RED ALERT

Usha Haley has studied China's economy from the inside out, and has words of warning about Shanghui's acquisition of Smithfield Foods.

Photos by Marc Soracco

By Lisa M. Keefe, editor

Usha Haley is an emerging markets specialist who's studied the emerging markets of Asia for years. "It's the high growth potential of these markets, how interconnected they have become, and also the fact that these economies are the ones with the youngest populations," she says, "except China, but China's a very interesting exception."

An interesting exception on a number of levels. In a country that boasts fully one-quarter of the world's population and a top-down form of government, social stability is the government's first priority — ahead of, say, sound business and economic practices, Haley says.

"It's the reason why, for example, they have engaged in capacity increases [of] 20 percent every year in so many strategically important industries, despite worldwide surpluses."

Haley, professor of management at West Virginia University and director of the Robbins Center for Global Business and Strategy, testified before the Senate Agriculture Committee in July on the then-proposed acquisition of Smithfield by Shuanghui International. She warned of the downside for U.S. interests if the acquisition were to go through. She took some time to discuss her ideas in more depth with *Meatingplace*.

Meatingplace: What's going on in Asian countries, and China in particular, that drives what's going on in the U.S. and [elsewhere]?

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HALEY: Yes, we want [Asia's] markets but they come with their own baggage, their own systems, their own problems, which then mesh with ours. Take China, where you have one official source [of information] and so here lies some of the problems: In order to make rational decisions about these countries, A) we have to know something about their cultural institutions and where they're coming from, and B) we have to get information on them and not just the kind of information that we like to rely on. Just [having] statistical information, hard [data], is useless in these countries.

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[When my co-authors and I] wrote "The Chinese Tao of Business," we spoke to senior managers in China about what it took to succeed there. All the successful ones relied on what we would call 'soft' insider information … qualitative data, networks, etcetera, not the quantitative statistical information we use in the United States. But … gathering information independent of the government and disseminating it is against the law in China.

And it takes years to develop these information networks … not just the traditional, familial networks but also including business and government networks in China. By the time Western managers have managed to get information that is relevant … they're transferred. With them goes all their networks. Loyalty in China is an individual system of friendship. It's not institutional.

Meatingplace: Is China's economy fundamentally stronger now than it was 15 or 20 years ago?

HALEY: I think it's fundamentally weaker. The country's economy is far more important — with China being so interconnected with other economies … than it was 10 years ago — but we know so little about what happens there, so we don't get adequate data for our strategic decisions.

There are many disconcerting statistics emanating from China, such as the amount of excess capacity that is added every single year. One of the most troubling statistics is the level of local government debt. The Chinese central government does not know the extent of this debt. They estimate that it's about $3 trillion … or about 36 percent of China's GDP.

These official debt estimates don't account for a whole bunch of other investments [such as] local governments' backing local companies' expansions and projects [for which] the government [gives the] companies subsidies. I estimate that actual debt is more than 180 percent of GDP.

Meatingplace: That can't be sustainable.

HALEY: No, it's not sustainable. But the flip side of it is we can't just completely cut China out. China's too well-connected with our economy and every other economy. We can see that China's growth is [slowing from last year, and that] has already affected Australia and will affect Brazil, because they've become huge exporters of commodities to fuel China's growth. We really don't want China to have a hard landing. The entire world economy cannot just depend on the United States.

Meatingplace: What are the most important things that Westerners do not understand about working with China?

HALEY: That it's a nonmarket economy and the government is extremely important in every aspect of a business, whether it's obvious or not. In China, what you see is rarely what you get, and what you see is often just the tip of the iceberg. Things don't happen immediately, either, unless the central government or some provincial government wants it so and then they undertake actions for their own interests.

Meatingplace: Is the Chinese culture and government likely to have an effect on this side of the ocean in terms of Smithfield's operations, and perhaps the pork industry overall?

HALEY: I sincerely believe it will. If Shuanghui's bid is approved and allowed to go through [it was approved by the company's shareholders in September], Smithfield Foods and its 400-plus farms across the country will be controlled by the Chinese government. And let me go out of my way to say why this is so. On paper it doesn't look [like that's the case]; [Shuanghui International is] a private company. But then you start sifting through the labyrinth of connections and you see the government influence throughout.

[Shuanghui's many advantages], including being able to list on the Shanghai Stock Exchange, getting all sorts of subsidies and benefits from provincial governments, and having very senior administrators in the central government go out and try to [allay] fears about Shuanghui's operations, especially when the Clenbuterol scandal became public [in 2008] — all these developments show very close business-government connections. That soft, submerged information on connections is far more important than who's officially on the board of directors and what the ownership is. [A company doesn't get] these advantages without government sponsorship, and the government only sponsors what it can control. That's the Chinese system.

Meatingplace: How would you expect the Chinese government's sponsorship and control of

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Shuanghui to affect Smithfield's operations on this side of the ocean?

HALEY: The Chinese government … wants Smithfield for various reasons. One of them is to alleviate social unrest through the reassurance of a brand name … but eventually what China wants to move into is higher value-added manufacturing.

China has no economies of scale. Most of the companies [in China's strategically important industries, including pork production] are small and fragmented. [But] Chinese products sell for 30 percent less than U.S. and European products. Everyone says that's because China has cheap labor, but labor costs are under 7 percent globally in these industries [such as steel, auto parts, paper and pork] — generally about 3 and 4 percent of these industries' [total cost of production]. These are capital-intensive industries. That's where the subsidies come in. [Chinese companies] are able to maintain these low costs because local governments kick in these huge subsidies in the form of free land, free water, free electricity, loans that never have to be repaid, etcetera, so that these industries can continue operating in their provinces and employ people. Also, these industries are geared toward exports so that the local governments get revenue. One concern with Smithfield and Shuanghui will arise when Smithfield starts exporting ham — and I have no doubt that there will be more ham exported via Smithfield into China, just as I also have no doubt that the other U.S. companies will not be able to compete with Smithfield for the Chinese market. The only way these other U.S. pork producers would be able to compete would be to sell themselves to a Chinese buyer.

Now, … Shuanghui will get Smithfield pork products from the United States, mix them with [products from] local pigs and then sell them under the Smithfield brand, not just to the Chinese but also back to the U.S. and for the U.S. export market.

That's … going to affect the U.S. brand name. There will be food scandals. The U.S. companies will lose their export markets, their international distribution channels, [access to] Mexico. And, [Shuanghui] will re-export processed food which is higher value-added, back to the United States. The Chinese are putting in an enormous amount of money into building production capacity in these areas.

We don't have the laws that allow U.S. consumers to identify [the country of origin for] any food product processed in any fashion. And I think consumers should have a choice.

For the Chinese, this is the first step. I know there are several other Chinese companies that are looking [to buy in the U.S.]. They have bought in Australia, Brazil and New Zealand and they're looking to buy farmland in the United States. And [we've seen] the changes in these strategically important industries occurring in less than five years. When the Chinese move, they move very fast, and our regulatory system with all its checks and balances is very slow.

Meatingplace: You can take the production of tires or metal goods or whatever and move them; agriculture is necessarily geographically tied to a particular area. So, is it a direct parallel to look at some of these other industries and say this is the same thing that happens in food production?

HALEY: You have the actual farming which cannot … take place just anywhere in the world. Selling the food and the brand and the packaging of the food can take place anywhere in the world. Different segments of the food supply chain can be farmed out and will be farmed out.

As I said, this is just the first acquisition. I can give it to you in writing: I guarantee that if this acquisition goes through … within five years a great proportion of our large farms [will be] controlled by the Chinese. Currently, their motives may be entirely benevolent … but this is not something that we can bank on forever, and that's where national security comes in.

Meatingplace: Food is a particularly difficult thing to move around even on a commodity basis. It doesn't travel well. So it seems economically infeasible to move the commodity product over to China for the further processing and then re-export the products to other markets.

HALEY: Yes, but then you're making your calculations on market prices. And I'm saying this is a strategically important industry [and] the shipping [and] the production will be subsidized. Once China has production of most of our food supply, which I would think would be within five years, then it will raise prices.

Look, I think China's behaving rationally; this is what I would do if I were in China's position. [But] I'm on the U.S. side and we should be behaving rationally as well.

Meatingplace: And behaving rationally means don't assume everybody thinks the same way.

HALEY: China, first of all, is … an emerging market where politics trump economics. That is how it views the world. Efficiencies matter not.

Meatingplace: When people in the United States point to Mexican and Brazilian ownership in the protein business, is that a direct parallel?

HALEY: No, because China is a state capitalist society. This takeover amounts to government control of our industries, and governments everywhere have different interests than companies do. Some of these interests overlap, but the governments' interests also go to international security and companies' do not.

I'm all for free markets, but in this instance it is not one and will not be one. It's absurd to talk about the advantages of this acquisition in free market or economic terms. The markets have failed in this instance.

I'm not against the Chinese making acquisitions in the United States. The U.S. is and has historically been an open market for foreign direct investments and the Chinese should continue to invest here, but perhaps not in industries … we consider strategically important and directly affecting our welfare. The ownership matters. The ownerships' interests and goals and motivations matter.