Ethics and Diamonds: Paradoxical Issues Surrounding Guanxi Relations in China

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EXTENDED ABSTRACT

INTRODUCTION

In this manuscript, we use the Chinese diamond industry as a case study to examine how political, economic and cultural forces shape market exchanges and business ethics. We draw on the work of Li Karande and Zhou, (2009), who analyzed the difference between rule and relational or social based governance in light of the US and Chinese diamond industries. The study also builds on the work of Yen, Barnes and Wang, (2011) who created the GRX scale to capture the degree of guanxi (relationship orientation) among exchange partners and Barnes, Yen and Zhou, (2011) who analyzed the influence of such components on relationship satisfaction and organizational performance. In the current paper, we argue that the Chinese diamond industry illustrates an interesting paradox. Generally, the business infrastructure in the west is largely based on a rational or rule-based governance model (Bushman, Poitroski and Smith, 2004), however, the diamond trade is distinct as it tends to employ more social, or relational governance mechanisms (Bernstein, 1992; Spar, 1994). Similar to the latter, Chinese business frequently follows a relational governance model (Gu, Hung and Tse, 2008; Hwang, Golemon, Chen, Wang and Hung, 2009; Lu, 2009), but in contrast, China’s diamond industry tends to be rationally administered (Li et al., 2009; Berger and Herstein, 2012) and riddled with fraudulent behavior. In other words, instead of making deals based on trust, close relationships and connections, Chinese diamond merchants rely on methods such as
simultaneous trade or cash-based transactions to protect themselves in this environment. This study aims to uncover the forces and dynamics that have given rise to this paradoxical situation and what we can learn from it.

Most researchers have discussed the positive effects on business ethics of guanxi when conducting business in China (Barnes et al., 2011; Hwang et al., 2009; Chadee and Zhang, 2000; Tsang, 1998). In contrast, very few researchers have discussed its negative side (Guthrie, 1998; Gu, et al., 2008; Berger and Herstein, 2012). This paper makes an attempt to fill this gap and offer a more balanced picture of guanxi relations in business ethics through the lens of moral degradation (MD).

**LITERATURE AND FRAMEWORK**

The social governance mechanism which Chinese firms rely on is known as guanxi i.e. relationship connections that individuals build in order to influence or secure resources (Fan, 2002; Hwang et al., 2009; Berger, Choi and Herstein, 2013). In order to examine this phenomenon in more detail, we decided to use the GRX scale (Ganqing, Renqing, and Xinren) developed by Yen et al., (2011), which to the best of our knowledge is the first and only scale that comprehensively can be used to examine social network relationships in a Chinese context. Our concept posits two pathways for enhancing performance through ganqing, renqing, Xinren, and satisfaction. We consider these four constructs to have a positive influence on performance i.e. sales growth and greater profitability (Chadee and Zhang, 2000).

*Ganqing* (affection or feelings), is the emotional element of guanxi has been shown to affect firm performance through reducing transactional costs, which in this context may result in less fraud (Yang, 1994; Tsang, 1998; Barnes et al., 2011). *Renqing* (obligation and favor), which is based on mutual reciprocity, improves *performance* through increased relationship satisfaction (Barnes et al, 2011). *Xinren* (cognitive component), is built on one's trust in the
other and their ability to perform what was promised. To enhance performance, one needs to be satisfied with the relationship, based on a degree of mutual reciprocity (Shi, Shi, Chan, Liy and Fam, 2011; Gu et al., 2008; Gao, 2011).

The Hypotheses we tested are as follows:

H1: High levels of Xinren in the relationship will positively enhance Ganqing.
H2: High levels of Xinren in the relationship will positively enhance Renqing.
H3: High levels of Renqing will positively enhance satisfaction in the relationship.
H4: High levels of relationship satisfaction will positively lead to greater performance
H5: High levels of Ganqing will positively lead to greater performance

METHOD AND RESULTS
A two stage methodology was utilised. The first stage was exploratory in nature and used qualitative tools. The second employed a quantitative approach using a two stage process. We specifically examined the existence of social networks in business to business relations using the GRX scale developed by Yen et al. (2011) to consider these components and their influence on satisfaction and performance. The case study approach to theory building was used to develop our propositions (Eisenhardt, 1989; Yin, 1994) and further examine the GRX scale’s suitability among our respondents. Using a qualitative research approach, we sought to highlight the importance of the contextual elements needed to understand and analyze the industry. The aim of the qualitative stage was to obtain a better understanding of the effect of governance on channel behavior. The scope of the interviews allowed for data triangulation and further validation of the GRX scale.
At the second stage, a database of diamond firms operating in China was generated from sources that included the Israeli Diamond Exchange (IDE), the Diamond Administration of China (DAC), and the Belgium (BDE) Diamond Exchange. Out of a total of 252 questionnaires that were sent out, 212 were returned, yielding an 84% response rate. The measurement scales for Ganqing, Renqing, Xinren were captured using five-point Likert scales, based on the GRX scale. Furthermore, we incorporated questions from Yen and Barnes (2011) to measure satisfaction and performance.

The interviews confirmed previous findings by Li et al. (2009) that trade in the Chinese diamond market involves more fraud and corruption than in other international diamond markets. This was highlighted by the following response from one of the Chinese diamond firms: “I would rather do business with a person I do not know or trust ... it makes business less complicated”. Surprisingly, in contrast to other Chinese industries, the findings here suggest that social networks function poorly. This was highlighted by the following comment: “The Chinese way of doing business is through Guanxi ... keeping one's word is very important in-order to keeps one's 'face' ... but in this industry it is very problematic”. The interview data indicated that Chinese diamond firms do not believe that Ganqing, Renqing and Xinren are necessary in the Chinese diamond industry. It was even noted that in most cases, it does not exist, or in extreme cases can damage business, as illustrated by one of the companies: “The sales person is only concerned with making profit ... I understand it so I do not trust them ... it’s only business”.

The qualitative data are fully presented in the paper and the results from the surveys confirmed the paradox that a negative direct relationship between xinren and performance exists, and thus trust can be seen, in the Chinese diamond industry, as a negative component.
This runs contrary to traditional Chinese models in a relationship context (Guthrie, 1998; Huang and Rice, 2012; Berger and Herstein, 2012). The findings are in line with those from our qualitative research and support the work of Li et al., (2009).

**DISCUSSION**

The Chinese diamond industry should, in theory, follow a socially based governance model, yet it does not. Why? Our analyses identified five interrelated themes that help explain why exchange in the Chinese diamond industry tends to be transactional rather than relational. These are (1) the quality of information; (2) the tension between long-term and short-term goals (opportunistic behavior); (3) disequilibrium in the market; (4) the absence of appropriate legal controls from the De Beers cartel; and (5) governance and the rule of law in China. Each of these is discussed fully in the paper.

We investigated the Chinese diamond industry as a case study and found that the relationship between trust and performance is negative, which further supports the claim that the lack of clear laws and unethical business dealings in China's business environment, in many cases encourages opportunistic behavior and may drive honest businesses out of the market. In a society affected by MD, individuals and businesses tend to tolerate and even accept dishonest actions. This may lead to an overemphasis on market-oriented values in the pursuit of profit, conflicting with the embraced positive virtues of guanxi norms (Huang and Rice, 2012). Hence, in transitional economies, the official and unofficial business models of conducting business caused by MD offers an interesting context for exploring the impact of ethical behavior and such models on firm performance.
This manuscript conceptually and empirically adds to the literature by providing greater understanding of some of the socio-cultural characteristics surrounding China's dynamic and fast moving business environment. Facilitated through China’s relatively weak legal infrastructure, we illustrate the emergence of an interesting paradox in the diamond industry that brings about problematic outcomes and relational dilemmas, emanating to a degree from moral degradation and a country in transition. We feel our study’s findings make an interesting addition to the literature and send a warning signal to practitioners. That is, for those firms wishing to develop a market presence in China and seek to nurture business relationships or guanxi, then this could well vary significantly across different industries. Practitioners should therefore be cautious, particularly those who are new entrants to the Chinese market.

**Keywords:** China, Business Ethics, Diamond Industry, Social Capital, Governance Mechanism, GRX Scale, Guanxi, Performance, Moral Degradation.
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