

SPOTLIGHT ARTICLE

From Subprime to Sovereign:
The Global Financial Crisis
and Its Impact on Portugal

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Introduction

Here we are in the year **2008**. These times were ones of **economic prosperity**, with no global economic crises for more than 20 years and no world wars for 60 years — no better time in previous history to be alive. It seemed like crises were a **thing of the past** and that the world was on course for many years of prosperity. However, that optimism would soon disappear with the **collapse of Lehman Brothers** and the huge **financial and later economic crisis** that erupted in the whole world, **reshaping** the way **banks and governments** operate to this day.

In this article, the aim is to explain **what the behaviors and measures** that caused the crisis were and **how it was fought**, while also taking a detailed look at **Portugal's situation** as one of the countries that were not directly the most affected by the 2008 crisis, but were largely damaged by its **collateral effects**.

Subprime Crisis – How it Started

The combination of a rapidly expanding **real estate bubble** in the United States and increasingly **risky lending practices** proved sufficient to trigger the subprime crisis. In the early 2000s, historically **low interest rates** encouraged millions of households to purchase homes, while property prices continued to **rise steadily**. This persistent appreciation reinforced the perception that risk was minimal, prompting banks and other financial institutions to **extend credit** to borrowers with **weak repayment capacity**.

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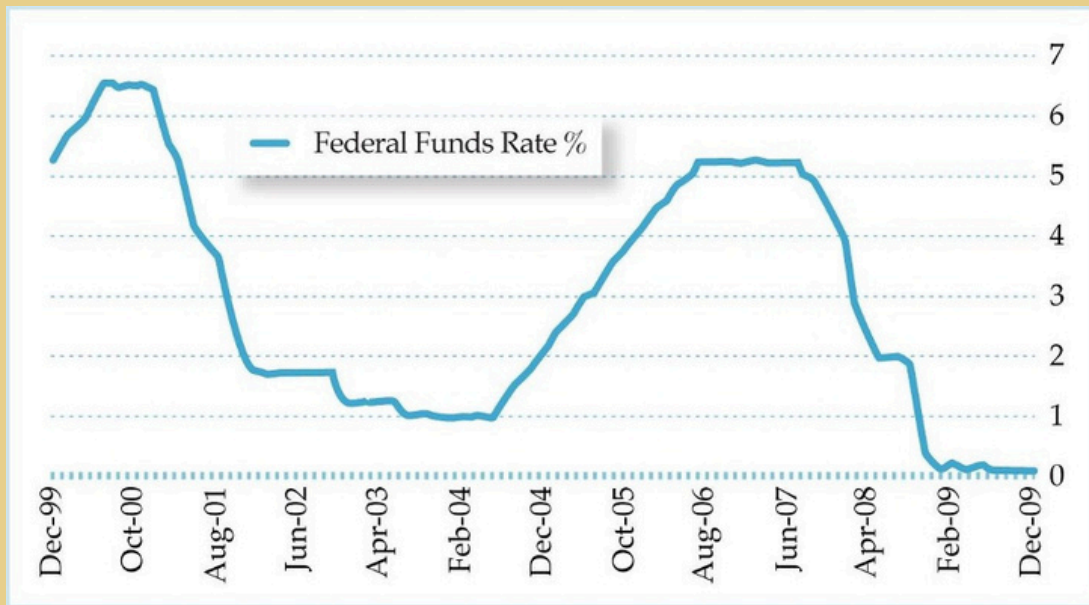


Figure: Short-Term Interest Rate, 2000-2009

Source: Mises Institute, "The Subprime Crisis," Quarterly Journal of Austrian Economics

Year: 2014

The expansion of **subprime lending** was further amplified by the intensive use of **securitization** through instruments such as **Mortgage-Backed Securities (MBS)** and **Collateralized Debt Obligations (CDO)**. These mechanisms transformed **high-risk mortgages** into **financial products** that appeared safe, reducing incentives for lenders to rigorously assess **borrowers' solvency**. By spreading these **securities** across **investors worldwide**, the financial system became deeply exposed to any downturn in the **U.S. housing market**.

When **house prices** eventually stopped rising, and **adjustable-rate mortgages** reset to significantly higher levels, **mortgage defaults** increased sharply. The resulting devaluation of securitized products eroded confidence in financial markets and generated mounting **liquidity pressures**. These strains ultimately converged in 2008 with the collapse of **Lehman Brothers**, triggering the **global propagation of the financial crisis**.

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The U.S. real estate market entered the early 2000s under conditions that were ideal for rapid expansion. As previously discussed, historically **low interest rates**, rising **homeownership rates**, and **public policies** that promoted access to housing reinforced the perception that credit should be broadly available. **Financial institutions**, facing intense competition and high expectations of profitability, gradually relaxed their **lending standards**.

Subprime mortgages emerged as the financial sector's response to growing demand and pressure to expand **business volume**. These loans, often structured with **low introductory rates** followed by substantial **upward adjustments**, were granted even when borrowers lacked the capacity to meet long-term **repayment obligations**. Confidence rested on the belief that house prices would continue to rise: if **repayment difficulties** arose, refinancing or selling the **property** was assumed to be sufficient to prevent losses.

However, this logic became unsustainable once house prices began to stabilize. Between 2006 and 2007, the number of **households** unable to meet their **mortgage payments** increased sharply, leading to a surge in **foreclosures**. What initially appeared to be a limited correction quickly evolved into a **structural collapse in demand** and a widespread decline in **property values**, setting in motion a **recessionary cycle** that the market could no longer contain.



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Collateralized Debt Obligations (CDO). Through securitization, **banks** pooled thousands of mortgages — including both **prime** and subprime **loans** — into a single financial product that was then divided into different **risk tiers** according to **risk level**.

Credit rating agencies played a crucial role by giving high ratings to products that, in reality, contained large amounts of **low-quality loans**. Institutional investors around the world — including banks, **insurance companies**, and **pension funds** — bought these securities believing that the risk was well diversified and that **large-scale defaults** were highly unlikely.

The problem emerged when the **models used to assess risk** failed to predict a widespread fall in house prices. As mortgage defaults increased, the expected **cash flow** from MBS and CDOs dropped sharply. Because these products were **highly leveraged** and **traded globally**, their **loss in value** spread quickly, undermining confidence in financial markets and freezing **liquidity** across the system.

The breaking point of the crisis came on 15 September 2008, when Lehman Brothers collapsed. The **investment bank**, heavily exposed to **subprime mortgage assets**, was unable to secure **funding** as confidence in the **interbank market** collapsed. The U.S. government chose not to intervene, believing that allowing the failure would prevent moral hazard linked to future **public bailouts**.

The decision proved disastrous. **Lehman's bankruptcy** triggered an unprecedented loss of confidence: banks stopped lending to each other, **money market funds** faced massive **withdrawals**, and **credit to businesses** contracted sharply. Within weeks, the **financial turmoil** spread to Europe and other regions, revealing how deeply interconnected **global markets** had become.

Governments around the world were forced to intervene with **emergency programs**, **state guarantees**, and, in some cases, the **nationalization of troubled banks**. The **financial shock** quickly turned into a deep **economic recession**, marked by rising unemployment, a sharp decline in international trade, and long-lasting fiscal imbalances.

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Impacts of The Subprime Mortgage Crisis on Stock Markets

After the collapse of the American bank, by putting **public money** into a **privately owned bank**, **stock markets** around the world collapsed, as **investors** began redeeming their **investments**, decreasing **liquidity** in the market. This means that those who had money invested in **banks** and **stocks** asked to withdraw it for fear of losing it, but the banks couldn't cover so many **withdrawals**. Due to this decrease, **stock markets** felt the blow. On August 9th, the French bank **BNP Paribas** cancelled three **high-risk funds** specialising in U.S. mortgage debt. The **European Central Bank** (ECB) was forced to intervene in the market, injecting 95 billion euros in an attempt to calm the investors. Only a month later, on September 14th, Northern Rock, one of the **UK's main mortgage providers**, requested an **emergency loan** and obtained **financial assistance** from the **Bank of England**, the UK's central bank. Upon hearing the news, the following morning, **account holders** lined up to withdraw their money from the bank, the first time this had happened at a **British institution** in **140 years**. In just **one day**, customers withdrew 1 billion euros, and the bank's **stocks plummeted 32%**.

As a consequence of the lack of **liquidity** in the market, American International Group (AIG), one of the largest **insurance companies** in the country, had its **credit rating downgraded** for underwriting more **credit derivative contracts** than it could afford to pay. This means the insurer reported that it would be able to pay off more **loans** than it had the money to do so. As a result, the **U.S. government** decided to intervene and inject **public funds** to save the company (taxpayer money used to save a private company).

Following the collapse of **Lehman Brothers** and **AIG**, other **major financial institutions** around the world, such as Citigroup, Northern Rock, Swiss Re, UBS, and Société Générale, reported huge losses in their **balance sheets**, further increasing **market distrust**.

The events of September 15th, 2008, completely crashed **stock markets**. The **Dow Jones Index** on the New York Stock Exchange fell **4.42%**, the S&P 500 fell **4.69%**, and the Nasdaq fell **3.6%**.

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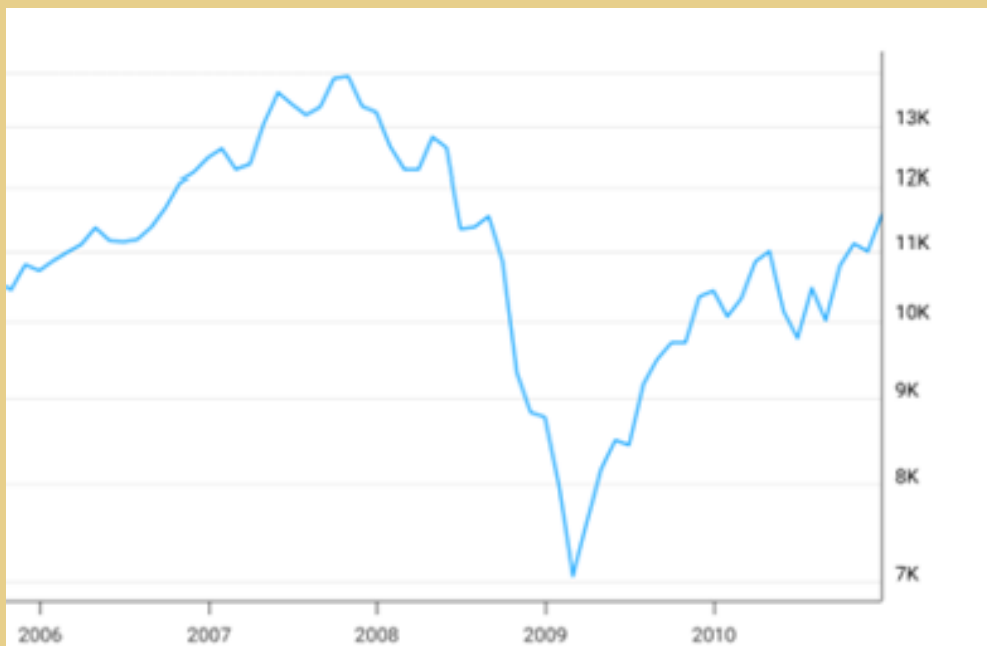


Figure: S&P 500 Index

Source: Macrotrends

Year: 2025



Figure: Dow Jones Annual Performance

Source: Macrotrends

Year: 2025

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Sovereign Debt Crisis

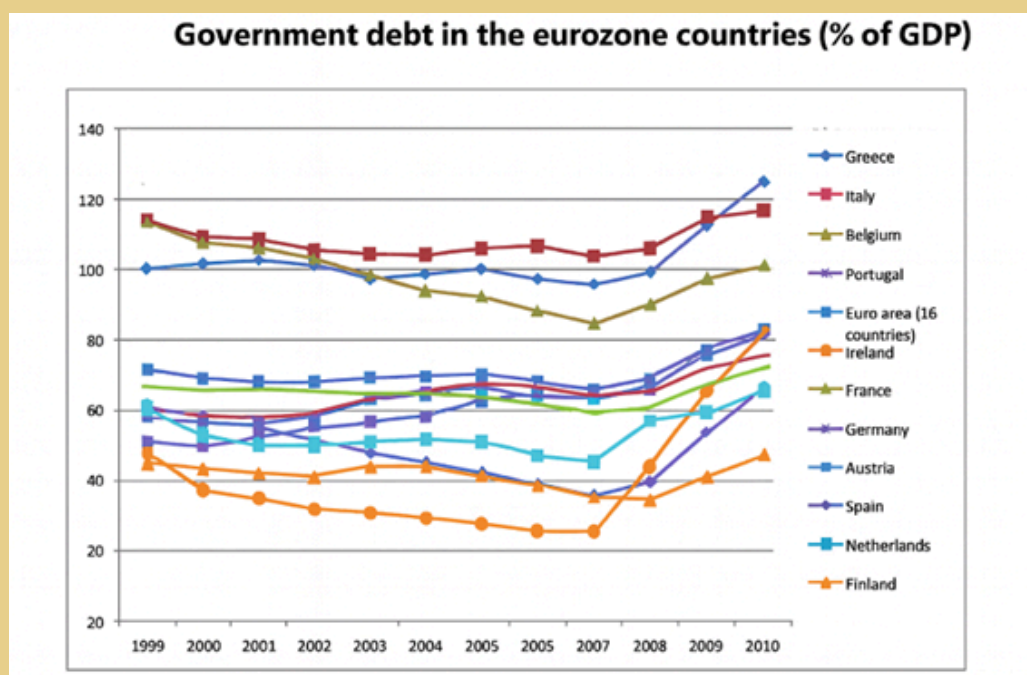
The **financial crisis** triggered by the collapse of the **subprime market** in the US (2007–2008) became one of the greatest recent economic disruptions, quickly spreading from the financial system to the **real economy**, with recessions, declines in activity, and rising unemployment. The need for **state support** for the financial sector exposed, in Europe, **structural fragilities** that had been partially concealed by the previous phase of growth.

The combination of **high levels of public and private indebtedness**, persistent **fiscal imbalances**, and **macroeconomic asymmetries** between countries created the conditions for the emergence of the **sovereign debt crisis** between 2010 and 2013. This process showed how state interventions and economic contraction worsened public accounts, raising **debt-to-GDP ratios**, especially in countries such as Greece, Ireland, Spain, Italy, and Portugal. The role of **rating agencies** and the **widening of spreads** proved central, influencing perceptions of States' ability to meet their obligations. The **European response**, including instruments to mitigate instability and the **actions of the ECB**, became essential to restoring confidence and stabilizing the **euro area**.

The collapse of the **subprime market** quickly became a **global phenomenon** that shook markets and the functioning of economies. Europe, being highly **financially integrated**, immediately felt the impact, with banks exposed to **complex assets** and dependent on **interbank funding**, becoming vulnerable to the **freeze in credit**.

In **2008**, a **clear rupture** occurred: in the **private sector**, corporate debt fell due to bank restrictions and bankruptcies; in the **banking sector**, losses, instability, and the breakdown of financial markets emerged; in the **public sector**, debt rose sharply, especially in **Portugal, Greece, and Ireland**, due to falling revenues, increasing **social expenditures**, and the need for **bank bailouts**.

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Description: Evolution of the government debt in the eurozone countries (% of GDP)

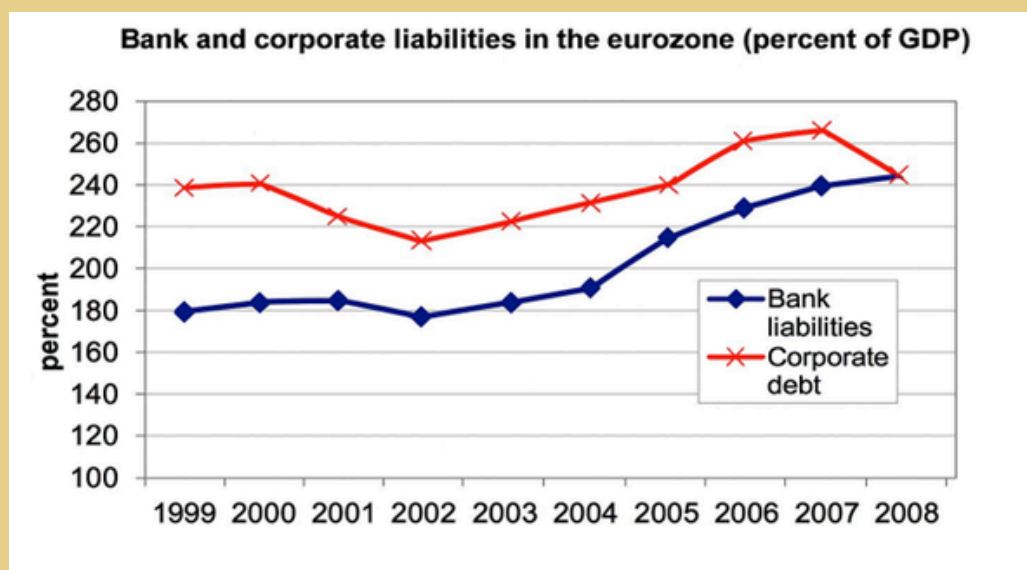
Source: European Commission, AMECO database

Year: 2010

The **emergency measures** adopted (guarantees, recapitalizations, and nationalizations) increased **public expenditure**, while the **recession** reduced the tax base, **widening deficits** and accelerating the increase in debt. In many countries, **debt-to-GDP ratios** also grew due to the **fall in the denominator**, with economic contraction intensifying **budgetary pressure**. **Pre-crisis vulnerabilities** amplified this evolution: in **Greece**, divergences in budgetary data; in **Ireland**, the collapse of a **leveraged banking system** connected to the real estate sector; in **Spain and Italy**, structural fragilities and a **halt to credit**; in **Portugal**, **low growth and limited productivity**.

The **simultaneous deterioration** of public accounts and economic activity generated a perception of **fiscal fragility** and **dependence on external financing**, turning the banking crisis into a **generalized budgetary crisis** and a prolonged period of **economic instability**.

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Description: Evolution of bank and corporate liabilities in the eurozone (% of GDP)

Source: European Commission, AMECO database

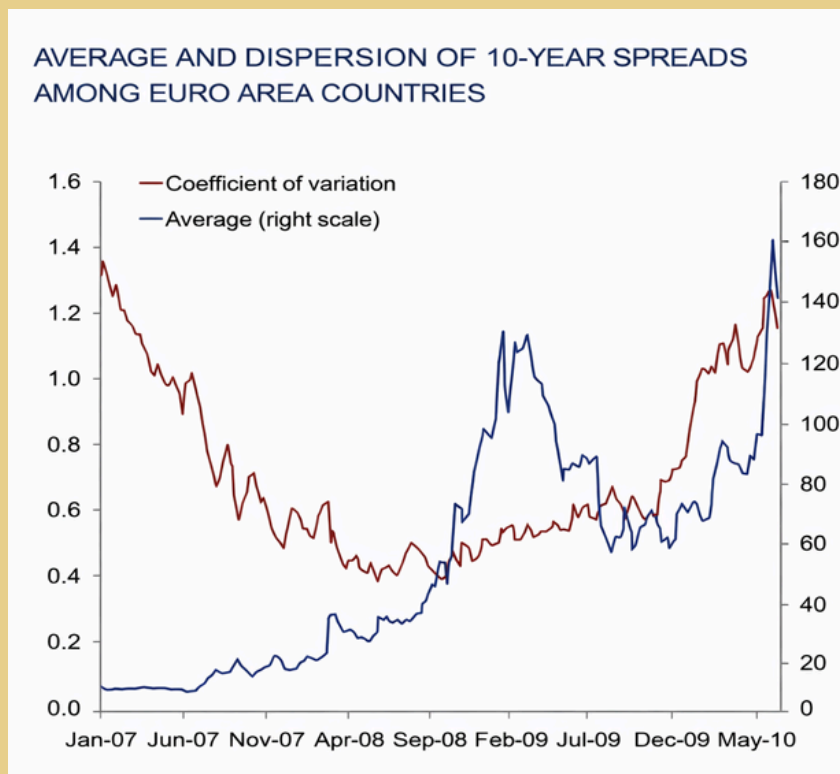
Year: 2022

The crisis profoundly altered the assessment of **sovereign risk** in the euro area. After September 2008, a structural change occurred in the determinants of **spreads**: **idiosyncratic factors** gained greater weight, and markets began reacting more strongly to **country-specific signals**.

Rating agencies — firms that rate debt instruments according to the debtor's ability to repay — thus played an **amplifying role**. Before the crisis, rating revisions had a limited impact because the debt of euro area countries was seen as **relatively homogeneous**. With the **loss of confidence**, ratings became **informational triggers**: a **downgrade**, or even a review outlook, immediately increased the **risk premium**.

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According to the **Bank of Portugal**, this new sensitivity reflected the growing fear of **sovereign default** and led to differentiation among countries previously considered similar. The agencies reinforced this dynamic by giving credibility to signs of **fiscal and economic deterioration** that were already emerging, contributing to the rapid **rise in spreads**. Although they were not the central cause of tensions, their announcements accelerated market movements, especially in countries with **weak fundamentals**. A **circular cycle** emerged: **deterioration of fundamentals → rising spreads → rating revisions → further increases in spreads**. Thus, rating agencies became indirect participants in the escalation of sovereign financing costs during the crisis.



Description: Evolution of the 10-year spread in the eurozone

Source: Thomson Reuters.

Year: 2021

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The worsening of spreads also resulted from **contagion mechanisms** linking **banking fragilities, sovereign risks, and financial integration**. The **Bank of Portugal** identified that, after September 2008, spreads became more sensitive to **idiosyncratic factors**, especially to **banking shocks** and doubts about the **States' ability** to support their financial systems, aggravated by the **transfer of bailout risks** to public accounts.

To halt this dynamic, the **ECB** adopted **large-scale monetary measures: liquidity expansion** through **LTROs**, broadening of collateral, and open market operations. Later, it introduced **OMTs**, aimed at restoring the **transmission of monetary policy** and containing **excessive spreads**, reducing **contagion** and **systemic risk**. At the institutional level, the **EFSF** and the **ESM** were created, designed to provide **conditional financial assistance** and convey joint response capacity. The effectiveness of these instruments also depended on the **perceived solvency** of the guarantor States and the ratings attributed to the funds.

These measures are considered important **shock absorbers**, but they only became fully effective when combined with **monetary credibility, fiscal discipline, and conditionality**. Thus, although **contagion** initially amplified spreads, **monetary and institutional interventions** were decisive in breaking the **adverse cycle** between banks, ratings, and **sovereign debt**.

Impact of the Crises on the European Union, particularly in Portugal

In the years **preceding the global financial crisis**, the Portuguese economy exhibited a combination of **macroeconomic stability and structural fragility**. After joining the Eurozone in 1999, but only starting to have Euros circulating by 2002, Portugal benefited from **low interest rates and easier access to credit**, which contributed to expanding consumption, rising household indebtedness, and an increase in public and private investment. Yet these developments masked a **deeper stagnation**. From the early 2000s onwards, the country experienced one of the **lowest growth rates** in the Eurozone, reflecting **chronic productivity problems and a persistent loss of competitiveness** relative to its European partners.

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On Graph 8, it's easy to witness that while Portugal grew its GDP at a greater rate than Germany in large parts of the 1990s, it failed to repeat the success once entering the Eurozone, **not being able to capitalize** on a relatively crisis-free economic period, unlike Poland, for example, which didn't join the Eurozone.

Economic performance **fluctuated** modestly throughout the decade. Though Portugal hosted the Euro 2004 football championship, the broader structural issues remained unresolved: **low levels of innovation, heavy dependence on non-tradable sectors** such as real estate and retail, and an export base that struggled to expand in higher-value-added industries. One of the **chronic issues** of Portugal's economy is the **negative Trade Balance** (of Goods), which kept being negative throughout the whole decade. **Unemployment** during the early 2000s oscillated between 3,9% and 6,4%, registering a **moderate increase** throughout the years. In 2004, the government of Prime Minister Pedro Santana Lopes collapsed. **Economic stagnation**, combined with **political instability**, culminated in the **dissolution of Parliament** by President Jorge Sampaio. The ensuing elections in 2005 resulted in a decisive victory for José Sócrates and PS, who formed a majority government after campaigning on promises of modernization, technological innovation, and more disciplined public finances.

Nevertheless, when the **global financial crisis** erupted in 2008, Portugal initially appeared relatively insulated from **the most dramatic effects**. Unlike Ireland and Spain, Portugal had not experienced a large, speculative property bubble and its **banking sector**, although **fragile**, was not as exposed to toxic assets as financial institutions elsewhere. As a result, the immediate shock was less catastrophic. GDP contracted only mildly in 2009 compared to other EU countries, and unemployment, while rising, did not initially surge as dramatically as in other **crisis-hit economies**. This relative resilience created the impression, both politically and publicly, that Portugal might weather the storm without requiring drastic interventions.

However, this **temporary stability** masked the underlying structural weaknesses that had accumulated over the preceding decade. **Low productivity, weak export performance, chronic deficits, and a reliance on external financing** meant that Portugal entered the crisis with **limited capacity to respond** to prolonged economic stress. The stimulus policies adopted in the run-up to the 2009 elections (in which José Sócrates was again victorious (despite losing his majority) would soon interact with these vulnerabilities, **contributing to the fiscal deterioration** that ultimately pushed the country into the center of the **European sovereign debt crisis**.

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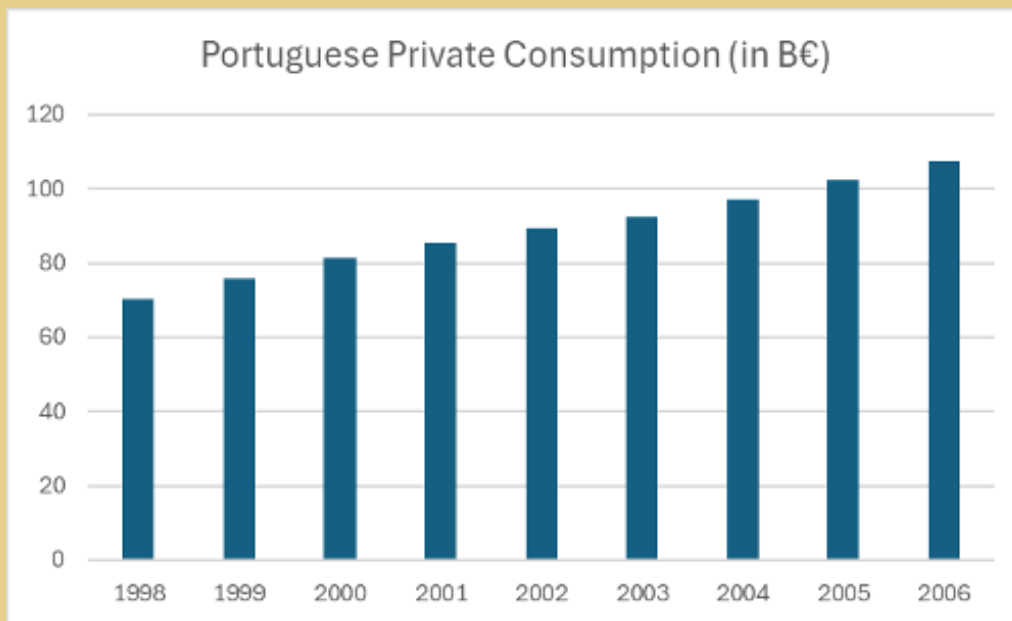
The country was turned upside down with an **employment rate** reaching 11% by the late 2000s and eventually a record 16,5% by 2013. **Public deficit** was also at an all-time high in 2010 (11,4%), tied with Greece and only topped by Ireland (32,1%) in the EU. **Public debt wise** (in terms of GDP), Portugal also surpassed the 100% negative mark in 2011.

This left no choice for Prime Minister José Socrates, who had to declare the coming of **TROIKA** in 2011, an **alliance between the European Commission, the European Central Bank, and the IMF**, which would implement severe measures to save Portugal from **bankruptcy** and the Euro currency from **collapsing**. José Socrates reached an all-time deep in popularity, which was used by the opposition party PSD and its leader Pedro Passos Coelho to turn down **National Budget** and provoke national elections in which they emerged victorious, having the difficult task of keeping Portugal afloat while being extremely conditioned by TROIKA.

Between 2011 and 2014, the Portuguese government **implemented deep cuts in public-sector wages and pensions, froze or reduced bonuses** (13th and 14th month pay), **eliminated extra pay and substantially reduced the disposable income of many workers and pensioners**. At the same time, there were broad **increases in taxes and indirect levies** (ex. IVA increases, higher energy and utility costs), **reductions in social spending and public investment, and deep cuts in health, education, and welfare outlays**, all aimed at reducing the fiscal deficit and stabilizing public finances.

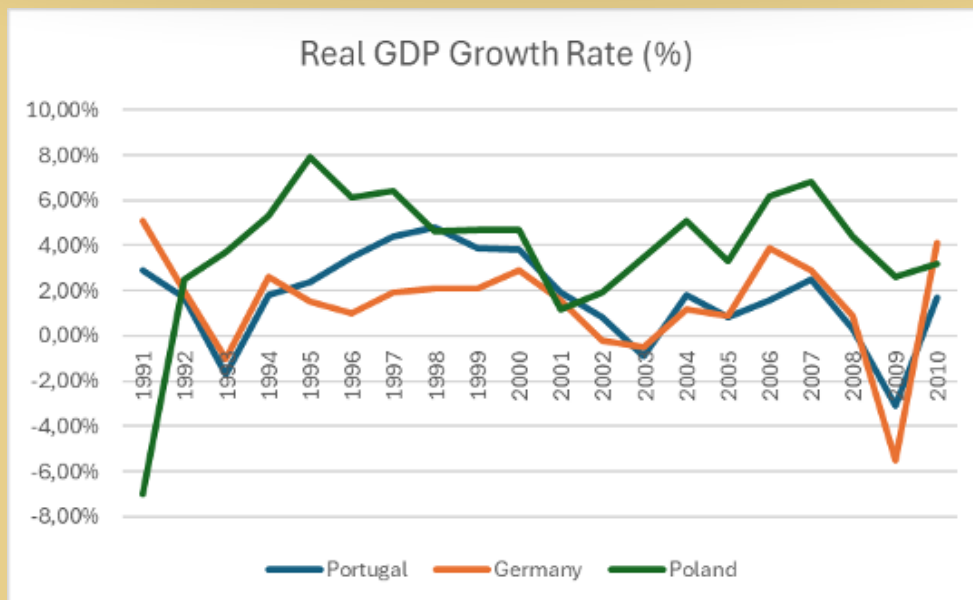
These austerity measures amounted to a cumulative financial adjustment of tens of billions of euros (over 2011-2014), **significantly affecting household incomes and public-sector employment**, while **reshaping the structure of public expenditure and revenue**. Portugal let go of TROIKA in 2014, after a lot of effort by the government and especially the Portuguese people, with a **decreasing unemployment rate and real GDP growth**.

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Description: Evolution of Portuguese Private Consumption (in B€)
Source: BP Stat

Year: 2025



Description: Real GDP Growth Rate in Portugal, Germany and Poland between 1990 and 2010
Source: World Bank Open Data

Year: 2025

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Conclusion

In conclusion to this article, it's important to point out that these **crises**, although very damaging to many people not just in Portugal but the whole world was, at large, **evitable**. There were many **human mistakes** that were made **not only leading to the emergence of the crisis** but also in **response to it**. From the banks that highly overestimated the repaying power of users who had no conditions for it, to the **ludicrous expansive measures** taken for electoral purposes **devaluing the impact of a global crisis** and running straight into another more powerful one. This crisis is not only a **very important lesson** from the past, but also an essential one for the future.

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