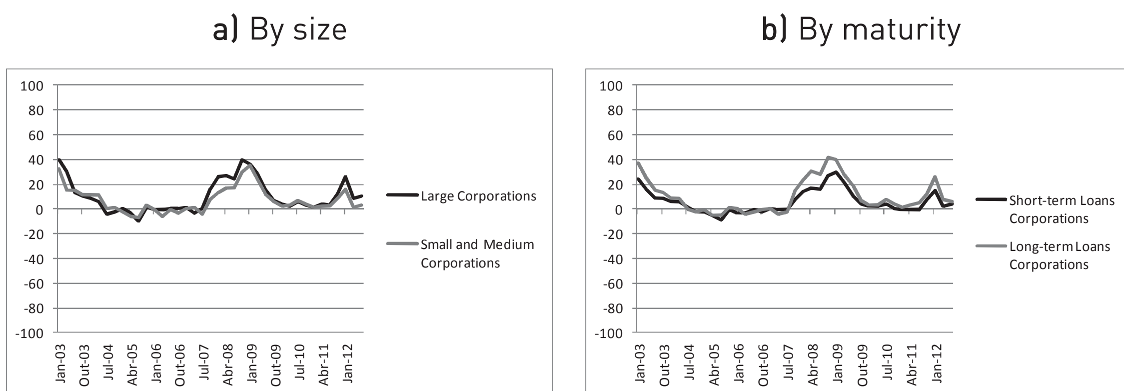


Source: Bank of Portugal

In the euro area, the overall tightening of credit conditions was stronger for large corporations than for small and medium size corporations (see Figure 134a). Similarly, credit conditions have been more aggressive in the case of long-term loans (see Figure 134b), even though the difference was less significant than in Portugal.

Figure 134 – The euro area diffusion index for credit to corporations

a) By size b) By maturity

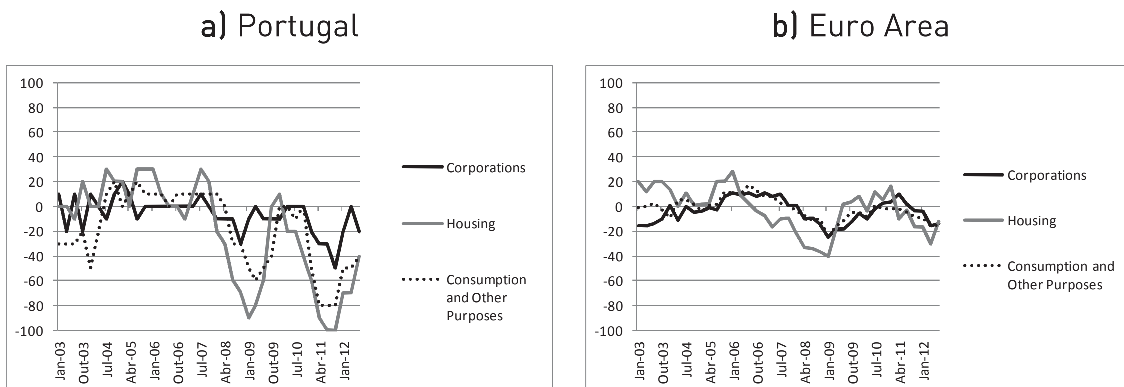


Source: European Central Bank

The Bank Lending Survey allows us to assess also the evolution of credit demand from the perspective of banks. This demand in Portugal has fallen since July 2007, both for households and firms (see Figure 135a), reflecting the current weakness of the Portuguese economic activity. For households, that reduction was boosted by the deterioration of consumer confidence, increase of unemployment, retraction in consumption of durable goods and pessimistic outlook for the housing market. On the other hand, the demand for loans by corporations has declined less due to the effect of opposing factors. On the one hand, the fall in demand has been boosted by falls in investment and in the movement of mergers and acquisitions. On the other hand, an increase in demand has been motivated by the rise of short-term funding needs and debt restructuring procedures faced by some corporations.

The demand of credit has also declined in the euro area from January 2008, recovering slightly afterwards (see Figure 135). It can be easily observed that the drop in the demand for loans in the last quarters has been much smaller in the euro area than in Portugal.

Figure 135 – The demand for loans in Portugal and in the euro area.



Source: European Central Bank

9.4. Investment survey: firms' perspectives

The Portuguese National Statistical Institute, INE, realizes a qualitative survey of the investment environment in order to periodically assess investment activity of large and SMEs.

In accordance with the survey, Portuguese corporations have recognized a considerable increase in the limiting factors of investment from 2008 (see Table 31).[55] Effectively, in 2011 the proportion of firms facing constraints to investment reached the unprecedented level of 58%, even surpassing the level of 52% achieved during the 2002 downturn.

Between 1998 and 2011, the sectors facing on average more limitations to investment were extractive industry, manufacturing and construction (see Table

[55] We use the April's surveys, which cover all the previous year.

31). On the other hand, corporations from financial and insurance sectors, real estate sector and accommodation and food service activities were the ones with less investment obstacles.

Table 31 – The percentage of corporations who recognize the existence of limiting factors of investment

CAE (3rd Revision)	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Mean 98-11
Extractive Industry	36	37	39	36	47	62	57	41	31	72	52	66	58	36	**48**
Manufacturing	45	51	50	51	57	53	51	48	51	53	58	57	57	36	**51**
Electricity, Gas and Water	29	30	24	27	38	52	58	47	46	45	48	41	31	41	**40**
Captation, Remediation and Distribution of Water	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	65	66	**65**
Construction	42	36	37	45	55	50	50	52	48	46	55	55	57	69	**50**
Wholesale/Retail Trade, Repair of Vehicles	42	30	38	36	50	40	45	40	38	32	43	44	42	51	**41**
Transportation and Storage	26	35	34	36	45	44	52	42	39	41	60	37	46	52	**42**
Accommodation and Food Service Activities	31	28	32	31	39	35	31	19	15	24	24	40	51	81	**34**
Information and Communication	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	62	60	**61**
Financial and Insurance Activities	20	18	14	11	20	17	14	35	10	14	10	8	20	22	**17**
Real Estate Activities	27	28	27	37	36	38	40	25	33	32	37	46	42	49	**35**
Consultancy, Scientific and Technological Activities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	41	49	**45**
Administrative/Support Services	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	45	56	**51**
Total	**38**	**40**	**42**	**43**	**52**	**45**	**46**	**42**	**42**	**40**	**48**	**49**	**50**	**58**	**45**

Source: INE (Inquérito Qualitativo de Conjuntura ao Investimento)

The factors limiting investment were diverse (Table 32), but the deterioration of the outlook for sales, return on equity and the capacity of auto-financing are the limiting factors most referenced by corporations on average. On the other hand, the difficulty of hiring qualified employees and capital markets represent the factors that affected investment activity the least. The fact that an important limiting factor of investment was the capacity of auto-financing is an indicator that firms relied heavily on this form of financing.

Since 2007, it is also relevant to notice that the difficulty in obtaining credit increased faster than overall limitations to investment (see Figure 136). In 1998 only 15% of firms said reported difficulty in obtaining credit, while in 2011 that number increased to 30% (see Table 33). In 1998, the difficulty in obtaining credit was the seventh most important limiting factor of investment, whilst in 2011 that factor had climbed to the third position, but still much less important than the deterioration of the outlook of sales. In 2011, the sectors facing more

difficulty were the industrial sectors, with the industries of electricity and construction as the more penalized. Between 1998 and 2011 the sectors facing more difficulty in obtaining credit were manufacturing, construction (especially since 2004) and transportation and storage, on average (see Table 33).

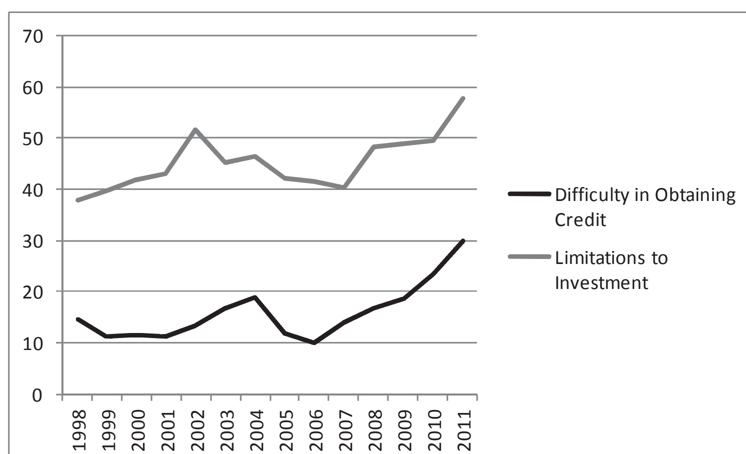
Broadly the same conclusions are reached if we use the *main* factors limiting investment instead of the factors liming investment (see Table 4, in Annex)

Table 32 – The factors limiting investment

CAE (3rd Revision)		Insufficient Production Capacity	Deterioration of the Outlook for Sale	Difficulty of Hiring Qualified Employees	Level of Interest Rates	Return on Equity	Capacity of Auto-Funding	Difficulty in Obtaining Credit	Capital Markets
Extractive Industry	1998	26	31	26	15	35	39	17	1
	2003	31	58	1	11	46	4	1	0
	2011	3	96	0	59	31	64	36	2
Manufacturing	1998	24	48	20	17	33	36	20	1
	2003	19	73	12	12	42	33	22	1
	2011	16	68	6	31	43	31	34	1
Electricity, Gas, Water, Sewerage, Remediation	1998	0	17	6	3	20	34	0	0
	2003	1	9	0	11	4	55	35	0
	2011	14	17	0	20	17	37	48	0
Captation, Remediation and Distribution of	1998	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2003	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2011	13	36	0	15	27	27	27	2
Construction	1998	19	37	34	27	44	39	13	0
	2003	11	71	15	20	44	24	12	4
	2011	10	79	0	29	50	33	39	8
Wholesale/Retail Trade, Repair of Vehicles	1998	7	53	13	10	36	29	9	2
	2003	12	69	7	17	47	33	17	0
	2011	6	79	4	24	44	26	26	0
Transportation and Storage	1998	12	42	17	20	36	38	29	3
	2003	7	77	12	6	42	19	38	0
	2011	1	50	0	40	50	23	20	0
Accommodation and Food Service Activities	1998	12	49	31	18	30	45	4	0
	2003	21	34	1	3	73	5	0	0
	2011	11	83	1	11	53	28	28	0
Information and Communication	1998	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2003	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2011	10	52	11	15	36	37	24	1
Financial and Insurance Activities	1998	0	15	2	5	21	23	0	2
	2003	3	51	1	18	16	29	0	22
	2011	0	30	0	32	30	4	28	0
Real Estate Activities	1998	6	40	12	8	17	32	10	0
	2003	19	54	13	6	53	40	6	9
	2011	12	62	0	25	37	48	12	23
Consultancy, Scientific and Technological	1998	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2003	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2011	12	69	2	16	29	26	22	8
Administrative/ Support Services	1998	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2003	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2011	14	73	6	19	40	18	31	3
Total	1998	**16**	**47**	**19**	**15**	**34**	**34**	**15**	**1**
	2003	**14**	**68**	**10**	**14**	**46**	**30**	**17**	**2**
	2011	**10**	**73**	**3**	**26**	**44**	**29**	**30**	**2**

Source: INE (Inquérito Qualitativo de Conjuntura ao Investimento)

Figure 136 –Limiting factors of investment.



Source: INE (Inquérito Qualitativo de Conjuntura ao Investimento)

Table 33 – Difficulty in obtaining credit by sectors

CAE (3rd Revision)	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Mean 98-11
Extractive Industry	17	13	16	21	16	1	2	6	6	11	43	21	6	36	**15**
Manufacturing	20	16	15	12	15	22	26	17	15	14	13	19	27	34	**19**
Electricity, Gas and Water	0	10	0	0	0	35	19	14	6	7	7	12	24	48	**13**
Captation, Remediation and Distribution of Water	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	19	27	**23**
Construction	13	8	21	15	8	12	25	18	12	14	22	19	23	39	**18**
Wholesale/Retail Trade, Repair of Vehicles	9	5	6	7	14	17	13	7	6	14	18	18	19	26	**13**
Transportation and Storage	29	22	12	22	20	38	23	15	14	20	18	54	61	20	**26**
Accommodation and Food Service Activities	4	9	17	15	10	0	14	0	0	0	7	1	18	28	**9**
Information and Communication	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	15	25	**20**
Financial and Insurance Activities	0	3	0	0	0	0	0	20	0	3	2	3	8	28	**5**
Real Estate Activities	10	9	7	13	11	6	11	7	11	16	22	16	12	12	**12**
Consultancy, Scientific and Technological Activities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	25	22	**24**
Administrative/Support Services	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	23	31	**27**
Total	**15**	**11**	**12**	**11**	**14**	**17**	**19**	**12**	**10**	**14**	**17**	**19**	**23**	**30**	**16**

Source: INE (Inquérito Qualitativo de Conjuntura ao Investimento)

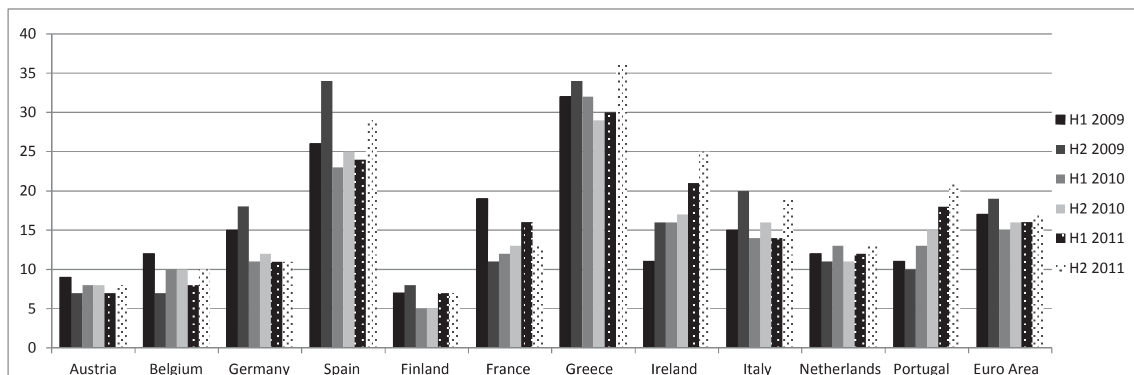
9.5. Survey on the Access to Finance

Since 2009, the European Central Bank conducts a biannual survey on the access to finance of small and medium-sized enterprises in the euro area. Each

survey refers to the financial conditions that firms faced in the six months preceding it. [56]

According with that survey, the proportion of firms considering access to finance as the most pressing problem has increased very little since the first half of 2010 in the EA, while the increase has been very strong in Spain, Greece, Ireland, Italy and Portugal (Figure 137). These four countries were facing the consequences of the Euro Sovereign Debt Crisis. In the second half of 2011 the percentage of Portuguese SMEs saying that finance was their biggest problem was 21%, which was the fourth largest number in the EA. But it should be noticed that only from the first half of 2011 did the proportion of SMEs saying that finance was their most pressing problem become larger in Portugal than in the EA.

Figure 137 – The access to finance as a pressing problem faced by SMEs (% of respondents)



Source: European Central Bank (Survey on the Access to Finance of SMEs in the Euro Area)

One reason why Portuguese firms are considering finance as a growing problem relates to the decrease in the availability of bank credit (loans and

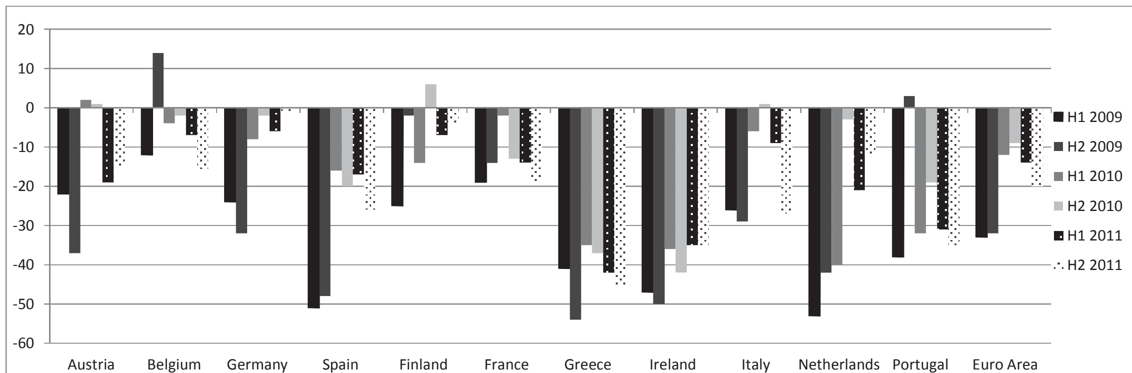
[56] However, the reference period of the survey has changed: H1 2009 (first half of 2009), H2 2009 (second half of 2009), H1 2010 (from March to September 2010), H2 2010 (from September 2010 to March 2011), H1 2011 (from April 2011 to September 2011) and H2 2011 (from October 2011 to March 2012).

overdrafts) since the first half of 2010 (see Figure 138 and Figure A 5 in Annex). This decrease was stronger in Portugal than in the EA. In contrast, since the second half of 2011 and against the tendency of the EA, the net proportion of firms reporting a decline in the availability of credit decreased in Germany and Finland.

Moreover, the majority of euro area's SMEs recognized that the main factors affecting banking credit and overdraft availability was the deterioration of the outlook to the general economic activity and the worsening of the outlook to their sales and profitability.

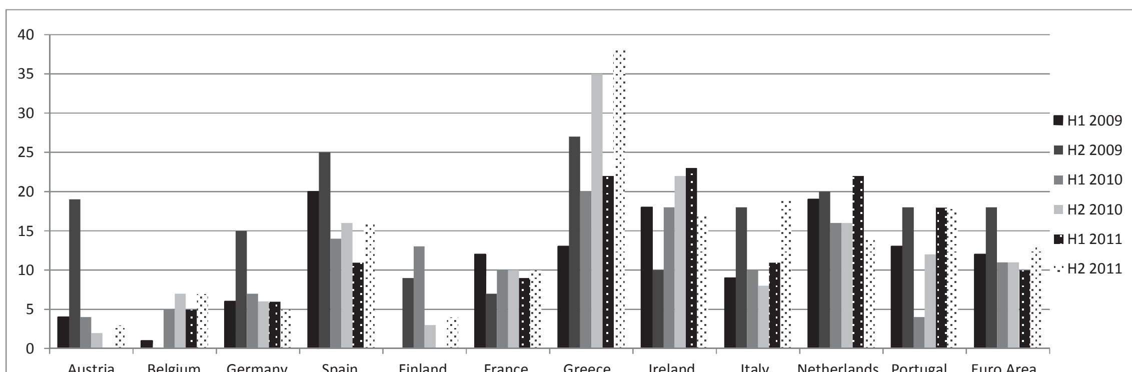
The extreme case of weak credit availability is the rejection of credit. Since the first half of 2009 that the percentage of firms that applied for a loan but were rejected has been larger in Portugal than in the EA, especially from 2011 onwards (see Figure 139). In 2011, the increase in the rejection rate in Portugal was larger than in the EA, while in Germany, Ireland and Netherlands there was even a decline in that rate. We can also observe rates of rejection larger than average in Italy, Spain and Ireland.

Figure 138 – Change in the availability of bank loans as perceived by SMES (net percentages[57])



Source: European Central Bank (Survey on the Access to Finance of SMEs in the Euro Area)

Figure 139 – Rejection rate of bank loans by SMEs (percentage of firms that had applied for bank loans)

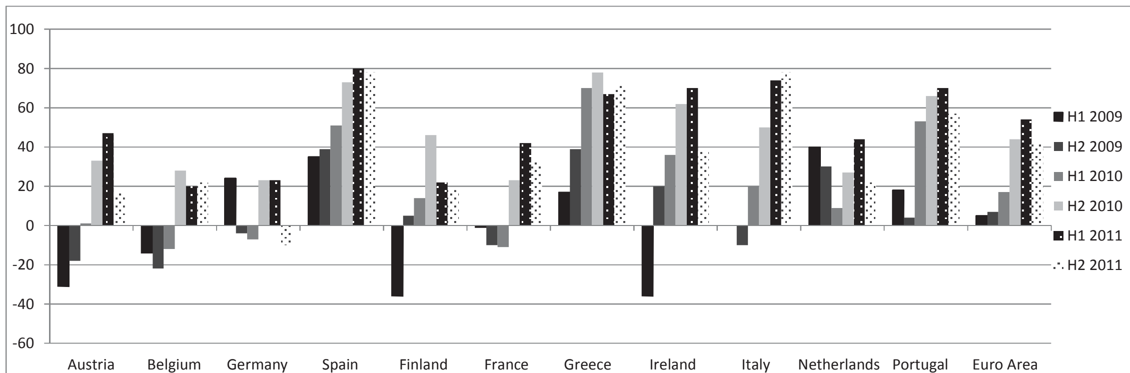


Source: European Central Bank (Survey on the Access to Finance of SMEs in the Euro Area)

Since the second half of 2010, the Portuguese SMEs not only saw the rejection rate of their credit applications increase, but also observed a strong increase in the interest rate charged, and this increase was once more larger than in the EA (see Figure 140). The increase of other credit costs was very strong especially in the first half of 2010 (see Figure 141). Since then the increase in other credit costs in Portugal has been among the largest in the EA.

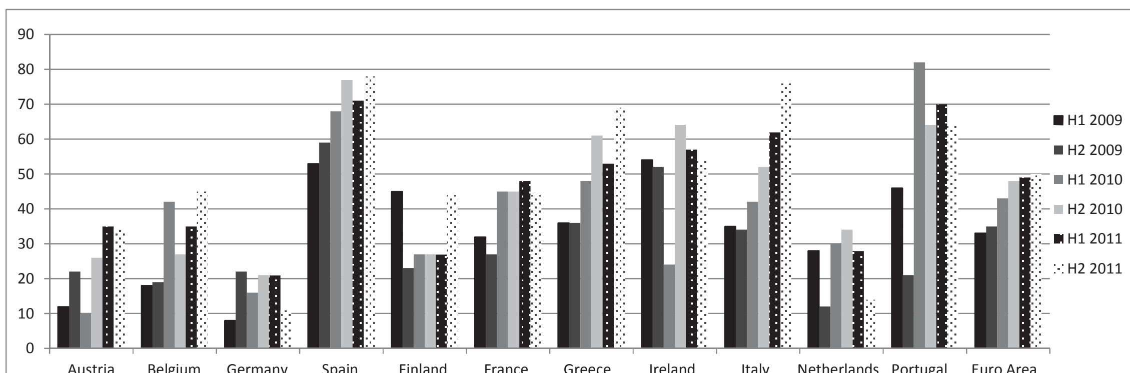
[57] The net percentage refers to the difference between the percentage of firms reporting an increase for a given factor and those reporting a decrease.

Figure 140 – Change in the level of interest rates of banks loans to SMEs (net percentages)



Source: European Central Bank (Survey on the Access to Finance of SMEs in the Euro Area)

Figure 141 – Change in the level of other costs of financing of banks loans to SMEs (net percentages)



Source: European Central Bank (Survey on the Access to Finance of SMEs in the Euro Area)

The short sample available on the survey indicates that in 2009, before the start of the Euro Debt crisis, the access of SMEs to finance was not worse in Portugal than in the EA. But from 2010 the crisis implied a larger deterioration of the access to credit by SMEs in Portugal than in the EA. The worsening of the credit costs started in the first half of 2010, while in terms of credit availability the tightening started in the second half of 2010, with a strong increase in 2011.

9.6. Concluding remarks

In recent years, Portuguese firms increased the use of debt as source of financing, and in 2011 they were among the most indebted of the EA. NFC used increasingly long term bank loans, which constitute a more stable way of financing long term investment. To finance short-term responsibilities they preferred short term debt securities, which they used in large quantity. These securities are mostly owned by banks, which make use of this market mechanism to increase their profits.

Since 2003 to mid-2011, active interest rates were high in Portugal than in the EA, with the exception of the interest rates for credit to households to buy houses. Higher interest rates may reflect a larger risk premium of Portuguese firms and households or less competition on specific segments. In the segment of credit for housing purposes the lower interest rates seem to indicate more competition in Portugal than in the EA. Portuguese banks charge higher interest rates to small firms than to larger firms, with the difference been quite significant (larger than in the EA).

From the end of 2008 deposit rates increased above the Euribor 6 months due to the financing difficulties of banks. From the perspective of banks, from July 2007, credit conditions in Portugal have become tighter, with the tightening being worse in Portugal than in the EA. A similar situation occurred between January 2003 and July 2004.

From the perspective of firms, from 2008, large and small and medium sized Portuguese firms identified an increase in the limiting factors on investment. In 2011, 58% of the firms were facing restrictions on investment. Between 1998 and 2011, the sectors facing more restrictions were manufacturing and construction. Finance and insurance, real estate had the smallest level of restrictions. The most important factors of limitation were the deterioration of

the outlook of sales, return on equity and the capacity of auto-financing. The importance of auto-financing as a limiting factor indicates that some of them do not have access to other sources of financing.

Since 2007 difficulties in obtaining credit increased faster than the overall limitations to investment. In 2011, credit was the third most important limiting factor, with 30% of the firms reporting credit limitations. Between 1998 and 2011, the sectors facing more difficulties in obtaining credit were manufacturing and construction.

Using a European survey on SMEs, we conclude that in 2009 before the start of the Euro Debt crisis, the access of SMEs to finance was not worse in Portugal than the EA average. But from 2010 the crisis implied a larger deterioration in access to credit by SMEs in Portugal than in the EA.

After the Subprime crisis and especially after the Sovereign debt crisis there were factor in the Portuguese banking system that can explain the reduction in credit supply: liquidity difficulties of banks, increase in uncertainty, rise of capital requirements, and the increase in non-performing loans.

10. Involvement of financial sector in restructuring NFCs [58]

This point considers the involvement of the financial sector in restructuring NFCs. In Section 10.1 M&A are assessed, with particular emphasis on the role of banks and international investors. In Section 10.2 the dimension of deindustrialization in Portugal is described, and some suggestions are made on the role of the financial sector in that process.

10.1. M&A in the non-financial sector

Mergers and acquisitions (M&A) have an important role in the process of firms' internationalization and reorganization. In the last years, this phenomenon has increased substantially, despite the recent fall after the 2007 financial crisis. Among the reasons that explain the increase in the movement of M&A at a local and international level during the last years, we highlight the integration of European Union's economies, globalization of markets, technological development, economies of scale, availability of capital and financial innovation, and privatizations in Eastern European countries.

However, M&A have not affected all countries equally. Among the countries where, in 2001, the share of M&A was larger than the share of GDP, the UK has a prominent position (see Table 34). This probably is explained by the larger importance of financial markets in that country. In Portugal, the share of GDP is very similar to the share of M&A, like in Greece. But comparing with Italy and Spain, the relative importance of M&A is larger in Portugal.

The ECB bank lending survey presents the perspective of banks on credit demand from non-financial corporations for M&A. Since January 2003, on average, the demand of bank credit for M&A has been smaller in Portugal than

---

[58] Point 11 in the terms of reference.

in the EA (see Figure 142). Another important feature is that the demand for credit to undergo M&A has exhibited a downward trend since July 2007 both in Portugal and in the EA, with the decline been larger in Portugal, particularly in the period from October 2009.

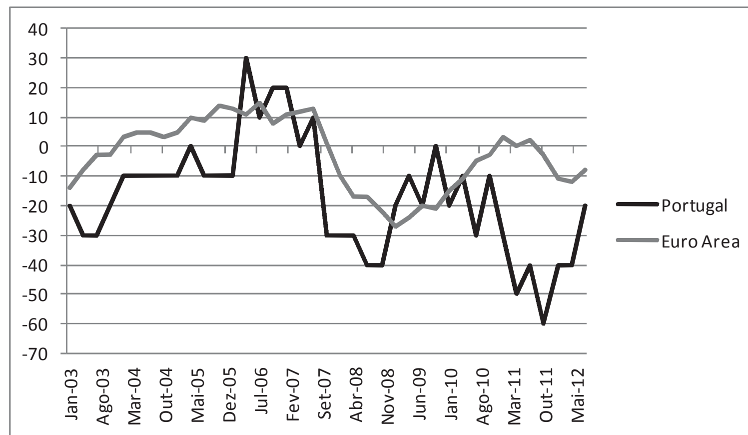
Besides banks, other source of financing for M&A is venture capital. In Section 4.3, we observed that the VC Buyout activity in Portugal is less intense than in other EA countries.

Table 34 – Share of European M&A and GDP (2001)

	Share of Mergers and Acquisitions (%)	Share of GDP (%)	Difference
Belgium	2,8%	3,2%	-0,4%
Denmark	2,6%	2,1%	0,5%
Germany	16,3%	28,2%	-11,9%
Greece	1,1%	1,4%	-0,3%
Spain	5,0%	7,0%	-2,0%
France	13,5%	18,1%	-4,6%
Ireland	1,7%	0,9%	0,8%
Italy	6,2%	12,6%	-6,4%
Luxembourg	0,5%	0,2%	0,3%
Netherlands	6,5%	4,9%	1,6%
Austria	2,1%	2,7%	-0,6%
Portugal	1,2%	1,3%	-0,1%
Finland	3,9%	1,6%	2,3%
Sweden	5,3%	2,8%	2,5%
United Kingdom	31,4%	13,2%	18,2%

Source: European Commission (2001)

Figure 142 – Banks perspective on the demand for loans to finance M&A by non-financial corporations



Source: European Central Bank (Lending Survey)

Neves (1997) highlights that the small size of Portuguese firms in some sectors imposes a process of M&A at the national level in order for firms to increase their size. After reaching a certain maturity and dimension, companies are better prepared for cross-border growth through M&A at an international level.

According to A. T. Kearney (2009), the volume of M&A between Portugal and the Rest of the World has increased in the last years from an annual growth of 2% in 2005 to 21% in 2008. The foreign firms buying Portuguese firms are mostly from emerging markets. The Portuguese firms investing abroad also target typically emerging markets.

A large part of the external buyers of Portuguese firms are energy companies and sovereign wealth funds from oil-producing countries, which are looking to diversify portfolios. Companies from emerging markets invest mainly in minority stakes in large Portuguese companies of the PSI20, although they are also reference shareholders in some companies of the PSI-20 index (mainly in the banking and energy sectors). Investments are mainly aimed at listed companies from PSI-20 index (about 92%), where Angola has been the main investor in the Portuguese stock market (about 3% of the total of PSI-20),

followed by Brazil (around 1% of the total of PSI-20). Against this backdrop, Angola and Brazil have accounted for about 60% of all operations of M&A done in Portugal.

Indeed, according to A. T. Kearney (2009), in September 2009, the weight of capital from emerging markets in the PSI-20 index capitalization was 4,9%, which is three to five times higher than what occurred in other European indexes like IBEX-35 (0,7%), DAX-30 (1,3%), CAC-40 (1,7%).

On the other hand, Portuguese companies have privileged majority stakes in Brazil, Turkey and Poland, based on a strategy of internationalization in markets with a high growth potential.

The Portuguese financial sector has played an important role in this growing process of M&A, namely as provider of consultancy services or even as lenders. Major Portuguese banks, through their investment banking activity, provide financial advisory services and solutions indispensable to the process of M&A, namely: advisory services for operations involving corporate equity investment trading (acquisitions, sales, mergers, demergers, management and leveraged buy outs, management buy ins, partnerships, joint ventures and any other form of corporate business combination), corporate economic-financial assessments, analysis of synergies associated with business combinations between companies, financial restructuring studies, reorganization of corporate equity investments, support for economic and financial reorganizations preparing companies for equity market operations, formation and coordination of financial consortia, identification of business partners and opportunities.

CGD (through Caixa – Banco de Investimento) and BES (through Espírito Santo Investment Banking) are the main providers of these types of services, although some consultancy firms also provide financial advisory services related to the process of M&A, like Deloitte, KPMG, PricewaterhouseCoopers, Ernst & Young,

Capgemini, among others. Still, CGD and BES are clearly leaders of this type of financial services in Portugal.

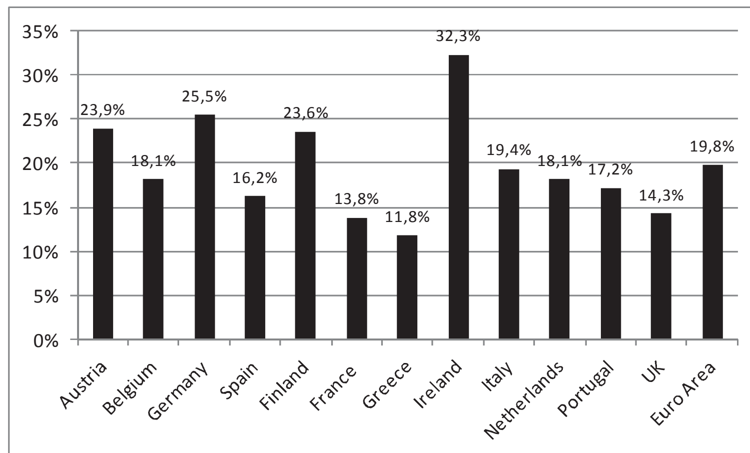
In the coming years, A. T. Kearney (2009) anticipates a strong growth of M&A from emerging markets, supported not only by the great dynamism of these economies, but also by the stabilization of capital markets, recovery of commodity markets, necessity to invest in more stable and developed economies for risk diversification, among other reasons.

10.2. Portuguese deindustrialization

Industry except construction

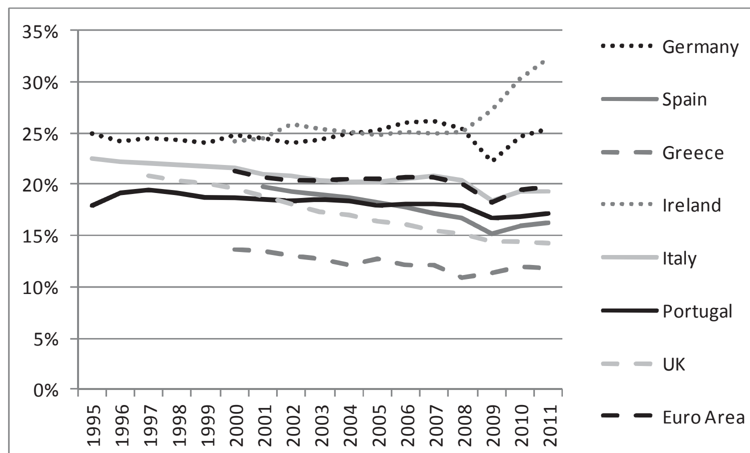
In Section 3.1 we saw that in Portugal the weight of industry in GDP has declined especially since 1990. In 2011, the weight of industry except construction in GDP was lower in Portugal than in the EA11: 17.1% and 19.7% respectively (Figure 143). The "process of deindustrialization" between 2000 and 2011 was slightly larger in Portugal than in the EA, with industry losing 1.5 p.p. in terms of its importance on GDP in Portugal and 1.44 p.p. in the EA (Figure 144 and Table 35). If analyse since 1995, the conclusion in similar. In terms of industry employment, the fall between 1995 and 2011 was also larger in Portugal than in the EA, but with the difference being larger than for the value added: -6.2 p.p. and -4.8 p.p., respectively (Table 35).

Figure 143 – The importance of industry (except construction) in several countries of the EA (2011)



Source: Eurostat

Figure 144 – Evolution of the importance of industry (except construction) in several countries of the EA (% of GDP)



Source: Eurostat

Table 35 – The importance of industry (except construction) in several EA countries (% of GDP and employment)

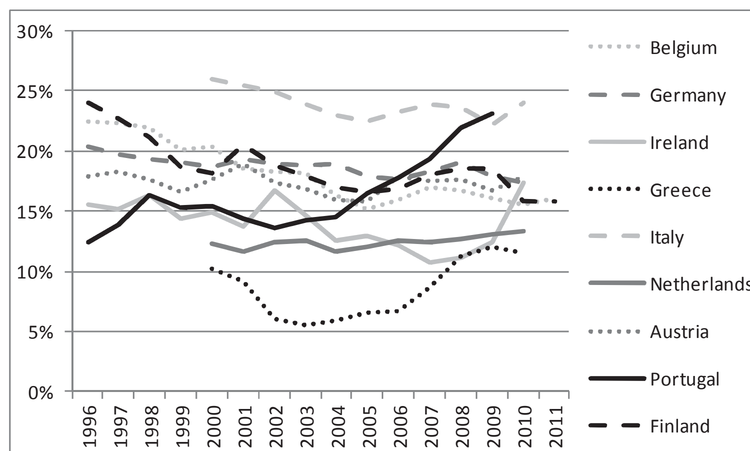
Country	Gross Value Added					Employment				
	1995	2000	2011	Δ 1995-2011	Δ 2000-2011	1995	2000	2011	Δ 1995-2011	Δ 2000-2011
Austria	22,2%	22,6%	23,9%	1,8	1,3	20,5%	18,8%	16,4%	-4,1	-2,4
Belgium	19,7%	20,5%	18,1%	-1,6	-2,3	18,6%	16,9%	13,0%	-5,6	-4,0
Germany	25,0%	24,8%	25,5%	0,4	0,7	23,3%	21,3%	18,8%	-4,5	-2,5
Spain	n.a.		16,2%	n.a.	16,2	n.a.	18,7%	12,9%	n.a.	-5,8
Finland	20,2%	23,5%	23,6%	3,4	0,1	20,8%	20,5%	16,4%	-4,4	-4,1
France	15,1%	15,5%	13,8%	-1,3	-1,7	16,9%	15,4%	12,0%	-4,9	-3,4
Greece	n.a.	13,7%	11,8%	n.a.	-1,9	n.a.	12,7%	11,1%	n.a.	-1,7
Ireland	n.a.	24,2%	32,3%	n.a.	8,1	n.a.	18,7%	13,0%	n.a.	-5,7
Italy	22,5%	21,5%	19,4%	-3,2	-2,2	23,8%	22,5%	19,4%	-4,4	-3,1
Netherlands	20,2%	18,8%	18,1%	-2,1	-0,7	14,6%	13,0%	10,4%	-4,2	-2,5
Portugal	17,9%	18,7%	17,2%	-0,7	-1,5	22,7%	20,8%	16,5%	-6,2	-4,3
UK	n.a.	19,6%	14,3%	n.a.	-5,3	n.a.	n.a.	n.a.	n.a.	n.a.
Euro Area	n.a.	21,2%	19,8%	-0,4	-1,4	n.a.	19,2%	15,8%	-4,8	-3,4

Note: The variation 1995-2011 for the euro area was obtained by the unweighted average of 11 countries.

Source: Eurostat

Concerning the investment in industry (except construction) in proportion of total investment in the period 1996-2004, Portugal occupies a bottom position in the European context, with industry representing around 15% of total investment (Figure 145). After 2004, the importance of industry in investment increases considerably, reaching 24% in 2009, which was the highest value in the nine EA countries analysed.

Figure 145 – The investment in industry (except construction) (% of total investment)



Source: Eurostat

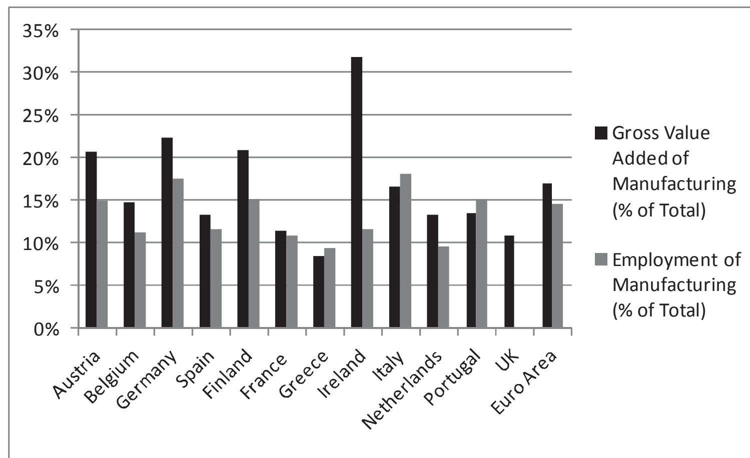
Manufacturing

The sub-sector of industry more important is manufacturing and is also the more exposed to international competition. Other industrial sectors as electricity, gas and water supply are more focused in the domestic market. That is why we are dedicating particular attention to manufacturing in this point of the text.

In 2011, the weight of manufacturing in GDP was lower in Portugal than in the EA11: 13.5% and 16.9% respectively (Figure 143). Between 2000 and 2011, the weight of manufacturing in GDP decreased 1.8 p.p. in Portugal and 0.8 p.p. in the EA (Figure 144 and Table 35). Broadly the same qualitative conclusion is reached if the analysis is done since 1995. In terms employment the fall in the importance of manufacturing was also larger in Portugal than in the EA: 4.3 p.p and 3.3 p.p., respectively (Table 35).

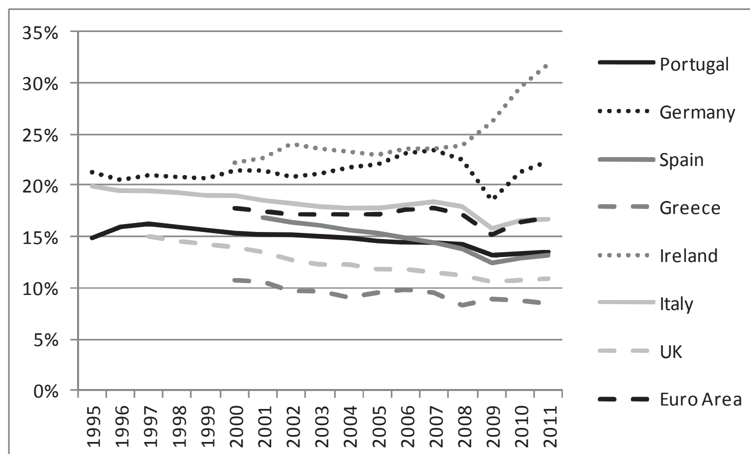
From the previous data, we conclude that the process of deindustrialisation in Portugal was more intense in manufacturing than in the overall industry (except construction). This process was also relatively stronger than in the EA.

Figure 146 – The importance of manufacturing in several countries of the EA (2011)



Source: Eurostat

Figure 147 – Evolution of the importance of manufacturing in several countries of the EA (% of GDP)



Source: Eurostat

FESSUD

This project is funded by the European Union under
the 7th Research Framework programme (theme SSH)
Grant Agreement nr 266800

Table 36 – The importance of manufacturing in several EA countries (% of GDP and employment)

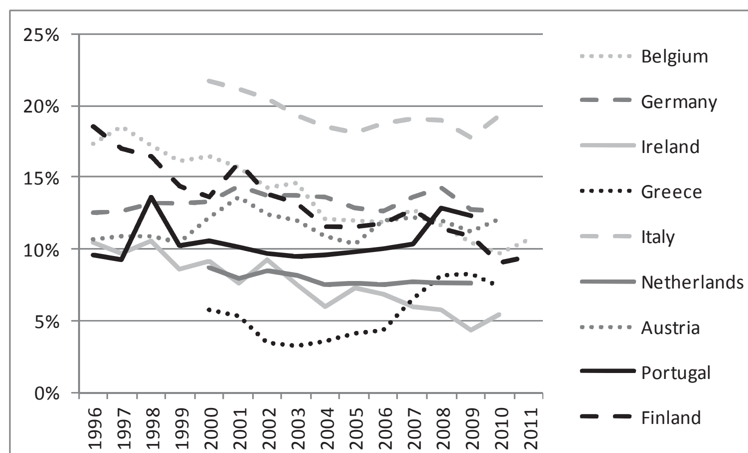
Country	Gross Value Added					Employment				
	1995	2000	2011	Δ 1995-2011	Δ 2000-2011	1995	2000	2011	Δ 1995-2011	Δ 2000-2011
Austria	18,7%	19,2%	20,6%	1,9%	1,5%	18,7%	17,4%	15,0%	-3,6%	-2,3%
Belgium	17,0%	17,4%	14,8%	-2,2%	-2,6%	16,6%	15,2%	11,3%	-5,3%	-3,9%
Germany	21,3%	21,4%	22,4%	1,1%	1,0%	21,3%	19,7%	17,5%	-3,8%	-2,2%
Spain	n.a.	n.a.	13,2%	n.a.	n.a.	n.a.	17,6%	11,6%	n.a.	-6,0%
Finland	17,2%	20,7%	20,8%	3,6%	0,1%	19,3%	19,2%	15,1%	-4,1%	-4,1%
France	12,6%	12,9%	11,5%	-1,0%	-1,4%	15,7%	14,3%	10,8%	-4,9%	-3,5%
Greece	n.a.	10,7%	8,5%	n.a.	-2,2%	n.a.	11,2%	9,4%	n.a.	-1,8%
Ireland	n.a.	22,3%	31,8%	n.a.	9,5%	n.a.	17,4%	11,5%	n.a.	-5,9%
Italy	19,9%	19,0%	16,6%	-3,3%	-2,4%	22,5%	21,2%	18,1%	-4,4%	-3,0%
Netherlands	14,2%	13,7%	13,3%	-0,9%	-0,4%	13,6%	12,1%	9,6%	-4,0%	-2,5%
Portugal	14,9%	15,4%	13,5%	-1,4%	-1,9%	21,2%	19,4%	15,1%	-6,1%	-4,3%
UK	n.a.	14,0%	10,9%	n.a.	-3,1%	n.a.	n.a.	n.a.	n.a.	n.a.
Euro Area	n.a.	17,7%	16,9%	-0,3%	-0,8%	n.a.	17,9%	14,5%	-4,5%	-3,4%

Note: The variation 1995-2011 for the euro area was obtained by the unweighted average of 11 countries.

Source: Eurostat

Concerning the investment in manufacturing as a proportion of total investment in the period 1996-2011, Portugal occupies an intermediate position in the European context, with manufacturing representing around 10% of total investment (Figure 145). This number puts Portugal below Germany and Italy, but above Austria and Netherlands. More interestingly, in Portugal we do not observe a downward trend in the importance of manufacturing in investment, as has occurred in the other European countries.

Figure 148 – The investment in manufacturing (% of total investment)



Source: Eurostat

Tradable goods sectors

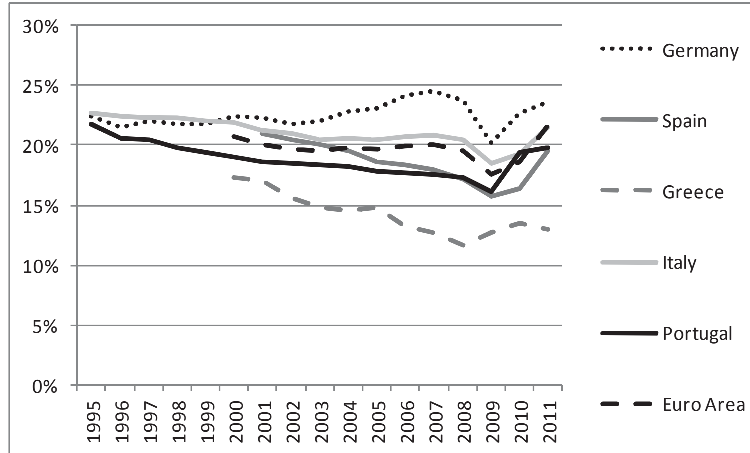
A common argument regarding the recent evolution of the Portuguese economy is that it has been concentrating on non-tradable goods sectors. But this argument ignores what has been happening in other industrialized countries. In order to assess this argument we studied how the value added of agriculture, forestry, fishing and industry (except construction, electricity and water supply) in terms of GDP has evolved in the last years. [59] The first thing that we observe is that in Portugal and the euro area non-tradable goods sectors lost importance from 2001 to 2009, but in 2010 and 2011 they re-gained relevance (Figure 149).

In 2011, the importance of non-tradable goods sectors in the Portuguese economy was slightly smaller than in the EA: 19.8% and 21.6%, respectively.

In terms of evolution, results depend on the terms of comparison. Between 2000 and 2009, the importance of non-tradable goods sectors has declined less in Portugal than in EA12 (-2.7 p.p. and -3.1 p.p., respectively), but has declined more than in the EA8[60] (-1.9 p.p). If we start the analysis in 1995, the decline in these sectors in Portugal in comparison with the EA8 is even more clear (-2 p.p. and -0.4 p.p., respectively).

[59] This analysis assumes that construction, electricity and water supply belong to the non-tradable goods sector and ignores that some services are tradable, as for example tourism.
[60] EA8 includes Austria, Belgium, Germany, Finland, France, Italy, Netherlands and Portugal. For these countries there is data since 1995.

Figure 149 – Tradable goods sectors in % of GDP



Source: Eurostat

Table 37 – The importance of tradable goods sector in several EA countries (% of GDP)

Country	Gross Value Added						
	1995	2000	2009	2011	Δ 1995-2011	Δ 2000-2009	Δ 2000-2011
Austria	20,7%	21,1%	20,8%	22,7%	2,0	-0,3	1,6
Belgium	18,2%	18,6%	15,3%	16,1%	-2,1	-3,2	-2,5
Germany	22,5%	22,4%	20,1%	23,6%	1,1	-2,3	1,2
Spain	n.a.	n.a.	15,7%	19,6%	n.a.	n.a.	n.a.
Finland	21,4%	24,1%	23,6%	24,3%	2,9	-0,6	0,2
France	15,0%	15,3%	13,6%	13,7%	-1,4	-1,6	-1,6
Greece	n.a.	17,3%	12,7%	13,0%	n.a.	-4,7	-4,3
Ireland	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Italy	22,7%	21,9%	18,5%	21,5%	-1,2	-3,4	-0,4
Netherlands	20,2%	18,8%	17,1%	17,8%	-2,3	-1,7	-1,0
Portugal	21,8%	19,0%	16,2%	19,8%	-2,0	-2,8	0,9
UK	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Euro Area	n.a.	20,7%	17,5%	21,7%	-0,4	-3,2	1,0

Note: The variation 1995-2011 for the euro area was obtained by the unweighted average of 8 countries.

Source: Eurostat

Credit and securities by sector

Attending to the decline in the importance of manufacturing in terms of value added, it is possible to raise the hypothesis that manufacturing has been less favoured in terms of financing. We obtained some support for this hypothesis with the analysis of the investment survey (Section 9.4), which shows that between 1998 and 2011 the sectors facing on average more difficulty in obtaining credit were manufacturing, construction (especially since 2004) and transportation and storage.

Now we look at how credit to non-financial corporations has grown by sector of activity. We have divided the analysis into three periods: before 2000 (1993-1999), after Portugal has joined the Euro and before the Subprime crisis (1999-2007), and after the Subprime crisis (2007-2011). The two first periods were the ones with the largest credit growth. During these two periods the sectors that had a growth of credit clearly above average were construction (only in 1993-1999), information and communication activities (only in 1993-1999), hotels and restaurants and real estate (Table 38). Manufacturing industry had clearly a credit growth below average. After the crisis, the growth of credit to construction and real estate decreased to levels below average, but hotels and restaurants and information and communication activities continued to have a flow of credit larger than other activities. In the period 2008-2011 primary activities and utilities also benefited from a large increase in credit.

Table 38 – Credit by sector (average annual growth rate)

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

Source: Bank of Portugal

In terms of the sectorial structure of credit to non-financial firms there existed a dramatic change between 1993 and 2011 (Table 39). In 1993, the sector receiving more credit was manufacturing, with 34.3% of the total credit; and the second most important sector was trade with 21.3% of credit. In 2011, the most important sectors in terms of credit were construction and real estate, with 20.3% and 13.5% of total credit, respectively.

Table 39 – Sectorial distribution of the credit to non-financial corporations

Sector	Dec-1993	Dec-1999	Dec-2007	Dec-2011
Agriculture	2,8%	1,5%	1,4%	1,8%
Mining	1,2%	0,7%	0,4%	0,4%
Manufacturing	34,3%	19,6%	12,6%	12,9%
Utilities	5,5%	2,9%	2,6%	4,3%
Construction	7,5%	17,1%	23,8%	20,3%
Trade	21,4%	20,9%	14,5%	12,9%
Transport	7,4%	5,1%	6,3%	6,9%
Hotels and Restaurants	0,2%	2,0%	3,7%	5,1%
Information and Communication	0,3%	1,7%	0,9%	1,2%
Holdings	10,3%	7,7%	9,0%	9,6%
Real Estate	3,8%	8,8%	14,7%	13,6%
Consultancy	5,2%	5,7%	7,1%	6,7%
Education and Health	0,1%	6,2%	3,1%	4,0%
Others	0,0%	0,0%	0,0%	0,1%

Source: Bank of Portugal

On a preliminary base, these numbers suggest that the banking system between 1993 and 2007 has favoured credit to construction, real estate and other non-tradable activities to detriment of credit to manufacturing. This attitude may simple be related with a smaller growth of manufacturing or with the fact that banks assess manufacturing as a high risk sector, exposed to the high competitive pressures from abroad. In addition, some banking groups had interests in non-tradable activities, such as real estate and health. [61] The high volume of credit to real estate and construction activities can also be related to the perceived high security that banks attribute to the collateral constituted by real estate assets. As in many countries, in Portugal the price of houses had been growing at a stable rate for a long time, offering a sense of security to banks.

Looking at the issuing of securities (shares and debt) by sector, it stands out that the sector issuing the largest amount is by far financial activities and insurance with 60.2% of the total amount of securities of the private sector

[61] Banks are interest in the health sector namely because of the connection of this sector with the insurance sector.

(Table 40). Utilities, transport and manufacturing are the next sectors in terms of importance, even though they have a very small proportion of total securities: the three sectors together represent less than 13%. Construction and Real state, which were sectors very important in terms of credit, have a very small representation in terms of securities (3% both). Finally, holding companies represent 18.9% of the amount of securities. It is worth mentioning that the importance of manufacturing industry in the total amount of securities outstanding has fallen from 17.0% in 1993 to 3.5% in 2011[62].

Table 40 – Securities (shares and debt) outstanding by sector (excluding the public sector)

Sector	Dec-1993	Dec-1999	Dec-2007	Dec-2011
Agriculture	0.5%	0.2%	0.2%	0.2%
Mining	0.5%	0.2%	0.1%	0.1%
Manufacturing	17.1%	6.3%	3.9%	3.5%
Utilities	4.1%	8.5%	7.8%	5.0%
Water Captation and Distribution	0.1%	0.2%	0.2%	0.2%
Construction	3.9%	1.8%	2.0%	1.9%
Trade	3.4%	1.5%	2.1%	1.9%
Transport	5.3%	2.7%	4.0%	2.3%
Hotels and Restaurants	1.4%	0.6%	0.4%	0.4%
Information and Communication	2.0%	9.5%	1.6%	1.7%
Financial	41.1%	46.8%	50.6%	60.3%
Real Estate	3.3%	1.2%	1.3%	1.1%
Consultancy	0.7%	0.9%	1.2%	1.9%
Education	0.0%	0.0%	0.0%	0.0%
Health	0.1%	0.1%	0.1%	0.1%
Non-Financial Holdings	13.8%	18.7%	24.0%	18.9%
Others	2.7%	0.9%	0.6%	0.5%

Source: Bank of Portugal

10.3. Concluding remarks

In this section we started by assessing the role of banks in the reconstruction of the economy, which was not an easy task due to the lack of data. The volume of M&A in Portugal is similar to the European average, but is larger than in

[62] Notice that holding companies may in reality include firms operating in other sectors.

countries like Spain and Italy. This may relate to the small dimension of the economy which facilitates foreign acquisitions. However, since 2003 the demand for bank credit to finance M&A was smaller in Portugal than in the EA. Yet, banks have played a key role in the advising operations. On the other hand, VC buyout activity is less intense in Portugal than in other countries of the EA.

In the recent past, M&A activity between Portugal and the Rest of the World, especially emerging markets has increased considerably. Firms based in emerging markets, especially Angola and Brazil, and more recently China, have made investments in listed companies.

Some large Portuguese firms have also invested in foreign countries, especially Brazil, Turkey and Poland, to take advantage of fast growth markets. Many of the large companies following internationalization strategies belong to non-tradable sectors, as for example Banks, Utilities (ex: EDP), Petrol companies (ex: Galp), Infrastructure companies (Ex: Brisa) and Trade companies (ex: Jeronimo Martins). As a result a large share of profits of many quoted firms comes from abroad.

Since 1995, manufacturing has lost importance in terms of value added, with the fall being larger in Portugal than in the EA. In 2011, manufacturing was less important in Portugal than in the EA. In terms of the weight of investment in manufacturing the situation was better, with investment being at an intermediate position in European terms in 2008-9, even though before 2008 the level was smaller than the average. Also, Portugal was able to maintain the investment in manufacturing, while in other countries there was a decline.

In 2011, tradable goods sectors were slightly less important in Portugal than in the EA. Since 1995 the decline on the weight of those sectors on the economy was stronger in Portugal than in the EA8, showing the concentration of the economy on non-tradable activities.

Between 1993 and 2007 the banking sector favoured credit to construction, real estate and other non-tradable activities, while the credit to manufacturing grew at much slower rates. The issue of securities, which is an alternative to bank credit, was completely dominated by the financial sector (with a weight of 60.3% in 2011), which has increased its importance since 1993.

11. The process of privatization [63]

Like many other countries, Portugal went through a comprehensive process of privatization which started in the middle 1980s and is still unfinished. Even though privatizations were a common trend in many countries during this period, the extent of this process in Portugal was outstanding. The reason for this goes back to the Portuguese revolution of 1974. In the course of the revolutionary process, vast domains of the economic activity were nationalized, both as a result of the ideological orientation of the provisory government and the perception of the risk of economic sabotage by part of prevailing business and financial interests (which were largely at odds with the regime change).

Banking and insurance were the first sectors of activity to be massively nationalized in the post-revolutionary period. In early 1975 all credit institutions, savings banks and mutual agricultural credit banks, with the exception of institutions with foreign capital participation, became State-owned. In the same vein, all insurance companies were nationalized, with the exception of those that were to some extent foreign owned and mutual insurance entities. In the following months, nationalizations were extended to several other activities, including electricity, gas, water infrastructure, transports and transport infrastructure (rail, sea, air, and road), basic industries (petrol, chemicals, basic metallurgy, cement, pulp, mining, ship building, tobacco, etc.), among others. The Portuguese Constitution which was approved in 1976 declared the recent nationalizations as irreversible – a situation which would only be inverted in 1989.

Although some partial privatizations had already taken place since the middle 1980, the 1989 changes in the Constitution marked the beginning of the privatization process in full blown. The extent and rapid pace of this process is

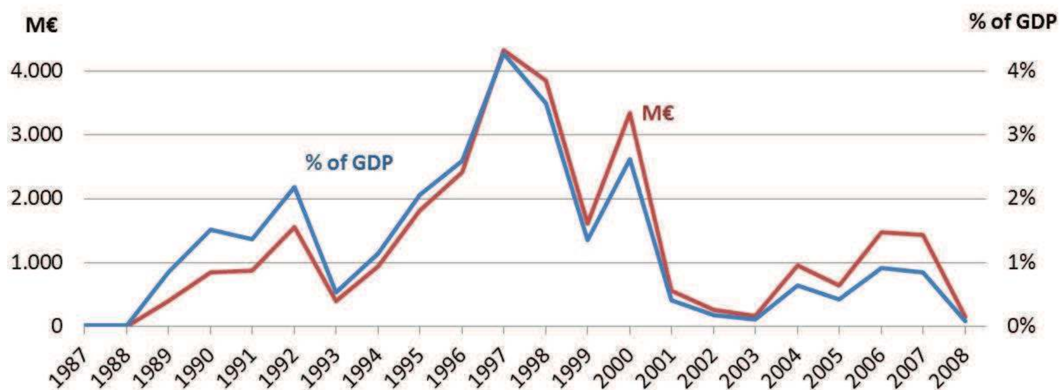
---

[63] Point 12 of the Terms of Reference.

easily grasped in figures: in 1988, state-owned firms represented approximately 1/5 of the GDP and 1/15 of total employment; in 1995 such figures had dropped to 1/10 and 1/30 in 1995, respectively, and in 2000 to 1/20 and 1/50.

The post-1989 privatization process in Portugal can be broadly divided in three periods: 1989-1993; 1994-1999; and after 2000. These periods differ with respect to the volume, main drivers and implications of privatizations, as well as the main sectors being privatized.

Figure 150 – Privatizations by year (in M€ and in percentage of GDP, current prices)



Sources: Ministry of Finance and AMECO

Portugal had since 1985 a conservative government (holding a single-party majority in Parliament since 1987), which was largely inspired by the Thatcher government in the UK. According to the ruling party's program, reducing the role of the State, together with the development of the capital markets, were crucial ingredients for promoting the modernization and competitiveness of the Portuguese economy.

Notwithstanding its liberalizing stand, the Government was concerned with keeping the control of the privatized firms in national hands. However, large

national business or financial groups were virtually absent, and until the early 1990s the stock market played a residual role in the Portuguese financial system and in the investment decisions of both households and firms. Therefore, the success of the privatization program, according to the Government's goals, implied advancing by steps, starting with fostering the development of national, private-owned financial groups, as well as increasing the attraction of national investors (both firms and households) to the stock market.[64]

Thus, the first phase of the privatization process in Portugal was dominated by changes in ownership of financial firms. Before the end of 1993, almost all State-owned banks and insurance companies (representing nearly 80% of the financial sector) were privatized, with the exception of the CGD group (one of the main financial groups, which remained in public hands until the present day) and a few banks which would be privatized in the following years. Concurrently, the financial sector was liberalized in accordance with EEC's single market program, even though limits were imposed to the participation of foreign investors in the privatized firms (typically, to a maximum of 25% of the capital).

The EMS crisis of 1992-3, the impacts of which were amplified in the Portuguese economy by the rapid liberalization of the capital account (see chapter 1), put the privatization program on hold. On one hand, the crisis caused a strong decrease in the expected revenues of the program, leading the postponement of several planned sales. On the other hand, the goal of boosting the participation of households and non-financial firms in the stock market was jeopardized by the volatility in stock prices. The 1987's New York Stock Market

[64] The appeal to 'popular capitalism' in the context of the privatization program served also the purpose of increasing the popular support to what was by then a somewhat a politically controversial option.

crash was still fresh in the investors' minds, and bank deposits were by then considered a safer haven for both households' and firms' savings.

From 1994 onwards, several factors contributed to accelerate the privatization program. First, the economic recovery implied brighter prospects for selling State-owned firms at good market prices. Moreover, the increased macroeconomic and monetary stability (which was a top policy priority in the context of the EMU project – see chapter 1) translated into significant drops in real interest rates, pulling savers away from bank deposits to riskier assets (namely stocks). The newly privatized (or recently created) banks were then willing to get actively involved in privatizations as part of their diversification and growing strategies. Last but not least, the need to comply with the so-called Maastricht criteria in order to participate in the EMU created additional incentives for the Government to raise revenues through the selling of State-owned firms (which were then largely channeled into public debt redemption).

Thus, the second half of the 1990s witnessed the zenith of the privatization program in Portugal. During this period, the control of many of the most important Portuguese firms was transferred to private hands, including: EDP (electricity), Petrogal (oil refining), Brisa (highways), PT (telecommunications), Cimpor and Secil (cement), Siderurgia Nacional (steel), Quimigal (chemicals), CNP (petrochemicals), and Tabaqueira (Tobacco).

In many cases, while maintaining only a minor position in the capital, the Portuguese State retained its capacity to influence the decision of the privatized firms by holding special voting rights ('golden shares') in the election of the Board of Directors and in other strategic decisions. Such 'golden shares' were always a focus of tension with the EC authorities, since they conflicted with the principle of free capital movements in the EU, but while they prevailed (i.e., until recently) they were effective in helping to maintain the control of such firms in national hands. In particular, by reducing the interest of foreign investors, the

'golden shares' held by the Portuguese State were instrumental for strengthening the position of Portuguese financial groups in the recently privatized firms.

As mentioned before, the goal of maintaining the control of privatized firms in national hands was also pursued through a strong appeal for the participation of small investors in the privatization program. In order to overcome the risk aversion of such investors, the privatization program provided more favorable conditions for small investors to buy shares in privatized companies. Together with the substantial drop in real interest rates, this led to a huge increase in the involvement of households and non-financial firms in stock market transactions, gradually increasing the propensity for financial risk-taking among those segments of the financial system. As Lopes (1996) put it, small investors were anxious to make capital gains from short-term transaction, but few have established themselves as long-term investors.

By 2000 the State-owned enterprise sector in Portuguese had been substantially reduced. However, some relevant assets were still (in whole or in part) in State hands, including: CGD (bank and insurance), EDP (electricity), GALP (oil distribution), TAP (air transport), ANA (airports), CP (railways), RDP (radio), RTP (television) and CTT (post), among others.

In the first years of the new millennium, the pace of privatization was reduced, not only because the greatest part of the program was by then completed, but also due to the unfavorable economic context. As the performance of the Portuguese economy improved after 2005, the privatization program has regaining momentum, but it came to a halt with the advent of the international crisis in 2008. A new wave of privatizations is presently planned in the context of the adjustment program associated with the international loan obtained in 2011, as part of the strategy to reduce the high levels of public debt.

It is difficult to make an overall assessment of the privatization process in Portugal. The immediate impact of the privatization program in the development of the Portuguese stock market – one of the declared goals of the program – is clear. In 1996, privatized companies accounted for over 40% of market capitalization in shares and over 50% of the transaction turnover (Corkill, 1999). One can, therefore, conclude that the Portuguese stock market has benefited from the privatization program – even though this was not enough to transform it into a significant source of finance in the Portuguese enterprise sector. Arguably, the privatization program has contributed to the indebtedness of Portuguese firms and households, many of which have recurred to credit to acquire shares.

Privatizations were also relevant for reducing the Portuguese public debt ratio in the year that preceded the inception of the euro, helping to comply with the conditions for participating in the euro zone from the beginning.

The impact of privatization on the performance of privatized firms is less clear. On one hand, while many of the privatized firms have thrived, other have shrunk or even disappeared. On the other hand, the most important privatized firms operate in highly regulated markets, making it hard to distinguish between the effects of privatization and of regulatory practices on firms' performance.

12. Culture, inequality, and households finance [65]

This section focuses on the cultural and social issues and their relation with the country's economic growth. In Section 12.1 we study the cultural characteristics of the typical Portuguese and the institutions, looking how they may have a negative effect on economic performance. In Section 12.2 we quantify the contribution of non-for-profit organization for economic activity, in an attempt to assess the erosion of the culture of solidarity. Next, Section 12.3 studies how the financialisation of the health services has evolved. Finally, Section 12.4 looks at the emergence of a culture of consumption based on credit by reviewing the evidence on the growth of credit for consumption.

12.1. Cultural and institutional aspects

The economic performance of a country is also affected by its culture. Some authors venture into attributing the perils of the Portuguese economy to 'cultural idiosyncrasies', such as (Bento, 2009): the individualistic stance and unwillingness to cooperate, lack of confidence and persistence, disorganization, resignation, and jealousy. These characteristics overshadow the adventurous spirit that characterized the Portuguese during the Age of Discoveries in the fifteenth and sixteenth centuries.

Those cultural features are supposed to have contributed to a poor dynamism of the Portuguese production system, as entrepreneurs fear to face new risks and challenges and show lack of spirit of initiative. This would affect innovation and productivity, with negative effects on economic growth.

This type of accounts suggest that relying on the State is one way found by the Portuguese businessman to avoid risk taking, a feature some associate with the

[65] Point 8 of the Terms of Reference.

legacy of the period of dictatorship (1926-1974). Then, the State played an important economic role in eliminating competition and innovation, erecting protectionist barriers and introducing regulatory red tape. The strong State protectionism before the 1974 Revolution may be seen as a cause for the absence of entrepreneurial spirit still today, since cultural characteristics take time to change.

Madureira (2002) highlights that the period of dictatorship between 1933 and 1974, supported by a corporativism system, delayed the development of many industries, namely through the *Condicionamento Industrial* imposed by the Decree-Law 19354/1931. This regulatory framework, even though respecting the private initiative, impeded real competition between firms, representing a strong protectionist framework, causing technological stagnation, creation of monopolies and deterioration of the quality of goods and services manufactured and sold.

More recently, according to Corkill (1999), in Portugal, like in other European countries, State aid has been used to protect national industries from the competitive pressure resulting from globalization and the European single market. In some parts of the Portuguese economy, the State is still thought as the main driver of economic activity, with the private sector depending on State subsidies and European funds to survive and do investments.

After the 1974 Revolution, Portuguese public institutions faced an important process of modernization, indispensable to the functioning of a market economy and to the values of democracy. Later, the process of integration into European markets accelerated the restructuring of public institutions, in order to manage the several programs and projects financed by European Union funds. Despite this evolution, excessive bureaucracy and inefficiency is still present in the Portuguese State. Some governments have been accused of manipulating European Union funds and State resources and of appointing a

huge number of public administrators with high remunerations based on political criteria. The inefficiency does not come from the lack of civil servants, that some even think have reached large numbers (Corkill, 1999). The malfunctioning of the State bureaucracy is probably related with mismanagement associated with the lack of qualified staff, under allocation of resources (ex.: technological resources), and the predominance of private over public interests on some occasions.

One way used to increase the efficiency of public bureaucracy was to introduce incentive and evaluation schemes similar to private firms. The real efficacy of such reforms is still to be assessed, since they have been implemented recently. Anyway, it should be taken into consideration that the introduction of incentives may crowd-out morality. That is where reforms of public administration should support socially valued outcomes and cultivate public spirit motives (Gintis et al 2005:4).

Regarding the "culture" of public policy, we observe a tendency for the affirmation of a neoliberal vision. Despite the 2008 financial crisis, the inclination of policy makers has been to assume that the market is the most efficient mechanism for affecting resources. The State should not intervene directly on resource allocation; it should only correct market failures. As a result the State should ensure the free functioning of the market, deregulating, privatising and increasing labour market flexibility.

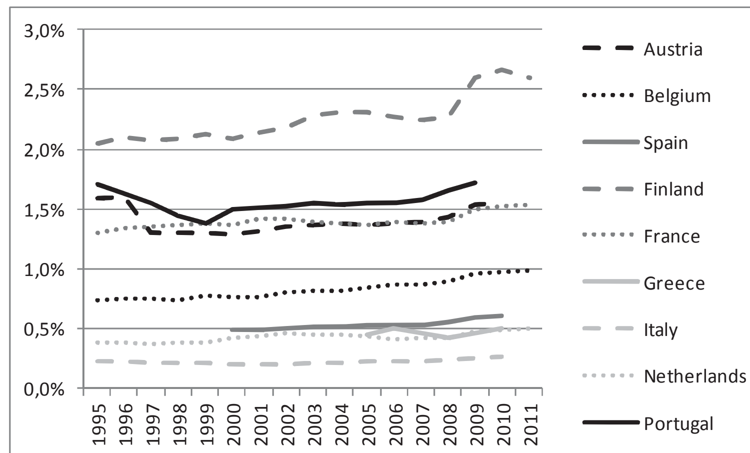
Regarding the all set of Portuguese institutional and legal framework, Garoupa and Rossi (2005) conclude that it has been quite mediocre, not favouring the process of economic growth and development. Portuguese institutions do not favour economic competitiveness when compared with institutions in other European advanced countries. They also point the existence of pressure groups that act as a barrier to the progress and public interest.

Those authors highlight four weaknesses of the Portuguese legal environment: the quality of laws, the regulation related to the entry of new corporations, the regulation of financial markets and the regulation of labour market. In any of these four cases, they note a higher level of inefficiency of the Portuguese institutional and legal framework in relation to other countries. Nonetheless, they recognize a positive evolution of the legal framework in Portugal in the last century, through the adoption of structural reforms, mainly after the integration within the European single market.

12.2. Non-Profit Institutions

Traditionally the Social State has been weak in Portugal, leading to the emergence of private non-for-profit social institutions. This explains why between 1995 and 2011, the importance of non-profit institutions serving households as a percentage of GDP has been higher in Portugal than in other European countries, with the exception of Finland (Figure 151). Moreover, this importance has been increasing in Portugal since the beginning of the 2000s, accompanying the upward trend seen in most European countries. These data indicate that civil society in Portugal has been able to organize non-profit institutions to serve households to a larger extend than the EA average and much more than other Southern countries.

Figure 151 – Gross value added of non-profit institutions serving households (% of total gross value added)



Source: OECD

12.3. The health sector and private interests

Many of the non-for-profit institutions act in the health sector. In Portugal, there is a public health system financed mainly by general taxation and organized as a National Health Service (NHS) with universal coverage both in terms of population and range of medical care. The NHS is a fundamental component of the welfare state.

The sustainability of NHS is compromised by the population ageing, which causes an upward trend of the spending on health. Campos (2008) indicates that the total expenditure on health (public and private) as a percentage of GDP has grown substantially, from 6.2% of GDP in 1990 to 10.2% of GDP in 2003, a trend that probably will continue in next years. Moreover, Barros (2008) adds that health expenditure in Portugal, as measured either in per capita terms or as a share of GDP, has grown faster than in OECD countries, mainly since 1995.

Besides the general increase in health care costs, the participation of the State in the funding of the health care system has increased. Campos (2008) states that public spending in healthcare percentage of total expenditures has

increased from 65.5%, in 1990, to 73% in 2005. The increasing financial effort made by the Government may not be sustainable especially in a context of economic slowdown, falling public revenues and increasing pressures towards fiscal consolidation.

In an effort to cut costs, the health sector has suffered a set of reforms in the last years. Some of them include the promotion of generic drugs prescription, the establishment of public-private partnerships for construction and clinical operations of new hospitals, change in the statutes of state-owned hospitals, the creation of an independent regulation authority for the health sector, the imposition of user fees, and the reorganization of health subsystems.

The establishment of public-private partnerships (PPP) was introduced by the Decree-Law 185/2002 dated August 20. In theory PPP can be divided in two types of programmes. In the first wave PPP the partnership includes the construction and maintenance of the infrastructure, as well as their management. The second wave PPP covers only the construction and maintenance of the infrastructure. The Portuguese government has always chosen the first type of PPP, with the exception of *Hospital Oriental de Lisboa* and *Hospital Central do Algarve*.

At the same time, the health sector has aroused the interest of private enterprises, including financial groups, which provide medical services, like private health insurances for their employees and customers and own clinics and hospitals. Recently, new private medical units have appeared, as for example *Hospital das Descobertas*, *Hospital da Luz*, *Hospital dos Lusíadas*, *Hospital da Boavista*, *Hospital do Algarve*, *Hospital de Cascais*. These units increased the offer of beds, operating and delivering rooms, among other things.

In addition, the largest financial groups in Portugal offer health insurance for their employees and customers: CGD Group offers Multicare, BCP Group offers

Médis, BES Group offers AdvanceCare, etc. The owners of these health insurances use the services of the private hospitals referred to above. Despite the existence of a public health service, the demand of private health insurances exist for reasons of easier access and (supposed) higher quality of medical services.

This increasing role of private enterprises and PPP on the Portuguese health sector has social and economic implications. First of all, this process has only benefited the population of the coast, of the main urban centres (Porto, Lisbon and Faro) and with medium and high incomes. Secondly, this has led to the transfer of a large number of professionals from the public to the private sector. Finally, it is important to note that the use of PPP alleviates the current financial pressure on the public budget, notwithstanding transferring the cost into future periods and generations.

In the typical PPP operation, there is a private firm responsible for the finance, construction and management of the infrastructure. Banks finance the operation and the leading firm of the partnership may also belong to a banking group. The State pays over a set of years a rent to the private firm in exchange for the construction and management of the hospital. In conclusion, PPP seem to be a profitable business for banks.

Despite the presence of these significant private providers, most health care in Portugal is still ensured directly by the NHS, whose survival needs to be ensured in the future. Barros (2008) warns that financial pressures over the NHS will not be alleviated in the coming years and additional tax effort will be required to cover the increasing public health expenditure.

The increasing penetration of markets in the health sector and in other sectors formerly in the sphere of the State may affect the values of individuals (Bowles, 1998). The prevalence of market institutions may change the behaviour of

individuals towards more market-oriented values, as a larger emphasis on competition with other individuals and less tendency towards solidarity.

12.4. Growth of credit to consumption

In some countries there has been a tendency for debt-led consumption, where the stagnation in wages pushes households to increase debt in order to sustain consumption. Before the 2008 Subprime crisis, in the USA poor households were gained access to credit to compensate for falling real wages.

In Portugal, the liberalization of the banking market and the euro membership reduced liquidity constraints on consumers. They used the wave of credit more to buy houses than for consumption, and consequently there was not a large growth of credit for consumption. Since 1980, the credit for consumption has increased at a slower rate than the credit for housing. Also, in 2011, around 80% of the credit to households was for buying houses. However, this figure understates the true importance of credit for consumption, since a part of the credit for housing was used for consumption (see Section 8.4).

Our reading of the Portuguese reality indicates that the credit for consumption given by banks was mainly to the middle class, not to the poor. But poor households may have had easier access to credit from non-banking institutions, where the screening process was weaker and interest rates charged were higher.

12.5. Concluding remarks

Portugal presents some cultural characteristics with negative effects on economic growth, namely unwillingness to cooperate, disorganization and fear to face risk. In addition to this, the history of the country before 1974, where the State did not promote competition between firms, also contributed to the fact

that businessman over rely on the State. In the present, public administration is still too bureaucratic and inefficient, and political criteria prevail on the management of civil servants, despite the affirmation of a pro-market culture in policy making in the last decade. Also, in the private sector there is a lack of a culture that values performance. In general, Portuguese institutions, legal framework, regulation and pressure groups do not favour economic growth.

A positive point of the Portuguese society and economy is that not-for-profit institutions are more important than in the EA, with a tendency to grow. Another positive point is the existence of a NHS offering quality services to all population. Public expense in health increased considerably due to population ageing and increase in service's quality. Mainly in result of the pressure to reduce the fiscal deficit after the crisis, a rationalization effort has been made on the NHS to reduce expenses.

Taking advantage of the NHS's weak points, private interest have been growing in the health sector, with the opening up new private hospitals and clinics, an increase in health insurances and the creation of PPP. These partnerships for the construction and management of hospitals benefit banking groups, because they finance the operation and sometimes manage the hospital. For the State, it is still to be proved if PPP in the health sector is a good choice in the medium and long term.

The NHS is an important factor to avoid social exclusion. Another type of exclusion is financial exclusion. In 2010 there were still 9% of adults without access to a bank account. Also, credit was distributed asymmetrically among families. The average banking client presents limited rationality in his investment and credit decisions, being very affected by the advice of banks when choosing banking products. Therefore, banks may bear some responsibility for the increase of households' indebtedness.

A more general analysis of poverty and inequality indicators allows us to conclude that in 2010 Portugal was one of the most unequal countries of the EU15 and with one of the highest poverty rates, but the situation has improved on both dimensions since 2000.

13. Inequality, poverty and financialisation[66]

This section relates inequality and poverty with financialisation. The first sub-section studies financial inclusion in terms of payment systems and credit, looking also at the way persons are able to make sound financial decisions. The second sub-section assesses the evolution of poverty and inequality in Portugal in recent years.

13.1. Financial inclusion

The non-for-profit institutions and the NHS serve households, being particularly important for poor and socially excluded people. Social exclusion may also manifest itself in terms of financial exclusion, in the sense that a person does not have access to basic financial services that facilitate and allow key daily operations. Despite the strong increase in the indebtedness of households, a representative survey shows that 11% of those interviewed over 15 years old do not have a bank account. Among the individuals with a bank account, only 29% has a mortgage loan and 32% a credit card (Bank of Portugal, 2011b). Moreover, based on the database IPEF (*Inquérito ao Património e Endividamento das Famílias*), Antão et al (2009:504) indicates that 40% of the Portuguese households have debts and 30% have mortgages.

According to the ECB (2009) the share of *all* households with a mortgage was 29.6% in Portugal (in 2006) and 20% in the Euro area (in 2005). Among the countries with available data, on this point Portugal was only exceeded by Ireland and the Netherlands.

Using the Global Financial Inclusion Database for 2011 (Demirguc-Kunt and Klapper, 2012), we can evaluate bank account penetration in an EA perspective

---

[66] Point 13 of the Terms of Reference.

(Table 41). The percentage of population with 15 or more years with an account in a formal financial institution is small in Portugal (81%), only higher than in Greece (78%) and Italy (71%). If the analysis is restricted to the poorest income quintile, the picture is even worse, with only 64% of the individuals having a banking account, which is the second lowest value in the EA only better than Italy (61%).

Regarding credit, family and friends stand out as an important source of new loans in Portugal, as expected by the tight family bounds that characterize Southern societies. New loans from that source represent 88% of the loans from formal financial institutions, representing a high value in European terms.

Finally, the penetration of credit cards is also low in Portugal, with only 30% of the adults declaring to have a credit card. Only Greece with a penetration rate of 17%, has a lower value on that indicator. Across all indicators of financial inclusion, Portugal, Greece and Italy stand out as a group with distinctive characteristics of low penetration of financial services.

In Portugal, the evidence presented shows that the use of credit and financial services is not as widespread as expected based on the aggregate figures of household indebtedness and on the development of the banking sector. This suggests also, as confirmed by Antão et al (2009: 498), that debts are distributed asymmetrically among families, with a relatively small fraction of households having a large proportion of the overall debt.

Table 41 - Indicators of financial inclusion 2011

Country	Share with an account at a formal financial institution (%)		Adults originating a new loan in the past year (%)			Adults with a credit card (%)
	All adults	Poorest income quintile	From a formal financial institution (1)	From family and friends (2)	((2)/(1))*100	
Belgium	96	92	11	5	45.5	54
Germany	98	97	13	9	69.2	36
Ireland	94	88	16	11	68.8	56
Greece	78	75	8	20	250.0	17
Spain	93	91	11	12	109.1	42
France	97	96	19	5	26.3	38
Italy	71	61	5	3	60.0	31
Netherlands	99	98	13	7	53.8	41
Austria	97	93	8	6	75.0	39
Portugal	81	64	8	7	87.5	30
Finland	100	99	24	15	62.5	64

Source: Global Financial Inclusion Database for 2011 (Demirguc-Kunt and Klapper, 2012)

The survey on financial inclusion from the Bank of Portugal allows other interesting conclusions. Around 54% of individuals say that what led them to choose banking products (saving or credit) they own was the advice received at the bank counter. From here we can infer that probably banks had some responsibility in the increase of households' indebtedness.

That responsibility becomes even clearer when there are signs of limited rationality on banks' clients. For example only 39% say they know the value of their mortgage loan's spread and 40% do not compare interest rates among banks before doing a credit (Bank of Portugal, 2011b). These figures indicate a low level of financial education, which we suggest is linked to the low levels of general education of the Portuguese population.

13.2. Poverty and inequality

One characteristic of financialisation processes is that they are associated with increasing inequality. At a European level, a set of factors challenged the European Social model (ESM) in the early 2000s, namely globalization, Europe's slow economic growth, and the ageing of population (Marques, Salavisa e Lagoa, 2012).

The impact of globalization occurs at three levels. Firstly, tax competition between countries to attract FDI has increased due to larger international mobility of capital. This creates a pressure on the ESM as social policies are financed by general taxation. Secondly, the weight of multinationals and in general the larger mobility of firms has weakened union power. In addition, trade and capital market liberalization have also reinforced the ideological opposition to the welfare state.

Regarding economic growth, there were several signs of Europe's decline, as it has been lagging behind its main competitor, the US, and lately had not been able to compete with the economic dynamism of emerging countries (mainly India and China).

As for ageing, there were significant demographic shifts in Europe since the 1970s. People live longer, mortality rates are decreasing, and fecundity rates have been falling. Indeed, the current fertility rate is low (1.5 children for EU-25) and significantly below the replacement rate of 2.1 (Commission, 2006, p.3).

Given this general background, we now analyse social cohesion in Portugal by looking at two main indicators: the at-risk-of-poverty rate after social transfers (referred to as 'poverty rate'), and inequality of income distribution.

Table 42 shows the evolution of poverty rate after social transfers[67]. In 2010, Portugal was one of the countries with 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 EU15 (Hall and Soskice, 2001). In terms of evolution between 2000 and 2010, Portugal has 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 EU15.

Table 42 - At-Risk-of-Poverty Rate After Social Transfers, 2000-10 (%)

Country	2000	2005	2008	2010	Change 2000-2010
EU-15	15	15.8	16.2	16.3	1.3
Belgium	13	14.8	14.7	14.6	1.6
Denmark	10	11.8	11.8	13.3	3.3
Germany	10	12.2	15.2	15.6	5.6
Ireland	20	19.7	15	16.1	–3.9
Greece	20	19.6	19.7	20.1	0.1
Spain	18	19.7	19.5	20.7	2.7
France	16	13	12.9	13.5	–2.5
Italy	18	18.9	18.4	18.2	0.2
Luxembourg	12	13.7	13.4	14.5	2,5
Netherlands	11	10.7	10.5	10.3	–0,7
Austria	12	12.3	12.4	12.1	0.1
Portugal	21	19.4	18.5	17.9	–3.1

[67] 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).

Finland	11	11.7	13.6	13.1	2.1
Sweden	9	9.5	12.2	12.9	3.9
United Kingdom	19	19	18.7	17.1	−1.9

Source: Eurostat, European Union Statistics on Income and Living Conditions (EU-SILC)

Note: 2000 data refer to the year 2001 for Sweden and Denmark

By looking at the percentage of people at-risk-of-poverty before and after social transfers, we conclude that the reason why Portugal is better than Italy and Greece in terms of poverty after social transfers is related to the ability of the social state to bring more people out poverty (Table 43). However, the capacity of the State to take people out of poverty in Portugal is still below what occurs in other European developed countries.

Table 43 - Comparing At-Risk-of-Poverty Rate After and Before Social Transfers, 2000-10 (%)

Country	Before social transfers		After social transfers		After social transfers minus before social transfers	
	2000	2010	2000	2010	2000	2010
EU-15	23	26.1	15	16.2	-8	-9.9
Belgium	23	26.7	13	14.6	-10	-12.1
Denmark	29	29.1	10	13.3	-19	-15.8
Germany	20	24.2	10	15.6	-10	-8.6

Ireland	31	40.4	20	16.1	-11	-24.3
Greece	22	23.8	20	20.1	-2	-3.7
Spain	22	28.1	18	20.7	-4	-7.4
France	24	25.2	16	13.3	-8	-11.9
Italy	21	23.3	18	18.2	-3	-5.1
Luxembourg	23	29.1	12	14.5	-11	-14.6
Netherlands	22	21.1	11	10.3	-11	-10.8
Austria	22	24.1	12	12.1	-10	-12
Portugal	**27**	**26.4**	**21**	**17.9**	**-6**	**-8.5**
Finland	19	27.0	11	13.1	-8	-13.9
Sweden	17	26.7	9	12.9	-8	-13.8
United Kingdom	29	31.0	19	17.1	-10	-13.9

Source: Eurostat, EU-SILC.

Note: 2000 data refer to the year 2001 for Sweden and Denmark

It can be argued that the poverty rate is unable to capture important aspects of social cohesion. A more complete indicator created for Europe 2020 strategy is the at-risk-of-poverty *and social exclusion*[68], which combines three indicators: people living in households with very low work intensity, people at-risk-of-poverty after social transfers, and severely materially deprived people. In 2010, the relative position of Portugal on that indicator remains almost the same as for the simpler indicator of at-risk-of-poverty, with the difference that Italy is slightly better than Portugal in this indicator.

[68] Eurostat, EU-SILC.

Table 44 – At-risk-of-poverty and social exclusion

Country	At-risk-of-poverty and social exclusion	
	2005	2010
EU15	21.5	21.7
Belgium	22.6	20.8
Denmark	17.2	18.3
Germany	18.4	19.7
Ireland	25.0	29.9
Greece	29.4	27.7
Spain	23.4	25.5
France	18.9	19.2
Italy	25.0	24.5
Luxembourg	17.3	17.1
Netherlands	16.7	15.1
Austria	16.8	16.6
Portugal	26.1	25.3
Finland	17.2	16.9
Sweden	14.4	15.0
UK	24.8	23.1

Source: Eurostat

The observation of the inequality of income distribution[69] reveals that Portugal is the second most unequal country of the EU15, only bettered than Spain. In 2010, the indicator of inequality was 5.6 in Portugal and 5 in the EU15. Notice that the inequality of income was larger in Portugal than in the liberal economy of the UK. Nevertheless, the evolution between 2000 and 2010 was very positive

[69] Inequality is measured as the ratio of total income received by the top quintile to that received by the lowest quintile.

in Portugal, since it was the country where the inequality indicator has decreased most (-0.8 p.p.), while in the EU15 there was an increase of inequality (+0.5 p.p.).

Table 45 - Inequality of Income Distribution (2000-10)

Country	2000	2005	2008	2010	Change 2000-2010
EU-15	4.5	4.8	4.9	5.0	0.5
Belgium	4.3	4.0	4.1	3.9	– 0.4
Denmark	3	3.5	3.6	4.4	1.4
Germany	3.5	3.8	4.8	4.5	1
Ireland	4.7	5.0	4.4	5.3	0.6
Greece	5.8	5.8	5.9	5.6	– 0.2
Spain	5.4	5.5	5.4	6.9	1.5
France	4.2	4.0	4.4	4.5	0.3
Italy	4.8	5.6	5.1	5.2	0.4
Luxembourg	3.7	3.9	4.1	4.1	0.4
Netherlands	4.1	4.0	4.0	3.7	0.4
Austria	3.4	3.8	3.7	3.7	0.3
Portugal	6.4	7.0	6.1	5.6	– 0.8
Finland	3.3	3.6	3.8	3.6	0.3
Sweden	3.4	3.3	3.5	3.5	0.1
United Kingdom	5.2	5.9	5.6	5.4	0.2

Source: Eurostat, EU-SILC.

Note: 2000 data refer to the year 2001 for Sweden and Denmark

In conclusion, the preceding analysis allows us to conclude that in 2010 Portugal was one of the most unequal countries of the EU15 and with one of the highest poverty rate, but the situation has improved on both dimensions since 2000.

13.3. Concluding remarks

An important dimension of social exclusion is financial exclusion. In 2010 there were still 9% of adults without access to a bank account. Also, credit was distributed asymmetrically among families. The average banking client presents limited rationality in his investment and credit decisions, being very affected by the advice of banks when choosing banking products. Therefore, banks may bear some responsibility for the increase of households' indebtedness.

A more general analysis of poverty and inequality indicators allows us to conclude that in 2010 Portugal was one of the most unequal countries of the EU15 and with one of the highest poverty rates, but the situation has improved on both dimensions since 2000.

PART IV – International integration and the Portuguese financial system

14. Impact of financial globalization on the national financial system[70]

In this section we aim to study how financial globalization has affected the Portuguese economy and more specifically the financial system. Firstly, in Section 14.1 we assess how trade, FDI and capital movements have impacted the Portuguese economy and especially how the latter have made it more vulnerable to external shocks. In Section 14.2 we analyse the internationalization of Portuguese banks.

14.1. Major impacts of globalization in the Portuguese economy

Globalization has three main economic dimensions: intensification of the trade of goods and services, FDI and the movement of financial capitals. Each one of these elements had considerable implications in Portugal.

The liberalization of commerce in the WTO that allowed Asian emerging economies to access European markets had a substantial negative impact on Portuguese traditional firms. By weakening Portuguese firms, trade liberalization had also an indirect impact on banks, by increasing credit default and reducing economic dynamism.

A positive effect of trade liberalization was that it allowed for the importation of products at a lower cost, increasing consumer surplus and reducing inflation.

Regarding FDI, after joining the EU in 1986 and up to 1992 Portugal benefited from a large inflow of FDI, with large spillovers effects on the industrial sector

---

[70] Point 1b of the terms of reference.

in particular. With the EU enlargement to the East much of the FDI, especially from Germany, was diverted to the new member countries.

The FDI in the areas of finance, real estate and trade had less positive effects on the economy. There is no doubt that competition increased in those sectors and there was a faster modernization. However, the FDI directed to finance, real estate and trade is looking to increase profits by enlarging their consumer basis and by operating in markets of imperfect competition.

The banking sector also benefited from the entrance of foreign banks, with the large entrance occurring in 2000 when Santander bought bank BTA and became one of the five largest banks operating in the Portuguese market. Foreign banks and institutional investors also have major stakes in the large banking groups: 100% in Santander, around 15% in BCP and BES, and 58.9% in BPI (see Annex III).

The entrance of FDI and foreign financial investment was especially important during the privatization process. Foreign capital also entered the stock market in large quantities as the market became developed, especially in 1999, 2001 and 2002. More recently foreign capital from developing countries, namely Angola and Brazil, has invested in large listed companies (Section 10.1).

Before the 2008 crisis, the World economy was characterized by large liquidity, *i.e.* by a large volume of financial capital looking for assets were to invest at high return rates. The East Asian and oil producing countries with large current account surplus and savings inundated the world and especially the USA with large quantities of capital. Asian countries were strategically increasing their foreign reserves to maintain the parity of their currencies with the dollar, and also trying to avoid a crisis similar to the Asian crisis of 1998. In that crisis those countries realized the importance of owning large sums of dollars during crises as protection against foreign capital flight. More recently, they have been diversifying the portfolio of currencies and have invested also in euro assets. In

2008, according with the journal The Economist 27% of the world exchange reserves were already in euros

The Portuguese Government benefited from the large liquidity in the World market, and before 2010 was able to sell its bonds at an interest rate almost similar to the German rate. More than 70% of the bonds of the Portuguese government were bought by foreigners. But the dependence on foreign capital has proven dangerous in many countries. FDI and also surprisingly the investment in stocks are relatively stable in periods of crisis. In contrast, credit and investment in deposits and bonds is easily scared and exits quickly in a period of crisis. That was exactly what occurred in Portugal during the Euro debt crisis in 2010.

A new characteristic of globalization is the high interconnection among banks. Financial products are traded globally. This facilitated the quick spread of the 2008 financial crisis, as investors did not know where toxic assets were located. Notice that, according with the Bank of Portugal Portuguese banks did not have toxic assets in considerable amounts.

The liberalization of capitals has facilitated the contagion of crisis, namely of the Subprime and Sovereign debt crisis. The larger trade interconnection between countries means that this channel of propagation is more active. Also, the cross-market rebalancing of portfolios is more relevant. International investors adjust portfolios to changes in countries' risk after a shock (Boyer et al, 2006). After a shock in one country, which also affects other countries, investors reduce risk by adjusting portfolios not only in the focus country, but also in other affected countries. Wealth constraints also play a role, since when investors suffer losses in the focus country of the crisis they have to sell assets in other countries (Kyle and Xiong, 2001). They need to sell assets due to margin calls or large withdrawals from mutual funds.

14.2. Internationalization of Portuguese Banks

The globalization process and the European single market allowed Portuguese banks to internationalize their activities. They have followed a strategy of internationalization mainly after the publication in 1992 of the Decree-Law 298/92 dated 31st December in accordance with the Directive 89/646/EEC dated 15th December (Second Banking Coordination Directive), which extended the single market to financial services. The new legal framework allowed any financial institution authorized to operate in the market of a member State to establish new branches or subsidiaries and provide financial services across borders throughout the European Union, obtaining the so-called "EU-passport". Hence, any bank based in the European Union obtained automatic access to a much wider market, eliminating formal national borders and restrictions on the range of financial activities permitted (with the exception of insurance activity to which "EU-passport" was allowed only in 1996).

The internationalization of banks was integrated in a more general wave of internationalization of the Portuguese economy from 1997 (Ribeiro, 2003). In 1998, the FDI of Portugal abroad was larger than the FDI in Portugal. The groups of firms leading the process were banks, large retail operators, construction firms, real estate and services to firms companies, and some industries. The most important destination countries were Spain, Brazil, Poland, Morocco and Angola.

The reasons for investing abroad were related with the rapid growth of the destination countries, while internally competition was becoming fiercer and market growth was slowing down. Additionally, emergent markets' consumers are less demanding than developed markets' consumers. The growth of the Portuguese economy in the second half of the 1990s also allowed the generation of cash-flow to invest abroad. Moreover, the rapid growth of credit facilitated the financing of some operations. Finally, the privatization process

created some large companies with internationalization potential and that were able to generate large revenues in a relatively protected domestic market.

From 2008, the FDI abroad slowed strongly, as firms faced financing and cash flow difficulties.

In general terms, the process of internationalization of Portuguese banks has taken different forms. The most important are the establishment of branches and representative offices in other countries, strategic alliances with other international financial institutions and the acquisition of foreign banks.

Portuguese banks have targeted two types of countries. On the one hand, they chose countries with strong cultural and economic affinities, like Angola, Mozambique, Cape Verde, Brazil, among others. Portuguese banks also decided to extend their activities to markets with a strong Portuguese community, like Switzerland, Luxembourg, France and Spain. On the other hand, they chose to be present in less developed markets, but with strong growth potential, like Poland.

The international activity of Portuguese banks has facilitated and promoted exports and direct investment by Portuguese companies.

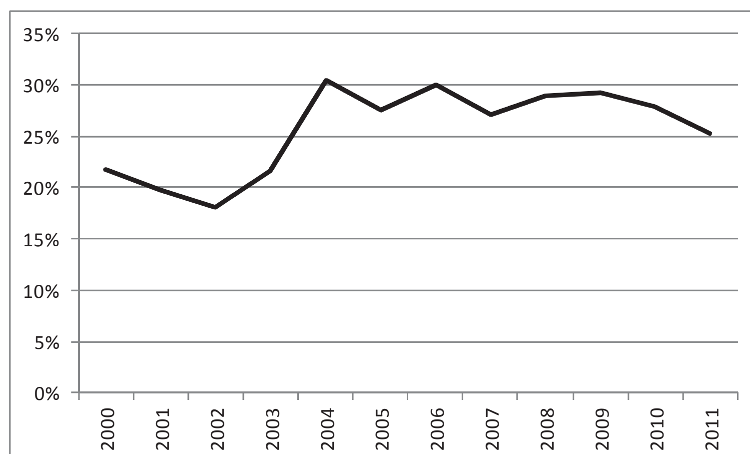
Due to the maturity of the Portuguese banking market and slow growth of domestic demand, profits from international activity are becoming increasingly important for banks. International operations accounted for around 8% of the total consolidated net income of the Portuguese financial institutions in 2006, 20% in 2007, 40% in 2008, 15% in 2009 and 22% in 2010.[71] Profits from international operations have been important to mitigate the decrease in the profits of the domestic activity, in a context of a strongly recessionary environment of the Portuguese economy, due to the fiscal consolidation

[71] Data from Financial Stability Reports of the Bank of Portugal, from 2006 to 2010.

process imposed by the Troika. Here it stands out that the internationalization of Portuguese banks has allowed them to take advantage of growing markets and to diversify their business risk. Additionally, it has permitted them to serve emigrants and firms in the several geographical locations where they are present.

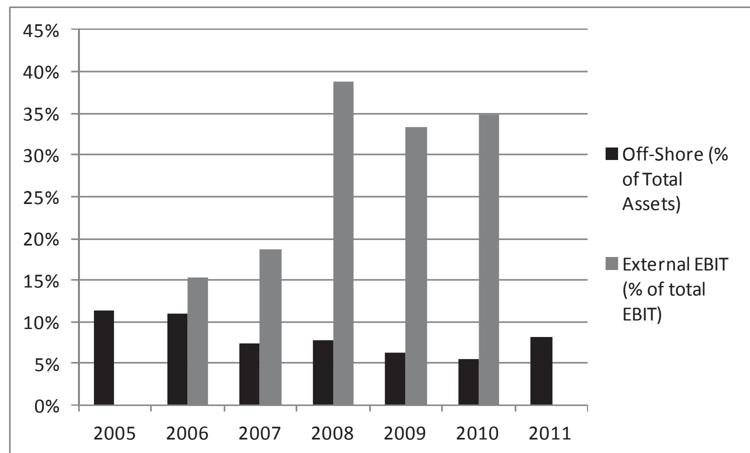
Looking at the total amount of external assets owned by Portuguese banks (not only investments in subsidiaries, but also securities), we find that they increased substantially in the last decade. The percentage of external assets in total assets (including securities) increased from 21.7% in the beginning of the 2000s to 29.3% in 2009 (Figure 152). This trend reversed in 2010 and 2011, with the importance of external assets in total assets declining to 25.3% in 2011. This reflects the strong turbulence of international financial markets, in the wake of the Subprime crisis and, more recently, the sovereign debt crisis in the euro area. National banks sold international assets as part of the general strategy of deleveraging. The off-shore activity has also diminished in recent years: it represented 11.4% of total assets in 2005 and fell to 5.5% in 2010. In 2011, there was an increase to 8.2%.

Figure 152 – External assets (% of total assets)



Source: Financial Stability Report from Bank of Portugal, several years

Figure 153 – Off-shore activities (% of total assets) and external Earnings before Interests and Taxes (EBIT) - % of total EBIT



Source: Financial Stability Report from Bank of Portugal, several years

The geographical dispersion of the international exposure has remained broadly unchanged, prevailing a greater exposure to more developed countries and, particularly, to euro area countries (Table 46).

Table 46 – Consolidated Foreign Claims of the Portuguese Banking System (in % of total international exposition)

Geographical Exposition	2004	2005	2006	2007	2008	2009	2010	2011
Developed Countries	68,4%	70,7%	71,2%	69,9%	70,1%	71,6%	68,8%	66,1%
Offshore Centres	15,2%	11,4%	11,0%	7,4%	7,8%	6,3%	5,5%	8,2%
Developing Countries in Europe	8,0%	8,3%	8,0%	10,4%	10,9%	10,3%	10,7%	11,3%
Others	8,5%	9,7%	9,7%	12,2%	11,3%	11,6%	15,0%	14,3%

Source: Bank of Portugal's Financial Stability Report, several years

Despite have increased, the international exposure of Portuguese banks continues to be smaller than other European banks, reflecting a more conservative stance by Portuguese banks (Financial Stability Report of the Bank of Portugal, May 2011).

According to Financial Stability Report of the Bank of Portugal (May 2012), in the next years, the optimistic outlook for the economic activity of some countries in

which Portuguese banking groups have important stakes should continue to support the growth of international activity.

14.3. Concluding remarks

Economic globalization had several implications on the Portuguese economy and financial system. The liberalization of commerce that allowed Asian countries and other emerging economies to access the European market had a negative impact on Portuguese firms, but allowed a reduction of prices of imported goods.

From 1986 to 1992 Portugal benefited from a large inflow of FDI, but the EU enlargement to East diverted much of the FDI directed to the Portuguese economy. FDI has also been directed to the financial sector, where some foreign banks compete and foreign investors have major stakes in the large banking groups.

Foreign financial investment has also played an important role in the promotion of the Portuguese stock market, especially in the period 1999-2002. More recently foreign capital from developing countries has invested in large listed companies.

In the public bond market, foreign investors became the major buyers and financed the State at very low interest rates before the Subprime crisis. More recently there was a flight of foreign investors from the Portuguese debt, originating a debt crisis. The free movement of capitals has facilitated the contagion of the debt crisis from Greece to Portugal.

The globalization process and the European single market on services allowed Portuguese banks to internationalize their activities. This process was integrated in a more general wave of internationalization of the Portuguese economy from 1997 onwards. Portuguese banks invested in countries with

strong cultural and economic affinities, and in less developed markets with less proximity but with strong growth potential.

As a result, the total amount of external assets owned by Portuguese banks increased substantially in the last decade, even though they are still below the levels of other national banking systems. The exposure is essentially to developed and "developing" countries in Europe. Profits from international operations have been growing in importance and became significant to mitigate the decrease in profits from domestic activity arising from the recession in Portugal.

15. Impact of European integration on the Portuguese financial system[72]

In this section we assess the impact of European integration on the Portuguese financial system. Sections 15.1 and 15.2 describe the major macroeconomic steps in the European integration and in the creation of a space for the free movement of capital at the European level. Section 15.3 analyses the convergence process of Portugal towards the euro, highlighting not only the successes achieved but also the negative implications. In this line of reasoning, Section 15.4 summarizes the major impacts of European integration on the banking system and on the Portuguese economy more generally. Finally, Section 15.5 studies how the single monetary policy may have differentiated effects on the national banking interest rates.

15.1. Major macroeconomic steps in the European integration

EMS

The European Monetary System (EMS) was created in 1979 in response to the collapse of the Bretton Woods System[73], in order to control the fluctuations of European currencies and, thereby, stimulate trade and FDI.

The EMS was essentially composed of the European Currency Unit (ECU) and the Exchange Rate Mechanism (ERM), functioning as a floating exchange rate regime with regard to external currencies. The ECU was a currency basket based on a weighted average of EMS currencies and it was used as the common denominator in the exchange rate grid for Community currencies.

---

[72] Point 15 of the terms of reference

[73] The Bretton Woods System was established after the Second World War by most of the industrialized economies, in order to ensure the currencies' stability. It functioned as a system of fixed (but adjustable) exchange rates, under which each country committed to maintain the stability of its currency to the US dollar. Besides, there was the guarantee of conversion of US dollars into gold, whose conversion rate was fixed at 35 US dollar per ounce of gold.

According to this new system, all governments were committed to keep their currency exchange rate towards other currencies of the system within bands. Thus, no country's exchange rate could fluctuate more than 2,25% from the defined central exchange rates, with the exception of the Italian lira, the Spanish peseta, the Portuguese escudo and the British pound, which were allowed to fluctuate 6%. In August 1993, these bands were widened to 15%, due to speculative pressures favoured by the process of capital liberalization.

Maastricht Treaty

December of 1991 saw the signing the Maastricht Treaty, laying the foundations for the creation of a single currency in Europe. Each country wishing to participate in the single currency had to fulfil the following five nominal convergence criteria:

First Criteria: Inflation rate could not exceed more than 1.5 percentage points of the average of the three best performing member states of the EU on that indicator.

Second Criteria: the nominal long-term interest rate must not be more than 2 percentage points higher than in the three lowest inflation member states.

Third Criteria: Applicant countries should have joined the ERM during two consecutive years and should not have devalued its currency during that period.

Fourth Criteria: The ratio of the annual public deficit to GDP should not exceed 3% at the end of 1998.

Fifth Criteria: The ratio of gross government debt to GDP must not exceed 60% at the end of 1998.

Stability and Growth Pact

The Stability and Growth Pact (SGP) is an agreement among EU member states, which imposes a legal obligation to avoid excessive public deficit, providing sanctions in the case of non-compliance.

According to the SGP, the public deficit is considered excessive if it breaches the maximum of 3% of GDP, except in the case of the occurrence of an extraordinary event or in the case of a recession.

If the European Council decides that the deficit is excessive, it issues recommendations to the Member State concerned to correct the excessive deficit in a given time frame. The non-compliance with the recommendations triggers further steps in the procedures, including for euro area Member States the possibility of sanctions.

15.2. Free movement of capital at the European level

Until the Single European Act of 1986, European capital markets were not very integrated, since capital could not flow freely across European countries. In 1986, the Single Act defined that capital was free to move in the EU. The implementation of this principle was done through a set of directives, which ended in the 1988 directive. Latterly, the Maastricht Treaty institutes in the article 56 the principle of free movement of capital.

The free flow of capital allows agents to diversify internationally their portfolios and brings more competition to national banking markets. In theory, clients can borrow in any European country.

To facilitate the free movement of financial institutions, regulation is defined at the EU level, guaranteeing that rules are uniform across national markets, and not requiring the registration of institutions in each market. However, the

supervision, i.e., the actual application and administration of the regulation is done at the national level. This can be justified on the grounds of the subsidiary principle and the better knowledge that national regulators have of their own banking system. In 2012, in the sequence of the recent financial crisis, this arrangement has been challenged by the European Commission, which proposed the creation of a single European supervision authority that will be able to better manage bail-outs of institutions affecting the stability of all the monetary area and induce more confidence on the markets.

The free movement of banking institutions and the euro has not led to a large movement of banks towards operations at a European scale, probably due to different regulations, tax treatments, national protectionism, and economic barriers associated to the business. M&A took place mainly at the national level. Nevertheless, there are some banks that grew to a pan-European scale, such as Santander and HSBC.

In Portugal, foreign banks participate in the Portuguese financial system and Portuguese banks have invested FDI in other European economies. Nevertheless, the analysis of the Portuguese financial sector highlights that the national dimension is still important. This result emerges mainly from two points. Firstly, foreign institutions still have a low market share. Secondly, the specific macroeconomic evolution of the national economy is still important in understanding the stability of the banking system.

The integration of national interbank markets was almost full. In the government bond market the integration was quite substantial until the Subprime crisis, with long term interest rates very similar in all EA countries. For corporate bonds of large firms the degree of integration was smaller.

In the stock market, the creation of a single currency, by eliminating currency risk, potentiates the international diversification of investments by economic agents. A single currency also incentivizes the merger of stock exchanges,

where scale economies are quite strong. The creation of Euronext in 2000 by the exchanges of Paris, Brussels and Amsterdam was an example of this trend. This exchange was able to become the fourth largest exchange in the world. The Portuguese Stock Exchange joined Euronext in 2007.

15.3. The Portuguese strategy of convergence to the euro: achievements and difficulties

Portugal had to fulfil the five Maastricht convergence criteria in order to participate in the European single currency. The compliance of these five criteria was assured by the Bank of Portugal (the first three criteria) and the government (the other two criteria).

Let us focus on the first criteria related to the exchange rate, inflation and interest rates. To ensure these criteria the Bank of Portugal adopted a monetary policy strategy during the nineties consisting in maintaining the stability of the escudo against the deutschmark.[74] Since the mark was the anchor currency of the EMS, that strategy ensured the stability of the escudo against the other currencies of the system. The main instruments of the central bank were the key interest rates and interventions on foreign exchange markets. This strategy was a success leading to the joining of the Escudo to the EMS in April 1992. The Portuguese escudo started then to fluctuate around a band of plus or minus 6% in relation to a central parity[75].

Given that Germany was a low inflation country, by maintaining the exchange rate stability with the mark, Portugal was able to reduce inflation rate of tradable goods sector. Prices of the Portuguese imported goods (consumption, intermediate and raw materials) from Germany began to grow moderately,

[74] This monetary policy strategy is normally known as "exchange rate anchor policy".
[75] This central parity was fixed initially at a level that has reflected the substantial appreciation of the escudo in the previous two years.

curbing directly CPI inflation and production costs of firms. The reduction of firms' costs meant that they were able to reduce their prices, including the prices of non-tradable goods. On the other hand, due to the higher competition of imported goods, the Portuguese producers focused in the internal market were forced to cut prices, in order not to lose market share. The same reasoning applied here for Germany is also valid for other countries of the system, also large commercial partners of Portugal, such as the UK and France.

Consequently, expectations regarding the future inflation rate started to decrease, feeding a reduction of nominal wages and profit margins, which implied a further reduction of the inflation rate.

With free movement of capitals, the maintenance of credible exchange rate stability also implied that the level of Portuguese interest rates approached the level of German interest rates (by the uncovered parity). In sum, the central bank was able to ensure the three goals of exchange rate stability and reduction of both inflation and interest rates. This was a decisive step for Portugal to participate in the single currency as a founder partner.

The reduction of interest rates achieved by the monetary policy also facilitated the achievement of the two criteria related with public finances: reduction of both public deficit and public debt. First of all the government started to pay lower interest rates on its debt contributing to those two objectives. Secondly, the reduction of interest rates to the private sector meant a boom in consumption and investment, compensating some difficulties in the exporting sector and supporting high economic growth and thus making a decisive contribution to reduce the fiscal deficit.

The balance of the participation in the EMS

Some months later after Portugal joined the EMS, the system was fustigated by speculative pressures favoured by the process of capital movement liberalization. The British pound and the Italian lira abandoned the system, and the Spanish peseta devaluated strongly. The overall bands of fluctuations were widened to +/-15%. Still, the Portuguese authorities maintained the parity of escudo within the EMS, supported by high interest rates and large foreign exchange reserves. Against this backdrop, the valuation of the real exchange rate of escudo started to generate some controversy (Lopes, 1996).

On the one hand, that valuation helped to decrease inflation rate, as requested by the process of nominal convergence under the Maastricht Treaty. Additionally, it was argued that this real appreciation was a result of a strong pressure of domestic demand and a policy-induced nominal devaluation could not have had a strong effect on the real exchange rate. The enthusiasts of this view emphasize in its support the dynamism of exports and the absence of difficulties in the balance of payments between 1989 and 1994.

Nevertheless, the adoption of that monetary policy strategy created difficulties in the sector of tradable goods. Real exchange rate appreciation caused loss of price competitiveness, which favoured an increase of imports and a decrease of exports. Additionally, while prices in the tradable goods sector felt quickly due to price convergence with Europe, production costs linked to wages and other non-tradable goods declined slowly. As a result, many corporations in the tradable goods sector bankrupted and unemployment rate jumped. The export sector faced difficulties and the level of production in manufacturing and agriculture decreased expressively.

Another factor favoring investment in the non-tradable goods sector was the funding cost (Bento, 2010). Since prices in the non-tradable goods sector have grown at a higher rate than prices in the tradable goods sector since the second half of the eighties, the real interest rate was lower for the former than for the latter sector. Since the non-tradable goods sector has a lower productivity growth and does not contributes to the improvement of the current account, the large growth and importance of that sector on the Portuguese economy has become an important constraint to development (Bento, 2010).

The supporters of the pessimistic view on the effect of the EMS in Portugal sustained that it prevented the adoption of a more accommodative monetary policy and, therefore, it was the main cause of the Portuguese economic recession between 1992 and 1994. Apart from that, exporting Portuguese firms were used to frequent currency devaluations to compensate competitiveness losses. The adaptation to a stronger currency was slow and implied a loss of exporting market shares.

The adoption of an exchange rate peg in the context of the EMS or more generally the adoption of the euro brings other costs for the Portuguese economy. Firstly, Portugal can no longer use the interest rate or the exchange rate to correct internal macroeconomic disequilibrium. Portugal's key interest rates are currently determined by ECB and during the EMS were determined by the Bundesbank, the anchor country. As an example of the perverse effects of this fact we have the recession in Portugal and Europe originated by the German Reunification. In 1992, the German government followed an expansionary policy to support the Reunification, resulting in high inflation. In response the Bundesbank increased interest rates, which implied an increase of interest rates in all countries of the EMS, including Portugal, which had a recessionary effect on the economy.

The adoption of an exchange rate peg or a single currency also implies a strong discipline of public finances. In a flexible exchange rate regime, high budget deficits, which produce inflation, can be accommodated with a depreciation of the currency. But in a fixed exchange rate system there is not such possibility, and high budget deficits imply a reduction of foreign reserves or an increase in foreign indebtedness.

15.4. Major impacts of European integration in the Portuguese economy

The joining of Portugal to the EU had a profound impact on the economy. The opening up of the financial system to the private sector in 1983 (with the change in the constitution) was accelerated by the joining of Portugal to the EU. After Portugal joined the EU in 1986, the integration of the economy into the common market required a gradual dismantling of the constraints on the financial system, particularly the State property of banks. Other major changes were the free entrance of European banks in Portugal and the harmonization of banking regulation, including capital regulation.

The participation in the euro in 1999 brought major benefits to Portugal, namely the reduction of interest rates and the easier access of banks to international financing. Portugal and other countries have also benefited from a low inflation environment ensured by the ECB.

At a microeconomic level, the reduction in exchange rate uncertainty brought many benefits to Portugal, namely the improvement in the quality of investment decisions involving exchange rate risk, increase in trade with countries from the monetary area and reduction of transaction costs. Households and institutional investors also had better conditions to diversify their investments with less risk. However, it seems that the euro did not stimulate much economic growth: since 1999 Portugal has diverged with Europe in terms of GDP per capita.

The euro offered a considerable protection for Portugal during the turbulence of the Subprime crisis. Other small countries with own currency, like Hungry, were badly affected by the crisis.

The major cost of the euro is that Portugal had to transfer the monetary policy to the ECB. This is would not be particularly costly if supply and demand shocks are symmetric in the euro area and in Portugal. In terms of major events, the Portuguese economy has been more affected than other European countries by the increasing competition from Asian countries and the EU Eastern enlargement. This occurs because the Portuguese industrial structure is more traditional and more based on cost factors than other more advanced euro area economies.

If macroeconomic shocks are asymmetric, they are not very negative for Portugal if adjustment mechanisms function well. However, in the Euro area and Portugal the adjustment mechanisms are not particularly strong, as the labour market is relatively rigid, workers mobility across countries is limited, and the European budget is very small to realize counter-cyclical transfers to countries affected by negative shocks.

As an example of how the euro has brought some difficulties in macroeconomic management, we have the fact that for Portugal, Spain, Ireland and Greece the Euro fail to adjust when unit labour costs (ULC) grew faster than the average after 1999. Between 1999 and 2007 the ULC grew 14% in the EA and around 27% in Portugal (See Figure 163 below).

It was argued above that a major benefit of the single currency was the reduction of interest rates and the easier access to external financing for private and public sectors. Yet, this environment of economic boom hid the necessity of reforms. At the same time the euro allowed the financing of large external deficits for a longer period than if the financing was done in domestic own currency.

The convergence process to join the euro was accompanied by a large decline of real interest rates in Portugal. This implied a faster growth of credit and aggregate demand, with obvious inflationary consequences. This one-off expansionary shock disappeared over time, namely because higher inflation originated a real appreciation of the currency.

The participation in the euro also implied the respect of the Growth and Stability Pact, which obliged in some years the country to follow a pro-cyclical tightening of fiscal policy during periods of slow economic growth or even recession. In addition, in the UE there is not a harmonization of taxes on corporations, which together with the free movement of capitals implies that countries are in tax competition. Some large firms have transferred their headquarters to countries with lower corporate taxes, reducing the collection of taxes in Portugal. In addition, firms, namely financial institutions, and also private individuals use off-shores accounts to avoid taxation. All this makes the fiscal consolidation at a national level even more difficult.

The European integration had other important impacts on the Portuguese economy. The structural funds were important in the modernization of public and private infrastructures. The FDI was also extremely relevant in the modernization of the industry, even though its flow declined considerably in recent years. Banks also used the opportunity to invest in other European countries.

On the negative side, the EU's agriculture and fisheries policies, which were not properly implemented by the national actors, or due to some wrong design of such policies, favoured the destruction of productive capacity and disinvestment in these sectors.

15.5. How the monetary policy of the ECB affects banks' interest rates

Since 1999 Portugal belongs to the EA, with its monetary policy defined by the ECB. The transmission of changes in the key interest rates to lending and deposit interest rates depends on the decisions of banks and the structure of the financial system.

In Portugal, there are flexible interest rates on credit to households and firms (See Section 9.3). As a result, the ECB key interest rates influence banks' interest rates of both new and existing loans, transferring the interest rate risk to households and firms.

Antão (2009) studies the degree of transmission of interbank interest rates using micro data for the period January 1990 to December 2002. She founds that changes in the interbank interest rate are fully transmitted to loan interest rates but the same does not occurs for deposit interest rates. Since the closer the pass-through is to one the larger is competition, it can be inferred with caution that competition is larger in credit than in deposit markets. Inside the credit market, results show that the pass-through and consequently competition is larger in the corporations segment than in the households segment.

The study also concludes that the velocity of adjustment is larger for deposits interest rates than for loans interest rates. It is also found that loans markets with larger concentration have a larger velocity of interest rates adjustment, but the adjustment is more incomplete. This indicates that the increase in concentration in the 2000s may have made the interest rate pass-through more incomplete.

Sørensen and Werner (2006) study a set of euro area countries and their results for Portugal confirm Antão (2009). The pass-through is more incomplete in deposits' than in credit's interest rates. The pass-through is also more partial

in households segments (mortgage and consumer) than in the firms segment. It is still confirmed that the velocity of adjustment is larger in deposits than in mortgage loans. However, the adjustment is the quickest in consumer loans and short term loans to firms (the paper does not include long term loans to firms in Portugal).

For the period 1992-1999, Banco of Portugal (2000) obtains similar results regarding the ordering of the size of the pass-through across market segments, even though the quantitative results point to a larger degree of pass-through. That paper finds that the long-term impact of interbank rate is 0.86 for deposits (181 days to 1 year), 1.07 for mortgages and 1.19 for short term loans to firms (181 days to 1 year). One point where Banco of Portugal (2000) differs from Sørensen and Werner (2006) is that it obtains the largest degree of pass-through for loans to consumption (1.39, 181 days to 1 year).

Comparing with the EA10 (unweighted average), Portugal has a long term deposits rate elasticity to interbank interest rate much lower than the average: 0.47 and 0.73, respectively (Table 2). The difference is not so large for mortgage loans, but still Portugal has a lower elasticity (0.87 versus 1.00). For consumer loans the degree of pass-through in Portugal is quite similar to the EA average of around 0.77. Finally, the pass-through in short term interest rates to firms is larger than the average: 0.93 and 0.77, respectively.

Table 47 – Interest rate pass-through across market segments

Country	Mortgage Loans			Consumer Loans			Short Term Loans to Firms			Time Deposits		
	Coefficient	Confidence Interval		Coefficient	Confidence Interval		Coefficient	Confidence Interval		Coefficient	Confidence Interval	
		Lower	Upper		Lower	Upper		Lower	Upper		Lower	Upper
Austria	0,698	0,416	0,981	0,887	0,747	1,027	0,755	0,633	0,877	0,512	0,437	0,588
Belgium	1,254	0,867	1,640	0,420	0,229	0,611	0,898	0,827	0,969	0,926	0,884	0,967
Germany	1,422	1,341	1,504	0,246	0,122	0,370	0,408	0,279	0,537	0,916	0,725	1,106
Spain	1,181	0,866	1,496	0,761	0,618	0,903	0,867	0,821	0,914	0,917	0,826	1,007
Finland	1,160	0,907	1,413	1,657	1,303	2,012	n.a.	n.a.	n.a.	0,350	-0,044	0,744
France	0,776	0,522	1,030	0,648	0,530	0,765	0,789	0,736	0,842	1,037	0,778	1,295
Ireland	0,770	0,288	1,253	n.a.	n.a.	n.a.	0,664	0,617	0,711	n.a.	n.a.	n.a.
Italy	0,549	0,146	0,952	n.a.	n.a.	n.a.	0,694	0,666	0,722	0,722	0,613	0,831
Netherlands	1,326	1,237	1,414	n.a.	n.a.	n.a.	0,987	0,959	1,015	0,709	0,550	0,868
Portugal	0,871	0,261	1,481	0,788	0,369	1,206	0,932	0,845	1,019	0,477	0,407	0,546
Euro Area	1,001	-	-	0,772	-	-	0,777	-	-	0,730	-	-

Note: Euro area is the unweighted average of 10 countries. Source: Sørensen and Werner (2006)

The velocity of adjustment is quite similar to the average for mortgage loans and time deposits, is smaller for short term loans to firms and larger for consumer loans (Table 40, in Annex).

Other studies seem to confirm the above results. Cottarelli and Kourelis (1994) and Kleimeier and Sander (2000) indicate that for short-term loans to firms, the long-term pass-through is larger in Portugal than in the Euro area. It is worth mentioning that Donnay and Degryse (2001) obtain the opposite result for loans to firms, but for mortgages they confirm a more incomplete pass-through in Portugal.

In conclusion, these results indicate that the effect of the ECB interest rate policy will be larger for Portuguese firms than euro area firms, but the effect on households will be milder in Portugal than in the Euro area.

15.6. Concluding remarks

The major macroeconomic steps in the European integration were the EMS, the Maastricht treaty that defined the creation of a single currency, and the SGP.

The liberalization of capital movements at the European level was initiated with the Single European Act. In 1989 the Second Banking Coordination Directive

extended the single market to financial services. To facilitate the free movement of financial institutions, regulation is defined at the EU level. An example of that is the EU Capital Adequacy Directive of 1993, which established uniform capital requirements at the European level. However, the supervision has been done at the national level. Recently the European Commission proposed the creation of a single European supervision authority.

For several reasons the free movement of banking institutions and the euro has not led banks to operate at a European scale, even though there are cross-border linkages. The analysis of the Portuguese financial sector highlights that the national dimension is still important.

Other areas were integration went further was in the interbank market and the government bond market, despite the disintegration observed during the Great Recession. In stock markets the tendency has been for a merger of national exchanges.

The Portuguese strategy to achieve the nominal convergence required by the Maastricht Treaty was to maintain the stability of the escudo against the deutschmark. This strategy created difficulties in the sectors of tradable goods because they were exposed to a strong international competition without a reduction in internal costs.

The belonging to the EMS and to the euro brought other major cost to the Portuguese economy: the loss of interest rate and exchange rate as policy instrument. The new monetary regime also implies a strong discipline of public finances, which was not a tradition in Portugal.

The joining to the EU had major impacts on the Portuguese financial system: privatization of banks, entrance of foreign banks, and harmonization of banking regulation with Europe.

The participation in the euro allowed banks to increase substantially credit to the non-financial sector and brought other microeconomic benefits. However, the euro did not boost economic growth of Portugal, even though it offered a safe haven during the Subprime financial crisis. After 1999 the economy also suffered considerable external shocks and had a large growth of labour costs, and was not able to use interest and exchange rates to respond, whilst the adjustment mechanisms to asymmetric shocks did not work very well in the Euro area. The use of fiscal policy during economic downturns was also limited by the SGP and the international tax competition.

An additional factor of heterogeneity is that the transmission of the ECB monetary policy to national economies is not homogeneous. The effect of the ECB interest rate policy will be larger in Portuguese firms than in euro area firms, but the effect on households will be milder in Portugal than in the Euro area.

Finally, FDI and European structural funds were very important in the modernization of the country, despite some negative impact of the common policy in agriculture and fishing sectors.

16. The integration of the national financial system in the international capital markets [76]

In Portugal, external capital financed the current account deficit, stimulated credit and real estate growth. Credit did not result in an increase of country's productivity, making the external deficit unsustainable. The existence of a single currency difficult the adjustment, since high inflation resulting from capital inflows originated a loose of external competitiveness and low or negative real interest rates that further stimulated aggregate demand and real estate growth.

When international investors started thinking the Portuguese situation as unsustainable, capital inflows suddenly stopped. Without its own currency, Portugal had a sudden stop of external financing, causing domestic credit rationing and a deep recession, which reduced the current account from negative values to zero.

This section is organized as follows. In Sections 16.1 and 16.2 the evolution of the financial account and international investment positions are described. Section 16.3 evaluates the size of foreign currency denominated loans and liabilities. Sections 16.4, 16.5 and 16.6 analyze how inflation, real interest rate and real exchange rate evolved in the recent past, and the interconnection between them.

16.1. Financial account

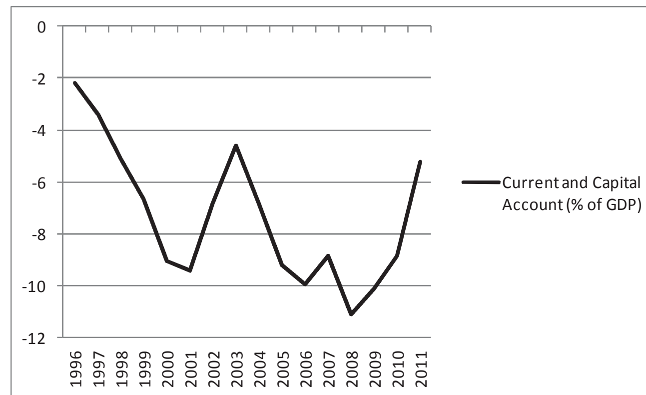
Portugal has had a high current and capital account deficit since 2000. Between 2000 and 2008 that deficit was on average 8.4% of GDP (see Figure 154). In 1995, the current and capital deficit was around 2% of GDP, and afterwards it

---

[76] Point 18 of the Terms of Reference.

increased substantially, reaching almost 10% in 2001. Despite some fluctuations related with the business cycle, the external deficit remained high up to 2008, when it reached the record of -11% of GDP. From 2009 to 2011 there was a rapid correction of the deficit due to the economic crisis and credit rationing of the economy.

Figure 154 – The Portuguese current and capital account

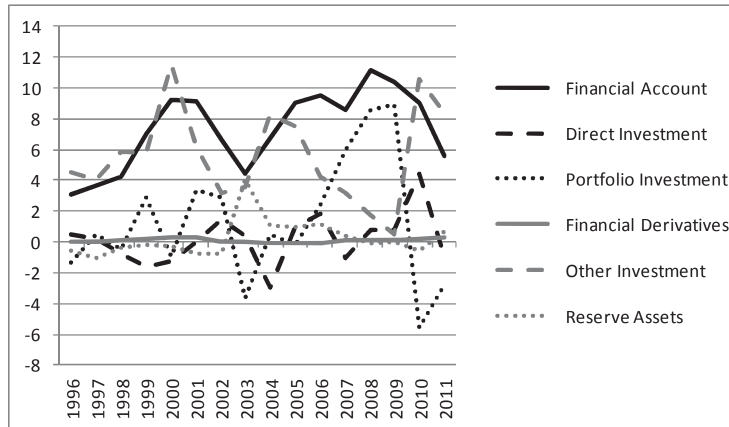


Source: Eurostat and Bank of Portugal

Even though Portugal has been a member of the EA, where the classical problems of foreign currency shortage are not present, the deficit of the current and capital account need to be financed. The financial account shows the channels through which the external financing of the economy occurs, both in terms of instruments and institutional sectors. [77] In Portugal, between 2000 and 2011, the two most important instruments to finance the current account were portfolio investment and other investment (see Figure 155). These instruments were mainly related to banks and the Government. When the government issues bonds that are bought by non-resident investors they are registered in portfolio investment, which explain the high relevance of this item.

[77] A deficit of the current and capital account is compensated by a positive balance on the financial account.

Figure 155 – The finance of the Portuguese current and capital account



Source: Eurostat and Bank of Portugal

An important way through which banks obtained foreign financing was by selling debt securities to foreign investors. The way of conducting this operation and its registration in the financial account has changed over time. Up to 2006 banks obtained financing in the international market through their foreign branches. The latter institutions sold long and medium term debt securities in euros in foreign markets. After, the branches transferred to their parent firms the issues' proceedings by means of loans or deposits. These financial flows were registered in the financial account as other investment.

From 2007 securities resulting from credit securitization have been sold directly by the parent bank in the national market and bought mainly by foreign investors. This change in the way of issuing debt is explained mainly by modifications in the tax law of mortgage securities' issues. These financial flows were registered in the financial account as portfolio investment.

Between 2000 and 2011, the importance of other investment and portfolio investment has changed considerably, reflecting the changes that have occurred in the economy and the changes in banks financing. From 2000-05 other investment was the main way of financing externally the economy, reflecting the increase of banks' foreign debt. From 2006 up to 2009, while

other investment decreased in importance, portfolio investment became more important. This was caused by the fact that banks started making emission of securities in the domestic market. In 2008 and 2009 the government also played an important role in the increase of portfolio investment.

In 2010 and 2011 other investment became again the main way of financing the economy. Since the government and banks did not have access to international bond markets, the financing of the economy was done through ECB's monetary policy operations. This meant an increase of other investment liabilities of monetary authorities. Moreover, the financing of the State was done by resident economic agents (especially banks) and by secondary market operations of the Eurosystem.

In 2011, other investment continued to be the most important instrument to finance the economy, while portfolio investment continued to have a negative contribution. Other investment increased because the Government received the first disbursement of the loan under the international financial assistance package. Finally, the financing of banks by the ECB was much more reduced in 2011 than in the previous year.

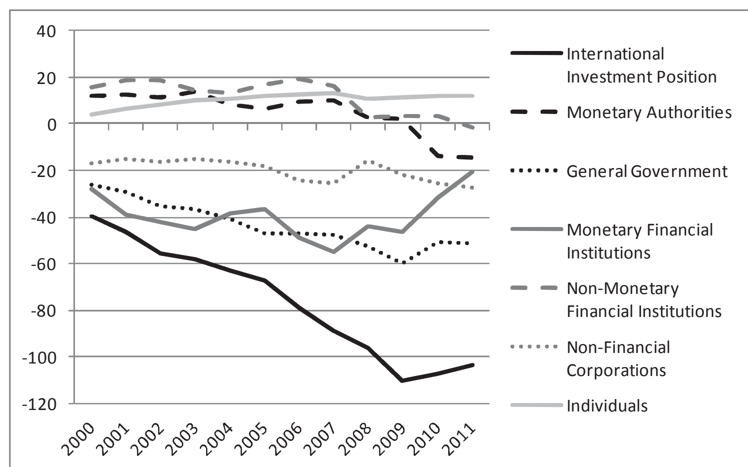
16.2. International Investment Positions

One can look at the International Investment Position (IIP) or net debt position of the Portuguese economy, which gives us the difference between assets and liabilities towards foreigners. This indicator reflects the financial transactions registered in the financial account, changes in securities' prices and exchange rates, and other adjustments.

A deficit of the current account corresponds to a surplus of the financial account. A surplus of the financial account results from an increase in foreign debt or a sell of domestic assets to non-residents. As a result of the current

account deficit in Portugal the negative IIP increased 71.1 p.p. from 2000 to 2009 (see Figure 156). The increase in portfolio investment explained 29 p.p. of that increase, other investment explained 27.3 p.p. and FDI explained 8.7 p.p. Portfolio investment was essentially related to foreign investors buying Portuguese Government and banks bonds, whereas other investment was related to banks getting financed abroad.

Figure 156 – The Portuguese International Investment Position



Source: Eurostat and Bank of Portugal

The main contributors to the increase in the IIP between 2000 and 2009 were the Government and banks. From 2000 to 2007 the negative IIP of banks has increased substantially, reflecting the process through which banks obtain financing in foreign markets to finance domestic firms and households – Figure 156. [78] From 2008 the negative position of banks against the exterior reduced quickly, because banks started to have difficulties in obtaining credit in the international markets.

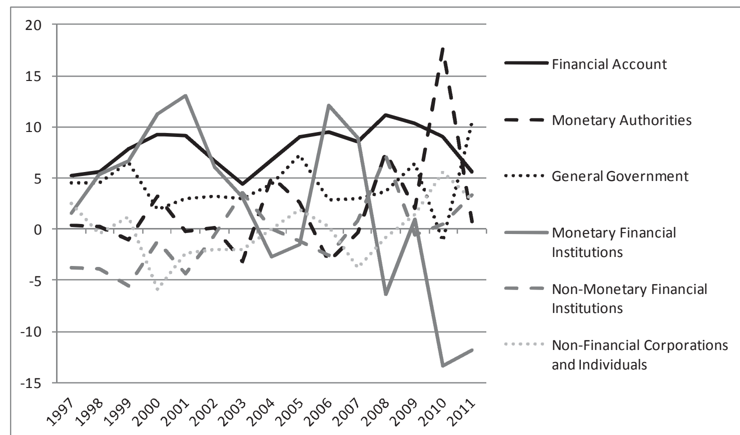
[78] Between 2003 and 2005 temporary operations between banks and the BP have affected the IIP of banks and the BP, but did not have effect on the global balance of the financial account (RA 2004 e 2005). These operations difficult the analysis of the importance of banks in the financing of the economy.

Likewise, the net debt position of the Government also increased substantially from -25.9% of GDP in 2000 to -48% in 2007. But in 2008 and 2009, when banks were already reducing their debt position towards foreigners, the Government was still increasing its debt, reaching -59.9% of GDP in 2009. Only in 2010 and 2011 the debt position of the government reduced considerably.

Before 2000 we do not have data on IIP, so we use data on the financial account (Figure 157). Between 1997 and 1999, banks and the General Government were also the institutional sectors with larger external debt.

Notice that the net debt of the private non-financial sector did not increase much. Between 2000 and 2009, the net debt of firms increased only 4.8 p.p. and families even reinforced by 7.6 p.p. their creditor position towards the rest of the world. Even though families and firms were getting more indebted, they were financed in the national banking system and not abroad.

Figure 157 – The Portuguese financial account by institutional sector (% of GDP)



Source: Eurostat and Bank of Portugal's Annual Reports

Yet, in 2009 and 2010 there was a considerable decrease of the IIP of NFC, which is partially explained by the issue of commercial paper bought by non-residents, the sale of shares by a large telecommunication company and the

sale of shares by a company of one of the main banking groups (Bank of Portugal, 2010 and 2011).

From 2000 to 2007 the non-monetary financial institutions had a considerable positive net asset position towards non-residents. The joining of Portugal to the euro and the positive cycle of financial markets during a considerable period induced institutional investors to diversify their portfolios buying foreign assets. But after 2007, with the increase of the risk, individuals disinvested from investment funds, which forced these institutions to sell their foreign assets. Latterly, bank deposits started to offer larger interest rates, making households prefer them to investment products offered by institutional investors (especially insurance companies and pension funds). As a result one can observe a steep decline in the net asset position of non-monetary financial companies in 2008 and 2011 (Figure 156).

16.3. Banks foreign Currency denominated loans and liabilities

In Portugal, the level of foreign currency denominated loans and liabilities is quite low when compared with other euro area countries, like Austria, France, Germany, Italy and the Netherlands (see Table 48). On the financing side, this clearly indicates that Portuguese banks obtain finance preferentially in euros. The reduced exposure to foreign currency is probably explained by the more conservative stance of Portuguese banks, which avoid taking great currency risks.

Moreover, the importance of foreign currency denominated loans and liabilities have decreased in Portugal from 2006 to 2008. On the liabilities side, probably Portuguese financial institutions have used less foreign currency funding due to the greater distrust of international investors in the creditworthiness of Portuguese financial institutions and the reduction of liquidity in international markets after 2007.

Table 48 – Foreign currency denominated loans and liabilities (% of total)

Country		2005	2006	2007	2008	2009	2011
Austria	Loans (% of Total Gross Loans)	n.a.	25%	23%	26%	22%	n.a.
	Liabilities (% of Total Liabilities)	n.a.	20%	17%	19%	14%	n.a.
France	Loans (% of Total Gross Loans)	n.a.	n.a.	n.a.	16%	14%	n.a.
	Liabilities (% of Total Liabilities)	n.a.	n.a.	n.a.	26%	24%	n.a.
Germany	Loans (% of Total Gross Loans)	10%	11%	11%	n.a.	n.a.	n.a.
	Liabilities (% of Total Liabilities)	10%	10%	10%	n.a.	n.a.	n.a.
Italy	Loans (% of Total Gross Loans)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	Liabilities (% of Total Liabilities)	n.a.	n.a.	n.a.	n.a.	n.a.	31%
Netherlands	Loans (% of Total Gross Loans)	n.a.	n.a.	n.a.	20%	n.a.	n.a.
	Liabilities (% of Total Liabilities)	n.a.	n.a.	n.a.	22%	n.a.	n.a.
Portugal	Loans (% of Total Gross Loans)	6%	6%	5%	4,4%	n.a.	n.a.
	Liabilities (% of Total Liabilities)	7%	8%	8%	5,8%	n.a.	n.a.

Source: IMF - Financial Soundness Indicators

16.4. Evolution of the Portuguese Inflation Rate

In the 1980's and the first half of the 1990's, Portugal was a high inflation country (Figure 158). Up to the Portuguese economy joining the European Monetary System, the differential in inflation was compensated by devaluations of the currency.

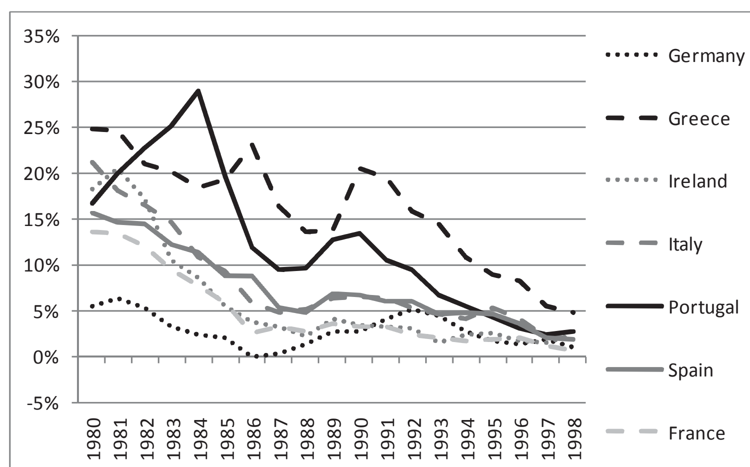
The Portuguese convergence effort to join the Euro meant that in the 1990s, namely in the second half, there was a significant reduction of inflation, to values close to the euro area average, as was imposed by Maastricht Criteria.

From 1999, with the creation of the euro, the single monetary policy implied that national inflation rates should be close (Figure 159), otherwise high inflation countries loose external competitiveness. In this context, Portugal has had one of the highest average inflation rates of the EA in the period 1999-2007, only supplanted by Greece and Ireland (Table 49). However, notice that the effect of the financial crisis implied that in 2008-10 Portugal had an inflation rate lower than the EA.

In a monetary union inflation differentials may be originated by price level convergence, due to the convergence of both tradable and non-tradable goods

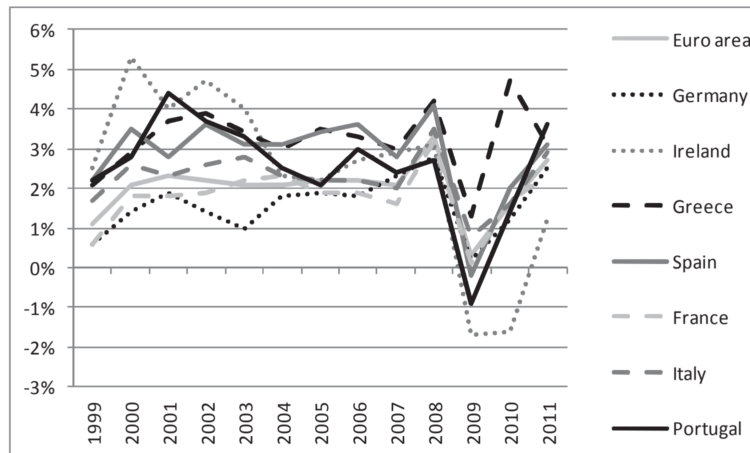
prices (Hofmann and Remsperger, 2005). On the one hand, tradable goods' prices convergence is caused by goods markets' integration that is boosted by the single currency. On the other hand, the introduction of a single currency may originate real income convergence leading to a convergence of non-tradable goods' prices, as predicted by the Balassa-Samuelson effect. During a catching up process, productivity growth occurs more in the tradable goods sector, which is exposed to higher external competition and is more capital-intensive. Consequently, in that sector wages increase without originating inflationary pressures. Since there is labour mobility among tradable and non-tradable goods sectors and competitions in goods market, wages also increase in the non-tradable goods sector. But in the latter sector productivity growth is slower, meaning that the increase in wages has to be compensated by an increase in prices. In sum, catching-up countries, where the productivity differential between the tradable and non-tradable goods sectors is high, will have larger non-tradable goods' inflation.

Figure 158 – Inflation rate (average annual rate of change) in the period 1980-1998



Source: OECD

Figure 159 – Inflation rate (average annual rate of change) in the period 1999-2011



Source: Eurostat

Table 49 – Inflation rate: periods' averages

Country	Mean 1980-1989	Mean 1990-1998	Mean 1999-2007	Mean 2008-2011
Austria	3.8%	2.6%	1.8%	2.2%
Belgium	4.9%	2.3%	2.0%	2.6%
Finland	7.2%	2.3%	1.6%	2.6%
France	7.4%	2.0%	1.8%	1.8%
Germany	2.9%	2.8%	1.6%	1.7%
Greece	19.5%	12.1%	3.2%	3.3%
Ireland	9.3%	2.4%	3.4%	0.3%
Italy	11.2%	4.4%	2.3%	2.2%
Netherlands	2.9%	2.5%	2.4%	1.7%
Portugal	**17.6%**	**6.4%**	**2.9%**	**1.7%**
Spain	10.2%	4.4%	3.1%	2.3%
United Kingdom	7.1%	3.5%	1.6%	3.4%
Euro Area	n.a.	n.a.	2.0%	2.0%

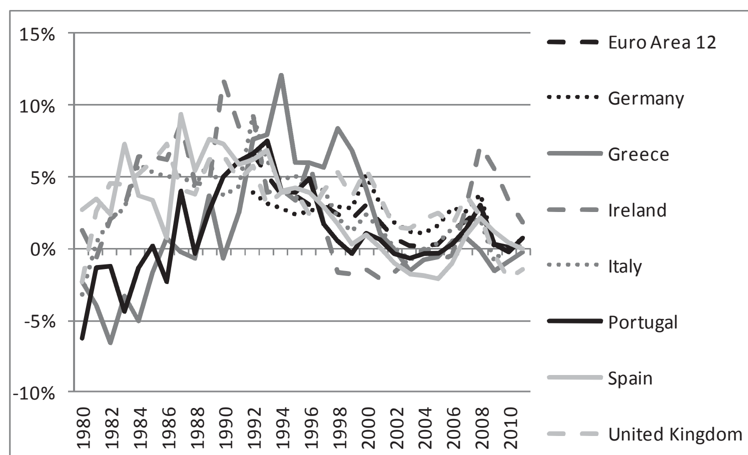
Note: The inflation rate is measured using the Consumer Price Index for the period 1980-1998 and Harmonized Consumer Index Prices for the period 1999-2011

Source: OECD (1980-1998) and Eurostat (1999-2011)

16.5. Evolution of the Portuguese real interest rates

As described in the previous section Portugal was one of the euro area countries with higher levels of inflation during the last three decades. Consequently, the Portuguese real interest rates have been among the lowest in the EA, constituting an important stimulus to investment. This trend has been more visible in relation to the short-term real interest rates, in a context where the evolution of long term real interest rates has been more similar between different European countries, mainly in the last two decades (Figure 160 and Figure 161).

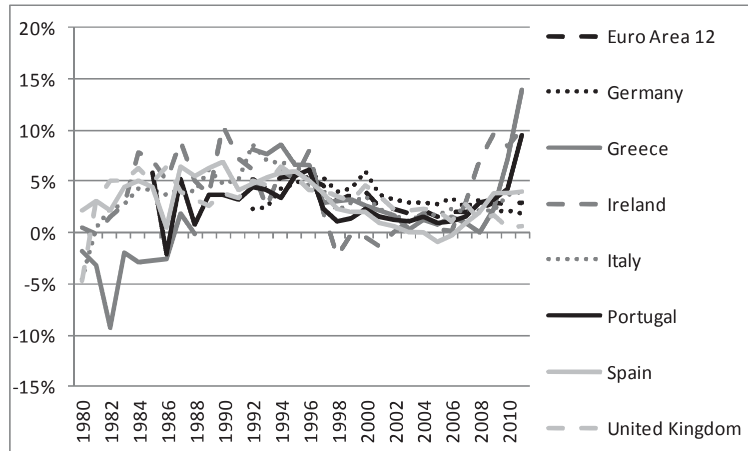
Figure 160 – The evolution of short-term real interest rates



Note: Interest rates are deflated using GDP deflator

Source: AMECO

Figure 161 – The evolution of long-term real interest rates



Note: Interest rates are deflated using GDP deflator

Source: AMECO

During the 1980s the short term Portuguese interest rate was on average negative due to the high inflation. The effect of these abnormally low interest rates could not be fully exploited by firms due to the weak supply of credit. In the 1990s the convergence effort to the Euro implied a tight monetary policy, imposing short term interest rates larger than the EA, which declined substantially after 1996. After the introduction of the euro, the existence of a single monetary policy implied that Portugal, which presented inflation rates higher than the average, had short and long term real interest rate lower than the EA average. During the last two years, this trend reverted and the Portuguese real interest rates increased, especially the long term real interest rates, due to the negative effects of the sovereign debt crisis.

Table 50 – The evolution of real interest rates on average

a) Short-term

Country	Mean 1980-1989	Mean 1990-1998	Mean 1999-2011
Austria	3,0%	3,9%	1,3%
Belgium	6,0%	4,1%	0,9%
Finland	4,8%	5,3%	1,3%
France	3,5%	5,2%	1,2%
Germany	n.a.	3,0%	2,1%
Greece	-1,9%	6,1%	0,6%
Ireland	4,2%	5,2%	0,9%
Italy	3,4%	4,8%	0,7%
Netherlands	5,0%	3,8%	0,7%
Portugal	**-1,0%**	**4,5%**	**0,4%**
Spain	4,6%	4,8%	-0,1%
United Kingdom	4,2%	4,4%	1,8%
Euro Area 12	n.a.	4,0%	1,1%

b) Long-term

Country	Mean 1980-1989	Mean 1990-1998	Mean 1999-2011
Austria	4,2%	4,8%	2,7%
Belgium	6,1%	5,2%	2,4%
Finland	4,3%	6,5%	2,6%
France	4,3%	5,5%	2,4%
Germany	n.a.	4,1%	3,1%
Greece	-2,5%	6,2%	2,9%
Ireland	4,2%	5,0%	3,0%
Italy	2,8%	5,5%	2,4%
Netherlands	6,2%	4,7%	1,9%
Portugal	**2,7%**	**3,8%**	**2,5%**
Spain	4,0%	4,9%	1,5%
United Kingdom	3,6%	4,5%	2,2%
Euro Area 12	n.a.	4,8%	2,5%

Note: real interest rates were calculated using the GDP deflator

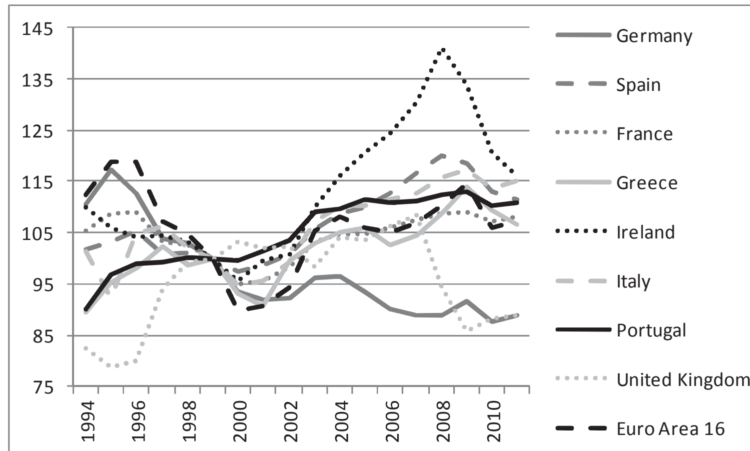
Source: AMECO

16.6. Evolution of the Portuguese real exchange rate

The Portuguese real exchange rate has increased since 1994, particularly between 1994 and 1996 and 2000 and 2003, which reflect a deterioration of the competitiveness of the Portuguese economy (Figure 162). The high levels of inflation and the non-existence of a nominal exchange rate to compensate explains that upward trend.

Comparing with other European partners, Portugal was the country of the EA that lost more competitiveness in the period 1994-1998. During this period the Portuguese real exchange rate appreciated 11.2% while in the EA there was average depreciation of the real exchange of 6.9% (Table 51). During the period of the euro, the Portuguese real exchange rate also appreciated more than the average of the EA16, but the difference was much smaller. The appreciation of the currency was 10.7% in Portugal and 7.3% in the EA16, respectively. In contrast, there was observed a gain of external competiveness in the United Kingdom, Germany and Austria.

Figure 162 – The evolution of real exchange rates (1999=100)



Note: This index aim to assess a country's (or currency area's) price or cost competitiveness relative to its principal competitors in international markets. Changes in cost and price competitiveness depend not only on exchange rate movements but also on cost and price trends. It is deflated by nominal unit labour costs (total economy) against a panel of 36 countries (EU27 plus 9 other industrial countries: Australia, Canada, United States, Japan, Norway, New Zealand, Mexico, Switzerland, and Turkey). A rise in the index means a loss of competitiveness

Source: Eurostat

Table 51 – Changes in the real exchange rate

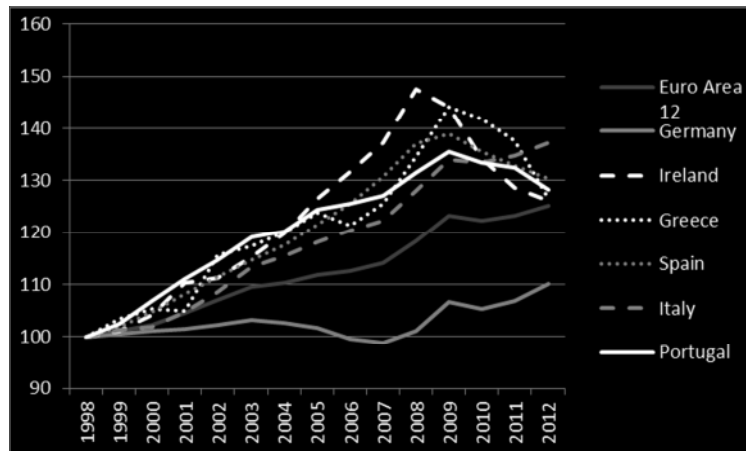
Country	1994-1998	1999-2011
Austria	-7.1%	-4.1%
Germany	-6.9%	-11.1%
Spain	-0.5%	11.4%
Finland	-0.9%	6.1%
France	-2.8%	8.1%
Greece	10.3%	6.6%
Ireland	-6.0%	16.0%
Italy	0.7%	15.2%
Netherlands	-2.0%	10.9%
Portugal	11.2%	10.8%
United Kingdom	20.5%	-11.1%
Euro Area 16	-6.9%	7.3%

Note: See Figure 162

Source: Eurostat

A common argument in the literature is that the loss of competitiveness after the creation of the euro in Portugal and also in Greece, Spain, Italy and Ireland was related to the rapid growth in labour costs (Figure 163). Indeed, the unit labour costs between 1999 and 2009 have grown 12.3% faster in Portugal than in the EU12. The difference to Germany was even larger (+29%). The data for Ireland, Greece and Spain indicate even larger differences to the average. However, from 2009 the ULC have suffered strong declines in the four Southern countries and Ireland, leading to an approximation with the EA12 average. Notice that the evolution of labour costs in the tradable goods sector in Portugal was less expressive than for the average of the economy (data not presented).

Figure 163 – Evolution of unit labour costs



Source: Ameco

16.7. Concluding remarks

The Portuguese economy had a high CA deficit since 2000, but from 2009 to 2012 there was a strong correction due to international credit rationing. During the years of high deficit, the financing was done by banks and the Government. Banks were the major intermediaries between the exterior and the non-financial sector. Consequently, the net debt position of the Portuguese economy

is dominated primarily by banks and the Government. The third position is occupied by non-financial corporations, due to FDI, sell of shares to foreigners, and the issue of short term debt.

Nevertheless Portuguese banks have low levels of foreign currency denominated loans and liabilities, meaning that they have a low vulnerability to exchange rate risk.

The current account deficit was partially explained by the growth of aggregate demand and the loss of external competitiveness associated with high inflation. In the 1980s and the first half of the 1990s, Portugal was a high inflation country. Until the Portuguese economy joined the European Monetary System, the differential in inflation was compensated by devaluations of the currency. The Portuguese convergence effort to join the Euro meant that in the 1990s, namely in the second half, there was a significant reduction in inflation, to values close to the euro area average. But since the creation of the euro, Portugal has had one of the highest average inflation rates of the EA, which implied a reduction in competitiveness.

High Inflation rates can be produced by low real interest rates that stimulate consumption and investment. In the 1980s the short run real interest rates were negative in Portugal, but firms and households did not increase much credit because there was a shortage of credit supply. In the first half of the 1990s the convergence effort to the Euro implied a tight monetary policy, with high real interest rates. But after 1996 the real interest rates declined substantially, to levels below the EA. After the introduction of the euro and up to 2009, real interest rates were below the euro area average due to a higher inflation in Portugal.

High inflation not compensated by a weak currency implies a loss of competitiveness. Portugal was the country of the EA that lost more competitiveness in the period 1994-1998, mainly due to the effort of

convergence to the euro. During the period of the euro, the Portuguese real exchange rate also appreciated more than the average of the EA16, but less than in the period 1994-98. The loss in external competitiveness of the economy was related with the rapid growth of ULC. The real appreciation of the currency and the rapid growth of ULC contribute to explain the high current account deficit since 2000.

Part V – The financial crisis in Portugal

17. The nature and impact of the (2007-?) financial crisis in Portugal[79]

In this section we make an outline of the effects of the financial crisis in Portugal. In Sections 17.1 to 17.5 the effect of the Subprime crisis is assessed, the road to the debt crisis is explained and the impact on key variables is analysed. In Section 17.5 a brief description of the 2011 financial rescue plan is performed.

17.1. The effect of the Subprime and Sovereign Debt Crisis in Portugal

The 2008 crisis was named subprime crisis because its origin was in the subprime credit segment in the US. In fact, during the first years of the 2000s and after the turbulence associated with the *Dot.com* crisis, the economic robustness and the accommodative monetary policy, among other things, favoured the increase of loans to high-risk households in the US, the so-called NINJA loans (loans to a type of borrower with "no income, no job and no assets"). These loans were fundamentally short-term and could be renegotiated more than once depending on the valuation of the property. For banking institutions the subprime credit segment was quite profitable due to its high interest rates.

In addition, the US banking institutions transformed these loans into securities (through securitization operations) and sold them to banks and other financial institutions all around the world, in a strategy of risk immunization and

[79] Point 16 of the Terms of Reference.

diversification. Later on, this caused the crisis to be global, affecting all economies in the world although with different intensities.

Between 2005 and 2006 over eighty per cent of new subprime loans were securitized, a strategy that potentiated the development of this segment. In fact, the subprime market in the US gathered some momentum during the first years of the 2000s, in a context where mortgage credit in this segment tripled between 2005 and 2006. In 2006, this segment accounted for around fourteen per cent of the total value of the market and twenty-one per cent of all new mortgages in the US (Bank of Portugal, 2008).

Nevertheless, in the beginning of 2007, the rate of default of this type of loans started to increase considerably due to the reversal in the upward trend in US house prices, with negative effects on US banking institutions. Besides, Leão (2009) points out two other serious consequences of the increase of the default rate of subprime loans. Firstly, banking institutions began selling the houses that were used as collateral. As such, the decline of US house prices intensified, which had negative repercussions in terms of in the fall of private consumption and investment. Secondly, the value of the CDOs, purchased by most of international financial institutions, fell expressively, and started to be called "toxic financial products".

This generated distrust between banks, because these "toxic financial products" were spread across the global financial system, without their exact location being known in terms of country or in terms of financial institution.

In addition, important financial institutions faced insolvency problems, being rescued by their respective governments (Bear Sterns, Freddie Mac and Fannie Mae in the US and Northern Rock in the UK are some examples). The failure of Lehman Brothers in September 2008 generated a climate of panic, leading to substantial instability in international financial markets, visible in the rise of

volatility and in the sharp drop in prices of the main cyclical assets such as shares and commodity prices.

As a result, some segments of interbank money markets have dried, mainly in longer maturities, which led to a liquidity shortage with direct effects in terms of the rise of loans' interest rates (for firms and households).

The financial crisis quickly became an economic crisis. Indeed, according to the European Commission (2009), the European Union economy entered the steepest downturn on record since the Great Depression. The transmission of the financial turbulence to the real economy evolved rapidly with credit restraint and sagging confidence hitting business investment and household demand for consumer durable goods (cars and appliances for example) and housing. The strong trade connections between countries have also facilitated the rapid cross-country propagation of the economic crisis. The same report highlights that potential output may also be affected by the crisis, due to the high risk aversion that leads to weak investment in physical capital and R&D.

17.2. The subprime market in Portugal and the exposure of banks to the Subprime Crisis

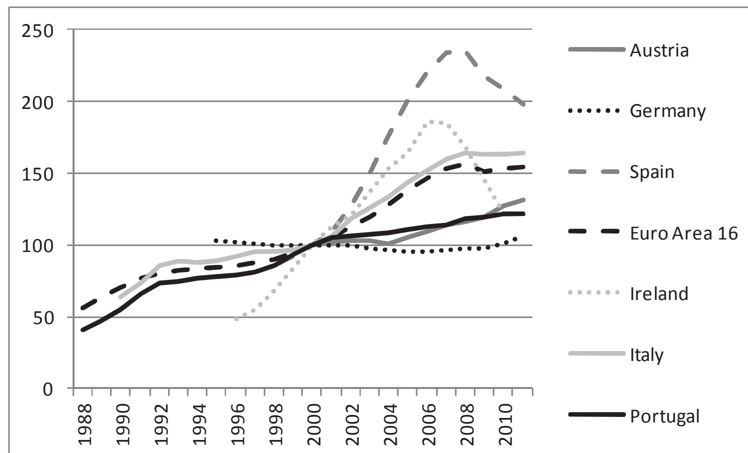
In Europe and particularly in Portugal there was not a subprime market like in the US, despite a similar evolution of interest rates and the upward trend of house prices in some European countries (Bank of Portugal, 2008b). Instead, in Portugal, there occurred a strong increase of credit to households and corporations during the first years of the 2000s, which increased the level of private debt to high values. One consequence of the rapid growth of banking credit was the decrease of the Portuguese banks' solvability to low levels in comparison to other European countries (See Figure 103 above).

Furthermore and 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 (thirty per cent) than in the US (forty-five per cent). That percentage is also lower than in the Netherlands (thirty-eight per cent) or in the UK (forty per cent). On the other hand, Portugal has one of the lowest ratios of credit instalments to income (around fourteen per cent) among the euro area countries. [80] Finally, Portugal also exhibited a low loan-to-value ratio.

On the other hand, in Portugal house prices had a modest increase when compared with other countries, like the US, the UK, Ireland or Spain (Bank of Portugal, 2008). Notice that nominal Portuguese house prices increased much less than the euro area average between 2000 and 2011 (Figure 164). Additionally, the real and nominal Portuguese 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, as the increase in households' income, decrease in nominal and real interest rates and the small dimension of rental market for housing purposes. From the second half of the 1990s, the increase in the supply of new houses avoided a surge in house prices.

[80] This ratio indicates what is the financial effort of the household with its debt.

Figure 164 – 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 a study from the International Monetary Fund stating that in 2007 deviations of house prices in relation to fundamentals were around thirty per cent in the UK, twenty per cent in Ireland, between ten and twenty per cent in France, Spain, Italy and Netherlands; and about seven per cent in the US. In Portugal, the deviation was close to zero per cent.

At the same time, the Portuguese banks did not held in their portfolios “toxic financial products”, having avoided the losses associated with these products. The main difficulty faced by Portuguese banks in consequence of the subprime crisis was the difficulty in obtaining funding in the international financial markets. Notice 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 to the issue of securitized debt by Portuguese banks, as well as by the large liquidity offered by the ECB. Notice that ECB has

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. In the beginning of 2012, the ECB reduced again its key interest rate to 0,75%, a new record low since the creation of the euro area.

In any case, the interest rate reduction by the ECB was slower than the Federal Reserve or the Bank of England, which have adopted programs of asset purchases ("quantitative easing"), in order to mitigate the downside risks of the crisis in the financial sphere and the real economy. However, this more conservative stance of the ECB is due to the fact that its mandate requires primarily the maintenance of price stability. Remember that commodity prices increased significantly in the first months of 2008, which may explain the more conservative stance of the ECB.

Additionally, in a context of high risk aversion and the intensification of flight-to-quality, the increase in the 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 in detriment of shares, investment funds, among others. Notice that Portuguese banks adopted, during this period, more aggressive strategies for attracting deposits, offering high interest rates compared with other financial instruments, like *certificados de aforro* or *títulos do tesouro*.

Nonetheless, the profitability of Portuguese banks felt strongly in 2008, reflecting the drop of commissions, increase of 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 of perceived credit risk lead the Portuguese banks to increase interest rate spreads in credit, which implied a considerable deceleration of private consumption and gross fixed capital formation. Thus and according to

the Bank of Portugal (2010), Portuguese households also decreased their investment in housing due to the higher level of interest rates (See Section 9.2). This caused a deceleration in the growth of house prices between 2007 and 2009. In other European countries there was even a decline in house prices, especially in Ireland (thirty-two per cent), Spain (eleven per cent), Greece (ten per cent) and France (seven per cent).

According to Synek (2009), the indebtedness of Portuguese households began to diminish after the beginning of 2008, due to the deterioration of consumer confidence as well as the reduction of employment. So, the saving rate has reversed the downward trend observed since the beginnings of the 2000s.

17.3. From the Subprime Crisis to the Sovereign Debt Crisis

The fundamentals of the Portuguese crisis

Before entering in the actual description of the details of the debt crisis in Portugal, we start with a digression on the fundamental reasons behind the crisis. The roots of the crisis in Portugal are related with current account imbalances that originated high foreign indebtedness (Higgins and Klitgaard, 2011). Since current account equals internal savings less investment, current account deficits accrue from a lack of savings to support investment.

During the convergence process of Portugal to the euro, interest rates declined significantly, and up to 2007 the Portuguese Government bond yields were almost similar to the German yields. The reduction in interest rates led to an increase in consumption above disposable income, originating a reduction of savings. With investment reducing slightly but continuing at high levels, domestic saving was not enough to finance domestic investment, leading to an increase in foreign indebtedness.

An additional problem was that the increase in aggregate demand increased the cost of labour, reducing external competitiveness and originating the loss of exports market share. Other structural factors also explain the lack of external competitiveness, as the appreciation of the euro, the entrance of new competitors in the international markets and the lack of preparation of Portugal for the knowledge-based economy. Investment was directed to non-tradable goods sectors, with a slow growth of productivity and which do not contributed to the improvement of the current account.

The unfolding of the crisis

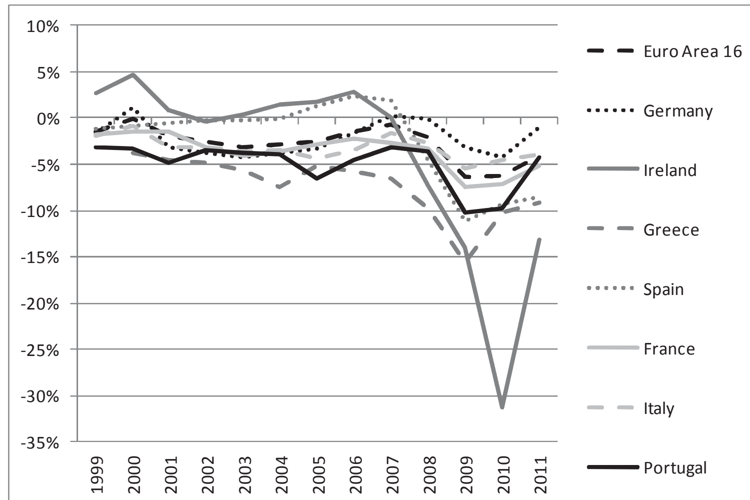
Against this backdrop, the Portuguese economy began to decelerate in the first quarter of 2008 and slipped into an unprecedented recession in the post-war period in the third quarter of 2008, as the majority of international economies.

Initially, the Portuguese economy was not very affected by the Subprime crisis, with a decrease of GDP smaller than the euro area in 2009. That happened due to the strong anti-cyclical response of the Portuguese government during 2009, following the European guidelines and the Keynesian recipe.

At the European level, the European Economic Recovery Plan was a launched in December 2008, a discretionary fiscal stimulus of around 2% of GDP, combining short-term measures to stimulate aggregate demand and maintain jobs, and longer-term measures to invest in strategic sectors, including research and innovation (European Commission, 2009). The aim was to promote economic growth and ensure sustainable prosperity, mitigating the downside risks arising from the subprime crisis.

Against this background, the deficit of the Portuguese Government grew expressively during 2009, surpassing the growth in other euro area countries (Figure 165).

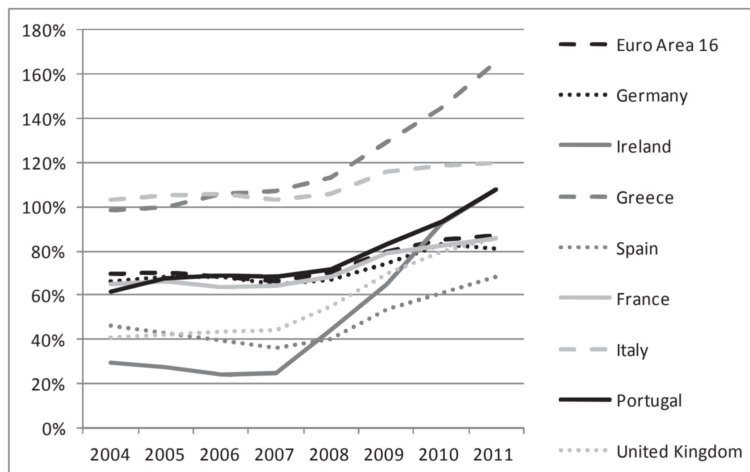
Figure 165 – Public deficit (% of GDP)



Source: Eurostat

However, this occurred in a country that struggled to maintain the public deficit below 3% between 2001 and 2008. So, in 2010, Portugal was one of the euro area countries with worse fiscal deficit. As a consequence, the 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 166).

Figure 166 – Public debt (% of GDP)

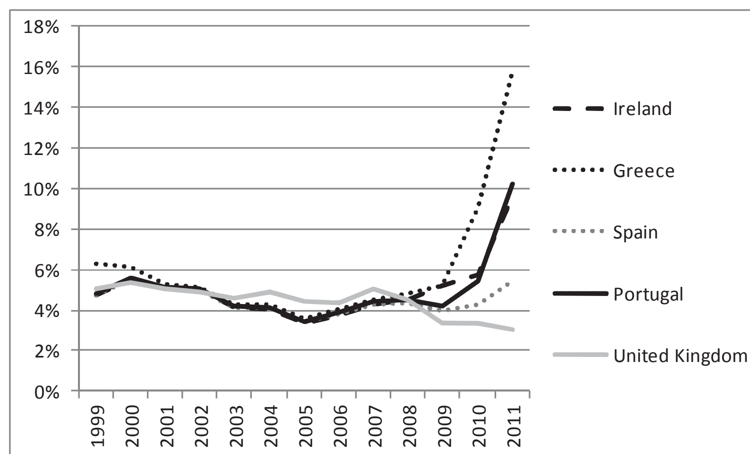


Source: Eurostat

The high levels of debt in the private and public sectors started to raise doubts with international investors regarding the capacity of households, corporations and the State to pay their debts in a scenario of low structural growth.

From 2007, the perception that the risk of Portuguese public debt had increased, meant that the interest rates charged to the Portuguese government and, consequently, to banks started to increase to very high levels, making the financing of the State and banks more costly (Figure 167). Notice that the risk premium between German and Portuguese long term interest rates increased to the highest levels since the creation of the euro area. At the same time, credit default swaps spreads of Portuguese banks, which measure their risk of default, also increased accordingly. The contagion from the Greek situation was also an important factor pushing Portuguese long-term interest rates up.

Figure 167 – Long term interest rates (%)



Source: Ameco

Credit default swaps were used to profit with the decline of the prices of banks' bonds. The characteristics of those financial instruments bring more benefits to speculators when they speculate on prices decrease than on prices increase. Some argue that they amplified the crisis by facilitating the speculation against corporate bonds (especially from banks), increasing directly the cost of debt funding.

Another way of speculating, but against banks' shares, is using short-selling. Recognizing the danger of such operations, the regulator of the securities market, *Comissão do Mercado de Valores Mobiliário,* imposed temporary restrictions to short-selling using stocks of financial institutions and approved new rules to increase the transparency of such operations. In some countries, this type of operations was completely banned.

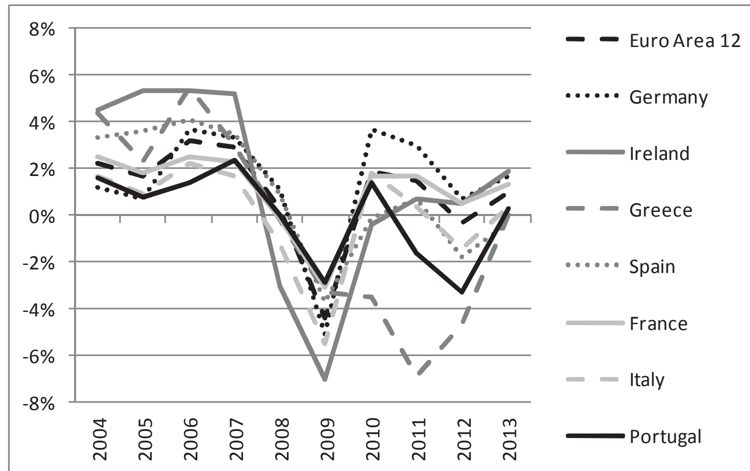
Given the continuous deterioration of the Portuguese situation, especially on the bond market, the most important international rating agencies (Moody's, Standard & Poor's and Fitch) adopted a set of downgrades to the Portuguese sovereign debt during 2010, which was quickly reflected in the reduction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

17.4. The impact of the crisis on key variables

Against this backdrop, the Portuguese government requested financial assistance from the European Union, the International Monetary Fund and the ECB on April 7, 2011. The Troika imposed a demanding program to be implemented in a short period, as described in the next section, with strongly recessionary effects. This program aims to ensure fiscal consolidation, financial stability and the promotion of the potential growth of the economy, through imposing a set of structural reforms.

While Portugal was not very affected by the Subprime Crisis, it was particularly affected by the Euro Sovereign Debt Crisis, presenting one of the worst growth performances among euro area countries in 2010 and 2011 (Figure 168). The outcome was not worse, because Portugal has maintained a good performance in terms of exports (Figure 169).

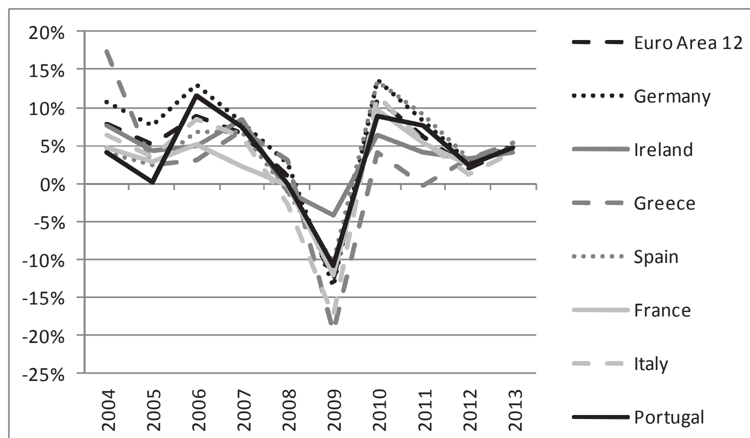
Figure 168 – GDP growth



Note: The values for 2012 and 2013 are forecasts

Source: Eurostat

Figure 169 – Exports growth



Note: The values for 2012 and 2013 are forecasts

Source: Eurostat

During 2011 and in the first months of 2012, the Portuguese domestic demand maintained a declining trend. Private consumption has remained suppressed by the fall in disposable income, as a result of fiscal tightening, reduction of compensation to employees and cuts in social benefits. Households' consumption registered the biggest fall among euro area countries.

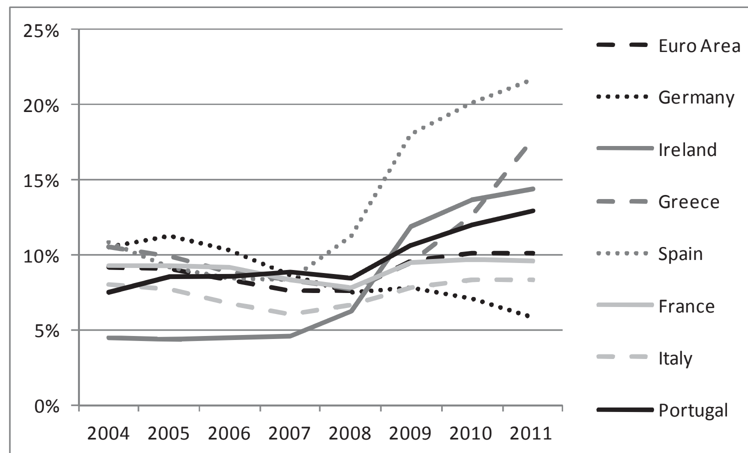
Gross fixed capital formation followed the same trend, accompanying the increasing number of corporate defaults. This was the most penalized expenditure component, recording a fall above 10%, the worst performance of the euro area with the exception of Greece.

Simultaneously, the Portuguese public consumption fell expressively during 2010 and 2011 due to the fiscal consolidation effort, a trend also visible in other countries with fragile public finances, like Greece, Spain and Ireland.

The negative evolution of growth implied that the distance between the unemployment rate in Portugal and in the euro area has increased considerably during the last three years, a trend that may be exacerbated in the coming years due to the current adjustment process of the Portuguese economy imposed by the Troika (Figure 170).

Nowadays, Portugal has one of the highest unemployment rate in Europe, being only lower than Spanish and Greek unemployment rates, which are above 20%. The Portuguese unemployment rate has reached historically high values in the last months, due to the upward trend of structural unemployment and the increase of long-term unemployment. After the Subprime crisis, Guichard and Rusticelli (2010) notes that the increase in long-term unemployment for most European countries has been in line with projections, with a somewhat stronger-than-expected increase recorded only in France and Portugal.

Figure 170 – Unemployment rate



Source: Eurostat

According to a preliminary report from *Ministério das Finanças*, *Ministério da Economia* and *Ministério da Solidariedade e Segurança Social* (2012), the rise of the Portuguese unemployment rate has affected all social strata, but particularly women, unemployed young people with university qualifications who seek their first job and people from construction and manufacturing sectors. At the same time, this report highlights that the rise of unemployment has been greater in the non-tradable goods sector than in the tradable goods sector and, particularly, in the following sectors: scientific and consultancy activities; electricity, gas and water supply and sanitation; and construction. On the other hand, sectors of textiles and cars manufacturing are the sectors where unemployment has increased less.

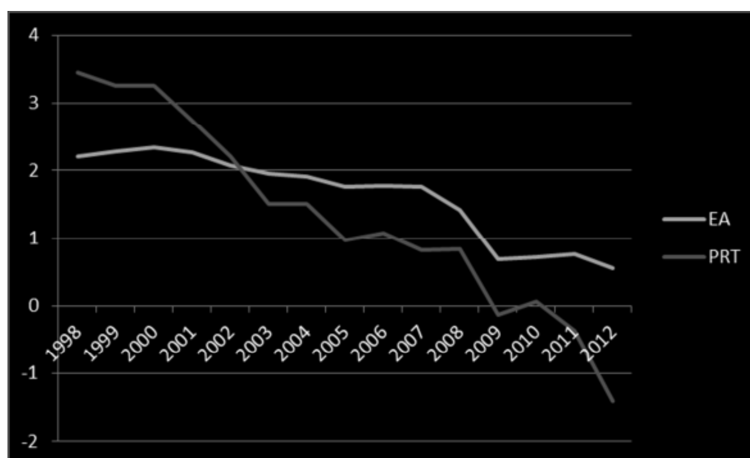
Apart from the cyclical and structural components, the report indicates that there are other factors that could explain the increase of the Portuguese unemployment rate: the current process of deleveraging and the tightening of credit conditions, expectations that the adjustment process of the Portuguese economy will take more time than previous recessions, lack of employment growth in dynamic sectors and the existence of rigidities in the Portuguese labour market (generous unemployment benefits, high employment protection,

high level of labour market segmentation, among others). Notwithstanding the current adjustment process, it seems crucial that there is promotion of a more dynamic labour market, especially for young workers, namely through the promotion of investment and the supporting of corporations funding needs.

17.5. Financial rescue of Portugal

This section is about the financial rescue of Portugal. To understand the reason for this rescue we have to go back to the year 2000, when the Portuguese economic growth started to decelerate considerably, with a strong fall on the potential output growth (Figure 171). The unemployment rate has grown increasing rapidly, reaching the highest levels since the 1974 revolution. Portugal was traditionally a low unemployment country, but in the end of the years 2000s the unemployment rate increased to levels above the European average.

Figure 171 – Growth of potential GDP



Source: Eurostat

Since 1995, domestic savings have reduced substantially, which has been accompanied by an increase in the indebtedness of most economic agents, and a deterioration of Portuguese public finances.

In this context, there was a strong increase in the risk premium of the Portuguese public debt since the second half of 2010, generating increasing difficulties for the public and private sectors to obtain financing. This fragile economic environment led the Portuguese government to request financial assistance from the European Union, the International Monetary Fund and the member countries of the euro area on April 7, 2011.

The financial assistance program was created to finance the State in the short run, favor a sustainable growth of the economy and restore the confidence of international financial markets on Portugal. The financial help covers the period between 2011 and 2014 and contemplates a total funding of 78 billion euros. At the end of the program, the Portuguese State should be able to obtain financing again in the debt market at sustainable interest rates.

Thus, the program involves the implementation of a set of structural measures and reforms, in order to increase the potential output growth, create more jobs, improve competitiveness, ensure a process of deleverage of the financial system and guarantee a trajectory of fiscal consolidation. The range and detail of the program contrasts with previous interventions of the IMF in Portugal. In past interventions, the main goal of IMF was to control public deficit and credit, and promote exchange rate devaluation, without the concern of suggesting detailed structural reforms.

The present program implies the reduction of the public deficit, from 9,8% of GDP in 2010 to 5,9% in 2011, 4,5% in 2012 and 3,0% in 2013. This downward trend will be guaranteed by the execution of policy measures that aim an increase of public revenue and a decrease of public spending. On the revenue side, these measures include a general increase of tax rates, as well as the

reduction of some tax benefits and exemptions. On the expenditure side, measures focus on the reduction of compensation to public servants, social benefits, transfers to regional and local government, among others.

Furthermore, the possibility of renegotiating the Public Private Partnerships (PPP) will be analysed, in order to diminish the financial obligations of the State. Effectively and according to *Direcção-Geral do Tesouro e Finanças* (2011), the amount contracted under PPP is very significant, particularly in the period between 2015 and 2018, in which it is estimated that the costs of current PPP could reach two thousand million euros per year. The costs with the current PPP account for around 1,0% of GDP in 2011, 0,8% in 2012, 0,8% in 2013, 1,1% in 2014 and 1,2% and 2015. Most of these contractual investments pertain to road infrastructures, followed by healthcare infrastructures. In sum, PPP represent a negative pressure on the effort of fiscal consolidation in the medium and long-term.

At the same time, there is the goal of reducing the expenditure of the National Health Service, namely through the adoption of measures regarding prescriptions and co-financing of medicines, the network of the National Health Service, and the management of hospitals with management autonomy.

Finally, the program also imposes a privatization plan, including firms in transports, communications and insurance sectors.

Regarding structural reforms, the main reforms will occur on the labour market, markets for goods and services, the housing market, the judicial system and the financial system, as described below (Bank of Portugal, 2010b).

In the Labour Market the program includes a set of measures, aiming to increase job creation, reduce market segmentation and allow an evolution of wages compatible with prevailing market conditions at the firm level. The focus is on the review of employment protection legislation, the revision of

unemployment protection schemes, the reduction of the cost of overtime labour and the promotion of collective negotiation at the firm level.

In the markets for goods and services, the program focus essentially on the energy, transports and telecommunications sectors, trying to promote competition, a reduction of State's involvement and an independence of regulators. In the energy sector, measures focus on the full liberalization and integration of the Iberian market in the electricity and gas sectors, as well as in the revision of support schemes for renewable energy and co-generation. In the transports sector, the program aims at greater rationalization of transport network. Finally and regarding the telecommunications sector, the reform's proposals are based on the reduction of entry barriers and the mobility of customers between different operators.

In the housing Market the main structural changes aim to guarantee greater efficiency in the rental market, in order to improve labour market mobility and reduce the level of private sector indebtedness.

In the judicial system the proposed measures aim to improve the efficiency of courts' management, reducing the time to judge cases and decreasing the number of cases awaiting trial. Moreover, these reforms also include the creation of two new courts, which will act on issues related to competition and intellectual rights and property.

Regarding the financial system, this program aims to ensure its stability, provide the necessary conditions for the functioning of financial intermediation, in a context of pronounced slowdown of the economy. In general terms, the main priorities of the program are oriented to the process of deleveraging of the banking system and increase of its solvency. Some important measures have been taken, such as the strengthening of banks' collaterals for borrowing money at the ECB, state guarantees for debt issues, periodic target leverage ratios, and a recapitalization plan (for greater detail see Section 2.4).

According with its governor (Costa, 2012), the Banco of Portugal played a central role in the current adjustment process, namely: *(i)* providing liquidity to the financial system; *(ii)* ensuring the recapitalization of banks, in order to meet their new risk profiles; *(iii)* encouraging the restructuration of banks to restore their levels of profitability in accordance with the current business environment; and *(iv)* preserving public confidence in the financial system.

17.6. Concluding remarks

In Portugal there was nothing similar to the phenomenon of subprime loans. Besides, in general credit practices do not seem to have been too aggressive and there was not a bubble in the real estate market. However, credit to the non-financial private sector grew at a rapid pace, leading banks' solvability to low levels (because credit growth was not accompanied by a proportional growth of capital). The lack of domestic saving to finance investment obliged the economy to obtain financing abroad, becoming exposed to an external credit rationing in case of a crisis.

Portuguese banks also did not have on their balance sheets the so called "toxic financial products". The main difficulty of banks was to find financing in the international markets after they have dried up in September 2008. Banks were forced to increase interest rate spreads, with negative consequences for the economy.

In order to avoid a major slowdown after the Subprime crisis, the government followed an expansionary fiscal policy, which weakened the country's fiscal position. The high levels of debt in the private and public sectors started to raise doubts with the international investors regarding the capacity of households, corporations and the State to pay their debts in a scenario of low structural growth. Interest rates on Government long term bonds increased noticeably, to

a point where financing in the markets was not anymore possible, leading the country to ask for international financial help.

The plan of financial assistance of Troika had two major goals: finance the State in the short run and restore the confidence of the markets in the Portuguese economy. The plan looks to achieve the last goal through the reduction of the fiscal deficit to 3% of GDP in 2013 and through a set of structural reforms aiming to increase the potential output growth, create more jobs, improve competitiveness, ensure a process of deleverage of the financial system and guarantee a trajectory of fiscal consolidation. The proposed reforms are essentially on the following areas: PPP, National Health Service, privatizations, labour market, goods and services market, housing market, judicial system and the financial system.

While the Portuguese economy was not very affected by the Subprime crisis, it was particularly affected by the sovereign debt crisis. In 2010 and 2011, the Portuguese growth performance was one of the worst of the EA. Unemployment rate grew to unexpected high levels that may undermine social stability, in a country where the social state is weak. Thigh credit conditions have contributed to the growth of unemployment, as well as the austerity imposed by the Government on the economy.

Conclusion

Since 1980, the Portuguese financial system has changed dramatically, both following and conditioning the evolution of the overall economy. In the second half of the 1970s and in the 1980s high inflation, monetary financing of the fiscal deficit and strong regulation of the banking system were the main characteristics of the macroeconomic environment. Governments after the 1974 Revolution adopted a strong interventionist approach to economic policy, thereby postponing the liberalization of the banking system. In the second half of the 1970s and in large part of the 1980s the Portuguese banking system was mainly dominated by public banks and it was subject to a strong regulation, with weak competition and innovation.

In the second half the 1980s and in the 1990s the liberalization of banking activities took place and monetary policy converged to European standards, with Portugal joining the EMS.

Liberalization of the banking sector

The liberalization of the banking sector started in 1984, when private banks were allowed to operate, followed by the elimination of restrictions to banking activity, privatizations of banks, the free entrance of EU banks, and the adoption of capital requirements. Since 1987, domestic banks reduced dramatically the financing of the Government, foreign banks entered the market, competition increased, there was a wave of takeovers, and the supply of credit increased.

Since 1999 the deregulation of the banking market, the privatisation of banks, and M&A increased considerably the concentration in the banking sector. This increase was one of the largest of the euro area and in 2010, the degree of concentration was above the EA, but it was not very different from other small European countries.

Despite the increase in concentration, competition has increased especially after 2000, causing a reduction of lending interest rates and an increase in credit supply to firms.

The financial integration and the increase in competition led to a modernization of the payment systems and channels of contact with customers. In other areas the progress was slower, as in the use of direct debits and credit transfers.

The growth of credit

In the first half of the 1990s the convergence effort to the Euro implied a tight monetary policy, with high real interest rates. Portugal was the country of the EA in which price-competitiveness has deteriorated the most in the period 1994-1998, as a result of the mixture of exchange rate stability and strong credit growth, both factors resulting from the decision to participate in the euro since its inception. This had strong negative impacts in the development of the tradable goods sectors.

Notwithstanding, after 1996 the economy grew at a rapid pace, largely as a result of the sharp decline in the real interest rates. The strong reduction in the level and volatility of inflation and interest rates, as well as an easier access to external financing by banks caused an increase in credit to the non-private financial sector. The increase of domestic demand hid the problems in the export sector.

Households saving rate decreased considerably since the beginnings of the 1980s. As a result the growth of deposits did not accompany the growth of credit, leading banks to search for other sources of financing. In a more competitive environment, borrowing from abroad and using credit securitization, banks were able to finance the strong cycle of credit growth, initiated in 1995 and ended in 2001/02, and induced by both demand and supply conditions. The use of credit securitization is an example of how a bank-based

system has used market mechanisms to strength its position. Apparently, credit securitization did not create incentives for banks to take excessive risks in credit granting.

The demand also increased considerably, not only due to the decrease in interest rates and increase in actual and expected GDP growth, but also due to specific characteristics of the Portuguese economy. On the households' side, the malfunctioning of the rental market, in a context marked by declining interest rates and increasing real incomes, fostered the acquisition of houses by households. The public policy of subsidized loans created an additional incentive for households to buy houses. On the corporations' side, there was a large effort to modernize production technology.

Credit to households grew much faster than credit to firms, especially in 1994-2002. The segment of credit to households that grew the most was credit for housing, with 80% of the credit to households in 2011 being for this purpose. The credit for firms with medium/long term maturities increased considerably, allowing firms to do more long term investments.

The rapid growth in credit implied that in 2011 both Portuguese households and firms were among the most indebted of the EA, making them vulnerable to an economic slowdown and increasing macroeconomic risk. Probably, credit to the non-financial private sector grew in excess. Since 2008 non-performing loans have increased considerably, especially for some sectors of activity and households' credit segments. Besides translating the deterioration of the business cycle, this constitutes an indication of the difficulties brought by the growth of indebtedness.

The growth of credit and aggregate demand, together with the loss of external competitiveness associated with high inflation implied a high current account deficit since 2000. Other factors weakening the exporting capacity were the liberalization of international trade that allowed Asian countries and other

emerging economies to access the European market, and the de-location of FDI to EU's new Eastern member states. The external financing of the current account deficit was done by banks and the Government. Particularly, banks were the major intermediaries between the rest of the world and the domestic non-financial sector.

Growth of the financial sector

Since the growth of credit generated the growth of the financial sector, in 2011 the importance of that sector in terms of production in Portugal was one of the highest in the EA, and between 1995 and 2011 the growth was one of the fastest. The Gross Operational Surplus (GOS) of financial institutions has grown faster than the GOS of non-financial corporations.

From 1995 to 2010, the financial sector has financed a high level of overall investment in Portugal. Nevertheless, since 2001 there was a decline on the level and efficiency of investment.

In Portugal, financial assets in proportion of GDP are high and they have grown fast between 1995 and 2010, indicating an accumulation of financial rents during the period. The domestic institutional sector with the fastest growth of financial assets was financial corporations, translating probably a transfer of wealth to the financial sector.

Also non-financial firms became more involved in financial operations, as indicated by the fact that such operations are increasingly more important in terms of revenues.

One financial area where Portugal is under developed is the stock market, and the tendency since 1993 has been for a negative divergence with the EA in terms of stock market capitalization. In contrast, Portuguese firms are among the ones of the EA that most issue debt securities, which have grown fast since 1993.

In the same vein, the role pension funds has been receding, with many private pension funds being transferred to the public domain. This movement had a short run positive effect on the fiscal deficit, but in the long run may have negative effects. The importance of investment funds decreased substantially, but the importance of real estate investment funds increased.

Taking advantage of the public NHS's weaknesses and the financial constraints on public investment, private interests have been growing in the Health sector, with the opening of new private hospitals and clinics, an increase in health insurances and the creation of PPP. These partnerships for the construction and management of hospitals benefit banking groups, because they finance the operation and sometimes manage the hospital. For the State, it is still to be proved if it is a good business in the medium and long term.

PPP have even been even more often used in the construction of motorways, bridges and other transport structures. Besides the supposedly superior efficiency of private operators in the construction and management of such structures, once more the main driver has been the possibility of quickly construct structures without affecting the current budget deficit. But an overall balance on the benefit for the State of such operations is still to be done.

Households have invested increasingly in retirement savings plans due to the fear of the end of public pensions system, feeding the growth of insurance companies.

Banks' behaviour

On the banking sector, there was the construction of banking groups through M&A and internal growth, which brought many advantages to banks. Probably on the context of those groups, banks have been devoting a large proportion of their credit capacity to finance non-monetary financial institutions.

Even though universal banking is the rule in Portugal, banks' decreased the amount of resources devoted to securities and financial operations, and their level of engagement in these operations is low. Portuguese banks also trade much less than euro area banks in derivatives, but they have a much higher level of off-balance sheet items.

The several transformations in the Portuguese banking system, namely the increase in competition, lead to a reduction in the financial margin, which however remained above the EA average. In compensation, banks have increased income from services and commissions.

On the cost side, banks have made a rationalisation effort that was interrupted by the financial crisis. Comparatively to Europe, Portuguese banks are relatively efficient.

Combining an analysis of revenues and costs, from 1996 to 2006 the tendency was for an increase in the ROE and ROA of the banking system. Naturally, the financial crisis turned the upward trend in a steep decline. Before the decline, the ROA of Portuguese banks was among the largest of the EA, but comparing with large firms in Portugal banks do not seem to have excess profitability.

The globalization process and the European single market on services allowed Portuguese banks to internationalize their activities. Profits from international operations have been growing in importance and have become significant to mitigate the decrease in profits from domestic activity due to the recession in Portugal.

From 1997 to 2010, the capital adequacy ratios of Portuguese banks have decreased. Initially, the decline was explained by the rapid growth of credit, and later on the period by losses originated by the crisis and difficulties in raising capital. Consequently, in 2008 and 2010, Portuguese banks had one of the lowest levels of regulatory capital of the euro area. Other area of fragility is the high credit-to-deposit ratio, making banks very dependent on market financing.

Financing the real economy

Even though in Portugal, there was no boom-bust cycle in real estate's prices. Despite this, the weight of real estate loans in total loans increased substantially since 1980, especially the credit for households to buy houses; and in 2011 total real estate loans represented around 60% of the loans portfolio. This weight seems to be larger than in some countries of the EA, making Portuguese banks particularly vulnerable to house prices fluctuations. The risk is mitigated because credit practices in housing loans do not seem to have been very aggressive. Moreover, the non-performing loans on households' real estate are not a problem. But non-performing loans of construction firms increased much more than the average of all industries.

Construction and real estate industries have lost importance both in terms of value added and investment at a faster rate than in the EA. In 2011, those industries were less important in Portugal than in the EA. But in terms of employment they were still a very important sector.

Turning now to the financing of firms of all sectors, in recent years Portuguese firms increased the use of debt as source of financing, and in 2011 they were among the most indebted of the EA. NFC used increasingly long term bank loans, which constitute a more stable way of financing long term investment. To finance short-term responsibilities firms use abundantly short term debt securities. These securities are mostly owned by banks, which make use of this market instrument to increase their profits.

Since 2003 to mid-2011, active interest rates were higher in Portugal than in the EA, with the exception of credit to households to buy houses. Portuguese banks charge larger interest rates to SME than to larger firms, with this difference been quite significant (larger than in the EA). Finally, there are indications that SME are less favoured by credit than large firms in periods of credit tightening.

Since 2007 difficulties in obtaining credit increased faster than the overall limitations to investment. In 2011, credit was the third most important limiting factor, with 30% of the firms saying to have credit limitations. Between 1998 and 2011, the sectors facing the largest difficulties in obtaining credit were manufacturing and construction (since 2004 only).

Using a European survey on SME, we conclude that in 2009 before the start of the Euro Debt crisis, the access of SME to finance was not worse in Portugal than the EA average. But from 2010 the crisis implied a larger deterioration of the access to credit by SME in Portugal than in the EA.

The perspective of banks regarding their own credit policy was more negative than the one of firms. From July 2007, credit conditions in Portugal became tighter, with the worsening been larger in Portugal than in the EA.

We observe that between 1993 and 2007 credit to construction, real estate and other non-tradable activities has grown much faster than credit to manufacturing. The alternative to bank credit, the issue of securities, was completely dominated by the financial sector, which inclusive has increased its importance since 1993.

The slow growth of credit to manufacturing may result from or cause the slow growth of that sector's output. Since 1995, manufacturing has lost importance in terms of value added, with the fall being larger in Portugal than in the EA. In 2011, manufacturing was less important in Portugal than in the EA.

The Bust

The growth of credit created the boom and the conditions for the bust. The high growth of aggregate demand, fed by credit and helped by a pro-cyclical expansionary fiscal policy in some years, originated that since the creation of the euro Portugal has had one of the highest average inflation rates of the EA, which implied a reduction in competitiveness. After the inception of the euro, the Portuguese real exchange rate also appreciated more than the average of the EA16.

Around 2002, high inflation, the inevitable slowdown of credit growth (given the increasing levels of indebtedness), the liberalization of worldwide trade, and the vulnerability of the Portuguese export structure to the appreciation of the euro against the US dollar, among other factors, translated into a long period of slow economic growth, resulting in increasing pressure on public finance. During the 2000s the Portuguese economy had one of the worst economic growth performances of the EA, with a high current account deficit financed abroad by banks and the Government.

Up to 2008 the State had helped the growing of finance and market mechanisms, namely through the privatization of banks and other firms, the liberalization of the banking market, fiscal incentives to households for buying houses and shares on the privatizations, integration of pension funds on public social security, and creation of PPP. Some of these decisions did not emerged spontaneously from political parties' programs, but aimed at solving public finance problems. In 2008, the State and the CB took measures to ensure the stability of the financial system, guaranteeing banks' debt, recapitalizing banks, re-enforcing the regulatory framework, and nationalizing of a small bank.

After 1990, the Government also worked for the improvement of the Welfare State. Even though that meant an increase in public expenditure, it was important for the reduction in income inequality and poverty. In spite of these

efforts, in 2010 Portugal was one of the most unequal countries of the EU15 and presented one of the highest poverty rates.

Therefore, when the Subprime crisis occurred, the Portuguese economy was already in a dismal condition. During this crisis, banks had difficulties in obtaining financing in the international markets. After the Sovereign debt crisis begun in late 2009, this and other factors – namely, liquidity problems of banks, increase in uncertainty, rise of regulatory capital requirements, and the increase in non-performing loans – help to explain the sharp worsening of the conditions faced by firms non-financial in obtaining credit.

As a result of the Subprime crises and its subsequent developments, the fiscal position of the Portuguese government deteriorated fast, both as a result of the ' automatic stabilizers' and, to a lesser extent, to the expansionary fiscal policy followed by the government (according to the guidelines agreed at the EU level). International investors (the main buyers of Portuguese public debt) started to raise doubts regarding the capacity of households, corporations and the government to pay their debts. Interest rates on government's long term bonds increased noticeably, forcing the country to resort to international financial help. Since 2009 the current account deficit has decreased sharply, as a result of both the international credit rationing, and the substantial drop in internal consumption and investment (both public and private).

In sum, several indicators suggest that the Portuguese economy has gone through a process of financialisation since the early 1990s, namely the large growth of private debt, the growth of the financial sector, the deregulation of financial markets, and the diffusion of market mechanisms to new areas. This process has contributed to create the conditions for the emergence of the Sovereign Debt crisis in Portugal from 2010 onwards.

References

A. T. Kearney (2009), Tendências geoestratégicas globais em Cross Border M&A (fusões e aquisições transnacionais) e o caso de Portugal, Lisboa

Abreu (2006), "Portugal's boom and bust: lessons from euro newcomers", ECFIN Country Focus, 3 (16)

Aglietta, M. (1998), *Macroéconomie Financière*, La Découverte, Paris

Allen, F. and Gale, D. (2001), *Comparing Financial Systems*, Cambridge, Mass.: MIT Press

Alexandre, F. *et al* (2011), "A Poupança em Portugal", *NIPE WP* 29/ 2011

Álvarez, N. (2012), "The Financialization of the Spanish Economy: Debt, Crisis and Social Cuts", *Mimeo*, Department of Applied Economics, University of Valladolid, Spain

Andrade, J. S. and Adelaide Duarte (2011), "The Fundamentals of the Portuguese Crisis", Estudos do Grupo de Estudos Monetários e Financeiros, Faculdade de Economia da Universidade de Coimbra, Nº16

Antão, P. (2009), "The interest rate pass-through of the Portuguese banking system: characterization and determinants", *WP Banco de Portugal* 5/2009

Antão, P. *et al* (2009), "Integração financeira, estruturas financeiras e as decisões das famílias e das empresas", *in* Banco de Portugal (2009), *A Economia Portuguesa no Contexto da Integração Económica, Financeira e Monetária*, Lisboa

APB (2010), "Boletim Informativo", *Associação Portuguesa de Bancos*

Assa, J. (2012), "Financialisation and its Consequences: the OECD Experience", *Finance Research*, 1 (1), pp.35-39

Bank of Portugal (1997, 2000, 2001, 2008, 2010, 2011), *Annual Report*, Lisbon

Bank of Portugal (2000), "Box II 7.2 Transmission of Movement in Money Market Interest Rates to Lending and Deposit Interest Rates", *Annual Report 1999*, Lisbon

Bank of Portugal (2004), *Financial Stability Report*, Lisbon

Bank of Portugal (2007), *Financial Stability Report*, Lisbon

Bank of Portugal (2008), *Financial Stability Report*, Lisbon

Bank of Portugal (2009), *Financial Stability Report*, Lisbon

Bank of Portugal (2010), "Box 1.1 Housing Markets in the Euro Area", *Annual Report 2010*

Bank of Portugal (2010), "Box The Economic and Financial Adjustment Programme under the Request for Financial Assistance to the European Union, the Member Countries of the Euro Area and the International Monetary Fund", *Annual Report 2010*

Bank of Portugal (2011b), *Survey on the Financial Literacy of the Portuguese Population 2010*, Lisbon

Bank of Portugal (2012), "Box 1.1 Implementation of Economic and Financial Assistance Programme: The Financial Stability Pillar", *Financial Stability Report May 2012*, Lisbon

Bank of Portugal (2012), "Box 3.3 Transfers of Pension Funds and its impact on Public Accounts in Portugal: 1997-2011", *Annual Report 2011*, Lisbon

Bank of Portugal (2012), *Financial Stability Report May 2012*, Lisbon

Barradas, R. *et al* (2011), "The Non-For-Profit Banks in Portugal: Specificities, Social Role and Evolution", *Review of Solidarity Economy*, 4, pp. 59-98

Barros, C. and Maria R. Borges (2011), "Measuring performance in the Portuguese banking industry with a Fourier regression model", *Applied Economics Letters*, 18(1) ,21-28

Barros, F. and Leonor Modesto (1997), "Portuguese Banking Sector: A Mixed Banking Sector", *International Journal of Industrial Organization*, 17(1999), 869-886

Barros, P. Pita (2008), Challenges Ahead for Portugal: The Health Sector in Franco, F. (ed) (2008), *Challenges Ahead for the Portuguese Economy*, Imprensa de Ciências Sociais, Lisboa, 167-184

Becker, J. *et al* (2010), "Peripheral Financialization and Vulnerability to Crisis: A Regulationist Perspective", *Competition and Change*, 14 (3-4), 225-247

Bento, V. (2009), Envolvente Cultural in Bento, V. (2009), *Perceber a Crise para encontrar o Caminho*, 2nd Edition, Bnomics, Lisboa, 146-156

Bento, V. (2010), *O nó cego da economia: Como resolver o principal bloqueio do crescimento económico*, Bnomics, Lisboa.

Blanchard, O. (2007), "Adjustment within the euro. The difficult case of Portugal", *Portuguese Economic Journal*, 6, 1-21

Bonfim, D. *et al* (2011), "Estimativa do impacto de fusões bancárias: uma aplicação ao sistema bancário português" *in* Bank of Portugal, *Stability Financial Report*, May 2011

Boucinha, M. and Nuno Ribeiro (2009), "An Assessment of Competition in the Portuguese Banking System in the 1991-2004", *Working Paper Bank of Portugal*, 1 (2009)

Bowles, S. (1998), "Endogenous Preferences: The Cultural Consequences of Markets and other Economic Institutions", *Journal of Economic Literature*, 36 (2), 75–111

Boyer, B. *et al* (2006), "How do Crisis Spread? Evidence from Accessible and Inaccessible Stock Indices", *Journal of Finance*, 61, 957–1003

Caixa Geral de Depósitos (2010), *Desenvolvimento da Economia Portuguesa*, Relatório CDG, Nº1

Campos, A. C. (2008), A Combinação Público-Privado no Sistema de Saúde in Associação Portuguesa de Economistas (eds.) (2008), *Anuário da Economia Portuguesa (O Economista)*, Lisboa, 154-161

Canhoto, A. e Jean Dermine (2003), "A note on banking efficiency in Portugal, *New* vs. *Old* banks", *Journal of Banking and Finance*, 27 (2003), 2087–2098

Castro, G. Lopes (2007), "O efeito riqueza sobre o consumo privado na economia portuguesa" in Bank of Portugal, *Economic Bulletin*, Winter 2007

Cingolani, M. (2012), "Finance capitalism: A look at the European financial accounts", Paper presented at the 9th International Conference Developments in Economic Theory and Policy, Bilbao, 28-29 June

Corkill, D. (1999), Institutions and the State *in* Aldcroft, D. (ed.) (1999), *The Development of the Portuguese Economy: The case of Europeanization*, Routledge, London, 50-57

Costa, C.S. (2012), *Intervenção do Governador Carlos da Silva Costa na Cerimónia de Abertura do Ano Lectivo da Faculdade de Economia do Porto: "Economia Portuguesa: Insuficiência estrutural de poupança e opções de política"*, Banco de Portugal.

Cottarelli, C. and A. Kourelis (1994), "Financial Structure, Bank Lending Rates, and the Transmission Mechanism of Monetary Policy", *IMF Staff Papers*, 41 (4), 587-623

Crotty, J. R. (2005), "The Neoliberal Paradox: The Impact of Destructive Product Market Competition and Impatient Finance on Nonfinancial Corporations in the Neoliberal Era", *in* Epstein, G. A. (2005), *Financialisation and the World Economy*, Edward Elgar Publishing Limited, Cheltenhan

Demirguc-Kunt, A., and Klapper, L. (2012). "Measuring Financial Inclusion: The Global Findex Database", *Policy Research Working Paper 6025*, The World Bank, April.

Direcção-Geral do Tesouro e Finanças (2011), "Parcerias Público-Privadas e Concessões – Relatório de 2011", Ministério das Finanças

Donnay, M. and H. Degryse (2001), "Bank Lending Rate Pass-Through and Differences in the Transmission of a Sngle EMU Monetary Policy", *Discussion Paper*, Center for Economic Studies, K.U. Leuven, 01.17

Duménil, G. and Lévy, D. (2005), "Costs and Benefits of Neoliberalism: A Class Analysis", *in* Epstein, G. A. (2005), *Financialisation and the World Economy*, Edward Elgar Publishing Limited, Cheltenhan

ECB (2009), "Housing Finance in the Euro Area", *Occasional Paper 101*

ECB (2011), "Recent Developments in Securitization", Banking Supervision Committee, ECB

Epstein, G. A. (2001), "Financialisation, Rentier Interests and Central Bank Policy", *Mimeo*, Department of Economics, University of Massachusetts, Amherst

Epstein, G. A. (2005), *Financialisation and the World Economy*, Edward Elgar Publishing Limited, Cheltenhan

European Commission (2002), *Directorate-General for Economic and Financial Affairs: Supplement A, Economic Trends, Nº 12*, Belgium

European Commission (2004), "The Portuguese Economy after the Boom", Directorate-General for Economic and Financial Affairs, *Occasional Papers* 8

European Commission (2006), "The demographic future of Europe – from challenge to opportunity", Directorate-General for Employment, Social Affairs and Equal Opportunities

European Commission (2008), "Commission adopts European Economic Recovery Plan", European Commission

European Commission (2009), "*Economic* Crisis in Europe: Causes, Consequences and Responses", *European Economy 7*, Economic and Financial Affairs.

Freeman, R. B. (2010), "It's financialisation!", *International Labour Review*, 149 (2), pp. 163-183

Garoupa, N. and Leonor Rossi (2005), Instituições e Quadro Legal *in* Lains, P. and Álvaro Silva (2005), *História Económica de Portugal 1700-2000 – Volume III – O Século XX*, Imprensa de Ciências Sociais, Lisboa

Gintis, H. *et al* (2005), Moral Sentiments and Material Interests: Origins, Evidence, and Consequences *in* Gintis, H. et al (eds.), *Moral Sentiments and Material Interests: The Foundations of Cooperation in Economic Life*, Cambridge MA: MIT Press), 3–39

Guichard, S. and E. Rusticelli (2010), "Assessing the Impact of the Financial Crisis on Structural Unemployment in OECD Countries", *OECD Economics Department Working Papers*, No. 767, OECD Publishing.

Hall, P. and David Soskice (2001), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*, Oxford, Oxford University Press

Hall, P. and Soskice, D. (eds) (2001) *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press).

Honohan, P. (1999), "Consequences for Greece and Portugal of the Opening-Up of the European Banking Market", *Development Economics Group*, The World Bank

Hofmann, B. and Remsperger, H. (2005). "Inflation differentials among the Euro area countries: Potential causes and consequences," *Journal of Asian Economics*, 16, 403-419.

Higgins, M. and Thomas Klitgaard (2011), "Saving Imbalances and the Euro Area Sovereign Debt Crisis", *Current Issues in Economics and Finance*, 17 (5), Federal Reserve Bank of New York

IMF (2006), "Portugal: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Securities Regulation, and Insurance Regulation", *Country Report 06/378*

IMF (2008), "The Changing Housing Cycle and the Implications for Monetary Policy", *World Economic Outlook*, Chapter 3, April

Jayadev, A. And Epstein, G. (2007), "The Correlates of Rentier Returns in OECD Countries", Working Paper nº 123, Political Economy Research Institute, Washington

Kleimeier, S. and Harald Sander (2000), "Asymmetric Adjustment of Commercial Bank Interest Rates in the Euro Area: Implications for Monetary Policy", Paper Presented at the Conference Financial Structure, Bank Behavior and Monetary Policy in the EMU, Groningen 5-6 October.

Kedrodky, P. and Stangler, D. (2011), "Financialization and Its Entrepreneurial Consequences", Kauffman Foundations Research Series: Firm Formation and Economic Growth

Krippner, G. R. (2005), "The financialisation of the American economy", Socio-Economic Review, 3, 173-208

Kyle, A. and Wei Xiong (2001), "Contagion as a Wealth Effect", *Journal of Finance*, 56 (4), 1410–1440

Kus, B. (2012), "Financialisation and Income Inequality in OECD Nations: 1995-2007", *The Economic and Social Review*, 43 (4), pp. 477-495

Lagoa, S. *et al* (2004), "Sistema Bancário: Evolução Recente e seu papel no Ajustamento da Economia Portuguesa", *Prospectiva e Planeamento 10*, Departamento de Prospectiva e Planeamento, 175-230

Leão, E. (2009), "A actual crise económica e a sua origem na esfera financeira", Revista Dirigir, IEFP, I.P., 3-8

Leiva, F. I. And Malinowitz, S. (2007), "Financialization in the Americas: Evidence and Consequences", Mimeo, University at Albany and Universidad Nacional de Colombia

Levine, R. (2002), 'Bank-based or market-based financial systems: which is better?', *NBER Working Paper Series 9138*.

Lima, F. e Paulo S. Pinho (2008), "Financial disintermediation and the measurement of efficiency in banking: the case of Portuguese banks", *International Journal of Banking, Accounting and Finance*, 1(2), 133–148

Lopes, J.S. (1996). *A economia Portuguesa desde 1960*, Gradiva.

Madureira, N. (2002), *A economia dos interesses: Portugal entre as guerras*, Livros Horizonte, Lisboa

Marques, P. , Salavisa, I. , Lagoa, S. (2011), "How has the Lisbon Agenda reshaped the European Social Model? An empirical analysis", Manuscript.

Mendes, V. and João F. Rebelo (1999), "Productive efficiency, technological change and productivity in Portuguese banking", *Applied Financial Economics,* 9 (1), 513–521

Mendes, V. and João F. Rebelo (2000), The Effect of Bank M&As on Efficiency: The Portuguese Experience *in* M. Abreu e V. Mendes (eds.), *What Financial System for Year 2000?*, Lisboa, 287-293

Menkhoff, L. and Norbert T. (2001), *Financial Market Drift: Decoupling of the Financial Sector from the Real Economy*, Springer, Heidelberg

Ministério das Finanças, Ministério da Economia and Ministério da Solidariedade e Segurança Social (2012), "A Evolução Recente do Desemprego, *Preliminary Working Paper*

Minsky, H.P. (1994), 'Financial instability hypothesis' in P. Arestis and M. Sawyer (eds.), *The Elgar Companion to Radical Political Economy*, pp.153–157

Mortágua, M. R. (2011), "The role of Caixa Geral de Depósitos in the current economic crisis (2007-2011): Does public ownership makes a difference?", Master Thesis in Economics, ISCTE-IUL

Neves, J. C. (1997), *Reestruturação de Empresas: papel das fusões e aquisições na internacionalização da economia*, in VI Congresso dos ROC, Universidade Católica Portuguesa, Lisboa

Orhangazi, Ö. (2008), Financialization and the US Economy, Edward Elgar Publishing Limited, Cheltenhan

Orsi, L. and Solari, S. (2010), "Financialisation in Southern European economies", *Working Paper nº 2*, Institutional Change and Trajectories of Socio-Economic Models

Palley, T. I. (2007), "Financialisation: What it is and Why it Matters", *Working Paper 153, Political Economy Research Institute*, Washington.

Peck, J. and Theodore, N. (2007), 'Variegated capitalism', *Progress in Human Geography*, 31 (6): 731–772

Power, D. et al. (2003), "Trends in the Rentier Income Share in OECD Countries, 2960-2000", Working Paper nº 58a, Political Economy Research Institute, Washington

Pinho, P. S. (1999), "The impact of deregulation on price and non-price competition in the Portuguese deposits market", *Journal of Banking & Finance*, 24 (2000), 1515-1533

Pinho, P. S. (2001), "Using accounting data to measure efficiency in banking: an application to Portugal", *Applied Financial Economics* 11, 527–538

Pinto, J. (1995), O Sistema Financeiro *in* Adriano, M. *et al* (eds.) (1994), *Portugal Hoje*, Instituto Nacional de Administração, Lisboa, 267-286

Ribeiro, J. F. (2003), "A Internacionalização da Economia Portuguesa na Década de 90", *Prospectiva e Planeamento 9*, Departamento de Prospectiva e Planeamento, 69-85

Ribeiro, M. P. (2006), "*Economia de escala e de gama e os efeitos da concentração na eficiência bancária*", Tese de Doutoramento, Universidade do Minho

Río, A. del (2002), "El Endeudamiento de Los Hogares Españoles: Una Comparación Internacional" in Banco de España, *Boletín Económico*, 43-50

Silva, J. and Miguel Diz (2005), "Mergers and Acquisitions in the Portuguese Banking Industry: Is it there a Process of Value Creation?", University of Evora, *mimeo*

Sørensen, Christoffer and Thomas Werner (2006), "Bank Interest Rate Pass-Through in the Euro Area: a Cross Country Comparison", *WP ECB*, 580

Stockhammer, E. (2010), "Financialization and the Global Economy", *Working Paper nº 240*, Political Economy Research Institute, Washington

Stiglitz, J. and Greenwald, B. (2003), *Towards a New Paradigm in Monetary Economics*, Cambridge University Press

Synek, C. (2009), "Impacto da recente crise financeira internacional na riqueza das famílias em Portugal e na área do euro", *WP GPEARI 2/2009*

Toporowski (2010), *Why the world economy needs a financial crash and other critical essays on financial economics*, Anthem Press, London and New York

Uhde, A. and U. Heimeshoff (2009), "Consolidation in Banking and Financial Stability in Europe: Empirical Evidence", *Journal of Banking and Finance*, 33, 1299-1311

Yeldan, A. E. (2000), "The Impact of Financial Liberalization and the Rise of Financial Rents on Income Inequality: The Case of Turkey", *Working Paper nº 206*, UNU World Institute for Development Economics Research

Annexes

Annex I

Table A.1 – (Re)privatizations in the Portuguese banking

Bank	Date
Banco Totta & Açores	
1st Phase	22-03-1989 and
2nd Phase	10-07-1989
3rd Phase	31-07-1990
	19-11-1996
Banco Português do Atlântico	
1st Phase	11-12-1990
2nd Phase	25-05-1992
3rd Phase	07-07-1993
4th Phase	24-03-1995
Sociedade Financeira Portuguesa	06-05-1991
Banco Espírito Santo & Comercial de Lisboa	09-07-1991
1st Phase	25-02-1992
2nd Phase	
Banco Fonsecas & Burnay	
1st Phase	27-08-1991
2nd Phase	20-07-1992
Banco Internacional do Funchal	23-11-1992
Crédito Predial Português	02-12-1992
União de Bancos Portugueses	
1st Phase	03-02-1993
2nd Phase	11-07-1995
Banco de Fomento e Exterior	
1st Phase	27-12-1994
2nd Phase	28-08-1996
3rd Phase	07-02-1997
Banco Pinto & Sotto Mayor	
1st Phase	16-11-1994
2nd Phase	28-03-1995
Banco Comercial dos Açores	
1st Phase	02-07-1996
2nd Phase	09-12-1996

Note: Sociedade Financeira Portuguesa – Banco de Investimento, S.A. changed its name to Banco Mello, S.A. and to Banco Mello Investimentos, S.A. on 26

June 1996. União de Bancos Portugueses changed its name to Banco Mello Comercial, S.A. on 28 June 1996. Source: Mendes e Rebelo (2000)

Annex II

Table A.2 – The velocity of adjustment of interest rates (adjustment coefficient of the Error Correction Model)

Country	Mortgage Loans		Consumer Loans		Short Tems Loans to Firms		Time Deposits	
	Coefficient	p-value	Coefficient	p-value	Coefficient	p-value	Coefficient	p-va
Austria	-0.192	0.001	-0.330	0.000	-0.027	0.640	-0.355	0.0
Belgium	-0.103	0.011	-0.058	0.144	-0.166	0.157	-0.153	0.1
Germany	-0.231	0.000	-0.180	0.003	-0.047	0.095	-0.246	0.0
Spain	-0.069	0.000	-0.526	0.000	-0.925	0.000	-0.396	0.0
Finland	-0.098	0.011	-0.211	0.000	n.a.	n.a.	-0.052	0.1
France	-0.076	0.001	-0.133	0.001	-0.780	0.000	-0.233	0.0
Ireland	-0.097	0.053	n.a.	n.a.	-0.315	0.002	n.a.	n.
Italy	-0.129	0.010	n.a.	n.a.	-0.330	0.000	-0.087	0.1
Netherlands	-0.190	0.000	n.a.	n.a.	-0.849	0.000	-0.154	0.0
Portugal	-0.124	0.023	-0.397	0.001	-0.287	0.000	-0.213	0.0
Euro Area 10 (average)	-0.131	-	-0.262	-	-0.414	-	-0.210	-

Note: Euro area is the unweighted average of 10 countries. Source: Sørensen and Werner (2006)

Table A 3 – Joiners and leavers of the Portuguese banking market

Date	Credit Institutions	Joiners	Leavers
1998	227	n.a.	n.a.
1999	224	5 Credifin Bank Brussels Lambert BIG Banco Rural Europa Rheinische Hypothekenbank AG	8 CCAM Olhão Universo Banco Directo CCAM Mesão Frio CCAM Peniche CCAM Baião CCAM Cinfães CCAM Sernancelhe CCAM Vila Nova de Paiva
2000	218	8 Caja de Ahorros Y Monte de Piedad de Madrid Citibank International PLC Banco Popular Español Renault Crédit International BMW Bank GMBH Caja de Ahorros de Galicia Banco Mais Banque Privée Edmond de Rothschild Luxembourg	14 CCAM Amarante CCAM Valpaços Caixa Económica da Guarda Citibank Portugal Argentaria Caja Postal Y Banco Hipotecario ygma Banque Banco Mello Banco Português do Atlântico CCAM Sabrosa CCAM Vila Real de Santo António The Bank of Tokyo-Mitsubishi CCAM Barlavento Algarvio CCAM Alcochete Banco Pinto & Sotto Mayor
2001	212	5 Banco Português de Gestão Dresdner Bank Luxembourg BANIF - Banco de Investimento BEST - Banco Electrónico de Serviço Total Eurohypo A. E. H. der Deutschen Bank	11 Banco Mello Imobiliári Banco Sabadell CCAM Arronches CCAM Benavente CCAM Monforte CCAM Samora Correia CCAM Vila Franca das Naves CCAM Carregal do Sal CCAM Pinhel Credit Lyonnais Portugal Banco Nacional Ultramarino
2002	202	3 Banco Postal Banco Espírito Santo dos Açores Eurohypo Aktiengesellschaft	13 CCAM Alcáçovas e Viana do Alentejo CCAM Ílhavo CCAM Penalva do Castelo CCAM Alte CCAM Vila do Bispo CCAM Santa Marta de Penaguião CCAM Amarante CCAM Mira CCAM Sever do Vouga Caixa Económica da Misericórdia de Ponta Delgada Eurohypo A. E. H. der Deutschen Bank RHEINHYP - Rheinische Hypothekenbank AG, Selectibail Selectibail
2003	200	4 Banco Cetelem Banque Centrale de Compensation - Clearnet BNP Paribas Private Bank General Electric Capital Bank	6 CCAM Aguiar da Beira CCAM Cabeceiras de Basto CCAM Celorico da Beira CCAM Aljezur Banco de Negocios Argentaria Banco Cetelem
2004	197	4 Santander Consumer Finance Banque Accord SA Portugal ypo Real Estate Bank International Monte de Piedad Y Caja General de Ahorros de Badajoz	7 CCAM Portalegre Banco Expresso Atlântico Banco Postal Banco Santander Portugal Central - Banco de Investimento Crédibanco - Banco de Crédito Pessoal Crédito Predial Português

This project is funded by the European Union under
the 7th Research Framework programme (theme SSH)
Grant Agreement nr 266800

2005	186	0	11 Banque Centrale de Compensation Clearnet CCAM Lagoa CCAM Mortágua Banco Sabadell CCAM Castro Daire CCAM Vila Viçosa CCAM Murtosa CCAM Santa Maria da Feira CCAM Ribatejo Centro CCAM Avis CCAM Vila Nova Anços
2006	178	1 Banco Primus	9 Banco Internacional de Crédito CCAM Figueiró dos Vinhos Hypo Real Estate Bank International CCAM Fafe CCAM Figueira da Foz CCAM Castelo Branco CCAM S. Pedro do Sul Bankboston Latino Americano CCAM Montemor-o-Novo
2007	175	6 Anglo Irish Bank The Royal Bank of Scotland Public Limited Company CCAM Torres de Viriato Dexia Sabadell Banco Local Banco Credibom CCAM Entre Tejo e Sado	9 Banco Popular Español CCAM Montalegre Banque Accord SA Portugal CCAM Nelas e Carregal do Sal CCAM Viseu-Tondela CCAM Sintra e Litoral CCAM Baixo Vouga General Electric Capital Bank CCAM Entre Tejo e Sado
2008	175	8 Banque Privée Espírito Santo BNP Paribas Securities Services UBS Bank CCAM Nordeste Alentejano Banco BIC Português Caja de Ahorros de Valencia Hyposwiss Private Bank Genève Banco L.J. Carregosa	8 CCAM Favaios CCAM Costa Verde CCAM Ponte de Sôr CCAM Portalegre e Alter do Chã Anglo Irish Bank CCAM Guarda e Celorico da Beira CCAM Fornos de Algodres CCAM Vila Nova de Tazém
2009	166	2 CCAM Alentejo Central Banco Privado Atlântico	11 Banco BANIF e Comercial dos Açores CCAM Armamar e Moimenta da Beira CCAM Alto Douro CCAM Barcelos CCAM Évora CCAM Alto Guadiana CCAM Guimarães UBS Bank Banco Millennium BCP Investimento CCAM Vale do Douro CCAM Vila Nova de Paiva
2010	160	1 CCAM Alto Cávado e Basto	7 Credifin Banco Privado Português CCAM Tarouca BSN - Banco Santander de Negócios Portugal CCAM Amares CCAM Santo Tirso CCAM Minho
2011	155	0	5 The Royal Bank of Scotland Sanpaolo Imi Bank Caixa de Aforros de Vigo The Royal Bank of Scotland Public Limited Company Caja de Ahorros de Valencia

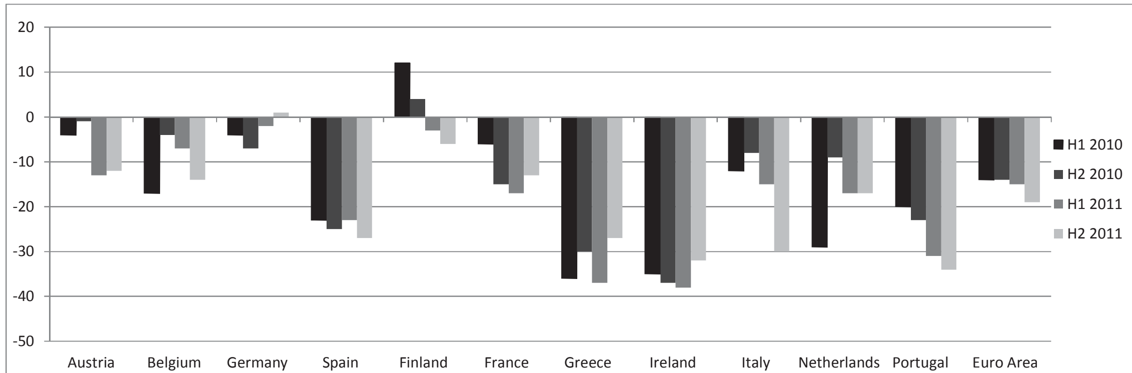
Note: "There are four events that could result in a financial institution joining the MFI sector: the establishment of an MFI as a result of a merger, the establishment of new legal entities as a result of the division of an existing MFI, the establishment of a new MFI and a change in a status of a previous non-MFI such that it becomes an MFI. There are five events that could result in a financial institution leaving the MFI sector: the involvement of an MFI in an merger, the purchase of an MFI by another MFI, the division of an MFI into separate legal entities, a change in the status of MFI such that it becomes a non-MFI and the liquidation of an MFI."
Source: ECB (Total number of MFIs, several years)

Table A 4 – The main factors limiting investment (% of the total).

CAE (3rd Revision)		Insufficient Production Capacity	Deterioration of the Outlook for Sale	Difficulty of Hiring Qualified Employees	Level of Interest Rates	Return on Equity	Capacity of Auto-Funding	Difficulty in Obtaining Credit	Capital Markets
Extractive Industry	1998	6	23	10	6	15	20	5	0
	2003	25	48	0	0	7	4	0	0
	2011	2	94	0	0	0	0	2	0
Manufacturing	1998	5	35	5	6	15	14	8	0
	2003	4	56	1	2	13	8	8	0
	2011	4	53	2	4	16	5	15	0
Electricity, Gas, Water, Sewerage, Remediation	1998	0	17	0	3	0	0	0	0
	2003	0	4	0	4	2	30	6	0
	2011	0	3	0	3	14	17	31	0
Captation, Remediation and Distribution of	1998	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2003	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2011	13	18	0	7	8	20	13	0
Construction	1998	7	30	7	6	21	18	3	0
	2003	5	51	5	1	15	8	6	2
	2011	2	65	0	0	7	5	14	0
Wholesale/Retail Trade, Repair of Vehicles	1998	1	41	7	4	14	15	1	0
	2003	6	55	1	6	15	9	3	0
	2011	1	62	0	2	18	4	8	0
Transportation and Storage	1998	8	33	6	0	23	13	4	0
	2003	0	50	0	1	8	6	30	0
	2011	1	45	0	0	29	5	15	0
Accommodation and Food Service Activities	1998	5	46	8	5	7	22	1	0
	2003	0	34	0	0	65	1	0	0
	2011	5	77	0	0	11	0	7	0
Information and Communication	1998	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2003	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2011	1	49	0	1	17	12	10	0
Financial and Insurance Activities	1998	0	13	0	3	19	10	0	2
	2003	1	45	0	13	11	21	0	0
	2011	0	28	0	3	2	1	28	0
Real Estate Activities	1998	1	36	6	5	15	16	4	0
	2003	9	28	11	1	20	22	2	1
	2011	0	38	0	0	12	37	12	0
Consultancy, Scientific and Technological	1998	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2003	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2011	5	53	0	1	11	11	9	5
Administrative/ Support Services	1998	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2003	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	2011	9	54	0	2	13	4	14	1
Total	1998	**4**	**36**	**6**	**5**	**15**	**16**	**4**	**0**
	2003	**5**	**52**	**2**	**3**	**17**	**9**	**6**	**0**
	2011	**3**	**59**	**1**	**2**	**15**	**5**	**12**	**0**

Source: INE (Inquérito Qualitativo de Conjuntura ao Investimento)

Figure A 5 – Change in the availability of bank overdrafts as perceived by SMES (net percentages)



Source: European Central Bank (Survey on the Access to Finance of SMEs in the Euro Area)

Annex III – Description of the main financial groups

CGD Group

Caixa Geral de Depósitos was founded in 1876 and was always owned exclusively by State capital. Since 1993, it is a public limited company owned exclusively by the State. It has the same rights and obligations of any commercial banks, acting in free and just competition with them. CGD Group is the largest financial group on the Portuguese economy and develops activities in several business areas, through some business companies owned directly or indirectly by the Group itself.

In aggregate terms, CGD Group has developed some business areas both at the national and international level, like commercial banking, investment banking and venture capital, asset management, specialized credit, insurance and health care, among others.

In Portugal, Group CGD has activity in many areas, namely:

- Commercial Banking, through Caixa Geral de Depósitos (100%);

- Asset management, through Caixa Gestão de Activos (100%), CGD Pensões (100%), among others;

- Specialised Credit, through Caixa Leasing and Factoring (51%), like other companies;

- Investment banking and venture capital, through Caixa Banco de Investimento (100%), among others;

- Insurance, owning some insurance companies, like Companhia de Seguros Fidelidade Mundial (100%), Império Bonança Companhia de Seguros (100%), Via Directa Companhia de Seguros (100%), like others;

- Health care, through shareholding in some hospitals.

Moreover, CGD Group participates in the capital of other non-financial corporations, like Zon Multimédia (10,9%), Tagus Park (10%), Cimpor (9,6%), Águas de Portugal (9,7%), Portugal Telecom (6,2%), Galp Energia (1,7%), REN (1,2%), EDP (0,2%), among others.

Internationally, CGD Group is present in some countries (Spain, Mozambique, Angola, Brazil, Cape Verde, among others), acting in the same business areas as at the domestic level, through participation in some companies, namely:

- Commercial Banking, by Spanish Banco Caixa Geral (99,8%), Brazilian Banco Caixa Geral (100%), Macaense BNU (100%), like other banks;

- Specialised Credit, through Mozambican BCI – ALD (46,1%) and Cape Verdean Promoleasing (60,2%);

- Investment banking and venture capital, through Mozambican Banco Nacional Investimento (50%), among others;

- Insurance, participating in some insurance companies, like Cape Verdean Garantia (65,4%) and Angolan Universal Seguros (70,0%).

The largest subsidiaries of CGD Group are Caixa Seguros e Saúde (capital owned: 1,229 Millions (M) € - 100%), Parcaixa (510 M€ - 100%), Banco Caixa Geral (Brasil) (395.8 M€- 99.79%), Banco para a Promoção e Desenvolvimento (182.2 M€ - 49.99%), among others.

BCP Group

Banco Comercial Português was founded in May 1986. In 1989, Banco Comercial Português created Nova Rede, a retail network oriented for the mass market customers.

Since then, Banco Comercial Português has been growing through acquisition of other financial institutions. In this way, Banco Comercial Português acquired Banco Português do Atlântico (in 1995), Banco Pinto & Sotto Mayor (in 2000) and Banco Mello (in 2000).

The brand Millennium BCP was created in October 2003, incorporation prior acquisitions and unifying the several retail networks of the group. Actually, BCP Group is the largest Portuguese private financial group.

After that and as Portuguese banking market reached some maturity, Banco Comercial Português extended its know-how for other countries with high growth potential and/or with the presence of the Portuguese community. In this way, BCP Group is now established in Poland, Greece, Romania, Switzerland, France, Luxembourg, Mozambique, Angola, China, among other countries.

BCP Group acts in several business areas, not only related with commercial banking, but also with other complementary activities, as asset management, investment banking and venture capital, insurance, among others. At the national level, Group BCP has activity in many areas, namely:

- Commercial Banking, through Millennium bcp retail network (100%) and Activo Bank (100%);

- Asset management, through Millennium bcp Gestão de Activos (100%), Interfundos (100%) and Pensõesgere (49%);

- Investment banking and venture capital, through Millennium bcp Investment Banking (100%) and BCP Capital – Sociedade de Capital de Risco (100%);

- Insurance, owning participations in some insurance companies, like Ocidental – Companhia Portuguesa de Seguros (49%) and Médis – Companhia Portuguesa de Seguros de Saúde (49%);

At the international level, BCP Group operates in some countries, offering products and services from different financial areas, namely:

- Commercial Banking, by Banco Internacional Moçambicano (BIM) (66,7%), Banco Millennium Angola (52,7%), Bank Millennium in Poland (65,5%), Banque Privée BCP in Switzerland (100%), among others;

- Specialised Credit, through Millennium Leasing (100%) and BG Leasing, both in Poland (100%);

- Asset management, through Millennium TFI (100%) in Poland, Millennium Mutual Funds Management (100%) in Greece, among others;

The largest subsidiaries of BCP Group are Millennium Bank in Greece (199.6 M€ - 100%), Millennium BIM (130.3 M - 66,7%), Banca Millennium in Romania (56 M€ - 100%), Banco ActivoBank (41 M€ - 100%), among others.

In the end of the first semester of 2012, the main shareholders of BCP Group were individuals (42,26%), institutional investors (34,05%), corporations (22,99%) and employees (0,70%). The respective capital is quite dispersed, although the main shareholders were: Grupo Sonangol (11,03%), Grupo Teixeira Duarte (5,36%), Grupo Sabadell (3,97%), Grupo Berardo (3,07%), Grupo EDP (2,99%) and Grupo Caixa Geral de Depósitos (2,96%).

BES Group

The origin of BES Group is clearly associated with the creation of Caza de Câmbio, in 1869, which was specialized on the national and international transactions of financial instruments.

Nonetheless, the name of Banco Espírito Santo only appeared in 1920, following a fusion with Banco Comercial de Lisboa, which originated Banco Espírito Santo

Comercial de Lisboa. This was nationalized after the 1974 revolution, gaining again a private status only in the second half of eighties.

BES Group is a universal financial services group, offering a set of services oriented to all type of segments, namely individual, corporate and institutional. BES Group also operates on different business areas, as commercial banking, investment banking, asset management, as described below:

- Commercial Banking, through Banco Espírito Santo retail network (100%);

- Asset management, through Espírito Santo Activos Financeiros (90%) and Banco BEST (75%);

- Investment banking and venture capital, through Banco Espírito Santo de Investimento (100%);

- Insurance, owning participations in some insurance companies, like Companhia de Seguros Tranquilidade;

At the same time, BES Group has a strong international presence, especially in some countries with cultural and economic affinities with Portugal, like Spain, Brazil, Cape Verde, Venezuela, United States of America, China, Poland, France, United Kingdom and Libya.

In Spain, BES Group operates through its 25 branches and 9 corporate centers. BES Group is also present in Brazil, through BES Investimento do Brazil and BESAF – BES Activos Financeiros. In Angola, BES Group has a strong presence through BES Angola, benefiting from its 34 branches, 1 private banking center and 1 corporate center. The activity of BES Group in Cape Verde is limited to the existence of 2 branches. In Venezuela, BES inaugurated recently a one branch. In Lybia, BES Group operates through a 40% stake in Aman Bank, owning 33 branches. In Poland, BES Group is present through Espírito Santo Investment

Sp. In France, BES Group conducts its activity through Banque Espírito Santo et de la Vénétie, in which it has a 42,69% stake. In China, BES Group is represented by BES Oriente. In the USA, BES Group conducts its activity essentially through Espírito Santo Bank, based in Miami. In the UK, BES owns one branch.

In the end of 2011, the main shareholders of BES Group were BESPAR - S.G.P.S., S.A. (35%), Crédit Agrícole, S.A. (8,63%), BRADPORT, S.G.P.S., S.A. (4,83%), Silchester International Investors Limited (5,67%) and Portugal Telecom, S.G.P.S., S.A. (2,09%). The remaining capital is spread by different shareholders.

Santander Totta Group

The Group Santander gained importance in the Portuguese market in December 2000, after the acquisition of Banco Totta & Açores. The latter bank had been re-privatized only in the end of 1992.

Santander Totta Group is present in several business areas, like commercial banking (individuals and small business, companies, promoters and brokers, cards and POS, and transaction banking), global banking and markets (equity, cash equities, fixed income sales, corporate finance and custody), asset management (investment and pension funds), among others. The presence of the group on those business areas is done sometimes through specialized companies:

- Commercial Banking through Banco Santander Totta;
- Asset management through Santander Gestão de Activos, Santander Asset Management and Santander Pensões;
- Insurance and Health Care using Santander Totta Seguros.

Internationally, the Group Santander is present in Angola, Cayman Islands and Porto Rico, through Banco Caixa Geral Totta de Angola, Serfim International Bank & Trust, Totta & Açores Financing and Bst International Bank, respectively.

In the end of the first semester of 2012, Santander Totta Group was owned essentially by Santander Totta, S.G.P.S., S.A. (97,65%) and TaxaGest - S.G.P.S., S.A. (2,22%).

BPI Group

The origin of this group was Sociedade Portuguesa de Investimento, founded in 1981. In 1985, Sociedade Portuguesa de Investimento changed its name to Banco Português de Investimento (BPI) and acquired the possibility to take deposits, grant short-term credits, participate in the interbank market and some foreign exchange transactions.

In 1991, BPI acquired Banco Fonsecas & Burnay, ensuring its entry into the commercial banking activity. So, BPI began to ensure the provision of a wide range of products and financial services to individuals and corporations.

In 1996, BPI also acquired Banco Fomento do Exterior and Banco Borges & Irmão, resulting in the creation of BPI Group in 1998 as a fusion between these three different banks.

Nowadays, BPI Group focus on five different business areas, like commercial banking, investment banking, private equity, asset management and insurance, as described below:

- Commercial banking, carried on by Banco BPI (100%) and the services provided by the Madrid branch;

- Investment banking, through BPI (100%) and BPI Suisse (100%);

- Private Equity, through BPI Private Equity (100%);

- Asset Management, through BPI Gestão de Activos (100%) and BPI Vida e Pensões (100%);

- Insurance, owning participations in Allianz Portugal (35%) and in Cosec (50%).

On an international level, BPI Group is represented essentially in Angola and Mozambique, through Banco de Fomento Angola and Banco Comercial e de Investimentos, owned in 50,1% and 30% by BPI Group, respectively.

The largest subsidiaries of BPI Group are Banco BPI (capital owned: 41.6 M€ - 100%), Banco Português de Investimento (62.1 M€ - 100%), Banco Fomento de Angola (558.1 M€ - 50,08%), BPI Vida e Pensões (140.2 M€ - 100%), Companhia de Seguros Allianz Portugal (182.7 M€ - 35%), BPI Gestão de Activos (24.2 M€ - 100%), among others.

In the end of the first semester of 2012, BPI Group was mostly owned by Grupo La Caixa (39,5%), Santoro (19,4%), Grupo Allianz (8,8%) and HVF, S.G.P.S., S.A. (3,0%). The remaining capital is spread by different shareholders.

Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 (contract number : 266800). The University of Leeds is the lead co-ordinator for the research project with a budget of over 2 million euros.

THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

FESSUD

This project is funded by the European Union under the 7th Research Framework programme (theme SSH) Grant Agreement nr 266800

THE PARTNERS IN THE CONSORTIUM ARE:

Participant Number	Participant organisation name	Country
1 (Coordinator)	University of Leeds	UK
2	University of Siena	Italy
3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
5	Pour la Solidarite, Brussels	Belgium
6	Poznan University of Economics	Poland
7	Tallin University of Technology	Estonia
8	Berlin School of Economics and Law	Germany
9	Centre for Social Studies, University of Coimbra	Portugal
10	University of Pannonia, Veszprem	Hungary
11	National and Kapodistrian University of Athens	Greece
12	Middle East Technical University, Ankara	Turkey
13	Lund University	Sweden
14	University of Witwatersrand	South Africa
15	University of the Basque Country, Bilbao	Spain

The views expressed during the execution of the FESSUD project, in whatever form and or by whatever medium, are the sole responsibility of the authors. The European Union is not liable for any use that may be made of the information contained therein.