

***Guanxi* and business environment in China:  
An innovative network as a Process of Knowledge-based Economy**

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*Abstract*

Guanxi is a specific part of Chinese business environment. Since the openness of China, it seems that a contradiction appears between the constraints of corporate governance and the cultural and traditional behaviour in business. Most of west analyses consider that guanxi is only a form of corruption and therefore it should be fight it out. The originality of our work is to frame these questions in the context of recent concepts such as communities of practice and epistemic communities. Based on these concepts, we consider that the firm can be analysed from a dual perspective: cognitive and organisational. The first one belongs to the guanxi logic and the second one to the corporate governance. According to these framework, we point out the fact that guanxi provides an innovative network in order to diffuse and enhance knowledge.

*Keywords:* Guanxi, corporate governance, communities, knowledge, network

## **1. Introduction**

Guanxi is a specific management of Chinese firms. According to [1], guanxi is defined as the existence of relationship between people who share a group status or are related to a common person. Guanxi is more focused on informal relation, non normative agreements, even sometimes with form of corruption. The role of guanxi is a good example of an entrenched cultural norm under pressure from international trends [2]. Since the Chinese entry in WTO, Chinese economy has also to be close to the international norms in order to develop trade, financial architecture and IDE, notably according to the OECD's norm of corporate governance. In this way, an apparent contradiction appears between the openness of China and the strong cultural' behaviour of Chinese manager.

The aim of this article is precisely to show that guanxi is not so opposed to the international constraints because it provides a support of knowledge creation, necessary in a context of the

knowledge-based economy. In other words, Chinese firms have to combine both international pressures and cultural habits in order to keep this advantage.

The originality of our work is to frame these questions in the context of recent concepts such as communities of practice ([3]; [4], [5]) and epistemic communities [6]. Based on these concepts, we will show that the firm can be analysed from a dual perspective: cognitive and organisational [7]. The first one belongs to the *guanxi* logic and the second one to the corporate governance.

In the first part, we present the recent evolution of Chinese firms in order to point out the pressures of international norms of corporate governance. The second part is devoted to a short presentation of the corporate governance *versus* *guanxi* features. The third and last part explains that, despite the pressures of normative corporate governance, *guanxi* appears as a support of knowledge creation and enhances the performance of the firm.

## **2. Recent evolution and characteristics of Chinese firms<sup>1</sup>**

Since the Fourth Plenary Session of the 13th CPC Central Committee in 1978, China has achieved some reform in state-owned enterprises [SOEs]. The primary goal of leaders in China is to maintain strong economic growth and increase prosperity. To do so, they will have to confront a number of problems, particularly the debt-ridden financial system and the inefficiency of state-owned enterprises [SOEs]. That massive waste of capital under China's socialist market economy cannot be stopped without fundamental reform, in particular, privatization and rule of law.

Private firms were illegal in 1978, and SOEs dominated the economic landscape. Today there are nearly 2 million private enterprises employing more than 24 million workers, and the number of private enterprises is growing by more than 30 percent per year. Much of the growth of the private sector has been spontaneous, in the sense that privatization took place without central direction as opportunities for trade increased, especially in the special economic zones. Local jurisdictions were allowed to experiment with new ownership forms, and, when they were successful, others sought to imitate that success.

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<sup>1</sup> This part is inspired by OECD (2007).

The growth in private output has also been the result of the higher productivity of most companies in the sector. The sharper incentives facing the private sector companies have resulted in them using less capital and labour to produce output than state companies. With the decision in 2005 to allow private enterprises to establish businesses in many previously restricted areas, further improvement in multifactor productivity may be possible. The growing importance of the private sector in supporting the economy makes it all the more important to further modernize the legal framework for business. The government is preparing legislation in three important areas: bankruptcy law, company law and the implementation of the constitutional amendment on property rights. The second draft of the bankruptcy law has now passed the legislature and is generally acknowledged to follow international best practice.

The law should clearly establish the precise claims that employees have on assets, limiting payments to wages owed to employees and leaving other costs, such as redundancy and resettlement expenses, to social funds. Secured creditors would be more likely to lend to private companies under such circumstances. A new company law is under consideration. A reduction in the barriers to the formation of both limited and joint stock companies should be a priority. The upper limits on the number of shareholders in a limited company should be abolished, while at the lower end companies with one shareholder should be allowed. For both sorts of companies the minimum capital requirements needed for incorporation should be lowered. Such changes would facilitate the expansion of privately owned companies.

The revised company law should aim to improve corporate governance, notably offering better protection to minority shareholders in both quoted and unquoted public companies and defining the role of corporate bodies such as the supervisory board and the duties of directors. In addition, the proposed anti-monopoly law should cover a much wider range of anti-competitive activities than do current laws. Finally, rapid introduction of the laws to implement the constitutional amendment on private property rights should be envisaged.

### 3. Features of corporate governance and guanxi

Technically, "Guanxi" stands for any type of relationship. In the Chinese business world, however, it is also understood as the network of relationships among various parties that cooperate together and support one another. The Chinese businessmen's mentality is very much one of "You scratch my back, I'll scratch yours." In essence, this boils down to exchanging favours, which are expected to be done regularly and voluntarily.

"Guanxi" can take on many forms. It does not have to be based on money. It is completely legal in their culture and not regarded as bribery in any way. So, there is no need to feel uncomfortable about it. Trustworthiness of both the company and individual is an important component. Following through on promises is a good indication of this. Treating someone with courtesy while others treat him or her unfairly is another aspect. Frequent contact fosters friendship as well. Chinese feel obligated to do business with their friends first. There are risks with this system, as well. When something goes wrong, the relationships are challenged, and friendships quickly disappear.

Corporate governance is assumed as such a mechanism which addresses all these agency problems within a joint-stock company. It governs relationships between different factor-owners of the firm, and in particular between capitalists and managers through allocation of residual claim and control rights by both explicit and implicit contracts.<sup>2</sup>

What is an efficient corporate governance system? In this regard, economists have come to the following conclusions:

First, and most fundamentally, the residual claim and the control right should be matched as much as possible, i.e., whoever has claim to the residual and assumes risks should also have rights to control, or conversely, whoever has rights to control should assume risks. Frank Knight (1921) might be the first economist arguing for this matching.<sup>3</sup> More recently, Harris

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<sup>2</sup> Focusing on corporate governance mechanism in this paper does not mean that product market competition is not important in disciplining management.

<sup>3</sup> According to him, "with human nature as we know it would be impractical or very unusual for one man to guarantee to another a definite result of the latter's actions without being given power to direct his work. And on the other hand the second party would not place himself under the direction of the first without such a guarantee." [p.270]

and Raviv (1989) argue that the claim residual should match the rights to control [voting rights] because otherwise "cheap vote rights" would lead to unqualified people being more likely to take over control of the firm. Dewatripont and Tirole[7] argue that residual claim is incentive schemes for controlling parties to take appropriate course of action. Of course, full matching between residual claim and control rights is impossible, and otherwise there would be no agency problem at all.

Second, managerial compensation should be more closely linked to performance of the firm, rather than fixed by contract. In other words, the manager should bear some risks! This argument has been well discussed in the literature of principal-agent theory.<sup>4</sup> In fact, this argument can be taken as a corollary of the first argument since, by his functioning as the marketing member, the manager holds "natural" control rights of business decisions, and therefore must be motivated by residual sharing, given that his actions are difficult to monitor and to contract upon. In particular, in order to motivate the manager to improve long-term productivity of the firm, not just to increase total sales revenue and current profits; managerial compensation should be more strongly tied to long-term stock price performance. In particular, it is desirable for the manager to hold a considerable stake in the firm as an inside owner, since only by so doing can the manager's interest be more concurrent with the outside shareholder's interests [8].<sup>5</sup>

Third, as discussed earlier, the authority of selecting and monitoring management should be assigned to capitalists. This argument can also be taken as a corollary of the first argument, since, by nature, capitalists are inevitably the eventual risk-bearers, and only they have adequate incentives to select good managers and dismiss bad managers, and to monitor managerial performance.

Fourth, the optimal corporate governance should be characterized by a state-contingent control structure; that is, the control rights should be contingent on the state of nature such that different claim-holders control the firm in different state. [9].

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<sup>4</sup> For a survey, see Hart and Holmstrom [1987].

<sup>5</sup> The evidence of strong correlation between the managerial payment and the firm's performance suggests that the actual residual stake held by the manager is more than proportional to his nominal stake [for a survey and synthesis, see Rosen [1992]].

Fifth, in order to mitigate the free-rider problem of investors, concentration of ownership with large investors is preferred [10]. When control rights are concentrated in the hands of a small number of investors with a collectively large cash flow stake, concerted actions by investors are much easier than when control rights, such as votes, are split among many of them. There are several distinct forms that concentration can take, including large shareholders, takeovers, and large creditors. A substantial minority shareholder has the incentive to collect information and monitor the management, therefore avoiding the free rider problem. He also has enough voting control to put pressure on the management in some cases, or even to oust the management through a proxy fight or a takeover [11]. Large shareholders thus address the agency problem in that they both have a general interest in maximization, and enough control over the assets of the firm to have their interests respected. Similarly, by combining substantial cash flow rights with the ability to interfere in the major decision of the firm, large creditors can also more effectively discipline the management through their contingent control rights than small creditors.<sup>67</sup>

Is the guanxi become the obstacle for the company? And should eliminate the phenomena in china? In fact, the guanxi provides a support of knowledge creation, necessary in a context of knowledge-based economy.

#### **4. Communities as a knowledge-based economy**

##### **4.1. Cognitive duality of the firm: the emergence of communities**

The works of Nonaka have highlighted the crucial role of knowledge, and specifically of the interaction between tacit and explicit knowledge, for the emergence of organisational knowledge within the firm. The firm consists of pockets of tacit and codified knowledge and of data flows that sustain and permeate each other. The individuals within these firms possess skills that can be defined as an accumulation of knowledge and experience that can be directly used in action [12]. The emergence of cognitive communities enriches the traditional

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<sup>6</sup> However, unlike equity, debt in a peculiar way may be tougher when it is not concentrated. If a borrower defaults on debt held by a large number of creditor, renegotiating with these creditors may be extremely difficult, and the borrower might be enforced into liquidation [Gertner and Scharfstein, 1991; Dewatripont and Maskin, 1995; Bolton and Scharfstein, 1996.]

<sup>7</sup> Costs of concentrated ownership are potential expropriation by large investors of other investors and stakeholder in the firm. For this reason, as argued by Shleifer and Vishny [1997], a good corporate governance system should combine some type of large investors with legal protection of both their rights and those of small investors.

approach of governance structures [13,14] by identifying the places where knowledge and/or activities have been created for the organisation of the firm.

#### **4.2 Epistemic communities and communities of practice**

Epistemic communities and communities of practice are the places where knowledge is created. The main point is that epistemic communities are actually focused on creating new knowledge, whereas communities of practice are focused on the successful outcome of an activity. In this case, the creation of knowledge is an involuntary result.

Epistemic communities are defined as “*small working groups made up of agents working on a mutually recognized sub-set of problems linked to a particular type of knowledge, and who at the very least, accept a procedural authority that is also acknowledged by all of them, and which is deemed essential to the success of their cognitive activity*” [6]. As such, they form a group of representatives sharing a common goal for the creation of knowledge, and a common structure that enables them all to understand it. Individuals belonging to epistemic communities focus mainly on the creation and codification of knowledge in order to establish a procedure for the resolution of problems. The process of the codification of knowledge suggests that there are codes that can be understood by the communicators. Moreover, a community is defined by the presence of a procedural authority that is either explicit or not. It has to mobilise the members of the community for the attainment of the cognitive objective. Consequently, it is the procedural authority that evaluates their membership.

People accumulate knowledge based on their own experience. The quality of this knowledge depends on two factors. The first is the variety of the individual experiences as they interact. The second factor is the “knowledge of experience” This corresponds to the notion of a rational evaluation of the feed back from experience that is validated by the procedural authority: It is the contribution by the members of the community to the cognitive objective that is assessed. And this assessment is based on criteria determined by the procedural authority.

Because of the heterogeneity of the representatives, the first task of epistemic communities is to create knowledge, which explains why it is necessary to create a codebook. From there, knowledge circulating within the epistemic communities becomes explicit but not codified, because it remains essentially internal to the community. The procedural authority validates

the cognitive activity of a representative. This authority assesses the contribution of each person to the realisation of the chosen goal within the community.

The concept of a community of practice has been presented by Lave and Wenger[3] who, by focusing on the practices of individuals, have identified groups of people involved in the same practices, who regularly communicate with each other in regard to their activities. The members of a community of practice seek first and foremost to develop their skill in the practice under consideration. Communities of practice can be seen as a means to develop individual skills. They focus on their own members [4]. This goal is achieved by building, exchanging and sharing a common pool of resources [15].

Wenger [15] and Brown and Duguid[4] state that self-organisation is an essential characteristic of communities of practice. According to Lesourne[16], self-organisation is the ability of a system to acquire new properties by organising itself or by modifying its own organisation. Self-organisation enables the system to evolve without the constraint of authority or any kind of determinism. The system is autonomous and creates a boundary between itself and the other functions of the company. This creates a kind of organisational frontier according to the terminology used in the theory of self-organisation.

More precisely, the autonomy and identity of communities of practice, which are the key characteristics of self-organisation, provide for the collective acquisition and processing of environmental stimuli [17]. Identity and autonomy are essential elements that enable the agent to define himself in relation to his environment and allow the members of the community to behave collectively.

Identity can be seen in the mutual commitment of the community. It is based on the jointly understood and continuously negotiated activities of its members. One member of the community contributes his own experience to it, and in turn, relies on the knowledge accumulated by the community to bring his activity to a successful conclusion. This process takes the shape of “war stories”[4] that the members tell each other when they meet. In this way, they develop a jargon that is only understood by the members. It becomes a mutual commitment that binds the representatives within a social entity, and ensures the cohesion of the community and the recruitment of new members.

Wenger and Lave [3] consider the practice of these communities as a vehicle for learning. On that basis, the community of practice assesses the individual. This assessment focuses on the values adopted by the individual and the progress made in his practice, both aspects being taken into account in the assessment.

Within communities of practice, knowledge is thus essentially “know-how” [4], which is tacit and socially localised. The type of knowledge depends on the aims and structure of the communities of practice. Consequently, the community has a tendency not to send any message to the outside world. Messages are usually only exchanged between the members of such a community. Lastly, they generate a common pool of resources (routines, sensitivities, artefacts, vocabulary, styles, etc.), which is mainly of a tacit nature, and the creation of knowledge is closely related to the “socialisation” type of knowledge conversion modes [18]; distribution and conversion of tacit knowledge into tacit knowledge.

Communities of practice and epistemic communities suggest a cognitive division of the firm whereby the company resembles a seamless piece of material piece of material web [19] with much knowledge in common, differing as to the degree and the subject of the knowledge (fundamental knowledge, languages, rules, etc.). Cognitive duality goes beyond the organisation chart of the firm; it oversteps the internal and external boundaries of the firm. Nevertheless, this seamless cloth requires knowledge management.

This distinction based on membership in one of these communities, enables us to highlight a cognitive duality central to the process of creating and distributing new knowledge within the firm. In other words, this cognitive duality must be accompanied by an organisational duality that is necessary for the cohesion and performance of the company.

The creative friction between these different bodies of knowledge leads to a learning process by interaction, which in turn, leads to new knowledge. Epistemic communities are places where real interaction takes place between the communities of practice from which the members of the epistemic community originate [20]. On a practical level, cognitive interrelations between communities of practice and epistemic communities can be deciphered by referring to the Nonaka and Takeuchi [18] model of knowledge conversion.

The following table presupposes the existence of a spiral for the creation of knowledge in the sense used by Nonaka and the SECI model [21].

**Tab. 1 the ‘SECI’ model and Communities of Practice - Epistemic Communities**

	Community of practice	Epistemic community
Community of practice	<i>Socialisation</i>	<i>Externalisation</i>
Epistemic community	<i>Internalisation</i>	<i>Combination</i>

Knowledge conversion modes provide an explanation for the relations between the communities and the nature of the knowledge that is generated and diffused. *In fine*, a system is set up, whereby organisational knowledge is in the service of the entrepreneurial vision. Indeed, the expertise of the epistemic communities in their visionary quest, leads to the creation of new knowledge that in turn, give rise to predominant new beliefs in the firm [22]. But for these beliefs to materialise, they must be diffused throughout the organisation. The process of codification can then be set in motion with the help of a suitable medium (a detailed strategic plan, manuals, specifications for the suppliers, data sheets, etc.). The product generated by the epistemic community resembles certain formalised elements [“combination” conversion mode]. At this point, the manager’s task is to make the entrepreneurial vision operational. In order to do this, he relies directly on the same communities of practice that are partly responsible for the new beliefs, as well as on the standard governance structures (“internalisation” mode of conversion) The existing skills are then enriched with new beliefs that turn into new codified knowledge. This knowledge enriches both the quantity and quality of the knowledge base upon which the activity of communities of practice is founded. Members of communities of practice can then make use of codified knowledge, as well as their own know-how, as they pursue their goal of improving

their practice. This process of enrichment through a particular repository of knowledge becomes a potential source of learning [23].

## **5. The influence of the guanxi on the communities**

Knowledge can be seen as a cultural product [24] it is the networks of people who meet and work with each other that often cause knowledge to migrate and be created. Technically, “Guanxi” stands for any type of relationship. In the Chinese business world, however, it is also understood as the network of relationships among various parties that cooperate together and support one another.

Bennett [25] stresses the importance of culturally derived values in the influence of organizational behaviour in China. In general, Chinese societies are still based on traditional Confucian values which include filial piety, industriousness, the saving of face and the networks of personal relationships [26]. One of the key values of Confucianism is its strong emphasis on inter-personal relationships and conducts [27].

Chinese believes that duality and contradictions are inherent in all aspects of life. Members of Confucian societies assume the interdependence of events, and understand all social interactions within the context of a long-term balance sheet; guanxi is maintained and reinforced through continuous, long-term association and interaction. In a high-context culture such as China, trust or commitment to another is secured by the potential damage to one’s social position or face which may result from failing to honour exchange obligations. The preservation of “face” and the accumulation of favours owed are the key drives underlying the concept of guanxi [28].

As many Chinese enterprises tend to be bureaucratic and rigid, Guanxi acts as a catalyst that enables a more flexible arrangement in the transfer of resources and knowledge from the target company to the learning company [29]. By engaging in the networking activities through trust building and favour exchanging, the learning and source companies form a loosely structured network that is based mainly on guanxi [30]. Guanxi could also improve the quality of knowledge since information passed from a guanxi partner to the receiver could be

assured of its reliability, richness and trustworthiness, thereby reducing the receiver's search cost, and allowing for more informed decision [30].

The guanxi can facilitate the transfer of tacit knowledge that is complex and difficult to be codified [31]. The most of the knowledge in communities of practice is tacit, and difficult to be codified, and can be learned implicative through the intimately interaction. And the guanxi can build the trust that is necessary for a person want to share his experience [32]. Moreover, the relationship-specific heuristics and specialized language that develop between strong ties are conductive to conveying complex chunks of knowledge [33].

## **6. CONCLUSION**

Guanxi is not simply a key feature of Chinese culture, but the mother of all relationships. Despite the pressure of corporate governance, guanxi appears as a support of knowledge creation and enhances the performance of the firm. In the modern company in china, we need the duality management both of guanxi and corporate governance.

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