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Abstract: A founding myth of the euro was that profound economic convergence could be achieved across the core and periphery of Europe. Scholarship from within Comparative Political Economy (CPE) has compellingly pointed to this myth of convergence as the fundamental mistake of the euro project.[1] Economic and Monetary Union was applied across a range of incompatible varieties of capitalism with little appreciation for how difficult it would be for peripheral economies to overcome long standing institutional stickiness. Yet, while institutional stickiness tells us much about the causes of *declining competitiveness*, it tells us much less about the origins of brand new patterns of *debt-led growth*. This article modifies this CPE account by drawing attention to the much overlooked case of Portugal. In contrast to CPE's emphasis on institutional stickiness, this paper explores the ways in which negotiation of European integration has been generative of institutional transformation leading to *debt-led* growth in Portugal. By combining Europeanisation with CPE, this article shows that, far from an inability to do so, in the case of Portugal, it has been the attempt to 'follow the rules' of European Integration that explains its damaging patterns of debt-led growth.

Keywords: Eurozone Crisis; Europeanisation; Comparative Political Economy; Periphery; Portugal

Introduction

The notion that projects of economic convergence were not promoted efficaciously enough by the European Union or its member states resonates throughout numerous strands of opinion on the eurozone crisis. This article develops a competing interpretation. By tracing the much overlooked case of the Portuguese economic crisis, I show how existing attempts at the promotion of economic convergence by European and Portuguese elites, *at their most successful,* were generative of unanticipated patterns of divergence. National and EU elites alike have tended to subscribe to a common sense belief that European integration would lead to processes of economic convergence among member states.[2] As Hall notes, an 'element of prophecy was built into this mythology' which remained, of course, unfulfilled.[3]

I outline this rethinking of the crisis in Portugal over three main sections. In the first section I show how the literature on Comparative Political Economy (CPE) emphasises the role of *institutional stickiness* as a central cause of the eurozone crisis. It sheds light on a foundational inequality in European integration. Economic and Monetary Union (EMU) was applied across a range of incompatible varieties of capitalism with little appreciation for how difficult it would be for peripheral economies such as Portugal to overcome long standing peripheral trajectories of economic development.

Section two takes this argument further by proposing the need to recognise that economic divergence can be caused just as much by *institutional transformation* as it can by institutional stickiness. I draw on Europeanisation theory to show that while a focus on institutional path dependency under EMU can tell us much that is useful about the specifics of Portugal's economic divergence with core EMU, CPE, especially Varieties of Capitalism (VoC), tells us very little about institutional transformation leading *to debt-led growth*.

Section three takes this framework and outlines how EU projects of convergence became generative of divergence via institutional transformation. I trace Portugal's Europeanisation, and show how the Portuguese variety of capitalism did not simply persist following EMU. Rather, Europeanisation of banking and finance during the 1980s and 1990s transformed the Portuguese economy into a brand new and unanticipated debt-led growth regime, leaving the economy in a particularly vulnerable position upon entering EMU.

The key contribution of this paper is the drawing together of literature from CPE and Europeanisation to show that accounts of the crisis in the European periphery are incomplete without taking account of both institutional stickiness and institutional transformation as components of economic divergence. Recognising this leads to the central claim of this article: it was as much Portugal's attempt to 'follow the rules' of European Integration, as its failure or inability to, that explains its current difficulties.

Institutional Stickiness: Comparative Political Economy and the Portuguese Crisis

A founding myth of the euro was that all member states could and should converge with each other. On the one hand, as set out in the Maastricht Treaty's 'convergence criteria', it was anticipated that the stringent conditions imposed by the EU on member states would force structural reform and lead to convergence of inflation levels, convergence of government deficit and debt levels relative to GDP, exchange rate stability culminating in a single shared currency, and interest rate stability. The Delors report on EMU even made it clear that the success of the euro depended, inter alia, on *'[g]reater convergence of economic performance'*.[4] On the other hand, for the so-called peripheral countries, convergence was also suggestive of more profound growth-rate and per capita income convergence with Western Europe, as well as an (unproblematised and often vaguely defined) project of modernisation and development.[5] Participating in the euro and the Single Market tended to be viewed by the periphery as a 'challenge for development'[6] wherein Greece, Ireland, and Portugal could each leave their 'peripheral' pasts behind and converge, in terms of their competitiveness, levels and forms of economic development, with their advanced Western European neighbours. As the late former Prime Minister and President of Portugal Mário Soares put it in a 1985 interview with *Le Monde:*

> 'No if we did not want to miss out on the end-of-the-century technological revolution, we absolutely had to join Europe. Now is the time!'[7]

Of course, the problems facing such visions of convergence were infamous even before the crisis hit. This first section shows how convergence in terms of competitiveness vis-à-vis the European core was always unlikely, if not impossible for Portugal because of the specificities of its 'sticky' national institutions. To make this argument I draw on the work of Comparative Political Economy (CPE) scholars such as Alison Johnston, Bob Hancké, and others to explore the causes of Portugal's declining competitiveness under EMU.[8] In doing so I establish the central role of institutional path dependency ('stickiness') in CPE accounts of the eurozone crisis.

The Institutional Roots of the Portuguese Crisis

The story of Portugal's economic crisis is perhaps less well-known than that of its fellow beleaguered peripheral European countries.[9] After a decade of stagnant growth and in the context of a broader eurozone crisis, Portugal applied for a €78 billion euro bailout from the EU and IMF in April 2011. Portugal's path to crisis differs in important ways from the rest of the periphery. Several divergences are worth noting initially. First, in stark contrast to the overheating of the Irish and Spanish economies during EMU membership, Portugal experienced anaemic rates of growth (see figure 1).[10]

[Insert Figure 1 here]

Second, figure 2 shows that Portugal failed to converge in terms of GDP per capita with either its euro area partners, or its fellow so-called 'cohesion countries'.[11]

[Insert Figure 2 here]

Third, Portugal certainly had fiscal problems. It first breached the Excessive Deficit Procedure (EDP) in 2001 and consistently ran large fiscal deficits throughout the 2000s, yet its public debt to GDP ratios tended to be around 10 per cent over that of Germany, never approaching Greek proportions (see figure 3).

[Insert Figure 3 here]

Fourth, as figure 4 shows, Portugal began to experience a widening current account deficit much earlier than the other peripheral countries. As early as 1995, Portugal's current account deficit began to widen dramatically, which sets it very much apart, not just from Germany, but from Spain, Greece, and Italy.

[Insert Figure 4 here]

A Comparative Political Economy (CPE) approach can shed light on Portugal's particular path to crisis. Although broad and diverse, CPE approaches to the study of the eurozone crisis can be argued to make three central observations.[12] First, national institutions matter: different institutional configurations of EMU member states produce different economic capacities and problems, develop over long periods of time and are 'sticky' or path dependent.[13] Second, EMU advantaged the institutional configurations of the core and disadvantaged those of the periphery in various ways. Third, core EMU countries have certain non-price competitive advantages over peripheral countries. I briefly elaborate on each observation by drawing on the work of Hancké, Johnston, Jones and others, and by relating them to the case of Portugal.

First, CPE approaches focus primarily on identifying the specificities of wage bargaining systems wherein peripheral economies such as Portugal diverge in important ways from the EMU core. Portugal has a specific history of institution building, associated with the Southern European Mixed Market Economy (MME) variety of capitalism, which sets it apart from the Coordinated Market Economies (CMEs) and Liberal Market Economies (LMEs) of core Europe.[14] As Höpner and Lutter put it, given the 'stickiness' of wage bargaining systems which have been 'established over many decades, with coordinated wage systems being particularly difficult to emulate' - the German case is a 'relic of a historical stroke of luck'.[15]Interestingly, in the case of Portugal, Royo and others observe strong corporatist tendencies.[16] It is worth noting that during the 1980s, centre-right governments set up systems of social dialogue and concertation at the macro level and succeeded in establishing the Standing Committee for Social Concertation (CPCS) which was enabled social dialogue at the national level between Trade Union confederations, Employers' Associations and the state. The CPCS has led to the signing of several tripartite agreements and has made it possible, especially during the 1980s and 1990s, for successive governments to ensure public support for wage bargains linked to important macroeconomic goals such as accession to the EEC and membership of the euro.[17]

However, Royo and others also note that this corporatist style system is marked by the twin legacies of Portugal's recent authoritarian past and a polarising democratisation process, each of which have resulted in a lack of coordination and trust.[18] The institutional character of post-revolution Portugal leaned towards the radical left during the late 1970s, but has certainly been watered down in the decades since. Nevertheless, opposition from trade union confederations has tended to lead Portuguese governments to abandon plans dealing with employers' demands for greater flexibility on dismissals and the reduction of the associated costs, greater working time flexibility and lower overtime pay.[19] This tends to lead to negotiation stalemates, especially during the 2000s, and organised labour's political influence is relatively stronger than organised business.[20]

Yet in many respects, trade unions in Portugal are relatively weak. Royo notes that since democratisation, Portugal's trade union structure has evolved as highly fragmented and union membership has been in decline.[21] There are no representation criteria in Portuguese law which effectively means that all trade unions in Portugal are considered representative, regardless of their actual membership levels.[22] This means that employers can bypass the strongest unions in a workplace and instead reach agreement with the unions that may be more accommodating.[23] In addition, collective agreements effectively apply to all workers, not just those who are members of the union doing the negotiating. This lowers the incentive to join a trade union, as workers will benefit from agreements anyway.[24] The result is a lack of uniform conditions nationally and significant variations in wage levels across different sectors.[25]

The second observation recognises that such specificities of Portugal's national specific institutions are by no means the whole story. Johnston and Hancké link these different national institutions to the design flaws of EMU.[26] Johnston focuses on the link between different wage bargaining systems and the instability of the euro. She shows that whilst institutional differences long predate the euro, they became existential threats under EMU. As the argument goes, EMU transformed sectoral labour market governance in the European periphery and prompted a steady rise in the relative prices of sheltered/non-tradeable sectors, vis-à-vis the core.[27] There are three broad reasons for this. First, CMEs such as Germany with coordinated wage bargaining systems have the institutional resources to control wage growth in sheltered and non-sheltered sectors, while MMEs tend to only achieve some wage moderation in non-sheltered, export-oriented sectors.[28] Second, Johnston recognises that despite this institutional asymmetry, during the 1990s, the EU provided political and economic costs to rising inflation across all countries. However, having joined the euro, the institutions and constraints no longer existed. Without these tight fiscal rules at the EU level national wage negotiators (especially in sheltered sectors) could allow wages to rise. Finally, countries like Portugal also lost important tools to manage declining competitiveness, such national central banks that were averse to inflation, and currency devaluations. MME tend to lack the institutions necessary to produce low inflation, and thus, ended up with higher real exchange rates and relatively declining competitiveness.[29]

Reis notes that it is often cited that unit labour costs in Portugal rose almost 20 per cent relative to those in Germany during the period 2000-2007.[30] Portugal actually achieved a slowdown in the growth of relative real unit labour costs after the introduction of the euro, yet what is important is that they still continued to rise. Relative increases in the cost of labour in Portugal were not associated with higher productivity, in fact, as Blanchard notes, it nearly vanished.[31] Blanchard notes that productivity growth in the business sector fell to around one per cent between 2004 and 2005 (it was three per cent in the 1990s) and Jones notes that total factor productivity grinds to a halt.[32] This meant that as even nominal wage growth decreased over the 2000s, any competitive advantage which could have been gained was offset by continued increase in relative labour costs and a decline in productivity growth.[33] As the argument goes, this contributed to Portugal's widening current account deficit.

Third and finally, Nölke shows how CPE approaches can explain institutional sources of declining competitiveness aside from relative unit labour costs.[34] CMEs or export-oriented economies such as Germany have an institutional advantage in building up incremental innovations in high-quality manufacturing, 'based on a sophisticated system of skill formation, in particular through vocational training' but also through relative job security and traditions in long term investment practices.[35] Peripheral economies typically have more of an advantage in the production of low to medium quality goods which rest on a more uneven system of skill formation. This has a number of consequences, not least of which is the vulnerability to competition from emerging economies outside of the EU single market.[36]

Portugal's economy has been characterised by a historic lack of large firms, a predominance of SMEs, and a high prominence of low-to-medium technology manufacturing exports. While SMEs employ 66.5 per cent of workers in the EU 27, in Portugal the figure is 76.9 per cent. Of these, employment is concentrated in micro firms more than it is in the rest of the EU (44.3 per cent and 33.5 per cent respectively).[37] Although Portugal's merchandise exports are now fairly diversified and its exports have moved in higher value products, during the 1990s and early 2000s traditional, low-technology goods featured prominently in Portugal's exports. These sectors proved extremely vulnerable to international competition from East Asia and Central and Eastern Europe over the 1990s and 2000s.[38] As the Banco de Portugal notes, although Portuguese exports (excluding energy) grew 5.4 per cent between 1997-2006, market share declined -2.1 per cent over the same period.[39] In particular, Portugal experienced declines in the "textiles, textile products, leather and footwear" sector from the period 1997-2006, mainly in favour of China and East Asia following the ending of the Multi-Fibre Agreement which had placed restrictions on the quantities of textiles and clothing that could be exported from developing countries to developed countries. Following the 2004 EU enlargement, Portugal also lost market share in the export of "motor vehicles, trailers and semi-trailers" over the period 2002-2006, in favour of the relatively highly skilled, low wage labour markets of Central and Eastern Europe.[40] Portuguese exports have been traditionally relatively vulnerable to international competition, and as Leao and Palacio-Vera note, the market share of Portuguese exports in the EU15, the destination for 71 per cent of Portuguese exports in 2008, declined by 33 percent between 2003 and 2009.[41]

Although critical of this so-called 'competitiveness hypothesis', Jones argues that a CPE account should be able to identify divergence of the periphery from the core in terms of five factors: an acceleration in the relative growth of unit labour costs, rising inflation, deceleration in productivity growth, deterioration in export performance and a deterioration of the current account.[42] As shown, and as Jones recognises, the Portuguese case reflects these divergences.[43] First, although Portugal experiences a slowdown in the growth of relative real unit labour costs after joining EMU (see figure 5), and a slowdown in the appreciation of the real effective exchange rate, both indicators of relative cost competitiveness continue to worsen relative to Germany, just at a slower pace.

[Insert figure 5 here]

Second, domestic price inflation also worsens and labour productivity grinds to a halt. Third, Portugal's labour productivity grinds to a halt during the 2000s. Fourth, Portugal's export performance deteriorates between 1999 and 2007. Finally, as figure 4 shows, this all shows up in Portugal's widening current account deficit.

These five economic divergences faced by Portugal tell the story of its specific path to crisis. Central to the emergence of these divergences is that Portuguese institutions proved resistant to change in the context of EMU. Yet, compelling as this CPE account is, tracing the lack of institutional transformation is far from exhaustive. As I show in the following section, this account is incomplete, even misleading, without taking into account the role played by institutional transformation in the emergence of debt-led growth in the Portuguese economy.

Accounting for Institutional Transformation: Europeanisation

Focusing only on the path dependencies of the Portuguese variety of capitalism can cause us to overlook the real and significant institutional transformations that the Portuguese economy did experience. The problem is not that institutional stickiness or EMU design flaws do not matter. The real problem is that perspectives emphasising this 'perfect storm' of sticky national divergences within an 'unfit-for-purpose' EMU problematically assume that the lack of institutional transformation exhausts the *origins of divergence* in Portugal's political economy. The logic is simple - the periphery diverged because it didn't transform. Portugal experienced speculative pressure in 2011 because of its competitiveness problems in the years before. Yet, as I show, the very distinctive form of crisis encountered by Portugal suggests that something is missing from this formulation.

In this section I draw on the literature on Europeanisation to develop a new account of the origins of the crisis in the periphery which can complement CPE's sensitivity to path dependent national varieties of capitalism under a flawed in design EMU. Bringing these two literatures together makes it possible to propose that the economic divergence experienced by Portugal involved not only institutional stickiness, but also institutional transformation. Portugal's crisis is about more than a failed attempt to converge. This approach makes it possible to show how Portugal's attempt to participate in *projects* of convergence was generative of *processes* of divergence.

Disentangling 'divergence' from 'institutional stickiness'

Focusing on the resilience of path-dependent institutions can certainly help us explain Portugal's declining competitiveness under EMU, but it downplays the commensurate importance of institutional transformation in the generation of Portugal's debt-led growth.[44] The key strength of CPE more generally is also its major limitation. That is its meta-theoretical foundations in historical institutionalism, approaches which, as Thelen notes have quite poor records in explaining institutional change.[45] This makes a lot of sense if we consider the origins of the approach. It first emerged as a critique of the hyper-globalist thesis and makes the argument that national models of capitalism can resist transformation in the face of external pressure for convergence.[46] Because institutions are 'sticky', these approaches have a strong tendency to emphasize continuity through time in the basic structure and logic of models of political economy.[47] CPE scholars consequently have less to say about institutional change over time because as, Thelen puts it,

> [The] idea of persistence is virtually built into the definition of an institution, it should perhaps not be a surprise that the question of change is a weak spot in the literature as a whole, and indeed across all varieties of institutionalism.[48]

Perspectives emphasising institutional stickiness overlook the fact that simply because a country has ‘failed to converge’ it does not mean that ‘things have stayed the same’. Failing to generate competitive economic growth does not mean a simple persistence of tradition (i.e., emphasising the legacy not just of Portugal’s revolution, but of the authoritarian *Estado Novo* in its wage bargaining system).[49] When Portugal, Greece, Ireland and others attempted to reform and modernise during the 1990s and 2000s, their efforts to do so resulted in significant and dramatic changes to their political economies, because transformation was an outcome of the attempt to reform and modernise. Had Greece and Portugal not attempted reform, they would not have transformed in quite the same way. Ultimately, a theory of institutional stickiness shuts down a myriad of interesting and important questions about the role of institutional change in generating economic divergence in these countries.

This overlooking of institutional change can be addressed by bringing CPE into dialogue with the literature on Europeanisation. Scholars of ‘Europeanisation’ study a country’s ‘domestic adaptation to European regional integration’.[50] Bringing in this literature has the additional benefit of addressing certain strands of CPE’s, especially VoC’s relatively weak conception of the international. For the latter, external pressure will not lead to domestic change, it will only shed light on and confirm existing national specificities. All meaningful change comes from within.

As Featherstone notes:

> Thus the approach would support hypotheses of path dependency in relation to external pressure and would stress the resilience of the particular market model in interpreting such pressures’.[51]

Europeanisation on the other hand takes the possibility of domestic transformation as a result of adaptation to European regional integration as its starting point.

Similar to CPE, Europeanisation literature has recognised that domestic adaptation to European integration is very unlikely to lead to convergence; as Radelli puts it, ‘Diversity of domestic responses – across countries, institutions, and policy domains – has become a key theme in Europeanization research'.[52] Some literature has focused on the 'differential impact of European integration'.[53] Existing specific domestic contexts may lead to differential results from the process of Europeanisation.[54] Laffan sees a persistence of diversity across national executives rather than convergence towards a particular model.[55] Although European directives are aimed at harmonising national policies, in reality, they leave much room for continued national diversity.[56]

However, digging a little deeper, the different variants of Europeanisation also tend to be explained as institutional path dependency, or in other words, how nation states can account for the timing, extent and terms of their adaptation to European integration. Radaelli notes that Europeanisation is sometimes measured in four ways (specifically in this case, Radaelli looks at European nations states adaptation to EMU – but the four criteria are widely used).[57] The first is accommodation, which indicates a pre-existing closeness of fit (i.e. Germany). The second is transformation, indicating lack of fit, but leading to fundamental challenges to existing domestic structures. Third is inertia, indicating a lack of change due to lack of fit and deeply entrenched domestic institutional veto players. Finally there is retrenchment, which indicates a paradox of negative Europeanisation.

Much like CPE, most research on Europeanisation and the European periphery tends to focus on inertia. This is perhaps because, as of yet, not enough attention has been paid to how transformation due to 'lack of fit' is much more likely to lead to divergence/institutional transformation, rather than convergence. When convergence fails to occur, researchers tend to focus on obstacles to that convergence – leading them to identify institutional, cultural, and political obstacles. Indeed, in cautioning against using the concept of Europeanisation as 'yet another way to refer to convergence and homogeneity in Europe', Radaelli and Pasquier recommend that 'the prediction to test is about *lack of convergence*, not its presence'.[58] Much recent scholarship on Europeanisation therefore emerges as a critique of earlier studies in the field which tended to expect convergence as a result of domestic adaptation to European integration. Framing their positions in this way has led them to emphasise the resilience/persistence of national differences just as VoC scholarship tends to.[59]

However, as I show in the next section, there is an implicit third option available within the Europeanisation framework: the possibility that domestic adaptation to European integration can lead to profound institutional transformation of existing domestic structures. It is possible to conceive of Europeanisation leading to the emergence of radically new hybrid domestic structures and patterns of growth. Divergence is conceptualised here as more than the resilience of national differences. It is (at the same time) the possibility of the emergence of entirely new kinds of national differences. Combining CPE with a Europeanisation framework makes it possible to show that the European project did not simply fail to manage a diverse range of varieties of capitalism. It is actively implicated in generating brand new patterns of fragility through transforming existing varieties, over time, into something new.

Europeanisation, Divergence and debt-led growth in Portugal

Dramatic institutional transformations occurred in Portugal during the 1990s and 2000s which cannot be captured by mere 'persistence' or continuations of existing trajectories. Rather, 'when Europe hit home', it led Portugal's economic development in new and unexpected directions. Recognising the possibility of Europeanisation being generative of divergence addresses both the limitations of the CPE approach – as it allows for the possibility of institutional change, and recognises the international (in this case European) constituents of domestic institutional development. This section comprises of two parts. First, I show how Portugal's adaptation to EU driven reforms relating to banking and finance contributed to institutional transformation leading to increasing private indebtedness. Second, I show how a rejuvenated banking sector damaged Portugal's competitiveness through overheating particular sectors of the Portuguese economy.[60]

Europeanisation and increasing private indebtedness

Portugal's economy experienced dramatic, accelerated transformation during the 1990s.[61] In stark contrast to the stagnant growth that was to follow, during the 1990s Portugal was among the top three fastest growing economies in the EU.[62] Yet, its economy was being reshaped along precarious lines, largely as a result of reforms relating to the process of joining the single market and EMU. Particularly in banking and finance, reforms took place in terms of liberalisation of regulatory frameworks, privatisation and the freeing of international capital movements.[63] What emerged was, as the European Commission puts it, a 'very competitive and innovative market highly suitable for absorbing the rapid increase in credit demand'.[64]

In its integration with Europe, Portugal committed to a reform agenda underscored by privatisation, deregulation and liberalisation. Up until this point, the Portuguese banking system was tightly controlled.[65] The legacy of the revolution and the 1976 constitution meant that banking and finance in Portugal was characterised by stringent controls, 'constitutionally irreversible' nationalisations, and state intervention. From the mid-1980s onwards, key reforms were implemented that reversed this. In 1984 the banking system was opened to private, foreign and domestic entry for the first time since the revolution.[66] Following accession, there was a wide-ranging overhaul of the financial system propelled by various EU banking directives and other measures.[67] Among the most important were the EU's Second Banking Directive of 1993, the EU's Capital Adequacy Directive (91/121/EEC), as well as Directives on the components of banks' capital (89/299/EEC), on the BIS solvency ratio (89/647/EEC) and on consolidated supervision (89/30/EEC).[68] The rate for compulsory reserves in the Banco de Portugal fell from 17 per cent in 1989 to 2 per cent in 1994 in line with European practice.[69] Portuguese banks' could now take on more risk, access new sources of financing and sell new products. Interest rates were deregulated, credit ceilings were abolished and open-market operations. All restrictions in consumer credit were abolished in 1995 (albeit this was comparatively late) following the completion of the Single Market. Privatisations also played an important role in this changing landscape.[70] By the 1990s, as a result of adhering to the requirements from the EC/EU, the financial system in Portugal had completely transformed.[71]

Credit fuelled consumer spending became a significant driver of economic growth during the 1990s. Household indebtedness was well above the euro area average of 80 per cent and Credit growth accelerated (in real terms) from close to 0% in 1990 to above 25% in 1998.[72] Lagoa et al. note that private consumption was responsible for 70 per cent of GDP growth in the period, gross fixed capital formation for 36 per cent, and public consumption for 21 per cent.[73] Portugal experienced a surge of investment during the 1990s and this would not have been possible without the wide availability of credit made possible by deepening European integration[74], and the concomitant liberalisation and deregulation of the banking sector during this period. Indeed, Portugal experienced profound convergence of borrowing costs both after joining the euro which drove the institutional transformation of Portugal during this period, increasing private and public indebtedness. Similar to the rest of the periphery, interest rates plummeted and with the absence of exchange rate risk, between 2000 and 2008 Portugal had access to a cheap pool of debt, in the form of long term bonds and notes.[75]

The favourable conditions associated with the prospect of joining the euro encouraged households to increase their borrowing at such high rates – namely disinflation, lower nominal and real interest rates, and rapidly rising income levels.[76] Similarly, the structural reforms relating to the banking sector ensured that there was a wide supply of credit to meet consumer demand, and the liberalisation of the credit market helped foster a strongly competitive environment where banks were eager to meet the growing borrowing demands.[77] In these different ways, EU reforms are strongly implicated in the transformation of Portugal into a 'debt-led domestic demand' model of economic growth during the 1990s.[78]

Linking debt-led growth to economic stagnation

We can also understand the role of European financial liberalisation and integration as a catalyst of the slowdown discussed in section 1.[79] Portugal's nominal 'convergence' with Europe since the 1980s had been premised on the inflation of domestic demand. Once this dropped, the economy accordingly stagnated.[80] Thus, we can link debt-led growth to Portugal's economic downturn in the following ways.

First, in addition to increasing indebtedness, this trajectory of credit-fuelled economic growth contributed to the expansion of particular sectors of the Portuguese economy. The incentives provided by the structural reforms geared investment and capital inflows to the newly profitable non-tradable sectors, including construction, retail and privatised utilities, which were less exposed to foreign competition.[81] A key example of this is the construction sector, which during the 1990s, grew at four times the rate of the rest of the economy.[82] These sectors were in turn financed through the pivotal role of the newly invigorated, liberalised and privatised banking sector. At the beginning of the 1990s 40 per cent of bank loans to non-financial firms went to manufacturing firms and this declined to 20 per cent in the 2000s.[83] However, the percentage of the construction and real estate sectors in total business debt rose from 10 per cent in 1992 to almost 40 per cent in 2008.[84] As a result of lower interest rates, an increased credit supply, and growing bank competition to direct a surge in capital flows into the non-tradable sector, macroeconomic imbalances grew.[85] This contributed to the stagnation in the 2000s as the construction sector saw its share in value added as a percentage of GDP fall from 7.6 percent to 6.6 percent, in stark contrast with Ireland and Spain.[86] In fact, Portugal was the only European country to register an annual decline in investment in construction every single year since 2002 until 2011.[87] As such, while the loss in market share for Portuguese exports played a role in the stagnation of the 2000s, the context of Portugal's declining export competitiveness is linked to the growth and decline of these non-productive inward looking sectors.

During the 1990s, non-tradable sectors, where productivity lagged, attracted far more investment from banking and finance than the vulnerable manufacturing sector.[88] As manufacturing became perceived as higher risk due to its exposure to international competition, newly privatised and liberalised banks began to direct credit to real estate, construction, and other non-tradable activities.[89] As such, Portugal's declining competitiveness has two interrelated facets. As manufacturing became increasingly threatened, the inward looking non-tradable sector grew, intensifying declining competitiveness and widening current account deficits.

Portugal's adaptation to the Single Market and EMU contributed to institutional transformation and divergence in Portugal during the 1990s. Portugal's downturn has its origins in the path dependencies discussed in section one. But these path dependencies cannot fully explain the emergence of credit led growth of the 1990s. This aspect of Portugal's crisis is best accounted for by focusing on Europeanisation driven institutional transformation. During the 1990s, the banking sector in Portugal appears to have been relatively more vigorous in fuelling credit led growth than it was in Ireland and Greece at the same time (see figure 4).[90] This is important, because Portuguese consumers were overleveraged and reassessed their incomes at the same moment they joined the euro. This, as well as a falling confidence in the Portuguese economy contributed to a marked decline in consumption.[91] As figures 6 and 7 show, Portugal's private indebtedness diverged with the rest of the EMU both during the 1990s and 2000s.

[Insert Figures 6 and 7 here]

High private indebtedness at the end of the 1990s contributed to stagnant growth rates in a number of other ways. Portuguese non-financial firms had a tendency to favour debt financing over equity financing during the 1990s, partially due to the availability of cheap credit leading to high corporate leverage. This further damaged Portuguese growth by the 2000s.[92] As the IMF notes, 'excess leverage may …have had a negative impact on investment, as over-indebted firms tend to pass up on new investment opportunities, particularly those with limited short-term benefits but higher long-term productivity gains'.[93] Indeed, investment growth in Portugal peaked in 1997 and then gradually declined to turn negative, in line with increasing leverage.[94] In other words, debt was so great in the corporate sector that it served as a barrier to accessing further debt, stalling productivity.[95]

Portuguese households and firms were also especially vulnerable to ECB interest rate rises. The ECB raised its key interest rate from 0.25% in early 1999 to 4.5% in late 2000.[96] This further dampened domestic demand and made public debt more expensive to service, leading to a breach of the Excessive Deficit Procedure (EDP) in 2001. The EDP breach committed Portugal to a pro-cyclical, contractionary fiscal policy, which further contributed to falling GDP.[97]

The Portuguese crisis can thus be understood as follows. During the 1990s a process of institutional transformation, facilitated by the EU, contributed to the expansion of economic growth in the non-tradable sector via the banking and financial sectors. Secondly, the limits of this new model became evident in the early 2000s when declining export competitiveness was not counterbalanced by domestic demand led growth – because of over-indebtedness. Tracing the transformation of the Portuguese economic trajectory has highlighted the importance of recognising institutional stickiness in the face of an unfit for purpose EMU. But it has also emphasised the pivotal role of Europeanisation of banking and finance. Through an attempt to prepare for the single market and the transposition of associated directives, banking and finance in Portugal dramatically transformed and drove brand new patterns of divergence, ultimately damaging economic growth.

As a case study, Portugal illustrates the damage caused by a small, peripheral European economy's attempt to pursue an agenda of economic convergence via an attempt to adapt to a 'one size fits all' model of European integration. Bringing Europeanisation into dialogue with CPE makes it possible to recognise that institutional stickiness and declining competitiveness matter, but it is vital that Portugal's divergence from the EMU core (and much of the periphery) is also generated by institutional change catalysed by Europeanisation leading to brand new patterns of debt-led growth. Perspectives which highlight the more readily apparent 'pathological' domestic origins of the crisis in the European periphery, should move towards a deeper engagement with the systemic, European level causes of the crisis which I have identified as pivotal. As a small country at Europe's edge, Portugal had limited agency to negotiate its process of European integration. As CPE scholars such as Regan have recognised, while Germany has been a rule maker, countries such as Portugal are rule-takers in the integration process, downloading institutional reforms it had little ability to shape at the uploading stage.[98] Membership of the Single Market and EMU was viewed by Portuguese political actors as 'the only way to keep a peripheral country at the heart of the EU's decision making process'.[99] Portugal swiftly adopted numerous legislative changes relating to banking and finance, contributing to earning the country the nickname of the 'good student' of European integration.[100] However, to quote Portuguese historian José Medeiros Ferreira, Portugal illustrates the perils of a peripheral country striving to position itself as a "good pupil to bad masters".[101]

Conclusion

This article has shown that Portugal's path to crisis was, to an important extent, catalysed by its attempt to participate in a project of European convergence. Rather than focusing on the ways in which EMU was disastrously incapable of handling the resilience of particular varieties of capitalism which were ill-suited to EMU, I have shown that the real 'design flaw' was the promotion of a specific project of convergence relating, specifically to banking and finance. Implementing a 'one size fits all' project of economic convergence across uneven levels and types of economies was always unlikely to produce homogeneity of models.[102] Yet, this article has developed a different critique of the integration process. I have shown that, in the case of Portugal at least, the attempt to mitigate these differences through some important and compulsory measures aimed at a specific type European convergence actually contributed to the emergence of brand new and perilous patterns of divergence.

This argument echoes invitations such as the one extended by Bache, Bulmer and Gunay which calls for Europeanisation studies and International (or, in this case, Comparative) Political Economy to engage more closely with one another.[103] By shedding light on how Europeanisation has been generative of a brand new trajectories of debt-led growth, rather than simply leaving existing national path dependencies behind, it has shown the real potential of Europeanisation studies to inform Comparative Political Economy theories of capitalist diversity. It by no means suggests that declining competitiveness and institutional stickiness do not matter. Had Portugal's banking and finance sectors not transformed so dramatically, it still would have likely encountered the problems of competitiveness highlighted by CPE scholarship. Thus, the Europeanisation approach proposed here should be seen as complementing CPE in the sense that it makes it possible to account for the dual importance of debt-led growth and declining competitiveness in the origins of Portugal's ongoing difficulties. The challenge for Portuguese and EU crisis management involves addressing each of these aspects.

Similarly, this argument also points to some fruitful contributions to the literature on debt and the Eurozone crisis. In particular, it echoes literature which emphasises the differentiated and regional specificity of varieties of financialisation and debt-led growth.[104] Similar to these accounts, rather than viewing financialisation as a top down, irresistible structural pressure this article has emphasised the importance of national contexts, and the specific, bottom-up role of domestic adaptation to European integration. This suggests that debt-led growth can emerge in different ways across different contexts and that the specific form of debt-led growth which emerged is inextricable from Portugal's particular experience of adapting to the 'one market, one money' project. As de Pinho and Soares suggest: 'without the need for alignment with single market legislation, the deregulation of the banks would have been much slower and probably less extensive'.[105] The potential significance of this point is that future research could analyse the intersection between national institutional contexts, Europeanisation, and debt-led growth through analysis of other European peripheral countries.

This novel reading of the origins of the eurozone crisis has important consequences for how existing political responses to the eurozone crisis should be evaluated. The official EU response has been marked by measures designed to correct the divergences of the peripheral states; to drive convergence more extensively and systematically – to prevent the periphery from endangering the rest of the eurozone through its failure to converge. Yet, if adaptation to new developments at the level of the EU is understood as central to emergence of crisis-prone trajectories of economic development, it suggests that a lack of convergence is not the main problem facing the eurozone. In fact, quite the opposite is true. The relative severity of the crisis in the periphery can be explained by the EU's commitment to the promotion of a single model of convergence across a variety of different European economic trajectories. It follows that any response to the Eurozone crisis will produce similar tensions unless it is recognised that any project of European integration is likely to produce multiple models of development. The challenge is not to heedlessly push for future convergence, but to envision ways in which virtuous patterns of divergence can be cultivated within a project of integration.

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Notes

[1] Regan, “Imbalance of Capitalisms”.
[2] Featherstone, “In the Name of Europe,”6-7.
[3] Hall, “The Euro Crisis,”.
[4] Delors, *Report on Economic and Monetary Union*, 11. Italics are the authors own.
[5] See Triandafyllidou et al., "Introduction".
[6] Antoniades, *Producing Globalisation,* 69.
[7] Clerc, ‘Mário Soare’,3.
[8] Hancké, *Unions, Central Banks, and EMU*; Johnston and Regan, "European Monetary Integration".
[9] Notable exceptions include Rodrigues and Reis “Asymmetries of European Integration,”; Lagoa et al. “The Case of Portugal,”; Royo “Paradox of Economic Divergence,”; Rodrigues et al. “Semi-peripheral financialisation”.
[10] Arnold, "”Export performance in Portugal"; Blanchard, “Difficult case of Portugal”; Brazys and Hardiman,”Tiger to PIIGS”,31.
[11] Giavazzi and Spaventa”Current account matters”
[12] Clift, *Comparative Political Economy*.
[13] Nölke, “Contribution of Comparative Capitalism,” 5; Clift, *Comparative Political Economy*,199–200.
[14] Hall “The Euro Crisis”; Nölke “Economic causes”,7-8.
[15]Höpner and Schäfer, “Integration among Unequals”, cited in Nölke, “Economic Causes”,9.
[16] Royo, “Portuguese Interest Groups”,163-171
[17] Távora and González, “Labour market policy”, 324.
[18] Royo, “Portuguese Interest Groups”,139; Távora and González “Labour market policy”.
[19] Távora and González “Labour market policy”,326; Royo, “Portuguese Interest Groups”,139.
[20] Távora and González “Labour market policy”,327; Royo, “Portuguese Interest Groups”,176.
[21] Royo, “Portuguese Interest Groups”,153
[22] Ibid,159
[23] Ibid, 160.
[24] Ibid, 160
[25] Ibid,161.
[26] Johnston, “Convergence to Crisis”; Hancké, “Unions, Central Banks, and EMU”; Hancké et al. “Comparative Institutional Advantage”.
[27] Johnston, “Convergence to Crisis”,22.
[28] Ibid
[29] Ibid, 5.
[30] Reis, “The Portuguese Slump”. Although Reis cautions that the case of Germany is not representative.
[31] Blanchard,”Difficult Case”,7.
[32] Blanchard, “Difficult Case”,7; Jones “Competitiveness and the European Crisis”93.
[33] Blanchard, “Difficult Case”, 7.
[34] Nölke, “Economic causes”.
[35] Ibid,10.
[36] Ibid,10.
[37] Távora and González, “Labour market policy”,324.
[38] Arnold, “Boosting Economic Performance”; Corkill, The Development of the Portuguese Economy,158–64.
[39] Banco de Portugal “Portuguese Export Performance”,208
[40] Banco de Portugal “Portuguese Export Performance”
[41] Leão and Palacio-Vera, “Can Portugal Escape Stagnation?",11.
[42] Jones, “Competitiveness”,92
[43] ibid
[44] Streeck, “Re-Forming Capitalism”; Streeck and Thelen, “Beyond Continuity”; Thelen “Institutional Change”.
[45] Thelen, “Institutional Change”,473.
[46] Featherstone, “Varieties of Capitalism”.
[47] Thelen, “Institutional Change”,473.
[48] Ibid,473.
[49] Royo,”Portuguese Interest Groups”.
[50] Vink and Graziano, “New Research Agenda,”.
[51] Featherstone, “‘Varieties of Capitalism and Greece”, 32.

[52] Radaelli, "Europeanisation: Solution or Problem?,",3; Bulmer, "Theorizing Europeanization,"52; Börzel and Thomas Risse, "Conceptualizing the Domestic Impact of Europe,"; Heritier et al., *Differential Europe*; Knill et al. "Neglected Faces of Europeanization",519-37.
[53] Wessels, *Fifteen into One?*; Heritier et al., *Differential Europe*; Vink and Graziano, " New Research Agenda," 9; Radaelli, "Italian State and the Euro",33.
[54] Vink and Graziano, "New Research Agenda,"9.
[55] Laffan, "Core Executives,".
[56] Vink and Graziano, "New Research Agenda,"10–11; Wessels, *Fifteen into One?*, xv.
[57] Radaelli, "Whither Europeanization?".
[58] Radaelli and Pasquier,39(italics added).
[59] Just as Wessels, *Fifteen into One?* and Heritier et al., *Differential Europe* do.
[60] This section draws on the discussion in Dooley, "Portugal's Economic Crisis".
[61] Teixeira, "Introduction",25.
[62] Figures cover the period from 1986-2000.
[63] Decressin and Mauro, "The Portuguese Banking System",5; Leão, et al., "Financialisation in the European Periphery",6.
[64] European Commission Occasional Paper 11,; Banco de Portugal, "The Portuguese Economy",xxi.
[65] Dooley,"Portugal's Economic Crisis"
[66] Rodrigues et al. "Semi-Peripheral Financialisation".
[67] See Decressin and Mauro "The Portuguese Banking System,"7 for a detailed summary of these measures.
[68] Decressin and Mauro, "The Portuguese Banking System"7–9; Dooley, "Portugal's Economic Crisis".
[69] Rodrigues et al. "Semi-peripheral Financialisation"
[70] See Decressin and Mauro, "The Portuguese Banking System", 10 for a list of selloffs.
[71] Honohan "Consequences for Greece and Portugal",3. The discussion of this paragraph draws on the detailed account of Decressin and Mauro "The Portuguese Banking System. See pages 5-10 especially.
[72] European Commission "Portuguese Economy after the Boom" 57; Lagoa et al., "The Case of Portugal,"17.
[73] Lagoa et al., "The Case of Portugal,",7.
[74] Ibid.,9.
[75] Rodrigues et al. "Semi-peripheral Financialisation"
[76] European Commission "Portuguese Economy after the Boom",57.
[77] Ibid.,58.
[78] Lagoa et al., "The Case of Portugal,"16.
[79] Banco de Portugal, "Portuguese Export Performance" 66.
[80] Dooley, "Portugal's Economic Crisis"
[81] Rodrigues and Reis, "Asymmetries of European Integration",197.
[82] Corkill, *Development of the Portuguese Economy*,43.
[83] Rodrigues et al, "Semi-Peripheral Financialisation",495.
[84] Ibid,496.
[85] IMF, Country Report,8.
[86] Reis, "The Portuguese Slump",156.
[87] Lourtie, "Understanding Portugal",6.
[88] Ibid.
[89] Leão, et al. "Financialisation in the European Periphery," note, from the period 1993-2007; Decressin and Mauro "The Portuguese Banking System".
[90] Lourtie, "Understanding Portugal"
[91] Cardoso, "Household Behaviour"
[92] IMF, "Country Report" 9.
[93] Ibid.
[94] Ibid.
[95] Selassie, "Portugal's Economic Crisis"5-7.
[96] Lagoa et al., "The Case of Portugal,"12.
[97] Lagoa et al., "The Case of Portugal,"12. ; Dooley, "Portugal's Economic Crisis".
[98] Regan, "Imbalance of Capitalisms",6.
[99] Teixeira, "Introduction",18-19.
[100] Ibid, 18-19.
[101] I thank an anonymous reviewer for directing me towards this quotation; see Gasper, "União Europeia".
[102] Smith, "Introduction".

[103] Bache et al, “Let’s get critical!”; See also Featherstone, “Varieties of Capitalism”.
[104] For instance, see Rodrigues et al. “Semi-Peripheral Financialisation” for an excellent account of Portugal; see also Engelen et al “Geographies of Financialisation”.
[105] De Pinho and Soares, “Single Market and Portuguese Banking”, quoted in Rodrigues et al. “Semi-Peripheral Financialisation”,488-489.