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Markets as networks: implications for strategy-making

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Abstract Based on empirical studies of firm exchange activities in business markets, this paper outlines a business network view of the firm-market relationship, which differs fundamentally from the view assumed by neo-classical economic theory. We define business networks as sets of connected business relationships. Thus business relationships and connections between relationships are the critical elements in the business network view. It is assumed, as suggested by the Uppsala internationalization process model, that an interplay between knowledge and commitment development is the mechanism that drives the relationship and network development process. Against this background the paper discusses how strategic change is analyzed in literature on alliances and networks. In conclusion the paper presents a set of propositions about strategy-making in business network settings.

Keywords Business networks · Business relationships · Learning · Commitment · Strategic change · Strategy-making

Introduction

Although the market environment is of central concern for management of business firms, we find very few discussions of market conceptualizations in the literature on strategy and international business. Even in marketing, market conceptualizations are almost absent (Weitz and Wensley 2002); the neo-classical economic theory's view of markets dominates. This is somewhat surprising as the role of the market concept in studies of firms is to get an understanding of the specific business firm's exchange conditions, while the main role of economists' use of the market concept is to explain production and price levels in the economy. For the neo-classical economists the market is not an empirical reality but a set of assumptions explaining conditions for production (Stigler 1968). Thus, Demsetz (1992, p. 6) argued that markets were "empirically empty conceptualizations of the forums in which exchange costlessly took place." Friedman (1953) stressed, however, that the realism of assumptions is irrelevant when evaluating a theory. The value of the theory depends on the predictions generated by the assumptions. For studies of specific business firms, however, we cannot be satisfied with viewing market exchange as assumptions. Relevance for business management must be based on empirical reality. Rather than using market exchange to explain something else we have to be able to explain market exchange in various situations. Moreover, explanations cannot be based on general views of the market. We need a theoretical approach that can explain specific exchange conditions for specific business firms even in the same industry.

The objective of this paper is to discuss some implications for strategy-making of the business network perspective on the firm-market relation. First, however, we present the empirical studies of the practice of market exchange activities in business markets and the business network view based on those studies. Then we discuss some critical issues within strategic management. We finally use the Uppsala internationalization process model to develop some propositions for strategy-making following from the business network perspective.

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We cannot refrain from commenting briefly on the fields of marketing and international business, though. In spite of the inventions of "relationship marketing" and "network marketing" being made, Coviello et al. (2002) found the practice changing slowly. Studying modern textbooks such as Kotler et al. (2008) and Solomon et al. (2009) makes it clear that the focus still is on a focal firm and the marketing mix perspective. Also, in international business the perspective largely has been on a focal firm in a neo-classical time environment and only recently has a network view perspective been argued (Hennart 2009; Johanson and Vahlne 1990, 2009).

Empirical studies of business market practice

"My overall task is to establish, develop and maintain relationships with the customers," marketing executives of several Swedish firms said when asked how they compete in international markets (Forsgren and Kinch 1970; Johanson 1966). This stood in some contrast to the neo-classical view of markets that the young Uppsala researchers had in their theoretical luggage when they conducted empirical studies in a research program in the late 1960s on Swedish firms in international competition. The importance that the marketing executives attached to business relationships was also very different from the lessons of the existing marketing mix models.

Some years later a research project on industrial purchasing demonstrated that the purchasing managers also considered relationship building and development strategically important (Håkansson and Östberg 1975). Against that background a group of Uppsala researchers started a research project on supplier-customer relationships in international business-to-business markets and invited researchers from France, Germany, Italy, and the UK to conduct a joint, large-scale empirical study of international marketing and purchasing of industrial products (IMP Project). The initial conceptual framework of the project focused on interaction in the form of exchange and adaptation between suppliers and customers (Ford 1997; Håkansson 1982; Turnbull and Valla 1986). The primary objective of the project was to investigate to what extent relationships were important in business markets.

Empirical data on almost 800 supplier-customer relationship cases were collected (Håkansson 1982). The study showed that practically all investigated firms were engaged in important supplier-customer relationships with domestic as well as foreign counterparts. The relationships were considered important with regard to both productivity and development. In the relationships the firms adapted products, processes, and routines to each other (Hallén et al. 1991). The project also demonstrated that considerable managerial efforts were invested in the relationships over long time periods (Hallén 1986). Frequently several managers from the supplier firm and the customer firm were directly or indirectly engaged in information exchange with one another (Cunningham and Homse 1986). Analysis of the relationship cases also indicated that social exchange processes were important in their development (Ford 1980)

A less expected finding of the project was that there were interdependencies between relationships. For example, business with one particular customer firm required that the supplier firm had a relationship with a specific supplier, business with one customer was an obstacle to business with an other, or alternatively, was necessary for being accepted by a certain potential customer, etc. This led to the idea that firms are engaged in networks of business relationships, that markets are networks of business relationships and that industries are networks of business relationships (Hägg and Johanson 1982; Håkansson 1989).

In a second research project about business markets the group, which also included US and Japanese researchers, took a further step trying to find out to what extent business in a certain relationship is affected by business in other relationships. Thus a supplier-customer relationship in focus may be affected by the customer's relationships with supplementary suppliers, by the customer's own customer relationships, by the customer's relationships with competing suppliers, etc. Based on data collected in this project Håkansson and Snehota (1995) analyzed a number of relationship cases and found that supplier-customer relationships were strongly interdependent with other relationships of the two parties, but that the nature of those interdependencies varied. In their analyses the interdependencies were associated with activities performed in the relationships, the resources involved in the relationships, or the individual actors engaged in the relationships.

In an analysis of the Swedish subset of the project, the most important customer relationships of 85 Swedish supplier firms with international operations were studied in order to find out to what extent other relationships of the customer were connected to the focal customer relationship and, consequently, had a more than marginal impact on the focal relationship (Blankenburg and Johanson 1992). In personal interviews with marketing executives, they were asked to select the most important customer relationship—focal relationship—that they had personal experience of and describe how it was affected by some other relationships—connected relationships—of the customer firm. Efforts were made to get equal number of relationships with customers in France, Germany, Italy, Japan, Sweden, United Kingdom, and United States.

More than 90% of the focal relationships were affected by connected relationships. The number of connected relationships was not related to the age of the focal

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relationship, and it was almost equal for relationships with equipment customers and material/component customers. There were no differences depending on the customer countries. A distinction was made between competitor connections and value chain connections. The number was almost the same. Interestingly, in both categories there were almost equal numbers of connected relationships with positive and negative impacts on the focal relationship, and connections with impact on the way of doing business in the focal relationship. The data also indicated that tighter modes were used to manage the connections with strong effects on the focal relationship. The findings above are crude underestimations of the role of connected relationships for two reasons. The data do not encompass the connected relationships on the supplier side, and they do not comprise the effects from the focal relationship to other connected relationships. The overall conclusion of the findings was that firms are embedded in relationship networks that extend beyond the boundaries of the firm. The strategic implication was that there are strong reasons to consider management of external network structures and processes as a central issue.

A business network view

Based on those empirical findings and Cook and Emerson's (1984) concept of exchange networks, business networks were defined as sets of connected business relationships where *business relationships* are exchange relationships between firms doing business with one another and *connected relationships* are relationships that are interdependent with one another (Anderson et al. 1994; Cook and Emerson 1984).

The business relationship is the central element in the business network definition. The importance of business relationships has also been stressed in a number of other studies besides the IMP project (Cannon and Perrault 1999; Ganesan 1994). Some of those have shown that business relationship development can fruitfully be explained as a social exchange process (Anderson and Narus 1984, 1990; Dwyer et al. 1987) in which two parties gradually and interactively learn about each other, build trust in each other and commit themselves to exchange with each other (Kelley and Thibaut 1978; Morgan and Hunt 1994). One of the parties—the supplier or the customer—takes the initiative to exchange, and to the extent that the counterpart responds and the two firms find the exchange satisfying, they interactively increase their commitment to future exchange, and a relationship characterized by mutual commitment may be created (Anderson and Weitz 1992). In the relationship development process the two firms may discover opportunities for reducing the cost of exchange and increasing their joint productivity by coordinating their activities (Wilson 1995; Zajac and Olsen 1993). To start with, the interdependence between the two parties is weak and unilateral as in ordinary arm's length transactions. But as the process develops the interdependence may become strong and the parties may become mutually tied to one another (Blankenburg-Holm et al. 1999). An important consequence of the relationship development process is that it has a long-term stabilizing effect on the exchange of the firms. A relationship reduces the uncertainty about future exchange.

The business relationships are created through enactment processes in which intentions, interpretations and expectations are important. Although formal contracts and visible flows of products and services may be elements in the business relationships, they are basically informal (Powell 1990). In that respect they differ from alliances, which normally are created through formal arrangements and decisions (Zollo et al. 2002). In addition, as business relationships are created in the process of two firms doing business with each other, they are strongly influenced by middle management views and activities. In contrast, alliances are normally formed in the top management level.

Developing relationships is a time-demanding process, and considerable managerial resources are involved in relationship building. Thus big investments are made in business relationships, and as many attempts to build relationships fail, those which succeed are important resources that may be of strategic importance (Dyer and Singh 1998). But, given the informal nature of business relationships, it is difficult for those who are not directly involved—both inside and outside the firm—to evaluate the investments and assets associated with different relationships. It is difficult to judge whether the investment in a specific relationship is enough to develop and maintain it.

The interdependence and the associated ties between the parties have two consequences. As suggested by power-dependence theory (Cook and Emerson 1978) and resource dependence theory (Pfeffer and Salancik 1978) the firms get some control over each other at the same time as they loose some sovereignty. In addition, organizational units that manage important relationships may get some power in relation to top management. An internal network of relationships that is linked to the external relationships is likely to develop (Forsgren et al. 2005; Ghoshal and Bartlett 1990).

The relationships have effects on knowledge development (Dyer and Hatch 2006; Gulati 1999a, b, Gulati and Gargiulo 1999). The parties learn from each other and adapt their routines so that they match each other's needs and capabilities, thus building inter-organizational routines. They also transfer knowledge between each other in ways that they would avoid if they just made arm's length

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transactions with varying parties (Zollo et al. 2002). In addition, the confrontation between a supplier's producer knowledge on the one hand and a customer's user knowledge on the other hand is a situation that is conducive to creation of new knowledge (von Hippel 1988).

As firms are engaged in a set of business relationships with important customer firms, supplier firms, intermediary firms and other cooperating firms, a focal firm is engaged in a network of business relationships (Johanson and Mattsson 1987, 1988). Primarily, such a network comprises the first tier partners, but as those firms are likely to be involved in other business relationships, second tier relationships may also be part of the firm's business network.

Given that relationship development is to a large extent a knowledge development process, the firm is likely to learn about its network partners, to learn from its network partners and to create new knowledge together with its network partners, resulting in some kind of common knowledge (Hägg and Johanson 1982; Kogut, 2000). The privileged knowledge about the network partners developed in the course of ordinary business activities is likely to lead to discovery and creation of business opportunities that firms outside this network are not able to find (Johanson and Vahlne 2009; Kirzner 1973). In addition the firm is engaged in an immediate market environment, providing some certainty about future exchange as compared with arm's length exchange outside the business network.

However, two relationship partners are not likely to have the same other relationship partners. Thus, although it may be possible to identify a biotechnological network (Powell et al. 1996), it is likely that the firms in that network have relationships with different firms in other technologies. In fact, such relationships may have a strategic competitive role in relation to the other firms in that biotechnological network as demonstrated by Burt's analysis of structural holes (1992). Similarly, the firms in a specific industry network are likely to have network partners outside that industry, but frequently they do not have the same network partners outside that network. In the same way, firms in a specific country network have relationships with firms in other country networks. Against this background it is reasonable to regard firms primarily as exchange units with an own unique relationship structure rather than as production units as implied in the micro-economic theory. Each firm has also an own and unique network position with strong strategic implications.

The second important conceptual element in the business network view is the connection that links relationships to each other. To some extent such connections may be an outcome of technological, institutional and other structural conditions. But to a large extent the connections are enacted in the firm. Typically they are a result of coordination efforts. For example, just-in-time relationships normally require coordination of several supplier relationships (Frazier et al. 1988). Such coordination across relationships is also a critical issue when regarding the firm as an exchange unit. Similarly, productivity can be increased through close coordination between important supplier relationships and important customer relationships.

As a consequence of the business network view it is reasonable to regard markets as networks. Those networks are organized through the ordinary exchange activities when firms do business with each other, and the network structure is a constraint on the firms' subsequent business activities. The networks may be more or less tightly structured in terms of relationship and connection strength and they may be more or less linked to each other. They may also be more or less stable or changing.

Since the strength and other characteristics of a specific business relationship cannot be known by outsiders, the characteristics of more distant networks cannot be known by a firm. Generally managers can know that there is some kind of network structure out there, but they cannot know which actors have relationships with one another. They can know still less about the characteristics of those relationships and how they are connected to each other. The business networks are opaque unless you are inside.

It follows from what is said above that those who are members are at an advantage in relation to those who are not in terms of knowledge and knowledge development as well as in terms of position in the focal network. That is, there is an insider advantage, or there is a liability of outsidership (Johanson and Vahlne 2009). Obviously, a first critical strategic point is: it is important to be an insider in interesting networks.

Strategic change

There are of course many schools of thought within the realm of business strategy. Useful overviews have been presented by, for example, Rajagopalan and Spreitzer (1996) and Wiltbank et al. (2006), making it obvious that regardless of which variety of strategic thought we turn to, the environment assumed, perhaps with one exception that we will return to, is an atomistic one implying that managers can concentrate on preparing just the focal firm for successfully competing in that environment. And we believe this is still the dominating view taken by strategy thinkers, even if there is now sometimes attention paid to partners with which exchange is critical to the development of the focal firm. An example may be the book published by proponents of the "dynamic capabilities view", Helfat et al. (2007), in which the analysis of the development of those capabilities mainly stays with the focal firm. It spends

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a chapter on "Relational Capabilities" as these may be important to the focal firm in getting access to resources by forming alliances or acquiring other entities. So, this analysis is clearly not assuming a network perspective.

According to Helfat et al. (2007), strategic change is about adjusting to and exploiting changes in the environment and this is, we believe, a very common view of what is implied by the concept of strategy. Agarwal and Helfat (2009, p. 281) say that something is "strategic" if it "relates to a firm's future prospects in a substantial way." They suggest a number of factors having such importance: products, policies concerning scope and diversity, organization structure, administrative systems, coordination, critical resources capabilities, routines and other processes and people. The issue here is not to discuss if this is a comprehensive list of factors but rather to review to what extent thinking about development of the most important of these factors becomes different if we assume that the focal firm is embedded in networks. Firms in a network context do not fully control their own resources. On the other hand they do have an impact on the resources of other firms and do to a large extent share ownership of intangible resources, such as knowledge, which is developed jointly with network parties.

There are indeed a growing number of articles in journals such as the *Strategic Management Journal* and *Academy of Management Review* where attention is paid to inter-organizational aspects of strategic management. Examples are drawing the border between the focal firm and the environment (Folta 1998; Parmigiani and Mitchell 2009; Wang and Zajac 2007; Yang et al. 2010), creating strategic alliances or formal networks (Ahuja 2000; Gulati 1999a, b, Gulati and Gargiulo 1999; Lin et al. 2009b; Osborn and Hagedoorn 1997), managing in alliances (Schreiner et al. 2009), learning from alliances (Lin et al. 2009a). Of course, we are not arguing these papers do not contribute valuable output. We are only arguing that these papers do not apply a business network perspective as outlined above.

Many books and articles on strategic management prescribe or at least have ideas concerning how to improve on the position of the focal company. Given the structural characteristics of the industry in which the focal firm competes, Porter (1980) expresses views on how to position the focal company, while Helfat et al. (2007) have ideas on how to develop the dynamic capabilities of the focal firm. In so doing it is assumed that the managers of the focal firm must not worry about thinking jointly with managers of other organizations, such as suppliers or customers, or taking their interests as seriously as those of the focal firm. If on the other hand the focal firm is exchanging knowledge, products, services and so on with other parties, it is evident that thinking in isolation on strategy is not meaningful. We believe that this is especially appropriate when thinking along the lines proposed by the proponents of the dynamic capabilities view, which we think is perhaps the most modern approach.

So, what happens in those dyadic, connected, relationships that may be of interest to strategic management? Our first main point then is: the focal firm is by definition always in a network, and hence an inter-organizational view is relevant as soon as its managers contemplate strategic change. But basically it follows from our view that strategic development is an ever ongoing process, ongoing as an integral part of efforts by many individuals, including middle management in the focal firm and its exchange partners to develop the business of there respective employers. Processes of learning and creation go hand-in-hand, for example leading to new product varieties being launched on the market and new markets being entered (Johanson and Vahlne 2009). Dynamic capabilities, not least relational capabilities, are developed and mutually adjusted to network parties (Helfat et al. 2007).

However, the process of building joint assets such as intangible technological knowledge does require that a sense of mutual trust and commitment is built. This happens in processes admitting experiential learning, where partners learn about each other and especially about each other's capabilities and intentions (Johanson and Vahlne 2009; Morgan and Hunt 1994; Nahapiet and Ghoshal 1998). This joint asset of trust and commitment then facilitates the informal coordination that guides the strategic change process. Presumably the informal, social control is more efficient than formal control (Dyer and Singh 1998).

From a strategy point of view the location of the border between formally independent entities becomes irrelevant. The processes referred to above are truly inter-organizational, and the outcome and of those processes is jointly "owned" (Håkanson and Snehota 1989; Saxenian 1994). Hence, strategic change is initiated in many sub-units of the organization, and to top management the strategy effort is to some extent to evaluate and support or hinder those changes at an early stage.

The focal organization can still make the exchange more beneficial for itself by improving on its bargaining position in the individual dyadic relationship but also in totality of such positions, i.e., its network position (Johanson and Mattsson 1985). Håkanson and Snehota (1989) suggest that to stress the novel attitude to strategy-making, we could use the concept of "relating" instead of "adjusting" to the environment. As strategy is about positioning the firm for a distant and unknown future, the "relating", implying joint learning, constructing and commitment building, helps decreasing the level of uncertainty. The network can be said to offer sort of a safety net, but not a passive one, rather one constantly changing thanks to aggregated strategy processes.

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To conclude: essentially we see strategy-making as a continuous process, and not a discrete effort, consisting of identification and development of opportunities, discovered and/or created by middle managers, to improve on the business of their respective employers; as these are tied to each other in relationships, the content of change is about changing, developing, relationships to parties in the network. By definition, the process is one of interaction, which is supported by mutual trust and commitment established over time. To be successful, the evolving strategy must be relevant to all the interdependent actors.

Strategy-making in business network settings

Now we try to combine the insights from the two areas of business networks and strategic change. As we think that strategic change must lead to a development process if it is to have any long-term effect, we prefer to talk about "strategy-making" rather than "strategic change." To capture the development process we build on the Uppsala internationalization process model, which assumes that an interplay between knowledge development and commitment is the mechanism that drives development processes such as firm internationalization processes (Johanson and Vahlne 1977, 1990). In a later version of the Uppsala model where the development is assumed to take place in a business network setting, some modifications have been made (Johanson and Vahlne 2009). First, while the original model considers commitment to markets, the later version considers commitment to business network relationships. Second, the 2009 version assumes bilateral—or even multilateral—knowledge development and commitment between relationship partners while the early model assumed unilateral learning about and commitment to foreign markets. Third, the early version implicitly assumed that liability of foreignness is the main obstacle to foreign market entry and expansion while the later version assumes that liability of outsidership is the main obstacle when entering new business networks.

Thus a strategy development process will take place as an outcome of action, most often joint action between network partners, whether intended or not. Self-evidently, the future is uncertain as there are many actors trying to create a future more favorable to themselves and their partners.

Against this background we suggest the following seven propositions as an agenda for future research:

P1: Strategic change with relationship partners is likely to lead to enduring development processes.

P2: Entry into new markets (whether geographic or product) can preferably be undertaken in cooperation with partners who are already insiders.

P3: In cases such as in Proposition 2, a causation mode may be applied (Sarasvathy 2001). If the focal firm does not have an insider partner, an effectuation mode is presumably more applicable.

P4: As relationships are connected, changes may be hard to implement, and the change process may be incremental. However, a series of incremental changes may have a revolutionary outcome.

P5: As middle managers are involved with different partners in their respective part of the environment, they will learn and/or create a variety of opportunities. These constitute a bank of seeds for potential strategic change to be evaluated and in some cases invested in by headquarters.

P6: Strategic change is indeed a continuous process.

The final proposition is sort of a meta-proposition. It states that:

P7: The focal firm must have an attitude of acting in ways favorable also to partners and manage the relationships as to create a valuable base for learning and creation and in that sense prepare for action, not necessarily known on beforehand. That is, the focal firm must make sure not to suffer from the liability of outsidership (Johanson and Vahlne 2009).

Some of these propositions are by no means new to the field. In those cases the underpinning is further strengthened. In other cases the propositions are new and should be studied more. We believe that the business network view, as it gradually wins support, will have a strong impact on descriptive and normative strategy and management research.

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