Georgia's Business #405

Guest: Rajeev Dhawan
Economist, Georgia State University

Richard Warner:
I'm Richard Warner, welcome. These are extraordinary times. Rising gas prices lead to inflation. Bank troubles make it harder to get a mortgage. Deep job cuts from car makers to news papers. For a lot of folks, this is a frightening time, but is former congressman Phil Graham right? Is this all a mental recession? Well the time was right to book Rajeev Dhawan form Georgia State University, nationally recognized, he's director of the economic forecasting center at the Robinson College of Business True or false, it's the worst I've seen.

Rajeev Dhawan:
It's probably not the worse but definitely there is a problem. This is like I would say, it started in last August, intensified in March, and now because of the oil prices being high, we're really suffering.

Richard Warner:
I saw you speak about it in August; I bet it was a year a go. This was at the GH&I lunch where you did a presentation predicting what the next couple of years were going to be like and you weren't really worried. I mean there was some concern there but it didn't appear things were going to be as bad as they were. Surprised?

Rajeev Dhawan:
A little bit. I think it's the oil price that is surprising me. I was always expecting oil to demand below $80 and that forecast I had to give up by February and when it became very clear that these supply problems are causing the issue, because, the demand is down. The world economy has slowed, we have slowed.

Richard Warner:
Demand is down here.

Rajeev Dhawan:
All over.

Richard Warner:
Well cumulatively you're saying demand is down from what it was?

Rajeev Dhawan:
Yes.

Richard Warner:
Really? Even with India and China?

Rajeev Dhawan:
Yes. They raised their prices to by 20% both these countries so the demand has to be down. But the issue is this, the demand definitely did not grow in the last one year, it actually even came down, the prices are going up. They're up a hundred percent. How do explain that? And for speculation, you have to have two counter parties. One has to bet high, one has to bet low. Otherwise you will have everybody betting on the one way. So, our goal, I mean it's a supply issue. And when the momentum gets going...

Richard Warner:
It's a supply issue? It's how much of the product we're getting is the reason that we're paying four plus?

Rajeev Dhawan:
Do you really believe that Nigeria, Iran, and Russia, and Venezuela are producing what they claim they are producing? These countries are unstable. All they have are their agendas. So all of a sudden one quarter of the world supply is, I would call it a question mark. Do you really believe stuff is coming out of Iraq? Or Iran for that matter? So there is always what I call a margin of error. Are they producing one million plus minus half a million or plus minus hundred thousand.

Richard Warner:
That's the first time I've heard that. So what you're saying is they're claiming they're producing and shipping it but they're not?

Rajeev Dhawan:
Where is the data for about production and shipping? We just rely upon good faith estimates by these producers and other people. So the issue, what we claim to be produced, if there is a error over there more than usual, then we are in trouble. And that's why I cannot explain, you know, with the demand coming down, speculation can cause some of the issues, but they cannot make it go hundred percent.

Richard Warner:
Okay. We're going to see how much of a politician you are because really economist are supposed to be like scientist and you're right down the middle. Do we need to be drilling domestically? Do we need to be increasing the domestic load?

Rajeev Dhawan:
Let's put it this way, we are importing 70% of the oil. So even if we drill everything domestic, that proportion is not going to fall by too much in the next 6 months or the next one year. But we have t drill it sooner or later or we have to produce oil from other sources. All we have to reduce are our consumption and the only decent solution which is workable is to reduce our energy consumption in the long run.

Richard Warner:
That's probably not going to happen.

Rajeev Dhawan:
It is going to happen. With the gas prices at four dollars a gallon. It is going to happen. It's already happening.

Richard Warner:
Well but enough to make a meaningful difference in inflation and in job security and in, it's dominos.

Rajeev Dhawan:
When it happened in the seventies when the prices quadrupled, people were shocked and there were price controls on the commodities. And we had a loss decade basically both in productivity and output and other stuff. Now we know that there are no constraints on the market. If you want to buy, if you want to fill up your tank, you're going to fill up your tank, but you're going to pay, which means, or go you go back home and realize, I just put in next to hundred dollars in the tank instead of putting into poker and beer and other stuff. So our goal, I'm going to change my habits. I may downsize the car or I may start combining my trips. Or I may yell at the people and say turn off the lights its costing money. So all this measures when they get ingrained, that's when you start seeing the benefits and the price is the mechanism that makes you do it. Alleviating by trying to find the short run, if you can find a couple of million barrels of oil per day someplace, they might bring the price down. But they're not going to solve the long run problem.

Richard Warner:
Went out to lunch yesterday with a manager of a media property in Atlanta who I respect who is jovial and always optimistic and I sat down at lunch with and he was, I've never seen him like this he said, this is awful. Revenues in the market are down twelve percent in a month and it's going straight down. We're really scared; we don't know what to do. Advertising, perhaps leading economic indicator, companies aren't going to spend money if they don't have it, if they don't think it's worth the investment. You buy that?

Rajeev Dhawan:
Housing got ramped up; it went way beyond what we call the equilibrium. It over shocked the optimal number by a long margin. It's on the way down for the correction, and that's where, that one place is where there’s definitely a depression sort of going on. Is you are in the construction business trying to construct or you're a builder, you definitely have a problem, sever one.

Richard Warner:
If you're a realist that is.

Rajeev Dhawan:
Yes. I mean especially in Florida and California. It's really bad.

Richard Warner:
How about here?

Rajeev Dhawan:
Here, depends upon the neighborhoods. Some neighborhoods it's pretty good. Some where there was an excess development. Let me put it this way, in 19990's, late 1990's which is what people call the mark of a good time over here, and at that time the job growth in the local town would be about 80 to 100 thousand jobs a year, and we were, how many permits were we building? How many houses were we building? About 50 to 60 thousand, at the most. Now our job growth on average, in the last four years, in the recovery, never crossed more that 50 thousand on the average.

Richard Warner:
This is Atlanta?

Rajeev Dhawan:
Atlanta. It might even have been less. And we only had job growth for three or four years. But we were building housing permits at the rate of seventy thousand. We built a lot. So where ever they built a lot more, like in the condo business, everybody wanted to be in midtown, downtown, Buckhead condo. All of a sudden the supply that's going to hit the market is going to be more than the existing stock of condos, if they all come through with their promises. So it all depends upon where you are and that's why they say real estate is location. And that matters.

Richard Warner:
Let me ask you, I see in the presses Merrill Lynch writes down 4.7 billion dollars in the second quarter, City Group writes down 7 billion dollars, they write it down. I'd love to write down some of my personal debt too. What's involved in writing things down?

Rajeev Dhawan:
Basically acknowledging that your asset, that your booked on your books let's say one dollar is now worth only say 97 cents. So you need to account your assets at say 97 cents and then take the charge that involves going into your reserves. I'm not an accountant but it involves going into your reserves, or putting money into reserves or it's basically loss of net worth. In simple terms.

Richard Warner:
So we're acknowledging that we've written this down? It's not like I'm a responsible party so I take the responsibility now lets move on. This has forced these companies to sell assets to cover that write down or is it just gone?

Rajeev Dhawan:
It's basically acknowledging what they hold on their books is now worth less. It doesn't mean they have to go sell. Now if you are leveraging, suppose you are the speculator or investor, and you were using this asset to double up, borrow more money, and invest some more, and you write down the value of your asset, you're going to have a margin call. and then you have to go either find the cash or sell this collateral.

Richard Warner:

Now let's go back. Apply that to the condo market and tot he housing market, these people who developed these midtown condos, downtown condos, it was hot for a couple years there. Are they going to end up writing those down or are we going to see the prices fall and create the market again because the price is at a lower point than it was?

Rajeev Dhawan:
See over there they have to make the payments to the bank. And if they can't make the payments to the bank then the next step is, the bank either forecloses on them, or renegotiates with them. Now if the bank forecloses, the banks are not in the business of building and renting, so they will have to sell it in the market and the prices will be depressed. so a lot of the banks right now are trying to make out a deal where they say, ok carry on, maybe another 6 months or a year this will work out, or we both take a hair-cut and they're some tax issues and legal issues over here. So a lot of creative financing will get done but ultimately the asset will be worth less and somebody will be buying it, and somebody will be taking a loss.

Richard Warner:
It's that old saying that if the bank loans you enough money then their partners with you. During the last recession, the reaction was to clamp down on shotty practices that cost people, investors, retirees, so much money. Sarbanes-Oxley was designed to prevent that mess form ever happening again. Some say the pendulum went too far. Now we're seeing the same thing with people who want to borrow money to buy a house. We're seeing a lot more conditions placed on the deal. It's a lot stricter, a lot harder to get. Are we in danger of that pendulum swinging too far and people who should be in houses can't afford to do it?

Rajeev Dhawan:
It's already happening. I mean I just recently bought a home a couple months ago.

Richard Warner:
How did that go?

Rajeev Dhawan:
It was tough to get a loan. You have to go through all the covenants. You have to document everything. And you have to have stellar credit. The bank had to really believe in you. So apply that to the typical person. See, a few years ago it was minimal requirements, money was cheap, everybody wanted to make a loan for the sake of making a loan.

Richard Warner:
In our case, I'm an entrepreneur; I got a no doc. Paid a little bit higher interest rate. I could have gotten a regular loan; it just would have taken longer. I have a hunch that that would never happen now.

Rajeev Dhawan:

It still might happen but the cost may be too high. Everything will happen. The sub-prime loans will still get made a little bit, little bit of loyalty, mostly prime, but it's called credit rationing or credit crunch. It's not the interest rate that's high. It's the covenants that will make it tougher to get the loan.

Richard Warner:
Covenant is...

Rajeev Dhawan:
Well show me last three years of your income. It so happened the first year was low, the other two years were high, maybe I don't want to give you the loan because all three years you had the same income. So things like that will come into play which will make the loan getting difficult to get. And the reason is this, the bank in turn were selling the loan in a securitized market. The banks don't keep the loans on their book, they service it a few months, build up the history, and it gets sold. They get mortgage backed securities. That's where Frannie and Freddie come in and the other banks. And right now nobody wants to do that too much. Even Frannie and Freddie are battling their own issues. So imagine the people who were creating that market in the mortgage backed security are fighting for their own life. What chances are there that they will be doing the full amount of business? So it will go down to the bank, originating the loan and holding it on their books. And the more that you have to hold it on their books by law you have to keep more capitalist reserve, which our goal, either they're going to charge you a hard interest rate or they're only going to make it to a very good borrower because they don't have that kind of money.

Richard Warner:
So somebody who is looking to buy or sell right now, what are they in for? What's your advice?

Rajeev Dhawan:
Basically, if you are buying because you have to buy. You moved in to this town, you need a house, you have a good credit, you will find a good loan sooner or later. But if you're trying to do this speculation, let me sell my home in one neighborhood, and then buy another one in a near by neighborhood, just try to move on, cash out or something, that will be tough. So, market is still open. They're still home sales going on, they're just not happening at the kind of profit margins either for the seller or for the real estate agent or for the bank that everybody will be happy.

Richard Warner:
To date, can you think of anybody any industry or vertical that has been exempt from this mess?

Rajeev Dhawan:
I mean so far if you look at the employment numbers, industries in health care areas seem to be adding jobs. That doesn’t mean that they're making a lot more money than they used to make before but at least they're not suffering that much. But let's look at the

hospitals in other places. You know that as the economy weakens, there will be less customers who will be going for procedures to these hospitals surgeries and other stuff. So they will be suffering some problems too. So it's not that everybody's immune, but some people are a little bit better off, but even within healthcare, it might be that the doctors and the hospitals may suffer a lot more loss, lot more fluctuations compared to somebody who's producing devices for healthcare.

Richard Warner:
I recall what the governor said when he was a guest on this show a few years ago. It was during the last recession. He said what people don't realize is that when financial times get tougher, the demand on our services gets greater and more expensive so you're squeezed at both ends. To some extent I would think hospitals are going to face inability to pay.

Rajeev Dhawan:
That will happen because the customer, the insurance customer that pays. Some people will be out of jobs, they may not have insurance. And lot of the things that procedures, that also add to the bottom line of any hospital. Those plastic surgery things, those other stuff. So those things go away.

Richard Warner:
Another one that was in the Wall Street journal, Google and Microsoft are reporting earnings that are very healthy. Wall Street doesn't like it because they're not as healthy as they wanted but never the less money is still very good. Digital seems to be healthy as much as health care.

Rajeev Dhawan:
Well it seems like from the revenue perspective that the technology sector is doing better but when you look at the employment side, they don't seem to be hiring that many people. Which means that their productivity per worker is rising as expected which may result in profits but they're not adding to the head count too much. So when I look at it from the economist perspective, when I have to do the forecasting for the local economy, the best metric I have is job growth, and over there, the information technology sector has not added jobs in the last five years. The lost a lot of jobs in 2001 to 2003 but they haven't added much.

Richard Warner:
More local companies. Future of Delta.

Rajeev Dhawan:
With the oil at 130, 140. Doesn't look to good. So they are doing the right thing. They are scaling back on their operations. They also have raised their ticket prices, but you know once you raise your ticket prices, you're going to have less people flying, on top of it, people have less disposable income with the economy slowing, so there will be less tendency to fly, so when you look forward into the future, oil at 130 is not good news for any airline, not just Delta. Even the foreign ones.

Richard Warner:
Coke. Big loss of Coke and CCE report trouble in the last quarter. The future of them.

Rajeev Dhawan:
Well their revenue grew overall by three percent in the worldwide. They would have liked to have it four or five and that means the profit margin will suffer, but at least it's not declining like in some other industries.

Richard Warner:
Where do you put your money now?

Rajeev Dhawan:
Well I'm not the investment advisor so I won't be able to tell you that. I have a saying since last one year and your segment is probably watched by a sector of small business people too, and I've been saying one thing since last October. Cash is king. And what does that mean? It means that for example, somewhere you have extra fifty thousand dollars laying around. Do you pay of your mortgage? Or do you keep the money in cash, on the site, for future emergencies of the business? Because you know one thing right now, the banks are already tight about giving you loans or extending your credit limits or they've been revoking the credit limits. So yes you can pay off your home loan, less debt over there right for some of the loan? But at the same time if you need the, if your cash flow turns sour in a few months and you need that money, where would you go? So you have to become your own banker. That's what I'm saying. Cash is king. You need to use the cash very appropriately. blindly going into the stock market or bond market or paying off the mortgage other things, you have to look at the opportunity cost not just in terms of interest forgone or interest saved. But what's the probability of getting a loan when you are in trouble six to nine months from now. That's one you have to factor in before you make any decisions.

Richard Warner:
The contrary would say, aren't there some good investments that are priced low right now because of the conditions? Part of the equation is buy low. That's not what you're saying though. You're saying keep the cash.

Rajeev Dhawan:
Buy low but if you need the cash yourself and you're worried that your bank may not make you the loan, then you have to become your own banker.

Richard Warner:
And you're seeing that? You're seeing banks not making loans and even credit lines withdrawn?

Rajeev Dhawan:
That's exactly what we call a credit crunch or a credit rationing or the credit is tight. It's when the loans, it's not that you get a loan at a higher interest rate, you just don't get the loan.

Richard Warner:
When we were talking earlier, what do you hear out there now as you're doing your research to do reports and so forth and you're trying to do investigative works on companies big and small? What are they telling you? What are you hearing?

Rajeev Dhawan:
What I'm hearing is that revenues are either stagnant or they're falling in something related to home building and that is where the biggest trouble is and the fall out of that, the negative multi-plan of the home industry scaling, before it even shows up in the employment numbers that much, is not now beginning to show up in the revenue collections of the state. And in the last three months the sales tax collections, thanks to high oil prices and the home activity declining, they've been really falling. And you only see that when you have bad times. You don't see that in good times.

Richard Warner:
Are you looking at oh nine as the turn around? What's the next year look like at this point?

Rajeev Dhawan:
I was trying to come up with a baseball analogy of this one although I'm not a baseball player but I'll try my best. It looks like we are probably in the fifth of the sixth inning of the game, in terms of bad times. But this game may get extended to extra innings and the random factor over here is the high oil prices. The problem was going on, the housing market was declining, but there's always the bottom, there's always a turn around. That turn around will get delayed if this oil remains above a hundred dollars a barrel 'til the end of this year. My expectations a couple of months ago were, oil will come below a hundred dollars by late fall. Unfortunately I have to post pone that below hundred dollars to early spring next year, And if that happens, everything gets delayed.

Richard Warner:
And yet Europe is paying six or seven bucks a gallon. They're used to it.

Rajeev Dhawan:
Europeans are actually paying even eight dollars a gallon. Now even they're complaining. They were used to paying five bucks a gallon but now they're paying eight. So everybody is complaining and the trouble is places where the heating oil is a big factor in the winter, northeast, mid-west, that is where the consumer will feel the bite of the hundred dollars and above barrel of oil in winter. If the oil comes down below a hundred before the winter starts, then we don't suffer that negative hit. But if we have to suffer in the winter, it's going to mess up the consumer more, consumer spending, and then delays the whole recovery. Even if the created problem may be a little bit coming under control. So you

got two issues, well three issues. Credit, housing, which may be inter-related, then you got the oil. And you add them all together, it makes for a bad mix. And that's what's happening right now. And if it keeps on happening to late fall, it's going to affect us to 2009.

Richard Warner:
Now the proponents of a free market will say that this will take care of it. This is going to force car makers to retool what they sell us. There's going to be that gradual reduction in the individual's carbon footprint. They're not going to be burning as much gasoline because they're going to be buying smaller more fuel efficient cars. Is the market place going to make up for hundred dollar plus barrels of oil?

Rajeev Dhawan:
The market place will do it but it takes time. It takes time to retool your factories to produce a different product. You can't do it over night. And it takes time for people to adjust their habits. It can't happen in three months. It will take time and that is why 2009 is now a question mark. And again I go back to my old tape. If the recovery gets delayed, then cash again your own cash, will come in more handy. So you see, then I would say you have to look at the probability. When would you need the cash? And if you need it, would you be able to get it from the bank? There are two uncertainties over here. When will the economy turn around, and will the bank be in the mood to give it to me before that. Both the things, you have to make your own individual probability based upon your business. Maybe you are in windmill production. Maybe your business is booming. You don't have to worry about those things, but if you are in real estate selling the condos, then of course. It's a totally different ball game.

Richard Warner:
Well you're getting a lot of business these days. I'm sure a lot of folks want to know what you think. I appreciate you stopping by.