

# Total Recall

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Dali L. Yang

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CHINA ONCE languished, a closed economy with several hundred million people living in abject poverty. Today, it is a major engine for world economic growth. It boasts a rising middle class and the world's largest foreign-exchange reserves. There can no longer be talk about global trade without mentioning the dragon, and the American consumer would be hard pressed to live without goods bearing the "Made in China" label.

For the past year, though, that very label has suffered from some serious image problems. Reports of toxic Chinese-made products have mushroomed: toys covered in lead paint, melamine-tainted pet food, defective tires, toothpaste containing diethylene glycol, contaminated fish and more. There is also talk of unlicensed Chinese chemical companies eager to manufacture and supply fake, subpotent or adulterated drug products. To be sure, the bulk of Chinese exports to the United States are made or assembled to American specifications.

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Nonetheless, the lengthening list of unsafe goods from China also points to the simple fact that, in their quest for lower costs and higher profits, way too many China-based manufacturers are willing to cut corners at the expense of consumer safety.

At their heart, China's real and exaggerated brand-image problems stem from a unique intersection of the American need for instant gratification and China's poisonous witch's brew of a "post-communist personality" with few moral moorings and unflinching enthusiasm for getting rich. Too often now, the acquisitiveness so palpable in Chinese society knows no scruples, shifts the costs to others, and is married to opportunism and cunning. Of course, there are many businessmen who have made it big by working hard and honestly, but it's the anything-goes mindset that rests at the root of many undesirable practices in China: from decadence to all manners of fake certificates, fake products, adulterated food and drinks, rampant official corruption and sheer disregard for the rights of workers in sweatshops. For many, socialism with Chinese characteristics has a lot in common with the early stage of capitalism Karl Marx described as primitive accumulation.

This phenomenon finds its roots in the Chinese brand of communism from which it was borne and the reforms from which it was shaped. Begun in the 1970s, the proliferation of unruly manufactur-

ers and exporters in China sprang from an environment where the potential for entrepreneurship among peasants and tradesmen was stifled. Technicians were jailed for moonlighting as consultants, and collective farms were enthralled to the party-state. Private business activities were severely punished or suppressed.

But after years of oppression, the government began to allow market-oriented reforms to modernize China's economy. Within a decade, the forces of enterprise were unleashed, but hand-in-hand with growth came rampant corruption. Reform making and profit making have often meant getting ahead of official policies and bending and breaking existing laws and regulations.

Along with these market reforms came preferential treatment for those of "the Party." China's leaders (and especially Deng Xiaoping) opened the floodgates, allowing government and party agencies, the armed police and even the People's Liberation Army to supplement their budgets with profits that they generated on their own. Here we see the strange melding of the strong party-state that desired a profit with the willingness to bend the rules: government control and unruly capitalism. By the 1990s, the Chinese mentality was then fully transformed. Though the Tiananmen crackdown of 1989 closed the route to political reforms, the raw energy unleashed in China was instead channeled to the pursuit of material wealth. Mammon became the new religion. Business fever took over.

The amazingly quick turn from the asceticism of the Mao era to the cult of Mammon under the leadership of the same Communist Party has landed China in what author Xiaoying Wang termed "a moral wasteland." Indeed, this is the world of double speak, with everybody mouthing the rhetoric of the moment as dictated by the party and yet often doing exactly the opposite of what's prescribed. Wang asserts that the Chinese have ac-

quired what she calls "the post-communist personality":

The post-communist personality has emerged against a background of nihilism . . . respond[ing] ferociously, almost uncontrollably, without a sense of proportion or limit, approximating as closely as humanly possible an unorganized assemblage of desires. Having lost its patience with all forms of asceticism, this ex-practitioner of communist asceticism and altruism has become a hedonist and egoist with a vengeance.

This spirit has animated China's headlong rush to capitalism and then some. It is fitting that one of the most popular books in today's China, written by Li Zhongwu in 1912, highlights how thick skins and cunning were the ingredients for getting ahead in Chinese history.

The reality of this "personality" can be frightening, leading many manufacturers to search for loopholes to slip through to get a leg up due to the relentless pressure for cheaper products. Their goal is to make some quick money, using deceit if necessary. This was apparently the case for suppliers who provided lead paint to the ill-fated toy makers. Likewise, some Chinese suppliers of wheat gluten deliberately added melamine, an industrial chemical, to artificially boost their product's protein reading and thus grade and price. In this situation, Gresham's Law prevails; honest firms find it hard to stay in business by competing on price. Even though a fix is available—manufacturers can lower costs and increase profits by improving the efficiency of production processes—oftentimes they just seek to substitute cheaper components. That can be done without sacrificing quality, but that often doesn't happen.

Yet, even with all this finger pointing, we have to keep in mind that the Chinese can't be blamed for all of the safety problems with products manufactured in-country. According to a Canadian analysis

of data on toy recalls over the last twenty years, the majority of the recalls involving millions of toys manufactured in China were caused by design defects, with primary responsibility lying with the toy companies. Indeed, a Mattel executive recently admitted that the “vast majority of those products that were recalled were the result of a design flaw in Mattel’s design, not through a manufacturing flaw in China’s manufacturers.”<sup>1</sup> In such cases, the solution for the resultant safety problems needs to come from the (mostly U.S.) toy companies.

Unfortunately, the rest of the product-quality and -safety cases are generally related to the continuing quest by manufacturers to lower production costs in the face of distributors buying at low prices, a rising currency, and rising labor and raw-material costs. But this unbridled drive to profit, with all its market obstacles and ensuing corruption, has not escaped the Chinese government. Almost from the beginning, it was clear some rein-in was needed. So the contemporary history of economic growth and market expansion is also a history of the modern regulatory state. First steps were put in place—imperfect, but an encouraging start—and all hope for a “morally reformed” China is certainly not lost.

### *Building the Foundation*

**N**O FOOLS they, in the early 1990s, the Chinese leadership took an initial stab at regulation after recognizing the need to build and rebuild the institutional infrastructure for a market economy. No modern economy allows the unbridled pursuit of self-interest, especially when that pursuit causes harm to others. In addition to the obvious internal problems, the collapse of communist regimes in the former Soviet Union and eastern Europe and, later, the downfall of governments in South Korea and Indonesia during the

Asian financial crisis spurred Beijing on even more. The Chinese leadership first reconfigured the tax and fiscal system to strengthen the central government’s fiscal capabilities and then revamped the central banking system to enhance financial supervision and promote financial stability.

Of special significance was the divestiture program undertaken amid the Asian financial crisis. In one bold move, the Chinese leadership got the People’s Liberation Army, the armed police, the judiciary as well as a host of other party and state institutions out of the business of doing business. This divestiture helped bring rampant smuggling and related corruption under control and was critical to the development of a level economic playing field.

With the passage of time, China’s leaders have also undertaken several rounds of government streamlining and restructuring to deal with an unruly market and rapidly changing socioeconomic conditions. In China, as in other developed nations, a bureaucratic alphabet soup of bodies has emerged to protect the rights of consumers, investors and workers. The advent of a consumer society and growing public awareness, in particular, have pushed safety and quality to the fore of policymaking. And happily, some of these institutions are becoming effective. The once toothless State Environmental Protection Agency has finally acquired some real bite in recent months, rejecting a higher percentage of projects submitted for approval on environmental concerns. The State Administration of Work Safety and the associated State Administration of Coal Mine Safety have worked hard to close dangerous coal mines and bring down the large number

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<sup>1</sup>Reuters, “Mattel Apologizes to China for Recall,” *International Herald Tribune*, September 21, 2007, <<http://www.iht.com/articles/2007/09/21/business/mattel.php>>.

of deaths from coal-mine explosions. In a typical move to use cheaper components to lower costs, Chinese toothpaste makers substituted diethylene glycol, an ingredient banned in the United States and other countries but permitted in China, for its safe but more expensive chemical cousin, glycerine. After the seizure of the toxic toothpaste, the Chinese government banned the use of diethylene glycol in an act of regulatory harmonization. Problem uncovered and resolved.

Yet, the picture remains, so far, less than perfect. These steps were encouraging, but anomalous. While improved regulatory capability—up-to-date product standards, abilities to monitor, test and punish—is a necessity and can go a long way toward the mitigation of product-quality issues, it is generally less effective when dealing with rogue businesses whose intentions are to evade detection and make a quick buck. Shutting down a toxic plant after a scandal is one thing. Using bureaucracies for effective preventive measures is another.

### *Cracks in the Mortar*

THE CHINESE government realized that simply creating an array of institutions was not enough—the bureaucracy must also function well, something especially difficult to achieve in developing societies. From poor interagency cooperation to a lack of resources and sheer logistical difficulties, troubles remained. Herein lies the crux of the problem for regulators and consumers in the United States and elsewhere when it comes to the quality of products imported from abroad. While China has established various regulatory agencies, enforcement has not been optimal. Regulatory authority is now fragmented among a multitude of government agencies—each mindful of its own turf and interests—that often fail to work together, especially at the local

levels. The main regulators of food safety, for example, include the Ministries of Agriculture, Commerce, Health and the General Administration of Quality Supervision, Inspection and Quarantine; the General Administration for Industry and Commerce; and the State Food and Drug Administration (SFDA). Failure among the regulators to coordinate and cooperate with each other is believed to have contributed to the deadly milk-powder scandal that came to light in 2004.

Making matters worse, the interests between central and local authorities often diverge. In particular, lower-level authorities may be more tolerant of counterfeiters and other dishonest businesses in their jurisdictions simply because these businesses generate employment and tax revenue. In the words of a *Business Week* reporting team: “Even if Beijing has the best intentions of fixing problems such as undrinkable water and unbreathable air, it is often thwarted by hundreds of thousands of party officials with vested interests in the current system.”

Partly to mitigate such divergence, the Chinese government has in recent years promoted the hierarchical integration of regulatory administrations, especially within the provinces. But, as pessimists argue, “China has built a bureaucratic machine that at times seems almost impervious to reform.”

China’s sheer scale and vast regional disparities present major challenges, too. While the major cities can deploy more personnel, resources and technology to enhance regulatory supervision, this is far from the case in outlying areas, where many of the small businesses, including counterfeiters, are often located.

Last but certainly not least, corruption has plagued some of the regulatory agencies, both in the headquarters and in the localities. Under Zheng Xiaoyu, the former head of the SFDA, and his close associates, some pharmaceutical companies were able to obtain a large number

of new drug approvals by submitting fake data and bribe money. Zheng was executed for bribe taking and dereliction of duty in 2007.

A history of Chinese regulatory developments in the reform era is thus one about the struggle to curb regulatory corruption and deal with and overcome various institutional flaws. As China's regulatory agencies contend with internal conflicts and cope with external pressures, are we sure they'll be able to effectively address their product-safety and -quality problems?

### *Learning from Experience*

**T**HOUGH THIS sounds like a story with an unhappy ending, it is that Chinese ability to turn desire into action—which may have led to these problems—that can also provide the solution. For the Chinese government does possess the ability to crack down when necessary. Two other tales in which the Chinese government had to take sharp corrective action over the past decade—civil aviation safety and doping in sports—are optimistic.

In the 1990s, China had one of the worst passenger aviation-safety records. A string of air disasters tarnished the country's international image and even led the U.S. Federal Aviation Administration (FAA) to consider restricting Chinese flights. This threat of international ostracism apparently prompted the Chinese leadership to take decisive action. In 2002, Beijing replaced China's top aviation regulator with Yang Yuanyuan to make safety the priority. Under Yang, the Civil Aviation Administration of China (CAAC) introduced a broad range of reform measures into the management of airlines and airports and focused CAAC's mission on safety. Most importantly, it insisted on rigorous safety compliance by companies and pilots. CAAC was also eager for foreign assistance. It rewrote

China's aviation regulations with help from Boeing and the U.S. FAA. It even enlisted specialists from the International Air Transport Association to audit Chinese airlines and release their findings. All this helped make the Chinese aviation industry a "global leader in air safety" with "the best safety performance in the world" between 2004 and 2007.<sup>2</sup>

A similar story of cheating, international ostracism and then successful reform finds its narrative in Chinese sports. While the reform era enlivened Chinese athletics, the ever-rising stakes for winning also increased the temptations for sportsmen and their coaches to cheat. Though cheating has been a worldwide phenomenon, in China, the decentralization of sports governance—which stimulated competition among the localities for medals—coupled with a rudimentary antidoping institutional environment offered especially fertile ground for the corrupt behavior of doping and match fixing. For a while, these incentives propelled China's rapid ascent as a global sports power, but it was only a matter of time before some of the athletes became a national embarrassment.

Chinese swimmers hauled in record amounts of gold medals in the 1990s. Soon after, China landed at the center of a series of high-profile doping scandals. These doping scandals—and the unprecedented number of Chinese athletes testing positive—cast an especially dark shadow on the meteoric rise of the Chinese women's swimming team. Much as the recent spate of product-quality and -safety problems has dented China's image as a manufacturing power, cheating in sports gave rise to the view that China

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<sup>2</sup>Andy Pasztor, "How China Turned Around a Dismal Air-Safety Record," *Wall Street Journal*, October 10, 2007. Yang Yuanyuan was replaced as the head of CAAC and posted to the State Administration of Work Safety in January 2008.

would seek to win by whatever means.

Though at first Chinese officials sought to explain away the doping scandals as the work of a few misguided individuals, when international pressure mounted, even threatening to exclude China from certain sports, Beijing knew it needed to address the issue. Salvaging the country's tattered reputation and regaining the world's confidence mattered.

In cooperation with international sports organizations, Chinese sports authorities undertook a multipronged approach to prevent the recurrence of doping embarrassments, establishing the China Anti-Doping Commission, strengthening antidoping laws and regulations, enhancing testing facilities and capabilities, and improving oversight of local teams. Meanwhile, going beyond international requirements, China began enforcing the "sudden death" treatment: swimmers who test positive for steroids, including first-time offenders, are banned from competition for life.

All this worked. China is transformed—near pariah in the late 1990s, model performer at the 2004 Athens Olympics. Not a single Chinese athlete tested positive for drugs in Greece, unlike several other major sports powers. But this cleansing did have an impact on China's medal count. Their swimming team dominated in the '90s, but they only won one gold medal in 2004. No matter, the value of that lone swimming gold to China's reputation: priceless.

### *Building Better*

**S**OMETIMES A strong party-state is a very good thing. The successful corrective measures with respect to aviation safety and antidoping in international sports are undoubtedly encouraging. China is able to comply with international rules and norms. Recognizing that China's reputation was at stake, China's leaders took

on serious reforms and tough regulatory actions. Unlike in many other developing countries, China, with its Communist Party, has the capacity to get things done when it matters.

Efforts to overcome corruption and cheating in the wake of opening up the Chinese market solved some problems, but created others. Though Chinese officials openly express their annoyance at Western media reports they feel exaggerate the magnitude of China's product-safety problems, they do realize that the reputation of "Made in China" is imperiled—and they care. As Vice Premier Wu Yi noted, bad press had caused "serious damage to China's national image." The government saw the writing on the wall and has taken a new wave of steps to improve watchdogging.

To help fix the problems plaguing regulatory agencies, like fragmentation and poor policy coordination, the State Council established a leading group on product quality and food safety in 2007. The leading group, headed by Vice Premier Wu Yi, is comprised of representatives from fifteen government agencies. And the Chinese government is putting muscle into policy implementation. Building on its long-standing efforts to improve market order, the Chinese government launched a nationwide campaign in August 2007 to investigate and fight the manufacture and sale of fake or substandard food, medicine and agricultural products. By October, the Chinese government had arrested 774 people in the crackdown. As of late November 2007, authorities had also closed down nearly 8,000 slaughterhouses for operating without licenses or for failing to meet government standards. For toy manufacturers blamed for producing toxic products, the Chinese government has suspended their export licenses—the kiss of death for an export business. Foshan Lee Der Toy Co., one of the first to be blamed for Mattel toys containing

lead, was shut down. The owner committed suicide.

But most importantly, the Chinese are upgrading quality standards in all areas, from food to pharmaceuticals. They're taking proactive measures to strengthen the monitoring and supervision of production and supply chains for food and manufactures, including implementing monitoring and inspection programs for wholesale farm-produce markets in all major cities, introducing recall mechanisms for food and more rigorously testing the quality of export products at the border.

In spite of the domestic campaign and crackdown, it is simply impossible for Chinese regulators to achieve full compliance in the domestic market in a short time period. There are hundreds of thousands of firms and families involved in producing food and manufactures. So, the focus of governmental action is, in the words of Wu Yi, "to strengthen the system of supervision and control over product quality, especially relating to *exports*." This means that, while there will be general improvement, the improvement in the domestic market will likely lag behind that of exports.

As with aviation-safety regulation and antidoping, the international pressure on China to improve product quality has been accompanied by international assistance. We can hope this collaboration will be as effective. On products ranging from preserved and pet foods and farm-raised fish to certain drugs, medical devices and toys, the United States and China have reached agreements to strengthen the quality of Chinese exports. Whereas previously, authorities would ignore the errant or unlicensed factories until after a product-quality problem had been uncovered, the agreements signed during the Third U.S.-China Strategic Economic Dialogue in December 2007 require Chinese exporters to register with the government and accept inspections to

ensure compliance with American standards. This is clearly designed to mitigate counterfeiting and safety problems before the products even leave China.

Also as part of the agreements, and as an indication of the growing interdependence between the Chinese and American economies, Beijing has allowed U.S. inspectors to become "embedded" in China to monitor the quality standards of certain Chinese export products, ensuring they meet U.S. quality standards. Stationing U.S. FDA personnel abroad helps bridge different regulatory systems. This kind of cooperation is a nascent but significant step toward deep regulatory integration and may also be replicated in other countries. All this highlights the disparity between American and developing-world standards.

Meanwhile, even without the major Chinese government initiatives, the massive recalls would have caused businesses on both sides of the Pacific to modify their behavior. Western buyers, mindful of the high costs of safety-related recalls, have become more demanding when it comes to quality and safety. On the other side, many Chinese manufacturers quickly adopted more rigorous testing and tightened quality standards to keep the orders coming in. Those unable to bear the rising costs and risks have simply exited the market.

It's unlikely that government regulation will be fully effective in the Chinese domestic market, if for no other reason than the sheer number of businesses that need to be regulated. But when it comes to Chinese exports to developed markets, the message is clear: Beijing will ensure products destined for American markets meet U.S. standards. As Wu Yi said, "China will live up to its responsibilities and obligations when it comes to product quality and food safety." Both government initiatives and market forces will point the way. After all, China's reputation is at stake. □