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Ireland exposed by reliance on faltering US economy

Bringing one's child to the doctor to get immunised against certain diseases is never easy. Although the pain of the injection lasts only a few seconds, subjecting our cherished little ones to even temporary distress goes against our natural instincts. Yet parents know that vaccines protect their children against viral diseases that can infect, cripple, or even kill. Shots may hurt like hell, but they are in the child's best interest.

With the US economy on the brink of recession and the dollar set to tumble further, it's time to think about immunisation shots for the Irish economy. The US economy is unwell, and given Ireland's reliance on the US, we are at elevated risk of infection.

This time last year, the US economy was expanding at an impressive rate of nearly 5 per cent, driven by heady consumer spending and a red-hot housing market. Growth slumped to less than half that rate in the second and third quarters of 2006 and more recent indicators suggest that the economy remains weak.

What went wrong? The problem was that the US housing market had become a bubble. That bubble burst during the summer, pricked by the cumulative effects of interest rate hikes by the Federal Reserve -- America's central bank -- which saw interest rates go from 1 per cent in 2004 to 5.25 per cent today.

As demand for new homes evaporated, developers found that they were unable to sell newly built houses. They responded by cutting back sharply on new construction and by slashing prices of unsold houses. Worryingly, the glut in new homes for sale is likely to get worse before it gets better. A slew of construction that began just before the downturn is only now coming on the market. Moreover, the effects of the past interest rate increases have yet to feed fully through into higher mortgage rates because many US homeowners have mortgages with rates that adjust only every couple of years.

Causalities are mounting among homeowners and mortgage lenders. The number of homeowners who can no longer afford to make mortgage repayments has soared. Homeowners are defaulting on their mortgages at an alarming rate, and banks and other mortgage lenders are busy repossessing homes. Several mortgage lenders have gone bankrupt. Difficulties so far have been mostly confined to the so-called "subprime market" which provides mortgage loans to borrowers with less-than-perfect credit histories. But distress in the subprime market may be the canary in the coalmine for more serious trouble in the broader mortgage market.

So far, the spread of the housing malaise to the rest of the economy has been fairly well contained. Consumer spending remains surprisingly robust. But unless the housing markets hits bottom soon, the already overstretched US consumer – who has binged for over a decade on declining savings and increased borrowing fueled by past house-price gains -- is unlikely to hang in for long. If the consumer stumbles, the wheels will surely come off the US economy in 2007.

An optimist might look to the Federal Reserve to ride to the rescue and start cutting interest rates soon. Indeed, investors are placing large bets that the Fed will ease sometime in 2007. However, inflation remains uncomfortably high and the Fed will want to see convincing evidence that it is coming down before easing monetary policy. As a result, any cuts in interest rates will probably be too little too late.

The virus that has laid low the US economy is being spread internationally through movements in the dollar. As prospects for the US economy dimmed and expectations of US interest rate cuts grew, the dollar began to drop. Unless the US economy stages a quick recovery, the dollar may have further to fall.

Even if the US manages to avoid recession in 2007, the dollar's slide will likely continue. The housing market bust might yet prove the trigger for the long awaited adjustment in the massive US trade deficit – the excess of US imports over exports. While economists have been predicting a crash in the dollar for years now without success, there are signs that this time may be different. Oil exporting countries have begun to talk openly about diversifying their massive holdings of dollar assets into euros and other currencies to reduce their exposure to the dollar. China, with more than $1 trillion in dollar reserves, is reportedly thinking along the same lines.

The drop in the dollar will hurt the Irish economy, though the extent of the potential damage is not easy to judge. Globalisation means that movements in exchange rates don't affect trade flows in the way that they used to. Multinational corporations have split their production processes across many countries and often invoice in dollars, a practice that makes their profits less sensitive to fluctuations in currencies. Additionally, the labour costs of some US firms located here are small compared with the profits earned by those same operations. A tumbling dollar will make Irish wages look expensive when translated into dollars, but subsidiaries of US multinationals in Ireland should still be able to turn a tidy profit. That said, exports to the US account for a chunky 20 per cent of Ireland's total exports. Without doubt, Irish firms exporting to the US will feel significant pain, as will Irish companies with large US operations.

The other scary thing about what has happened to the US economy is that there are many parallels between the US housing market this time last year and Ireland's housing market today. In particular, the explosion in so-called "non-traditional" mortgage products such as interest-only and no-money-down loans allowed the US credit boom to continue in 2005 and fueled even greater increases in house prices. But breaking up the furniture to throw on the fire after the coal has run out is hardly a good idea. These risky, and some might say reckless lending practices are becoming more common in Ireland. New homeowners that get seduced by these products could end up as firewood for the raging furnace that is Ireland's housing market at present.

To stay healthy, we need to pay more attention to our competitive position vis-à-vis other countries in Europe. It is, after all, to these countries that will look to sell our exports when the US consumer eventually runs out of steam. Although we have shared a common currency with a group of continental European economies since 1999, the share of our exports that go to the rest of the euro area has not increased since then. Wage costs in Ireland may already have overshot and a significant moderation in wage increases looks necessary to restore competitiveness.

Similarly, recent interest rate increases by the ECB, although painful for those making monthly mortgages repayment, should help to rebalance our economy by putting an end to our unsustainable housing boom. That will hurt, for sure, but without the shots we would be at risk of catching a far more serious disease.

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