Flexibility as Small State Strategy: Explaining Lithuania's Adjustment Successes

Vytautas Kuokštis, Ramūnas Vilpišauskas, Algirdas Bieliūnas[1]

First draft, comments welcome

Introduction

Since the re-establishment of independence in 1990 Lithuania faced a number of external shocks which affected its economy. The transition from closed centrally planned economy into the open market based economy itself had a systemic impact on economic activities and institutions in the country. Later, Lithuania's economy had to deal with the financial crisis in Russia in 1998, the Great Recession in 2008-2009 and more recently trade embargo applied by Russia in 2014 as a response to the EU's economic sanctions introduced after annexation of Crimea and Russia's aggression against Ukraine.

Although each of these external shocks had negative effects on Lithuania's economy transmitted through the channels of trade interdependence, the magnitude of those effects had been more limited than expected by many analysts. In 1998-1999 the effects of financial turmoil in Russia which was the key foreign trade partner of Lithuania resulted in country's economic decline which also led to the reshuffle of the government. However, Lithuania's economy recovered quickly and its companies redirected their exports to the EU market. Moreover, this external shock was welcomed by the newly appointed country's Prime Minister A. Kubilius as a positive push to reorient external interdependencies of Lithuania from Russia to the EU at the time of preparations to the EU accession negotiations. In 2008-2009, Lithuania experienced more significant external shock originating from the real estate crisis in the US which affected most of the EU. Its economy declined by around 15% in 2009 and its currency experienced significant pressures with prominent economists such Paul Krugman advocating devaluation as the most appropriate strategy out of the crisis. However, after Lithuanian authorities decided to defend the fixed exchange rate and adopted internal adjustment measures country's economy rebounded back again relatively fast. By 2015 Lithuania joined the euro zone as the last step of exiting the crisis. In 2014-2015, Lithuania was seen as the country particularly exposed to the external shock of decline in demand after Russia introduced retaliatory protectionist measures targeting exports from the EU member states (Kraatz 2014, Liuhto 2015). Yet again, the effects of Russian embargo on Lithuania's exports have been limited, its economy continued to grow and exports restructured.

These episodes of Lithuania reacting to external shocks present several interesting puzzles. First, what can explain relatively limited impact of significant external shocks on country's economy which defied predictions of many external observers? In other words, to use the concepts of Keohane and Nye (2012), what accounts for the relatively low degree of its vulnerability despite high sensitivity due to relatively high economic openness and external interdependence? Second, to what extent low vulnerability to external pressures is the outcome of economic agents' flexibility, to what extent it is an outcome of strategic decisions of country's policy makers to create an institutional framework which reduces vulnerability and allows to benefit from participation in the global economy? Finally, and more generally, what do those episodes of Lithuania managing external shocks tell us about the policy trade-offs of small open economies in their pursuit of managing complex interdependencies in the geopolitically risky environment?

---

[1] Vytautas Kuokštis and Ramūnas Vilpišauskas are professors at the Institute of International Relations and Political Science, Vilnius University, Algirdas Bieliūnas is a Master student of International relations and Diplomacy at the same Institute. This paper is part of the Jean Monnet Network project "Navigating the Storm: the Challenges of Small States in Europe".

In this paper we analyze the management of the two external shocks – the Great Recession of 2008-2009 and the introduction of the protectionist measures by Russia's authorities vis-à-vis exports from EU member states in 2014. These two external shocks were different in their nature and origin – one has been transmitted from the US and affected the real economy through the channels of finance with global implications, the other resulted from a policy decision of an important trade partner Russia, which retaliated to economic sanctions introduced by the EU. However, they both affected Lithuania's economy through external interdependencies allowing to observe and analyze reactions of economic agents and country's authorities. Therefore, we first discuss the patterns of trade interdependencies of Lithuania in order to assess to what extent they make the country sensitive and vulnerable to external influences such as market shocks and policy decisions by external powers. Then we analyze how country's economy reacted to those two external shocks in terms of economic development and changes in trade patterns, especially, how the actual developments differed from initial forecasts. This then leads us to addressing possible explanations of unexpected flexibility and resilience of country's economy by examining responses from the market participants and strategic decisions of country's authorities. In addition to general analysis of Lithuania's trade patterns we also zoom in to analyze trade in energy resources which have been considered particularly important from the point of view of external dependence on Russia. Finally, we conclude with assessing broader implications of Lithuania's experience for the management of small states' interdependencies and their study.

We argue that better than expected reaction of Lithuania's economy to those two external shocks can be largely explained by strategic decisions of restructuring interdependencies by country's authorities which in turn facilitated flexible reaction of market participants. The most important strategic decisions included liberalising trade in early and mid-1990s which eventually culminated in the accession into the EU providing access to its common market and the markets of countries which have free trade agreements with the EU as well as restructuring of infrastructure links such as energy to create alternative sources of supply. Easier access to other export markets and flexibility of economic agents able to adapt to shifts in demand for their products and services accounts for the relatively fast adjustment of Lithuanian economy despite its relatively heavy internationalization and external openness. Lithuanian economy proved to be sensitive but not vulnerable to the two external shocks.

With this analysis we aim at contributing to several academic debates. First, we provide our input into the studies of small states' strategies to minimize their vulnerabilities and increase their power in international relations (Neumann, Gstohl 2006, Thorhallsson, Steinsson 2017). It is the asymmetry of interdependence which can be seen as a cause for vulnerability of small countries to the outside shocks or manipulation of those relations by external power (Keohane, Nye 2012). We are interested in assessing what factors can make such small economies less vulnerable by still allowing them to benefit from participation in the international division of labor and specialization. In particular, our analysis shows what 'coping strategies' are used by small states, which are situated in geopolitically risky environment and are asymmetrically interdependent with foreign powers which use trade links with those states in pursuit of foreign policy goals. In other words, we discuss how external interdependencies are managed in the political context of high securitization of trade and other economic policies when market participants develop micro-level methods to hedge against political risks and to what extent state authorities assist or hinder their efforts. We focus on the patterns of interdependencies assuming that if the share of country's external trade is close or even exceeds 100% of its GDP it can be considered a small state with an open economy exposed to the outside shocks.

Second, we assess how membership in the EU is used in order to increase power vis-à-vis third countries by improving trade opportunities for country's companies within the EU leading to the diversification of trade and resilience of country's economy. In particular, we discuss strategic policies to reduce the asymmetric interdependence in energy resource trade and the use of EU membership to implement such policies as well as the difficulties of restructuring existing interdependencies. Lithuania as well as other Baltic States in this respect represent an interesting case of integrating into the regional organization such as the EU not because of the functional need to manage *already existing economic links* but in order to reorient their economic relations from Russia to the EU. The primacy of security motives and political strategic goals has important implications when interest groups with a vested interest in maintaining existing trade relations resist policies of diversification. In such a context implementation of policies aimed at reducing country's vulnerability requires strong political consensus and administrative capacities as well as solving collective action problems when infrastructure projects involve a group of countries such as Baltic and Nordic states.

Third, we challenge the view prevalent among the scholars of small states that democratic corporatism represents the most appropriate arrangement to manage external interdependencies in the face of external shocks (Katzenstein 1985, Thorhallsson, Kattel 2013). Despite the absence of consensus generating institutions regarding wage settlement and other important decisions affecting economic competitiveness, Lithuanian economy rebounded relatively fast from external shocks. The speed of adjustment is one of the indicators which suggests that Lithuania has not been vulnerable to those shocks.

Finally, our research can provide useful insights for scholars studying vulnerabilities and exposure to external influences of Eastern partnership countries in terms of managing their external relations with Russia and the EU. To be sure, there is a major difference of the absence of EU membership offer for those neighbouring countries compared to Lithuania. However, the experience of Lithuania in managing its interdependencies can provide useful insights into the possibilities and limits in responding to Russia's use of energy and trade policies in the pursuit of geopolitical goals.

Analytical framework for the study of small states' management of interdependencies

Our analysis is built on the concept of (inter)dependence and differentiation between the sensitivity and vulnerability of states in their interdependent relationship with the outside world developed by Keohane and Nye (Keohane, Nye 2012, Nye 2011). They defined 'dependence as a state of being determined or significantly affected by external forces' (Keohane, Nye 2012: 7). Small open economies usually are particularly dependent on external environment because they tend to benefit from foreign trade and investments relatively more compared to large economies. However, at the same time they become more exposed to the external shocks in the markets of their main trade partners or political decisions of external powers that can manipulate those trade links.

Keohane and Nye distinguish between the dimensions of sensitivity and vulnerability in interdependent relationship. Sensitivity refers to changes triggered by external shocks which take place within the existing policy framework and is measures by the speed and size of the costs experienced by affected country (2012:10-11). Meanwhile vulnerability dimension of interdependence rests on the relative availability and costliness of the alternative that various actors face, i.e. on the changed framework of policies. "In terms of the cost of dependence, sensitivity means liability to costly effects imposed from outside before policies are altered to try to change the situation. Vulnerability can be defined as actor's liability to suffer costs imposed by external events even after policies have been altered." (Keohane, Nye 2012:11).

Keohane and Nye only briefly mention the variables on which vulnerability of a country depends referring to "political will, governmental ability, and resource capabilities" (2012:13). Availability of alternatives or substitutes, if one refers to trade in energy resources – the example they use, is also important in differentiating between sensitivity and vulnerability. However, they do not elaborate on particular variables which are important in terms of states' vulnerability. In some recent work, which used the concepts of sensitivity and vulnerability to assess countries' interdependence, the focus has been on issue-linkage strategies in the relationship of Eastern partnership countries vis-à-vis Russia and the EU rather than domestic factors and policies which can reduce countries' vulnerabilities (Calus et al. 2018).

In our analysis we focus on strategic policies of Lithuania which aim at introducing or increasing availability of alternatives in terms of both sources of supply and export markets in its foreign trade as well as domestic regulatory environment which facilitates or constrains flexibility of domestic economic agents in reacting to changes in the external environment. We derive these variables from Keohane and Nye and other work on vulnerability of small states (see, for example, Griffiths (2014) who discusses different indexes of vulnerability, most of which include economic exposure and diversification of exports). We first assess the development of Lithuania's foreign trade in terms of both its size relative to country's GDP and diversification in terms of trade partners. Afterwards we discuss the effects of the two external shocks – the Great Recession and protectionist measures introduced by Russia. We assess the extent of the negative economic effects and the pace of the adjustment of Lithuanian economy. As argued by Nye (2011:55), vulnerability depends on "whether society is capable of responding quickly to change", therefore both the cost of external change and the pace of the adjustment are important.

On the basis of our analysis we argue that Lithuania's reaction to the two external shocks shows that despite its high sensitivity it was not vulnerable. Finally, we discuss the factors which could account for such resilience in the face of very high external openness.

Shifting patterns of Lithuania's trade interdependencies

After re-establishment of independence in 1990, Lithuania initiated external liberalisation reforms which formed an important part of the transition reforms (for more see Vilpišauskas 2014). Although its trade liberalization policies were more limited compared to Estonia's which removed all import duties in early 1990s, its foreign trade picked up fast reaching 100% of country's GDP by 1997. Although trade openness declined as a result of financial crisis in Russia in late 1990s, it soon picked up again to be interrupted by the Great Recession. It recovered soon again to reach 160% of country's GDP. In 2017, Lithuania was ranked 15th in the world in terms of exports-to-GDP ratio (World Bank data), and by trade openness (exports plus imports as percent of GDP) Lithuania stood at the 13th place.

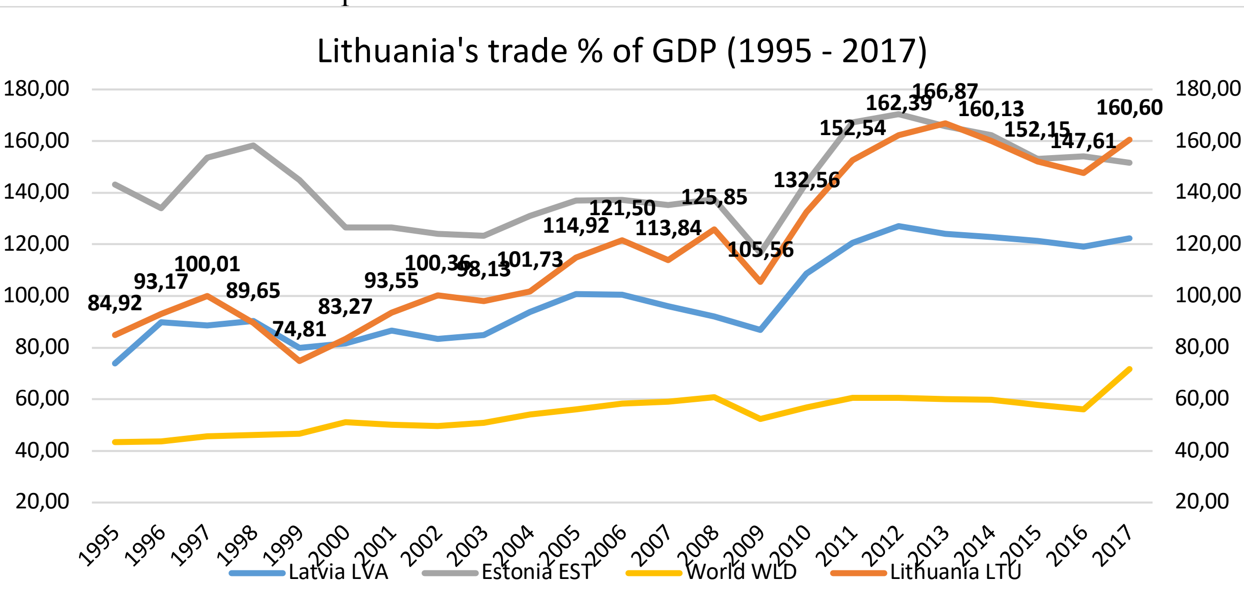
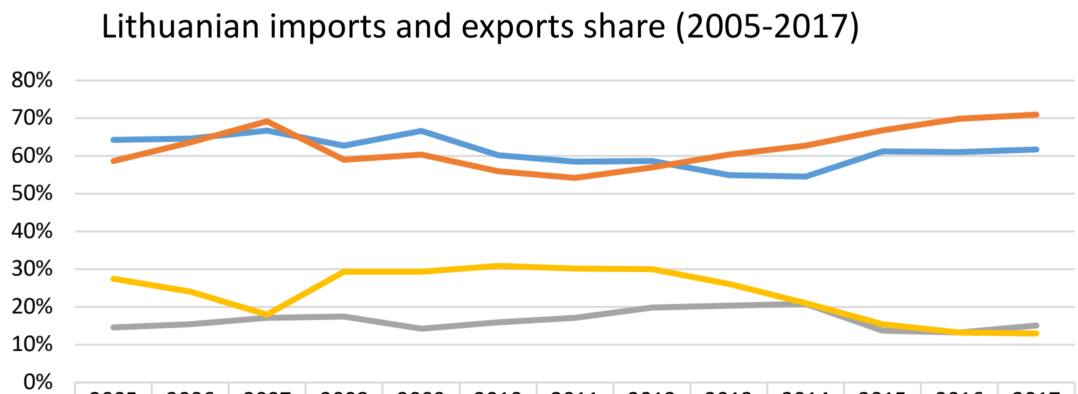


Figure 1, Lithuania's trade % of GDP (1995 - 2017). *World Bank.*

In early 1990s, former Soviet Union countries including Russia were the major trade partners of Lithuania. Although after liberalisation of trade with the other Baltic States, Nordic countries and the EU, the share of those countries in Lithuania's foreign trade started increasing, it was after the financial crisis in Russia in late 1990s when the EU became the most important trade partner. Since Lithuania's accession into the EU its share in country's foreign trade constituted around two thirds of total turnover (see Figure 2). For example, in 2017 members of EU comprised eight out of ten largest export and nine out of ten largest import partners for Lithuania. However, as an individual country Russia remained the main export and import market for Lithuania, although its share in country's exports fluctuated depending on the economic situation in Russia and policy measures applied by its authorities.



	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
EU Export	64%	65%	67%	63%	67%	60%	59%	59%	55%	55%	61%	61%	62%
EU Import	59%	64%	69%	59%	60%	56%	54%	57%	60%	63%	67%	70%	71%
RU Export	15%	16%	17%	17%	14%	16%	17%	20%	20%	21%	14%	13%	15%
RU Import	27%	24%	18%	29%	29%	31%	30%	30%	26%	21%	15%	13%	13%

Figure 2, Lithuanian imports and exports share (2005-2017). *Trademap, authors calculations (products and services).*

For more than two decades, imports from Russia were concentrated in energy resources. Lack of alternative infrastructure to that controlled by Russia made it *de facto* the only supplier of energy resources (SITC HS4-27) to Lithuania. This single category also accounted for most imports from Russia.

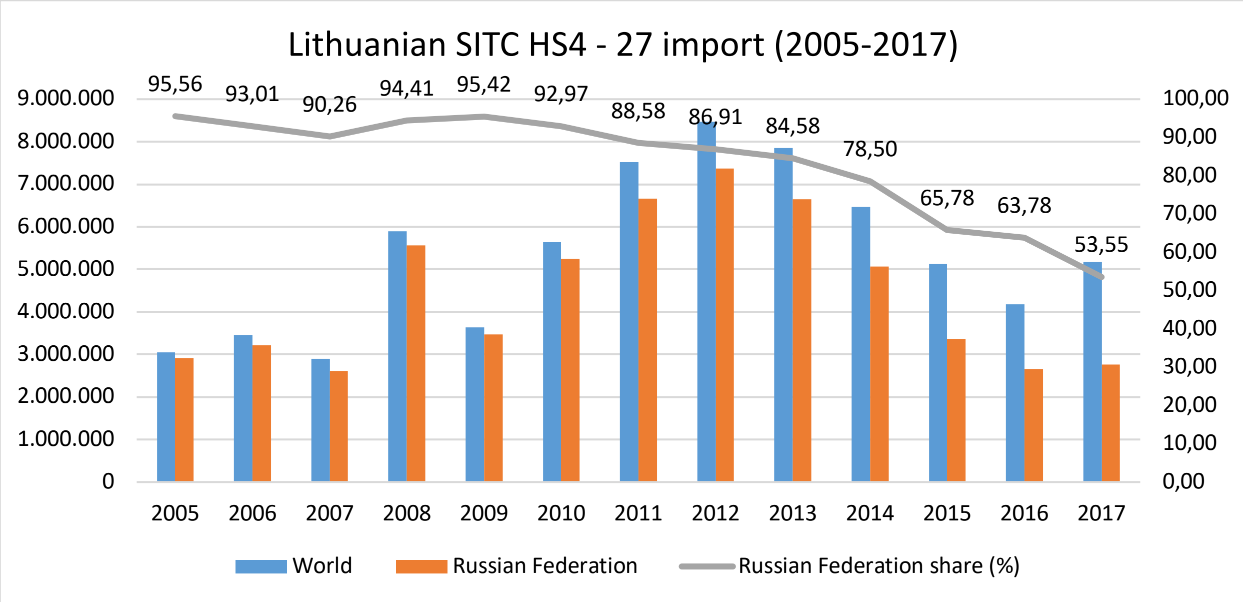


Figure 3, *Lithuanian SITC HS4 - 27 import (2005-2017). Trademap, Trademap, authors calculations (products and services).*

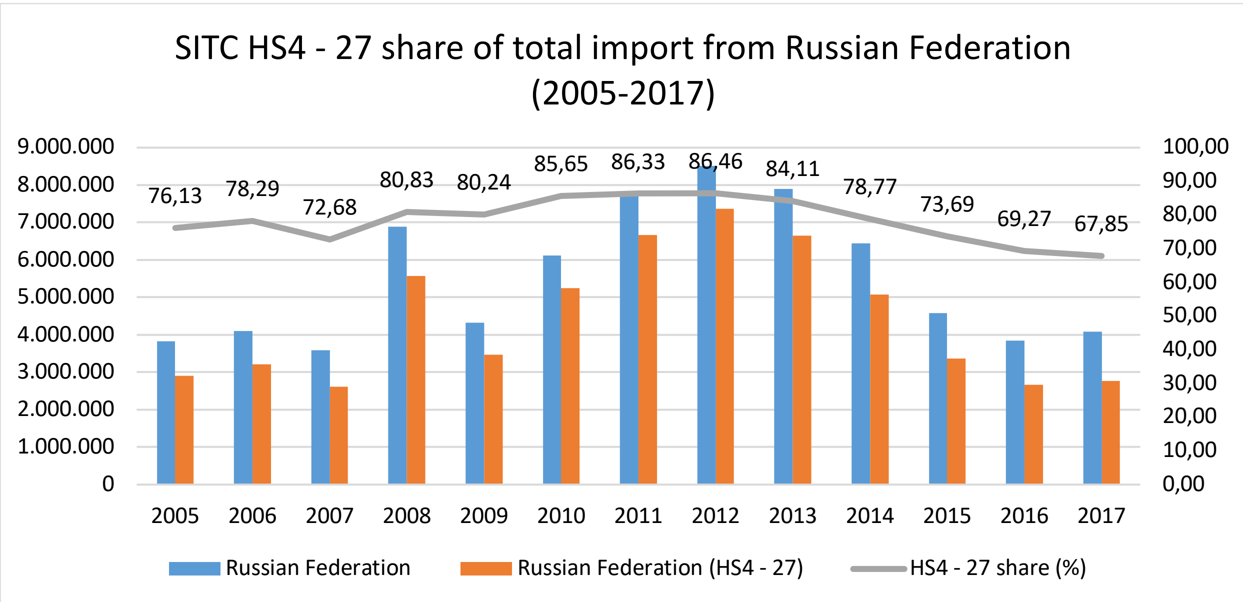


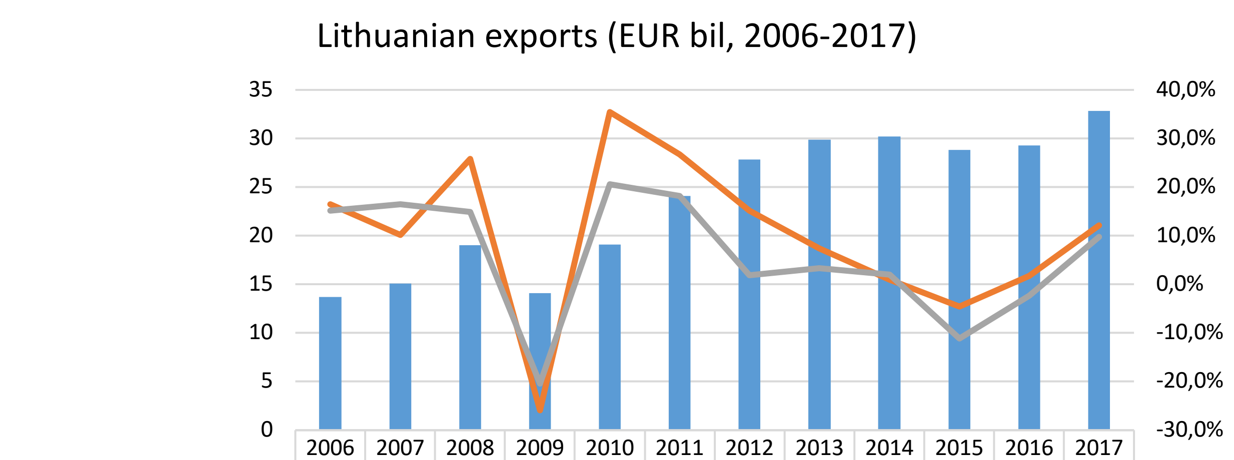
Figure 4, *SITC HS4 - 27 share of total import from Russian Federation (2005-2017). Trademap, authors calculations (products and services).*

Moreover, the overall trade relationships between Russia and Lithuania was defined by asymmetrical interdependence. As mentioned, for Lithuania Russia was the main trade partner in both exports and imports since the fall of the Soviet Union, and the only source of supply for such energy resources as natural gas until recently. For Russia, Lithuania was a minor trade partner. This significant asymmetry in trade relationship allowed Russia to use supplies of energy resources as an instrument of pressure on Lithuanian authorities. Already in Spring 1990 then Soviet Union imposed economic blockade by cutting supplies of oil in reaction to the declaration of the re-establishment of independence. Later, in particular since 2000 when V. Putin came to power in Russia, cuts in oil supplies and increase in price of natural gas were undertaken by Russian authorities.

The indicators on Lithuania's trade openness suggest that the country's economy can be powerfully affected by shifts in the global demand. This can also explain why the immediate impact of the Great Recession in 2009 was so severe. Lithuanian exports in 2009 fell by nearly 25.9% compared to 2008, which together with a steep fall in consumption and investment resulted in a very large contraction of real GDP. Furthermore, one must remember that several of the most important trading partners of the country – Poland, Russia, and Sweden – devalued or depreciated their currencies during the Great Recession. As Lithuanian authorities decided to defend its currency's fixed exchange rate to the euro, Lithuanian bilateral exchange rates with the mentioned countries appreciated in real terms, causing further competitiveness problems. One must also remember that numerous outside analysts were deeply sceptical of the Baltic strategy (Latvia and Estonia adopted essentially similar approach to the crisis) of pursuing 'internal devaluation', as they thought that it would be extremely difficult and costly to adjust without devaluing the exchange rate.

In the case of the second external shock, namely the Russian embargo introduced in 2014, Lithuania again seemed highly exposed. Russia was the biggest trade export market for Lithuania (not counting the European Union as a whole), in 2013 it accounted for 14% of all Lithuania's export (also see Figure 2 above). Of all the EU members, Russian sanctions were expected to have the highest impact in Lithuania (Kraatz, 2014; Markovic et al., 2014). Lithuania had the highest value of exports subject to the ban in terms of absolute value as well as a share of GDP – based on data from 2013, Lithuanian exports banned by Russia amounted to 2.6% of GDP, which was by far the highest value among all members, as the two other countries most affected by the ban – Estonia and Latvia – only had exports of 0.4 and 0.3 percent of GDP subject to the embargo (Kraatz, 2014, p. 6).

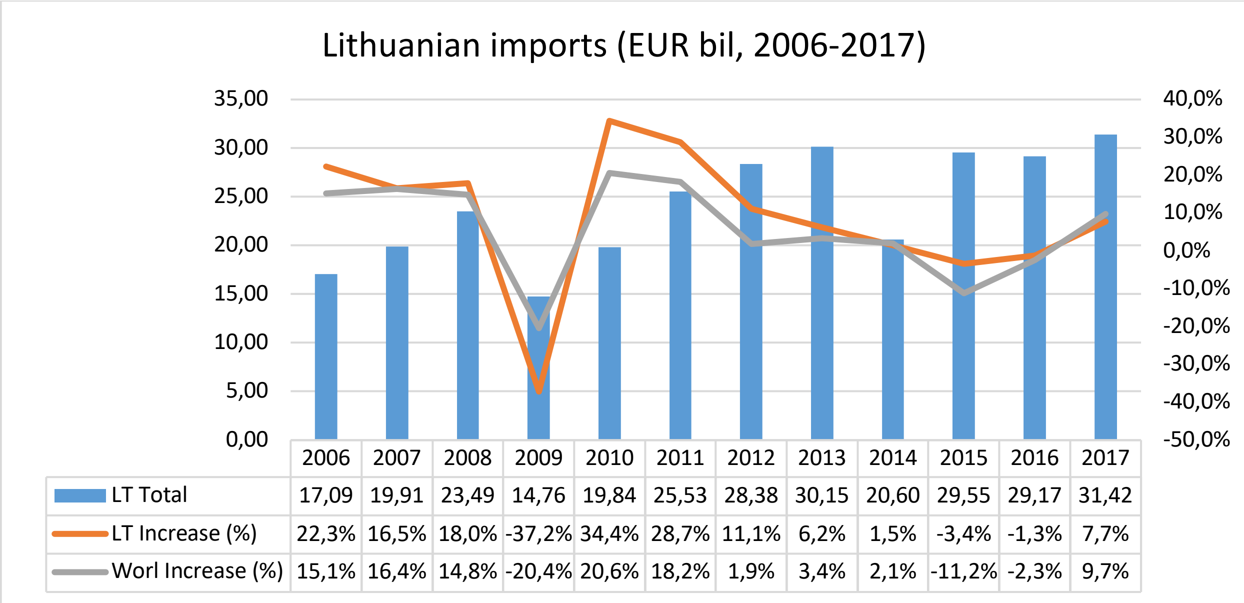
All of this suggests that in both cases Lithuania might have been vulnerable to these two shocks. However, with the benefit of hindsight, it is more appropriate to characterize Lithuania's position as one of sensitivity rather than vulnerability. To begin with, it is true that both Lithuania's exports and overall economic activity took a big hit in 2009, one should pay attention to the fact that Lithuania also experienced a very robust and fast recovery in terms of both of these indicators. In 2010, exports increased by 35.4% (nearly reaching the 2008 level), and then further by 26.7% in 2011 and 15.2% in 2012 (see Figure 5). By 2013, exports had more than doubled compared to the low point in 2009, and were also nearly 57% larger than the pre-crisis level (2008). Growth was visible across most destinations. During 2010-2013 Lithuanian exports grew to 148 destinations (11.42 EUR bln) and fell in 52 (0.59 EUR bln.).



	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
LT Total	13,71	15,11	19,01	14,09	19,08	24,12	27,84	29,91	30,18	28,8	29,31	32,85
LT Increase (%)	16,5%	10,2%	25,8%	-25,9%	35,4%	26,7%	15,2%	7,4%	0,9%	-4,6%	1,8%	12,1%
World increase (%)	15,1%	16,4%	14,8%	-20,4%	20,6%	18,2%	1,9%	3,4%	2,1%	-11,2%	-2,3%	9,7%

Figure 5, *Lithuanian exports (EUR bil, 2006-2017). Trademap, authors calculations (products and services).*

The situation was similar in terms of Lithuania's imports. In 2009, Lithuanian imports contracted by 37.2%. Then in 2010 imports increased by 34.4% and by the end of 2013 were 28% larger compared with pre-crisis level.

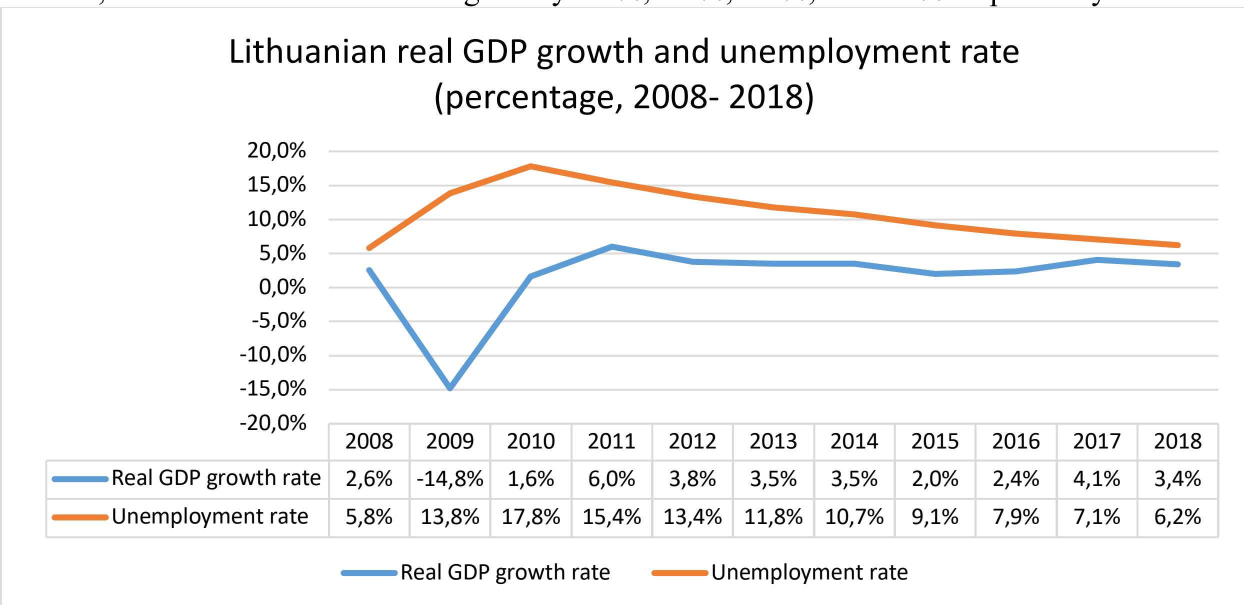


	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
LT Total	17,09	19,91	23,49	14,76	19,84	25,53	28,38	30,15	20,60	29,55	29,17	31,42
LT Increase (%)	22,3%	16,5%	18,0%	-37,2%	34,4%	28,7%	11,1%	6,2%	1,5%	-3,4%	-1,3%	7,7%
Worl Increase (%)	15,1%	16,4%	14,8%	-20,4%	20,6%	18,2%	1,9%	3,4%	2,1%	-11,2%	-2,3%	9,7%

Figure 6, *Lithuanian imports (EUR bil, 2006-2017). Trademap, authors calculations (products and services).*

This surge in exports and import effectively changed Lithuanian economy landscape. During this time trade as percentage of GDP increased from 105.56%, by trade openness 48th position globally in 2009, to 166.13%, by trade openness 11th position globally in 2013 (World Bank). This in turn meant that in just 4 years Lithuania became one the most open economies globally.

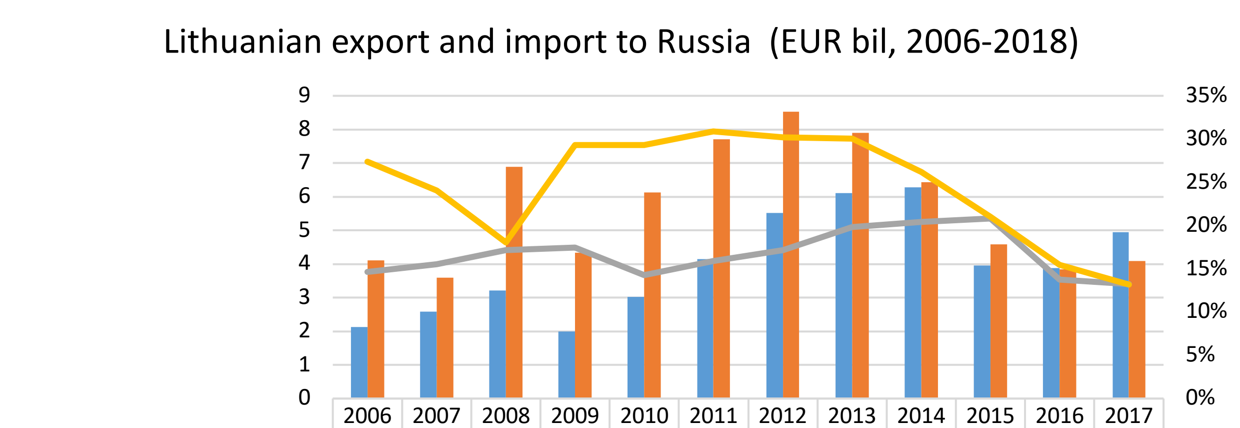
The recovery in foreign demand helped the country's economy to rebound from the crisis – it was a crucial development given the collapse of domestic demand and the pre-crisis economic overheating. Lithuanian real GDP only increased by 1.6% in 2010, but then expanded by 6% in 2011, 3.8% in 2012, and 3.5% in 2013. Lithuanian economy was among the fastest growing ones in the EU in the post-crisis period. Its numbers look even more impressive on a per capita basis: in 2010, 2011 and 2012 and 2013 it grew by 3.8%, 8.5%, 5.2%, and 4.6% respectively.



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Real GDP growth rate	2,6%	-14,8%	1,6%	6,0%	3,8%	3,5%	3,5%	2,0%	2,4%	4,1%	3,4%
Unemployment rate	5,8%	13,8%	17,8%	15,4%	13,4%	11,8%	10,7%	9,1%	7,9%	7,1%	6,2%

Figure 7, *Lithuanian real GDP growth and unemployment rate (percentage, 2008- 2018). Lithuanian statistics department.*

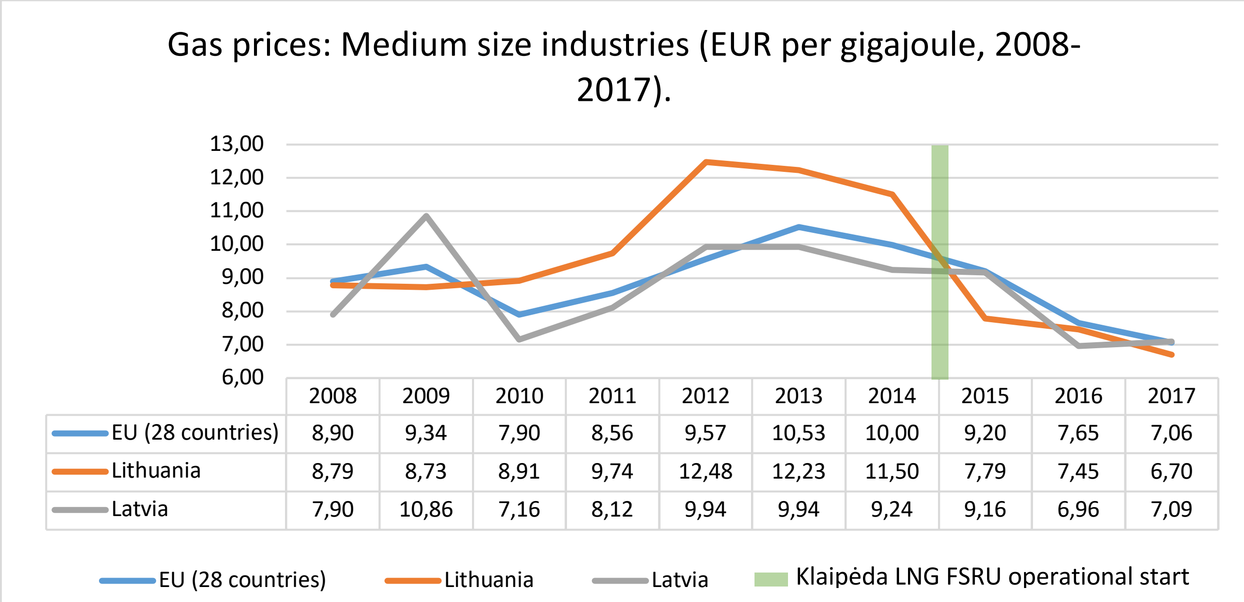
As for the impact of the Russian embargo, its effect was relatively minor in terms of aggregate economic welfare. Estimates put it at 0.81% GDP growth lost in 2014 and additional 1% in 2015 (Maricas, 2015 and LRT, 2016). Despite this Lithuanian economy still grew by 3.5% in 2014 and by 2% in 2015 (Lithuanian statistics department). Unemployment was falling, and wages increasing. It is true that certain specific sectors – notably food (especially dairy), transport and tourism – were considerably affected, but the economy as a whole escaped relatively unscathed. Lithuanian overall exports of goods and services contracted by 5% on an annual basis in 2015, stayed at that level in 2016, and started expanding robustly in 2017 (by 19%) (Eurostat data). Figure 8 further shows how Lithuanian exports and imports to Russia developed. In 2015, Lithuanian exports to Russia contracted by 37%, while the overall drop in exports was 4.6%. At the same time imports contracted by almost 29%. Although, this drop can be narrowed down almost entirely to a single category – energy resources (SITC HS4-27). Drop in it accounted for 91% of lost imports from Russia. However, this change was part of strategy of diversification of suppliers of natural gas which in the end of 2014 was finally implemented with LNG terminal coming into operation in Lithuania.



	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Export	2,13	2,59	3,22	2,00	3,03	4,15	5,52	6,10	6,28	3,96	3,88	4,95
Import	4,11	3,59	6,88	4,33	6,13	7,71	8,52	7,89	6,44	4,58	3,84	4,08
Total export share (%)	15%	16%	17%	17%	14%	16%	17%	20%	20%	21%	14%	13%
Total import share (%)	27%	24%	18%	29%	29%	31%	30%	30%	26%	21%	15%	13%

Figure 8, *Lithuanian export and import to Russia (EUR bil, 2006-2018), Trademap, authors calculations (products and services).*

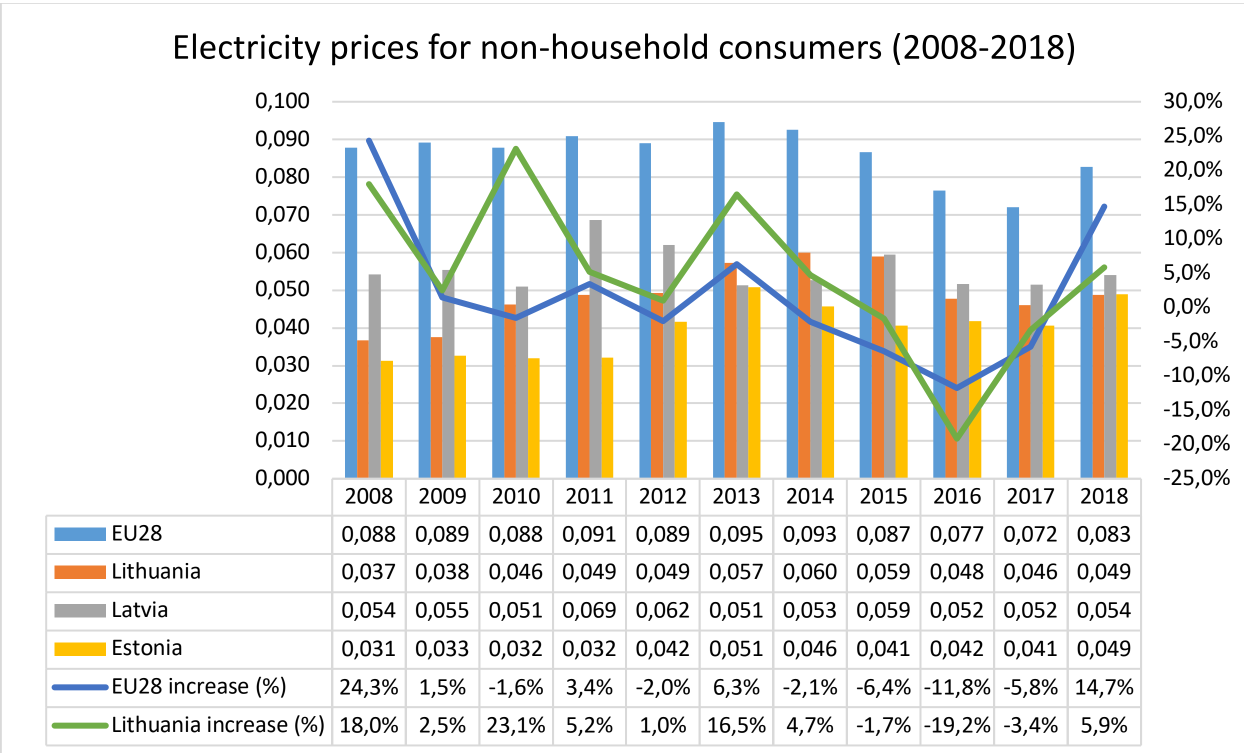
This in turn also had an important effect on prices, especially the price of natural gas sold to Lithuania. As the Figure 9 illustrates, since around 2009 when Lithuania started implementing EU 3rd energy package opting for complete unbundling of ownership in natural gas sector, the price charged by Russian company Gazprom started growing exceeding significantly average price of EU28 and the price paid by neighboring Latvia which opted for a transition period in adopting EU norms regulating gas sector.



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
EU (28 countries)	8,90	9,34	7,90	8,56	9,57	10,53	10,00	9,20	7,65	7,06
Lithuania	8,79	8,73	8,91	9,74	12,48	12,23	11,50	7,79	7,45	6,70
Latvia	7,90	10,86	7,16	8,12	9,94	9,94	9,24	9,16	6,96	7,09

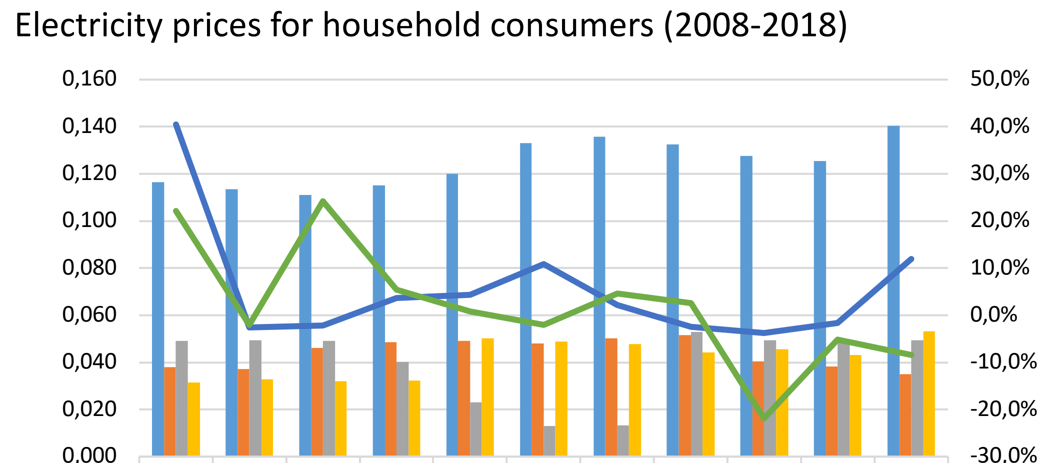
Figure 9, *Gas prices: Medium size industries (EUR per gigajoule, 2008-2017). Eurostat.*

Besides, in 2015 electricity cable linking Lithuania and Sweden became operational thus providing an important connection between the Baltic and Nordic electricity exchanges and a new source of supply. It also had a positive effect on prices of electricity paid by Lithuanian businesses and households (see Figures 10 and 11).



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
EU28	0,088	0,089	0,088	0,091	0,089	0,095	0,093	0,087	0,077	0,072	0,083
Lithuania	0,037	0,038	0,046	0,049	0,049	0,057	0,060	0,059	0,048	0,046	0,049
Latvia	0,054	0,055	0,051	0,069	0,062	0,051	0,053	0,059	0,052	0,052	0,054
Estonia	0,031	0,033	0,032	0,032	0,042	0,051	0,046	0,041	0,042	0,041	0,049
EU28 increase (%)	24,3%	1,5%	-1,6%	3,4%	-2,0%	6,3%	-2,1%	-6,4%	-11,8%	-5,8%	14,7%
Lithuania increase (%)	18,0%	2,5%	23,1%	5,2%	1,0%	16,5%	4,7%	-1,7%	-19,2%	-3,4%	5,9%

Figure 10, *Electricity prices for non-household consumers (2008-2018). Eurostat.*



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
EU28	0,117	0,114	0,111	0,115	0,120	0,133	0,136	0,133	0,128	0,125	0,140
Lithuania	0,038	0,037	0,046	0,049	0,049	0,048	0,050	0,052	0,040	0,038	0,035
Latvia	0,049	0,049	0,049	0,040	0,023	0,013	0,013	0,053	0,049	0,049	0,050
Estonia	0,031	0,033	0,032	0,032	0,050	0,049	0,048	0,044	0,046	0,043	0,053
EU28 increase (%)	40,5%	-2,6%	-2,2%	3,6%	4,3%	10,8%	2,1%	-2,5%	-3,8%	-1,6%	12,0%
Lithuania increase (%)	22,2%	-2,1%	24,2%	5,4%	0,8%	-2,0%	4,6%	2,6%	-21,9%	-5,2%	-8,4%

Figure 11, *Electricity prices for household consumers (2008-2018). Eurostat.*

To summarize, the impact of the external shock in 2008-2009 on the Lithuanian economy was significant but rather short-lived, as the recovery was fast and reflected in different indicators, including country's exports. The second external shock in 2014-2015 had a substantial microeconomic impact upon certain sectors, but the macroeconomic effect was very limited.

Therefore, this is evidence of Lithuania's high sensitivity linked to its very high external openness but Lithuania has proved to be not vulnerable to the global market turbulence and changes in foreign trade policy framework introduced by Russian authorities.

What explains Lithuania's resilience to external shocks?

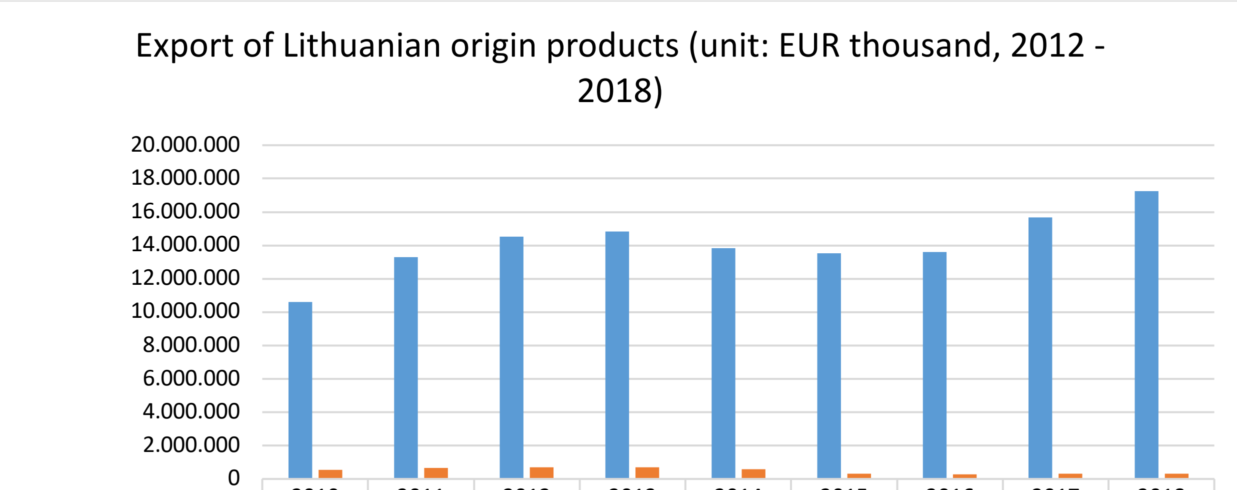
The previous section has established that, contrary to the expectations and concerns expressed by some analysts, Lithuanian economy has proved to be (much) more resilient to external shocks than had been expected. This puzzle is worth exploring in more depth since the factors which might account for such resilience are interesting from both academic and practical point of view.

To begin with, the Lithuanian economy has often been characterized as very 'flexible'. According to many analysts, this high level of flexibility enabled the robust recovery in the wake of the Great Recession (Purfield and Rosenberg, 2010). In economics – and even more so in political economy – the concept of 'flexibility' can actually have different meanings. One of the most popular definitions refers to the ability of nominal wages to 'adjust downwards' – in other words, a flexible economy is one in which wages can fall fast if there is a fall in aggregate demand (this can also be called labor market flexibility). This fall in wages translates into lower costs for businesses, which encourages them to expand production, hire workers, and thus leads to lower unemployment. In the context of a small open economy, lower wages and prices means higher competitiveness (lower real exchange rate), which results in higher exports and lower imports – and thus lower trade deficit (higher surplus) as well as growth in the real GDP and, consequently, lower unemployment. This channel is considered particularly important for countries that are unwilling to or are unable to devalue their exchange rates. Lower wages are supposed to result in lower prices, which in turn can increase competitiveness even if the nominal exchange rate is left unchanged – this mechanism is otherwise known as ‘internal devaluation’.

In Lithuania (as in the two other Baltic countries), wages indeed started falling earlier and faster than in the Southern Eurozone economies in response to the Great Recession and the euro zone debt crisis (Kuokštis, 2015); these two groups of countries had been facing similar economic challenges but in the end the Baltic group was able to deal with them more successfully. However, one must also point out that this ‘textbook’ internal devaluation model can account for only a small part of Lithuania’s adjustment success. First, wages fell much more in the public sector than in private businesses. Secondly, the bulk of adjustment of unit labor costs, which measure how much it costs to produce a unit of output, came in terms of productivity growth rather than lower wages. This has been discussed extensively by Blanchard et al. in Latvia’s case (2013) but Lithuania’s situation was essentially the same (Kuokštis, 2015). Third, even the adjustment of unit labor costs does not account for the very fast growth in exports, as they increased more than might have been expected based on this indicator alone (Kuokštis, 2015).

Finally, although not directly related to trade flows, one could also mention here another very important form of flexibility which helped with Lithuanian adjustment to the crisis – labor mobility. In response to the downturn, Lithuanians started massively emigrating, mostly to richer EU members. This in turn helped reduce unemployment, eased political pressure, and also resulted in higher remittance flows which stimulated domestic demand and to some extent substituted for the lack of government spending in the context of strong austerity.

With respect to Lithuania’s resilience in response to the Russian embargo, one should pay closer attention to the nature of Lithuanian exports to Russia, the vast majority of which were in fact re-exports, and not exports of Lithuanian origin (see Figure 12). This greatly limited the potential vulnerability of the Lithuanian economy. In 2013 re-exports, which are generally low added value, accounted for 80-90% of Lithuanian exports to Russia (Mauricas, 2015). In terms of exports of Lithuanian origin goods, which are generally high added value, Russia was the 8th largest destination after Germany, Latvia, Estonia, UK, Netherlands, Poland, Sweden and accounted for only 4.8% of overall Lithuanian origin goods export. This limited significantly the potential vulnerability of the Lithuanian economy.



	2010	2011	2012	2013	2014	2015	2016	2017	2018
World	10.614.15	13.281.66	14.505.39	14.832.74	13.841.03	13.531.76	13.593.77	15.692.19	17.236.56
Russian Federation	536.320	669.150	717.983	710.059	593.757	314.648	270.998	305.000	310.127

Figure 12, *Export of Lithuanian origin products (unit: EUR thousand, 2012 - 2018), Trademap.*

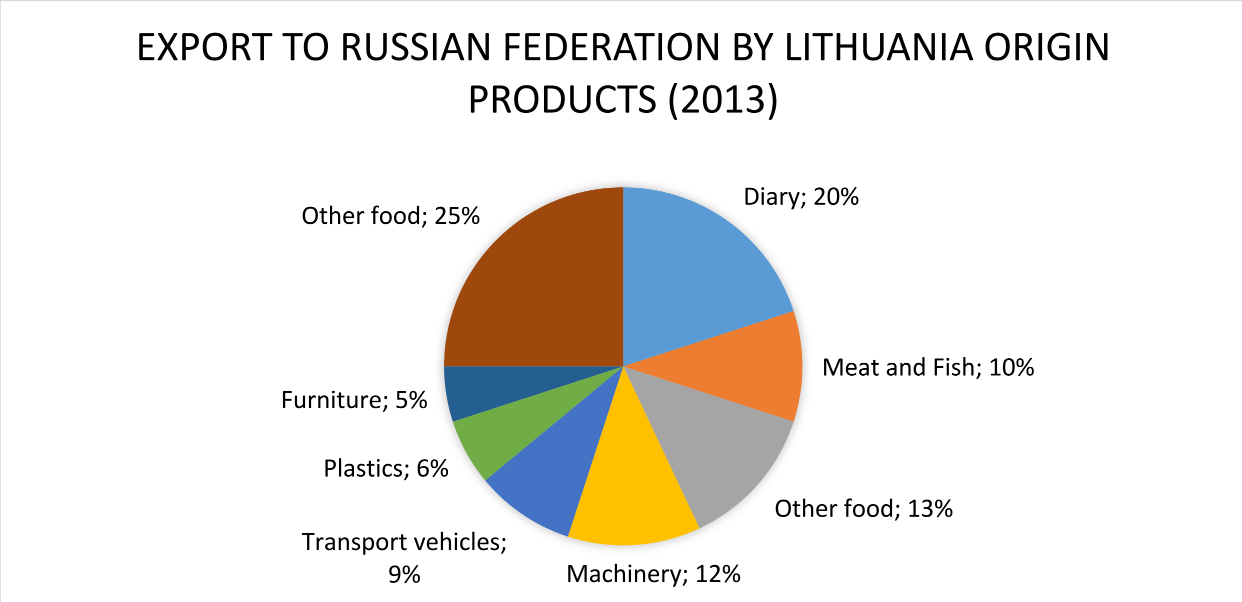
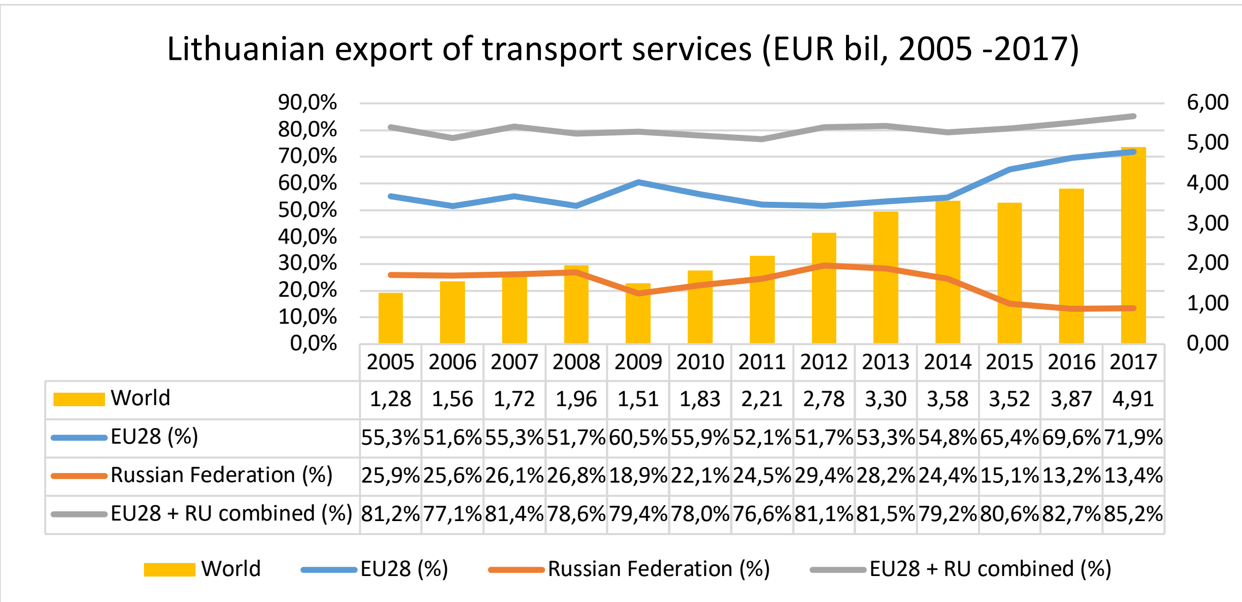


Figure 13, *Export to Russian Federation by Lithuanian origin products (2013). Lithuanian statistics department.*

As mentioned above on the response to the Great Recession, Lithuanian businesses have been very successful at flexibly adapting to the changing market conditions. This was also manifest in the second case of adjustment to the Russian embargo. Lithuanian transport sector, one of the most heavily dependent sectors on Russia prior to 2014, represents an excellent example of this. In just one-year companies working in this sector managed to completely compensate the loses from Russian market by expanding revenues in the EU. Furthermore, employment in this sector remained stable, in 2014 105.606 people worked in it, in 2015 105.429 and in 2016 it increased to 110 857 (Lithuanian Ministry of Transport and Communications, 2016). While the number on companies operating increased from 6.602 in 2014 to 7.054 in 2015 and 7 155in 2016. This suggests that companies actively hedged against risks associated with Russian market and were not significantly affected by the turmoil.



	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
World	1,28	1,56	1,72	1,96	1,51	1,83	2,21	2,78	3,30	3,58	3,52	3,87	4,91
EU28 (%)	55,3%	51,6%	55,3%	51,7%	60,5%	55,9%	52,1%	51,7%	53,3%	54,8%	65,4%	69,6%	71,9%
Russian Federation (%)	25,9%	25,6%	26,1%	26,8%	18,9%	22,1%	24,5%	29,4%	28,2%	24,4%	15,1%	13,2%	13,4%
EU28 + RU combined (%)	81,2%	77,1%	81,4%	78,6%	79,4%	78,0%	76,6%	81,1%	81,5%	79,2%	80,6%	82,7%	85,2%

Figure 14, Lithuanian export of transport services (EUR bil, 2005 -2017), *Trademap, authors calculations.*

The Lithuanian business community was well aware of possible risks associated with the Russian market – not only political, but also those related to corruption and the lack of independence of the judicial system. As a result, Lithuanian companies working with the Russian market adopted certain hedging strategies to mitigate risk, mainly prepayment and spot-purchasing. This is an important additional element of business flexibility considering that Lithuania was the most dependent country on trade with Russia among EU28.

Companies in the EU usually insure contracts with their EU-based clients to hedge against possible payment related issues. Insurance also allows them to provide the standard 30 days payment period after something is purchased from them. Additionally, if a client displays payment issues the insurance company notifies all other companies working with that client and, in some cases, declares that further sales will no longer be insured. Due to information sharing among insurance companies such *red-flag* usually causes a complete halt of business activities for the named client. If the case is not settled by companies involved insurance company takes the client to the court and pays out the compensation to the company that suffered damages.

However, this system and practice is virtually non-existing in Russia. High risk associated with judicial system mean that most insurances companies simply do not offer such services in Russia and those that do have rates that make insuring clients financially not feasible for most. Therefore Lithuanian companies usually require Russian counterparts to pay advance payments prior to receiving goods. They also apply reverse logic when purchasing from companies in Russia by stating that payments will be done only after goods are received.

The unpredictability of the Russian market leads to another important practical feature of business transactions – avoidance of long-term contracts. In practice this means that a spot-contracts prevail – a contract of buying or selling that is immediately settled. These and similar methods allowed Lithuanian companies to hedge against possible risk associated with Russian market even prior to 2014. Therefore, after sanctions were introduced losses related to outstanding payments and long-term obligations were minimal.

In general, the high flexibility of the Lithuanian economy was not a result of deliberate conscious planning strategy of policy-makers, at least not in the short-term responses to the challenges. During the Great Recession, Lithuanian authorities mainly focused on implementing fiscal consolidation trying to stabilize public finances and avoid sovereign default. There were no attempts at coordinating wage decreases or moderation, as is common practice in the Western corporatist small states (Kalanta, 2019). There were calls for higher labor market flexibility coming from the business community and some analysts, but the new, more liberal labor code was only adopted in 2016. That said, the government arguably contributed to the flexibility of the labor market in the short term by substantially reducing remuneration in the public sector, which then allowed private businesses to cut wages to a higher degree (although this move, again, was made largely to cut the public deficit rather than trying to increase the flexibility of the labor market).

In the second case – the response to the Russian embargo – the government again did not take any important deliberate action to help businesses reorient their exports and cope with the challenge. There were some initiatives related to financial compensation for Lithuanian agricultural sector companies from the EU budget, but they were short-term measures. In both cases, Lithuanian government largely relied on the underlying high degree of flexibility of the Lithuanian economy and businesses; in this sense, the government was to some extent "lucky" to be able to rely this vulnerability-reducing (resilience-enhancing) feature of the country.

However, in one respect the strategic decision making by Lithuanian authorities has been important in terms of reducing its vulnerability to external shocks and facilitating the adjustment of economic agents. It was the policy of strategic restructuring of interdependencies – improving trade conditions with the EU, first, by signing free trade agreement in 1994 and ten years later joining the EU, and, at the same time, minimizing dependence on trade with Russia (see Vilpišauskas 2019). Membership in the EU was important also because it included other Lithuania's important trade partners such as Latvia, Poland and Estonia, allowing an access to a largest common market in the world. Lithuanian companies, especially transport service providers, also managed to turn into their advantage the peripheral position of Lithuania, neighboring Belarus and Russia and combining advantages of legal certainty and free trade within the EU and the familiarity with the Eastern markets and their culture of informal deals.

In addition, it was mentioned that high level of migration was a significant factor in adjusting to the downturn; this was clearly enabled by Lithuanian membership in the EU, as the bulk of migrants went to rich EU members where they had the right to live and work as EU citizens. Thus, although the Lithuanian government for the most part did not step in and micro-manage the adjustment of the economy in the field of trade policy during the Great Recession and the Russian embargo, it had created the foundations for this adjustment by taking the broad strategic approach of ensuring access to foreign markets, even if this approach had been driven as much (and probably more) by geopolitical considerations rather than economic logic. Of course, as proven by the Greek (and to a lesser extent other Southern Eurozone) case, mere membership in the EU is hardly a *sufficient* factor in allowing fast adjustment – but it can certainly be categorized as a *necessary* one. In other words, the successful Lithuanian adjustments were a result of a *combination* of two important conditions: the inherent flexible domestic economy coupled with extensive secure access to foreign markets, in turn enabled by the state's long-time strategy of political and economic integration with the West.

The efforts at strategic reorientation have been particularly visible in the area of infrastructural connections (energy, transport) and completion of the "left-overs" from EU accession – joining the euro zone and Schengen. However, their practical progress has been uneven, in the case of energy projects, mostly because of resistance of interest groups with a vested interest in maintaining existing business links with Russia, election cycles and collective action problems when agreement with other regional partners such as Latvia, Estonia and Poland was needed (see Godzimirski, Vilpišauskas, Švedas 2015). Therefore, some projects aimed at providing alternative connections and sources of supply have been delayed or terminated. It was the approaching date of the closure of Ignalina Nuclear Power Plant in the end of 2009, the composition of political veto players in Lithuania after parliamentary elections in 2008 and presidential elections in 2009, and the supply of leadership by the European Commission with the presentation of the Baltic Energy Market Interconnection Plan that led to acceleration of regional energy projects such as Lithuanian – Swedish electricity connection and Lithuanian-Polish electricity connection. Still, Baltic States were not able to agree on the common regional LNG terminal and Lithuania proceeded to building it LNG terminal alone. More successful were efforts at europeanizing disputes with Russian suppliers of natural gas Gazprom when the European Commission initiated a case against its price setting practices based on the EU competition law.

Therefore, Lithuania's authorities have been more effective in creating legal conditions for the market participants to take advantage in the EU common market but less effective in implementing policies which involved state companies or heavily depended on state institutions' activities. Aside from removing barriers to trade with other EU member states and incrementally improving conditions with infrastructural connections and joining the euro zone, the Lithuanian state contributed to the flexibility of economic agents mostly in the form of its traditional relatively limited approach in terms of intervention into the economy. The redistribution measured by the share of state budget from country's GDP, the extent of industrial policy and in some other respects state is Lithuania is relatively limited. On some measures, Lithuanian political economy is more 'liberal' than the classical 'liberal market economies' such as the UK or Ireland. Contrast this to the Southern Eurozone countries which had earlier been characterized as 'mixed market economies' with a very important role played by the state. In these economies, the state is active in ensuring the protection of vulnerable social actors. By contrast, Lithuanian firms and society have for the most part learnt not to rely on the authorities to provide protection and rescue them from economic turbulences (Kuokštis, 2015). They had also grown accustomed to the very high fluctuations in economic activity in the Lithuanian economy, as it had already experienced a severe downturn during the transition in the early 1990s as well as during the financial crisis in Russia in 1998-1999.

Concluding discussion

Lithuania presents several interesting political economy puzzles. It has faced considerable economic shocks – the downturn during the Great Recession and the negative effects of the Russian embargo – but managed to deal with them relatively well (and better than had been expected). We argue that this can be explained by the fact that, while Lithuania looked vulnerable to these shocks (based on raw trade data), it was actually sensitive rather than vulnerable to them. In turn, we explain this sensitivity (resilience) as a combination of two factors. First, Lithuanian economy is highly flexible – i.e. able to quickly adapt to the changing external environment. Importantly, this flexibility has not been a result of deliberate short-term government action, and has arguably emerged partly *due to* the lack of state intervention over the years. Second, the state has successfully used its membership in international organizations – most importantly, the EU – which in turn enabled the flexible businesses to earn profits in foreign markets (and reorient their activities during the downturns) and diversify their activities.

Flexibility can have multiple meanings and take many forms (Jackson, 2007). First, one might distinguish between *economic* flexibility and *political-administrative* one. Political flexibility might refer to the ability of policy-makers to quickly adapt to the changing circumstances and adopt a new course of action. As for economics, one could distinguish between labour market flexibility and the overall, broader flexibility of the economy. The Lithuanian case has revealed that the country possesses many different types of flexibility. Concerning *political* flexibility, it is somewhat hard to judge because the government's approach regarding economic shocks has largely been off-hand – at least when it came to trade policy. In this, the Lithuanian case is very different from the classical adjustment processes extolled by authors such as Katzenstein (1985, 2003). Whereas the 'traditional' small states rely on social partnership, corporatism, and consultation to overcome challenges (and also enhance *their type of flexibility*), Lithuania has very weak tradition of social dialogue, consultation or consensus-building. Whereas the former have extensive welfare states and heavily rely on state intervention (at least in terms of redistribution, but also in industrial policy), Lithuanian state spending is focused on education, health care, social security, defense and internal order. In the economy and trade, Lithuanian government instead has provided a broad level-playing field and ensured a relatively benign environment for business by securing assess to the neighboring markets, mostly the EU. Business have in turn relied on/built up flexible practices to capture the opportunities provided by this access. Therefore, the Lithuanian case suggests that the corporatist small state model might not be the only viable and successful model of adjustment, and the Lithuanian formula suggests an alternative path (obviously, one could discuss other relevant consequences of the Lithuanian model, such as issues related to inequality and political legitimacy, but it would go beyond this paper). The Lithuanian model therefore provides a somewhat deviant case in the context of the political economy literature on small states where authors have mostly argued that the corporatist model is the most successful one.

In terms of economics, Lithuania has displayed a high degree of labor market flexibility – both in the classical case of relatively fast downward nominal wage adjustment as well as large labor mobility. However, these two dimensions alone are not enough to capture Lithuanian economy's flexibility. First, it was mainly the growth in *productivity* rather than lower wages which contributed to competitiveness. Second, Lithuanian exports appear to have increased even more than would have been predicted by these cost-based measures. In general, Lithuanian businesses have been very successful so far at reorienting their activities towards exports and finding new markets upon encountering difficulties in established ones. This suggests that analysts should broaden their view and definitions of flexibility, and also focus more on explaining what the different sources (and consequences) of different forms of flexibility might be.

Finally, resilience of Lithuania's economy also explains relatively strict and outspoken position of Lithuania's authorities with their strong support to the application of sanctions vis-à-vis individuals and entities in Russia linked to the annexation of Crimea and aggression against Ukraine. Progress in advancing with alternative sources of supply, in particular, of energy resources, and flexibility of Lithuania's economy allowed Lithuanian foreign policy-makers to be focused on demands related to Russia and be one of the most active supporters of closer relations between the EU and Eastern partners, in particular Ukraine, Georgia and Moldova.

References

Blanchard, O. 2013. Boom, Bust, Recovery: Forensics of the Latvia Crisis. *Brookings Papers on Economic Activity.*

Calus, K., Delcour, L., Gazizulin, I., Iwanski, T., Jaroszewicz, M., Klysinski, K. (2018) Interdependencies of Eastern Partnership with the EU and Russia: Three Case Studies, EU-STRAT Working Paper No. 10.

Enterprise Lithuania (2016). Lithuania-Russia Bilateral Trade, Retrieved from https://www.verslilietuva.lt/uploads/media/582c0fb0962fa/2016.11.16_Rusija_EN.pdf

Godzimirski, J., Vilpišauskas, R., Švedas, R. (2015) Energy Security in the Baltic Sea Region: regional coordination and management of interdependencies, Vilnius: Vilnius University Press.

Griffiths, R. T. (2014) Economic security and size, in Archer, C., Bailes, A. J. K., Wivel, A. (eds.) Small States and International Security, Europe and Beyond, New York: Routledge, pp. 46-65.

Jackson, W. A. 2007. Economic flexibility: a structural analysis. In: Ioannides, Stavros and Nielsen, Klaus, (eds.) Economics and the Social Sciences. Edward Elgar, Cheltenham, pp. 215-232.

Kalanta, M. 2019. The weakness of social dialogue in the Baltic countries: An employer-centric political economy perspective. *European Journal of Industrial Relations.*

Katzenstein, P. 1985. Small States in World Markets: Industrial Policy in Europe, Ithaca and London: Cornell University Press

Katzenstein, P. 2003. Small states and small states revisited. *New Political Economy.* 8(1): 9-30.

Keohane, R., Nye, J. S. (2012) Power and Interdependence, New York: Longman, 4th edition.

Kraatz, S. 2014. The Russian Embargo: Impact on the Economic and Employment Situation in the EU. Policy Department A: Economy and Scientific Policy; European Parliament.

Kuokštis, V. 2015. Jingle bells and struggling GIPS: Comparing the Baltic and the southern euro zone's crisis experience using the varieties of capitalism framework. *Acta Oeconomica.*

Lithuanian Ministry of Transport and Communications (2016), Transporto rinkos statistinių rodiklių apžvalga (2016 m. sausio–gruodžio mėn.) (translation - Overview of transport market indicators (January-December 2016)). Retrieved from https://sumin.lrv.lt/uploads/sumin/documents/files/2016%20m_%20Transporto%20rinkos%20ap%C5%BEvalga%20SM%20talpinimui(2).pdf

Liuhto, K. (2015), *To what extent are EU Member States economically dependent on Russia?*, Zeszyty Naukowe Uniwersytetu Szczecińskiego nr 854, „Finanse, Rynki Finansowe, Ubezpieczenia" nr 73, Wydawnictwo Naukowe Uniwersytetu Szczecińskiego, Szczecin, s. 993–1005; www.wneiz.pl/frfu.
LRT (2016), Ekspertai: Lietuva atsilaikė prieš Rusijos embargą (translation: Experts: Lithuania resisted the Russian embargo), https://www.lrt.lt/naujienos/verslas/4/153902/ekspertai-lietuva-atsilaike-pries-rusijos-embarga
Markovic, B. et al. 2014. The impact on the EBRD region of Russia's food ban. EBRD. https://www.ebrd.com/news/2014/the-impact-on-the-ebrd-region-of-russias-food-ban.html
Mauricas, Z. (2015). Baltics: Yes We Can! …Live without Russia, Retrieved from https://e-markets.nordea.com/api#!/article/21499/undefined
Mauricas, Z. (2014) The effect of Russian economic sanctions on Baltic States, Retrieved from https://e-markets.nordea.com/api#!/article/11743/undefined
Nye, J.S. (2011) The Future of Power, New York: Public Affairs.
Thorhallsson, B. and Kattel, R. (2013). Neo-Liberal Small States and Economic Crisis: Lessons for Democratic Corporatism. *Journal of Baltic Studies*, 44 (1), 83-103.
Thorhallsson, B. and Steinsson, S. (2017). Small state foreign policy. *Oxford Research Encyclopaedia of Politics*. Oxford: Oxford University Press.
Vilpišauskas, R. (2014) Lithuania's double transition after the re-establishment of independence in 1990: coping with uncertainty domestically and externally, in *Oxford Review of Economic Policy*, Summer 2014, vol. 30, no. 2, pp. 223-236.
Vilpišauskas, R. (2019) "Lithuania and the European Union". (forthcoming) In *Oxford Encyclopedia of European Union Politics*. Oxford University Press. doi:10.1093/acrefore/9780190228637.013.1113.