

Lithuanian-Russian economic relations in the context of Lithuania's EU-membership process

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1. Introduction

Since the beginning of the transition a decade ago, political and economic reforms in Lithuania have radically changed public policy making and the functioning of the economy. Internationalization, the opening of the economy as well as integration into the European Union (EU), have constituted a significant element of these reforms. The unilateral reduction of former barriers to international economic exchange was followed by a number of free trade agreements with neighbouring countries.

These measures, aimed at creating conditions for a market economy (e.g., competition and freedom of exchange), also reflected the political priorities of the successive governments of Lithuania. Gradual integration into the EU has become a significant priority of Lithuanian foreign policy. At the same time, another priority of this foreign policy is the preservation of friendly relations with Russia. However, economic relations with the CIS, and Russia in particular, have been subject to tariff and non-tariff barriers, and have become further distorted by incomplete reforms, state interventions and other political factors in these countries.

Similar changes have been taking place at the level of informal economic relations between Lithuania and the outside world. Several tendencies are worth mentioning. First, the significance of foreign trade has increased, indicating the openness of the Lithuanian economy. In recent years, the share of exports has been around 45 percent of GDP and the share of imports exceeding 50 percent of GDP. Second, there has been a significant shift in trade from Eastern to Western markets, and the EU in particular. The share of the EU in Lithuania's total trade turnover has increased from several percent at the beginning of reforms to around 50 percent in 1999. At the same time, the share of the CIS countries has decreased from about 85 to around 20 percent. The reorientation of trade has been the function of two main factors. First, it has been the function of geographical proximity and market size. After initial liberalization, around 80 percent of Lithuania's trade has been with the Baltic sea region countries, notably Germany, Latvia and Russia. Second, Lithuania's foreign policy of preferential liberalization has been acting as a facilitator of economic exchange with certain groups of countries, such as the EU or the Baltic States, while discriminating against other markets.

The latter connection constitutes the focus of this analysis. The main issue is the relationship between developments abroad and the choices of domestic actors. What is the impact on Lithuania's domestic policies of political and economic developments in those neighbouring countries with which Lithuania has intense economic links? How do preferential relations with some countries affect the relations with the third countries? What properties characterize the nature of the impact and the response of the domestic actors? What are the ways of improving the domestic response to external influences to fulfill the basic task of creating conditions for stable economic growth of the country?

This paper focuses on the effects of the international economic and political system on domestic policies of the states. As some analysts argue, "we can no longer understand politics within countries – what we still conventionally call "domestic" politics – without comprehending the nature of the linkages between national economies and the world economy, and changes in such linkages"¹. This analysis aims at identifying the causal relations between changes abroad and their impact at home, the factors that structure these linkages, domestic responses and how these

¹ Milner, H. V., Keohane, R. O. (eds.) *Internationalization and Domestic Politics*, Cambridge: Cambridge University, 1996, p. 3.

responses could be improved. Concretely, the focus is on the impact of Lithuania's integration into the EU on Lithuania's relations with Russia, and consequently on domestic policies and actors in Lithuania. While the integration of Lithuania into the EU has had a direct impact on mutual trade conditions, membership itself will have an impact on Lithuania's relations with third countries, and Russia in particular. It will affect the trade regime between Lithuania and Russia as well as wider political relations, which will provide new opportunities and impose new constraints on Lithuanian policy-makers and enterprises. The final outcome will depend on the EU's policy towards Russia and the internal situation in Russia. Both of these factors are dynamic and therefore there is a degree of time-related uncertainty, or what is usually referred to as the "moving target" problem.

The study also shows that while internationalization and integration constrain domestic policy-making, there is enough room for policy-makers to respond to external changes in a number of ways. Moreover, domestic policies remain the crucial mediating factor impacting on the functioning of the economy and the ability of enterprises to adjust.

The motivation for analyzing the impact of the economic crisis in Russia on Lithuania is to illustrate the linkages between external changes, and their practical significance vis-à-vis the functioning of the Lithuanian economy and domestic economic policy. Thus, for example, membership in the EU implies the complete transfer of external commercial policy to the competence of EU institutions and the adoption of the EU common commercial policy, which in turn will impact on Lithuania's trade with third countries. The impact of the economic crisis in Russia has become the subject of political controversies in Lithuania, and has been exploited by Lithuanian political parties as well as domestic interest groups. Enterprises facing adjustment problems have used the opportunity to demand certain protection measures which, when supplied, affect further developments in the economy. It is very likely that this issue will be exploited during the coming parliamentary election in Fall 2000.

This analysis has practical relevance insofar as it leads to a number of policy recommendations. At the same time, it aims to contribute to the broader theoretical discussion on internationalization, integration and their effects on a small transition economy and to advance understanding of these issues.

The analysis includes the following sections. First, a brief introduction to the economic reforms in Lithuania with the emphasis on foreign trade policy is presented. It is argued that the external liberalization of trade has resulted in a diversification of trade flows. However, two major foreign trade partners of Lithuania – the EU and the CIS - occupy the leading positions. Lithuania, being a small economy linked by economic relations with two major world trading areas, is dependent on the political changes in these territories without having a significant ability to influence the politics in the EU and Russia. The nature of these political and economic relationships reduces the role of Lithuanian policy-makers to the adaptive one, at least until becoming EU member. This section is concluded by the discussion of Lithuania's integration into the EU, its impact on Lithuania's external trade policy before and after future membership in the EU.

The next section discusses the factors that are beyond the reach of Lithuanian policy-makers, namely the EU's policy towards Russia as well as Russia's attitude towards the EU and its enlargement. The primary purpose of this section is to identify the main features of the EU's policy towards Russia and in turn, how future developments in this policy may provide a basis for Lithuania's position in this context.

The fourth section focuses on Lithuania's economic relations with Russia during the last decade and the likely impact of EU membership on the economic regime between Lithuania and Russia. It identifies areas where changes are likely, such as import duties, trade protection instruments and the conduct of preferential trade policy. The preliminary estimates seem to indicate that the economic effect of EU membership on Lithuania's trade with Russia is likely to be insignificant. However, it

will depend on such factors as Russia's accession into the WTO and EU policy towards Russia, especially the implementation of a free trade agreement between Russia and the EU. Other directions for further research include the impact of adopting the common external tariff on specific imported products from Russia to Lithuania, and the status of the Kaliningrad region inside the enlarged EU.

The last section of the paper analyzes the impact of the Russian crisis on economic policy in Lithuania and on the developments in its economy. The linkages between external changes and domestic politics and policies as well as the activities of enterprises are discussed in detail. It should be stressed that policy measures are introduced on the background of already existing policies and economic structures. These existing structures that still need to be reformed, such as the energy, agricultural and social sectors, or institutions that appeared during the transition process, themselves constrain or facilitate the ability of policy-makers to react to external shocks and the ability of enterprises to adjust to the resulting changes in the markets. Therefore, the impact of the Russian crisis on the Lithuanian economy – both at the microlevel and in terms of public finances - depended on advances in economic reforms in Lithuania, the ability of enterprises to adjust, and the policy measures taken by the government in response to the demands of some domestic actors.

The paper concludes with suggesting likely future consequences of Lithuania's membership into the EU on relations between Lithuania and Russia, and outlining the directions for future research in this field.

2. Reforms in Lithuania and developments in external economic relations

2.1. Economic reforms in Lithuania

After the re-establishment of independence in 1990, Lithuanian authorities have introduced comprehensive political and economic reforms aimed at establishing the democratic governance and conditions for the market economy. These measures included stabilization policies, liberalization of domestic and external transactions, privatization and establishing the institutions of the market economy².

Table 1. Categorization of economic transition measures

Category	Description
Stabilization	Policies aimed at internal and external balance (i.e. balanced budget, low inflation) which provide for stable and predictable business environment in which economic actors operate
Liberalization	Removal of barriers to entry into and exit from the market, creation of conditions for competition, removal of restrictions to domestic and foreign exchange, including foreign trade
Privatization	Selling or distributing the property (land, real estate, enterprises) to domestic and foreign private owners by way of public auctions, direct negotiations, distribution of vouchers or selling of shares to insiders
Institutional reform	In a widest sense, it includes creation of the market institutions such as private property, securities exchange, commercial banks, etc. as well as reforms of public finances, institutional structure of economic regulation and public administration (the latter involves privatization of some state functions, devolving them to the local administrative level and abolishing overlapping functions)

Source: compiled by the author

² See Balcerowicz, L. *Socialism, Capitalism, Transformation*, Budapest: CEU, 1995; World Bank, *World Development Report 1996. From Plan to Market*, Oxford: Oxford University Press, 1996; European Bank for Reconstruction and Development. *Transition report 1999. Ten years of transition*, London: EBRD, November 1999. For the discussion of economic reforms in Lithuania see, for example, Buračas, A. (ed.) *Lithuanian Economic Reforms: Practice and Perspectives*, Vilnius: Margi raštai, 1997.

It is not in the scope of this paper to provide the evaluation of the progress in introducing economic reforms in Lithuania. This has been carried out regularly by institutions such as the European Bank of Reconstruction and Development, International Monetary Fund and the European Commission. The purpose of the table given above is to provide the context for the more detailed discussion of measures taken in the area of trade liberalization. However, before presenting the main characteristics of the foreign trade policy it should be stressed that the economic reforms in different areas are interlinked. The table below presents the evaluation of the progress in transition in Lithuania and the neighboring countries given by the EBRD.

Table 2. Progress in transition in the Baltic States and Poland

Countries	Large-scale privatization	Small-scale privatization	Governance & enterprise restructuring	Price liberalization	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalization	Securities markets & non-bank financial institutions
Estonia	4	4+	3	3	4	3-	4-	3
Latvia	3	4	3-	3	4+	3-	3	2+
Lithuania	3	4+	3-	3	4	2+	3	3-
Poland	3+	4+	3	3+	4+	3	3+	3+

Source: EBRD (1999)

Thus, while the liberalization of external transactions could bring a large positive impact on the economic development of the country, slow progress in other areas acts as a barrier to the functioning of the market and adjustment to the changes in external environment. This should be stressed because one of the important factors that determined the response of the Lithuanian economy to the external crisis in Russia has been the state of the structural reforms. By the time of the start of the external crisis, Lithuania has been characterized by the slow progress in the areas of enterprise restructuring, in particular in the key infrastructure sectors such as energy, hardening soft budget constraints, in particular in heavily regulated agricultural sector, abolishing of restrictions to the entry into the markets and other barriers to competition as well as creating conditions for the functioning of financial markets, including non-bank financial institutions³. The legacy of incomplete reforms have to a large extent acted as a factor leading towards the negative impact of the external shock.

2.2. Reforming Lithuania's foreign trade regime

In Lithuania as well as in other CEECs, foreign trade liberalization represented important external dimension of transition process. It was connected with price liberalization, as imports were expected to help to align domestic prices with world market prices, increase domestic competition and provide consumers and producers with a choice of goods. Besides, it was to become one of the main sources of providing the country with hard currency. It was supposed to encourage export-led economic growth and provide for imported capital goods to revitalize the economy. Last but not the least, reorientation of foreign trade from former Soviet markets to Western countries and its reintegration into the world economy, besides being a central part of country's transition to a market economy, had important political and security implications for Lithuania⁴.

The decade of foreign trade regime reforms resulted in a change of foreign trade structure and volume of trade. Instead of describing the chronology of the trade policy measures, the following

³ See European Bank for Reconstruction and Development. Transition report 1999. Ten years of transition, London: EBRD, November 1999, p. 24-25.

⁴ Čièinskias, J., Cornelius, P. K., Treigienë, D. Trade policies and Lithuania's reintegration into the global economy in Buraèas, A. (ed.) Lithuanian Economic Reforms: Practice and Perspectives. -Vilnius: Margi raðtai. - 1997. - P. 347-385.

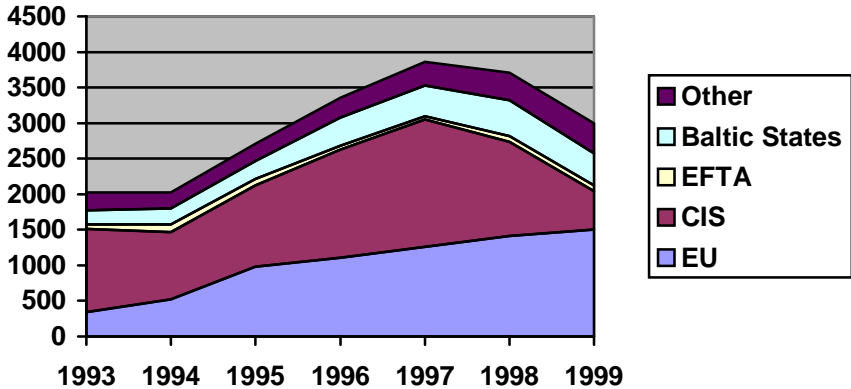
section presents the main features that characterize the Lithuanian foreign trade policy since it has been conducted independently.

2.2.1. Relatively rapid initial liberalization of the foreign trade regime

Before the transition, foreign trade in Lithuania was conducted by state agencies, and it was strictly regulated by quotas and licenses. As a result, entire foreign trade system had to be built, and after several years significant foreign trade liberalization and reorientation have been achieved.

Lithuania has undertaken a number of unilateral and contractual measures to liberalize its foreign trade regime. In 1993, a new trade law was adopted under which remaining quantitative restrictions on exports were eliminated. On the import side, a nearly uniform tariff structure with relatively low rates was introduced. The liberalization culminated in the acceptance of the obligations of Article VIII of the IMF’s Articles of Agreement establishing formally current account convertibility. The removal of the most non-tariff barriers to trade and relatively low level of import tariffs contributed to the rapidly growing volume of foreign trade. The Diagram 1 and the Diagram 2 show the dynamics of Lithuanian foreign trade since 1993, the year since which comparable data is available.

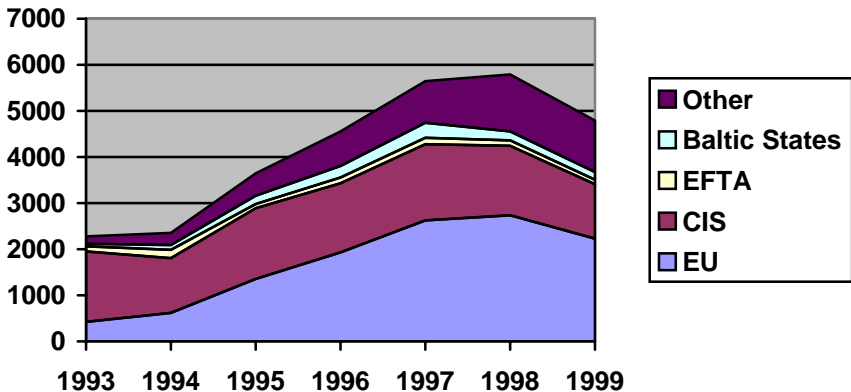
Diagram 1. Lithuania’s exports in 1993 – 1999, million US dollars



Source: Lithuanian Department of Statistics

Aside from the rapid growth of both exports and imports, the other tendencies include the increasing share of the EU and the Baltic states, and decreasing share of the CIS in Lithuania’s foreign trade turnover as well as the continuous negative trade balance with imports year after year exceeding the exports.

Diagram 2. Lithuania’s imports in 1993-1999, million US dollars



Source: Lithuanian Department of Statistics

The diagrams also illustrate the decline of both exports and imports since 1998. This has been the outcome of the Russian crisis and will be discussed in more detail in Section 5.

The changes in foreign trade structure that followed the initial liberalisation related not only to the destination of trade flows, or partner country, but also to product structure. As a recent study of the Baltic economies produced by the OECD has shown, in 1998 the revealed comparative advantage of Lithuania was found in products related to its natural and human resource endowments, namely, articles of apparel and clothing accessories, fertilisers, petroleum products, electric current, wood and furniture⁵. Although this leads the authors of the study to conclude that “the pre-war patterns of trade specialisation have re-emerged”, the Soviet time legacy has been also important in affecting the structure of trade in so far as the single factories in the oil processing industry or fertilisers industry play relatively important role for the exports and economic growth of the country in general.

To sum up, the rapid liberalisation of foreign trade regime has played a major role in creating conditions for the market economy and economic development of the country. As external analysts have concluded, “Lithuania’s generally liberal trade regime has been key in restoring economic growth...”⁶.

2.2.2. Emphasis on regionalism

It is quite revealing that although Lithuania submitted the application to become the member of the GATT, and later the World Trade Organisation in 1994, almost six years later it has still been negotiating the entry conditions. At the same time Lithuania has signed a number of free trade agreements and is a part of relatively deeply integrated intra-Baltic free trade area. Although a slow progress of WTO entry is mainly a victim to the activities of domestic interest groups (see below), the participation in numerous regional trading groups has been the defining tendency of Lithuania’s foreign trade regime, which is likely to culminate in joining the biggest regional entity in the world – the EU. Political factors seem to have been outweighing the economic considerations in choosing the form and the countries with which agreements on trade liberalization have been signed.

Thus, currently Lithuania has free trade agreements signed with 27 countries. The first free trade agreements were signed in 1992-93 with some EFTA states. Politically the most important has been the Free trade agreement signed with the EU in 1994 and in force since the beginning of 1995, which was later incorporated into the Association agreement in force since February 1998. The prospect of becoming EU member has been a crucial factor in facilitating trilateral agreements on free trade with the other two Baltic states as well as signing bilateral agreements with most of the CEFTA members⁷.

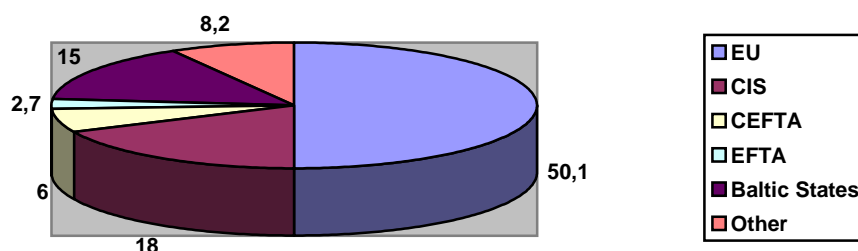
The increasingly preferential nature of foreign trade regime has been reflected in the structure of Lithuania’s foreign trade. Currently, about 75 percent of Lithuania’s foreign trade is conducted with the countries that have preferential status.

⁵ The Organisation for Economic Co-operation and Development, OECD Economic Surveys 1999-2000, Baltic states, A regional economic assessment, OECD: Paris, 2000, draft, p. 179-180.

⁶ International Monetary Fund, Republic of Lithuania: Staff Report for the 1999 Article IV Consultation, Washington, D. C.: IMF Staff Country Report No. 99/73, August 1999, p. 25.

⁷ On the impact of the EU on the intra-Baltic economic co-operation see Vilpišauskas, R. Regional integration in Europe: analysing intra-Baltic economic co-operation, EUI: Robert Schuman Centre, working paper, draft, 1999.

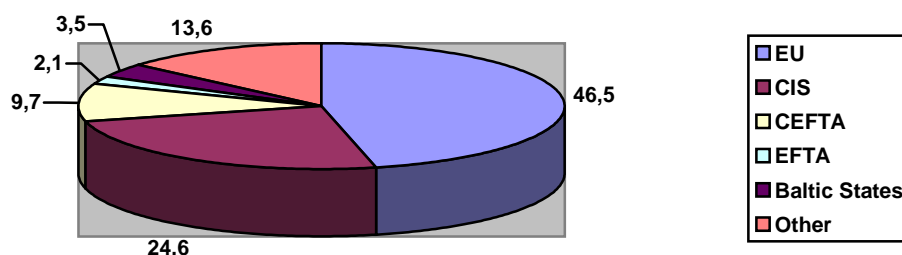
Diagram 3. Lithuania's exports to the main trade partners in 1999, %



Source: Lithuanian Department of Statistics

As the Diagrams 3 and 4 illustrate, the EU has become the largest trading partner accounting for about half of Lithuania's exports and imports. If one sums up shares of current and prospective EU members, the share of trade with these countries reaches 70 percent of Lithuania's total trade turnover. The majority of foreign direct investment (more than 60 percent) originates also from the EU.

Diagram 4. Lithuania's imports from the main trading partners in 1999, %



Source: Lithuanian Department of Statistics

However, as the data show, still around a quarter of imports come from the CIS. These are the imports that are likely to be affected by Lithuania's membership in the EU. The more detailed discussion of possible impact of EU membership on Lithuania's trade with Russia is presented in the Section 4.

2.2.3. Increasing instances of protectionism, in particular using non-tariff barriers

The liberalization of foreign trade did not represent a linear process, but could rather be characterized by uneven dynamics with increasing use of non-tariff barriers. Three factors could be influencing this tendency: (1) increasingly strong demands for protection of interest groups not counterbalanced enough by anti-protectionist groups such as consumers and user industries; (2) prevalent ideas and convictions of policy-makers who see the promotion of the competitiveness of local industries mainly as a function of their protection from foreign competition; (3) institutional set up of foreign trade policy which favors the status quo or the lowest-common denominator favoring protection.

(1) *Interest groups*. As one well-known analyst noted, "few policies tend to be more influenced by vested interests than trade policy"⁸. Lithuania's has been no exception from this rule, although

⁸ Pelkmans, J. European Integration. Methods and Economic analysis, New York: Longman, 1997, p. 207.

during the first years of transition, the power of protectionist interest groups have been weakened. Systemic transformation and structural changes have impacted on the power of interest groups, while the period of “extraordinary politics” allowed to ignore narrow interests. After certain period of stability, however, the organized interests have strengthened their power. At the same time, some enterprises have maintained the old links with the ministries, especially with the Ministry of Agriculture, as the labor turnover in this sector has been particularly low. The Ministry of Agriculture has as a rule been the most protectionist. The result has been level of import tariffs on average several times higher than for industrial goods (according to the Ministry of Foreign Affairs, the average level of import tariff in Spring 1999 excluding trade in agricultural goods was around 2.5 percent, while including the latter it exceeded 5.3 with average tariff on agricultural goods reaching 14.4 percent). The agricultural sector has acted as the main barrier to agreeing on WTO entry terms. The concentration of industries has strengthened their power to get protection, as illustrated by higher than average protection given to sugar or fertilisers producers. According to the Ministry of Economy, around 2.7 of conventional (MFN) tariff lines have a rate of over 40 percent. The lack of transparency of foreign trade policy has also been facilitating the introduction of trade barriers. Calls for protection increased in particular since the start of economic recession triggered by the Russian crisis, and the government responded to the demands of enterprises facing increasing pressure to adjust.

- (2) *Beliefs of policy-makers.* Majority of state actors involved in foreign trade policy decisions support the idea that the best way to support the competitiveness of domestic enterprises is to provide them with some kind of protection, and not to expose them to completely free trade. This type of understanding results in incremental increasing of trade barriers in the sectors where there is a presence of local companies facing adjustment problems, often where the state has an interest because of initial investments, for example, processing of some agricultural products. As the use of import tariffs is very limited because of international obligations under free trade agreements and negotiations with the WTO, policy-makers have increasingly advocated use of non-tariff barriers. In 1998-1999 the laws on anti-dumping, safeguard and countervailing measures have been approved, and the anti-dumping law has already been used against fertilizers imported from Russia and threatened to be used against imports from Belorussia, Ukraine and Latvia. Calls to use quality standards and certification procedures with reference to EU practices to prevent imports from the CIS have become quite frequent. Increase of import tariffs as well as certification procedures have been used in the aftermath of the Russian crisis. The popular view is that if certain barriers to trade are removed (for example, threshold prices or discriminatory stamp taxes and licencing rules eliminated as a part of WTO accession process) they need to be replaced by other, internationally accepted measures to ensure the same level of domestic market protection.
- (3) *Institutional arrangements.* Trade policy proposals, demands from enterprises in particular, are considered in the interministerial commission before they get on the government agenda. The Commission includes representatives of the main sectoral ministries, Ministry of Foreign Affairs, Ministry of Finance, Customs Department and Competition office and the largest organized interest groups such as the Confederation of Lithuanian Industrialists. Although formally decisions are taken by majority vote, usually the bias is towards the most protectionist policy or favoring the status quo, because the proponents of restrictive measures are usually more vocal. Even if decision is approved by the Commission, the government issues resolutions based on the principle of consensus. The budgetary and sectorial concerns usually not counterbalanced by free traders make trade policy biased towards more protection. When the international prestige is at stake or possibility of retaliatory measures occurs, the Ministry of Foreign Affairs promotes liberal trade policy. However, as the negotiations with the WTO demonstrate, sectoral concerns might prove difficult to overcome.

2.3. The impact of the EU accession on Lithuania's foreign trade policy

Joining the EU implies complete adoption of *acquis communautaire*. This also includes what some analysts called the “oldest and the most successfully integrated” policy area – Common Commercial Policy⁹. Although Lithuania will apply EU Common Commercial Policy (CCP) instruments and principles only upon the accession, trade in goods has been the area where the integration of Lithuania into the EU has progressed the most. Progressive elimination of barriers to trade between Lithuania and the EU has been taking place since the Free trade agreement came into force. Tariffs to imports of industrial goods from the EU will be finally abolished in 2001. The EU does not apply tariffs to Lithuanian exports of industrial goods, however, trade is still distorted by tariffs to agricultural trade and non-tariff barriers such as quality standards as well as commercial protection instruments such as anti-dumping duties. The integration process, implying the application of EU principles and legal norms, is supposed to finally result in complete abolishment of barriers to trade inside the internal market once Lithuania becomes part of it, and application of EU external trade regime. In general this means that Lithuania will become part to the largest regional entity in the world characterized not only by free trade, but by the free movement of goods, services and factors of production. At the same time, it will apply discriminatory and differentiated trade regime towards the third countries.

The application of CCP implies changes in several areas: adoption of common external tariff, adoption of common trade agreements with third countries and uniform application of trade instruments across all EU member states. These changes will impact on Lithuania's foreign trade regime and institutional arrangements as the competence to elaborate, negotiate and enforce external trade policy measures falling under the article 113 of the EU treaty will be delegated to the EU institutions, such as the European Commission and the so-called article 113 Committee representing the member states.

In general, adoption of CCP principles will involve relatively small changes in average tariff level of Lithuania, depending on concrete product groups. In 1995, the weighted average import tariff applied by the EU was around 4.5 percent, while as a result Uruguay round obligations it should be reduced to 3.6 percent for industrial products¹⁰. As it was indicated before, the average import tariff for MFN countries excluding agricultural goods applied by Lithuania in 1999 was around 2.5 percent. In general this indicates that MFN tariff level might slightly increase and some trade diversion could take place in Lithuania. The EU is characterized by complicated system of agricultural protection with a high level import protection for “sensitive” products. If no major reform is undertaken in the EU and the same rules are applied to acceding countries, the level of protection for agriculture is likely to increase in Lithuania. It should be noted, however, that EU membership involves many changes which all together should be taken into consideration. For example, increase in external protection might be more than counterbalanced by increase in competition in the Single market.

The adoption of EU conventional trade measures, i.e. agreements with the third countries implies abolishing of free trade in industrial products with Ukraine with which the EU trades on the MFN basis. It also implies adoption of a number of EU preferential agreements. These include the agreement on European Economic Area, Free Trade agreements with Mediterranean countries, the Generalized System of Preferences extended by the EU to the Lome convention countries. Actually, the EU applies the MFN regime only to six WTO members – the USA, Canada, Japan, Australia, New Zealand, and South Africa. The rest of the WTO members enjoy EU preferences in one or the other form. The adoption of EU conventional trade measures is likely to restrict Lithuania's trade with Ukraine and to provide new opportunities for trade with the countries that

⁹ Meunier, S., Nicolaidis, K. Who speaks for Europe? The delegation of trade authority in the EU, *Journal of Common Market Studies*, vol. 37, no. 3, p. 477.

¹⁰ Wolf, M. H., *The dog that failed to bark: the climate for trade policy in the European Union*, in Schott, J. J. (ed.) *The World Trading System: Challenges Ahead*, Washington, D. C.: Institute for International Economics, p. 127.

have the preferential regime with the EU. One of very few Lithuania's initial requests for temporary derogation from CCP rules relates to preserving the current free trade regime in industrial goods with Ukraine for 5 years after the accession, although it is unlikely to be agreed by the EU.

The adoption of commercial protection instruments potentially can make Lithuania's foreign trade regime more restrictive. First, the EU is well known for its frequent use of antidumping duties which in a period of 1990-1995 have averaged around 150¹¹. Upon joining the EU, these Lithuania will have to apply the duties enforced by the EU on its trading partners. It should be noted, however, that EU antidumping duties have not produced significant effects on countries that joined it recently, such as Finland. The adoption of the product quality and other standards applied in the internal market might also prevent some imports into Lithuania from the third countries. Most of these changes are likely to have an impact on Lithuania's trade with Russia, which is discussed in more detail below.

Before that, however, it should be noted that delegation of the competence over foreign trade regime to the EU will change the institutional setting of policy-making. In turn, this implies possible reduction in ability of domestic interest groups to influence trade policy measures and change in power balance in the policy-making bodies with a possibility of a more liberal bias. There is no uniform agreement among the analysts whether the EU has been developing towards more liberal external policy or towards becoming a "fortress Europe". However, the current tendencies seem to indicate the dominance of supporters of external trade liberalization, and keeping with the principle of "an open market economy with free competition" which is the main principle governing the EU trade policy (see the EU Treaty, Article 3a). At the same time, increasing linkages of trade and social or environmental policy matters complicate the move towards further liberalization of world trade and might also cause difficulties for a smooth accession of the CEECs into the EU.

3. The European Union and Russia

3.1. Establishment of relations and characteristics EU policy towards Russia

Since the outset of political and economic reforms in Central and Eastern Europe in the end of 1980s, the EU (EC at that time) has been increasingly involved in this region by using policy instruments such as trade agreements and financial aid. Until 1988, EC's diplomatic and economic relations with the USSR have been minimal and were based on "mutual non-recognition". Formal relations between the EC and USSR have been established in August 1988.

EU policy towards this region has been based on the principles of differentiation and conditionality. The first principle reflected general external policy of the EU and in practice was realized in the first years of 1990s by separating countries of the region into the potential applicants with association agreements and other countries, for which the prospect of EU membership was rather distant at the best. After some deliberations, the three Baltic states were included in the first group. This differentiation was also reflected by separate financial aid policy instruments such as Phare, which in the middle of 1990s became a part of pre-accession strategy for associated CEECs, and Tacis, which was targeted mainly to the CIS. Almost a decade later, with 10 CEECs negotiating the entry into the EU, the increasingly clear dividing lines between them and the rest of the region, including Russia, have become one of the reasons for a perceived need of the EU to pursue an inclusive policy towards Russia.

The principle of conditionality implied linkage of economic agreements and financial aid to the recipient country fulfilling conditions such as establishment of democratic institutions and conditions for market economy, respect for human rights and rule of law, and prevention of conflicts. Slow progress in some of these areas has probably been one of the reasons for indefinite

¹¹ Hanson, B. T. What happened to fortress Europe?: External trade policy liberalization in the European Union, International Organization, vol. 52, no. 1, Winter 1998, p. 59.

postponement of free trade agreement between the EU and Russia. Although the EU has been reacting to Russia's policy in Chechnya by threats to withdraw trade preferences or financial aid, these threats were often not fulfilled.

In December 1989, The EC and the USSR have signed the Trade and Economic Co-operation agreement which provided for the Most Favorite Nation Status (MFN), abolishment of some quantitative restrictions that the EC have been applying to state-trading economies and establishment of political dialogue between the parties. The agreement, however, soon became obsolete by changes taking place in the region and by the dissolution of the USSR. With Russia taking over the international rights and obligations of the USSR, the Trade and Economic Co-operation agreement has remained for about five years the basis for relations between the EU and Russia.

In 1991, the EU has introduced the Tacis program which later was extended to Russia and other CIS. At that time this was the largest support of this type ever provided for a single country. In 1991-1996, the sums allocated to Russia were around 927,9 million euro, in 1996-1999 the Tacis indicative program for Russia had a budget of 600 million euro¹². Most of these resources were targeted to restructure state enterprises, create conditions for private business, reform the public administration, social policy, agriculture, energy, transport and education sectors. Although the effectiveness of the Tacis program has been questioned, it has been recently upgraded by the EU.

3.2. The emerging partnership between the EU and Russia

Already in 1991, the idea of a wider agreement between the EU and Russia has been raised. In 1992 the idea of the Partnership and Co-operation agreement has been discussed by the EU and Russia, and it was signed in June 24, 1994. This agreement has until now remained the main contractual basis for relations between the EU and Russia, and is often referred to as the "core of the relationship between the Union and Russia"¹³.

The Partnership and Co-operation Agreement has established the following objectives of the partnership between the EU and Russia¹⁴:

- (1) to provide an appropriate framework for the political dialogue between the Parties allowing the development of close relations between them in this field,
- (2) to promote trade and investment and harmonious economic relations between the Parties based on the principles of market economy,
- (3) to strengthen political and economic freedoms,
- (4) to support Russian efforts to consolidate its democracy and to develop its economy and to complete its transition into a market economy,
- (5) to provide a basis for economic, social, financial and cultural cooperation founded on the principles of mutual advantage, mutual responsibility and mutual support,
- (6) to promote activities of a joint interest,
- (7) to provide an appropriate framework for the gradual integration between Russia and a wider area of cooperation in Europe,
- (8) to create the necessary conditions for the future establishment of a free trade area between the EC and Russia.

¹² European Dialogue, Tacis program helps to rebuild Russia, January-February 2000, p. 12.

¹³ See the Annex II of the European Council on the Common Strategy of the European Union on Russia adopted in Cologne on June 4, 1999.

¹⁴ See The Agreement on partnership and co-operation establishing a partnership between the European Communities and their Member States, of one part, and the Russian Federation, of the other part, Official Journal L 327, 28/11.1997, p. 3-69.

The Partnership between the EU and Russia aimed at both developing political relations between the two parties and deepening economic cooperation, the principles of which were based on GATT rules. The establishment of the free trade area was foreseen as the next step of the economic cooperation. It was agreed that the EU and Russia together will examine in 1998 whether “circumstances allow the beginning of negotiations on the establishment of a free trade area”¹⁵. However, the negotiations on the free trade agreement have not been started yet, and taking into account internal developments in Russia, are not likely to be started in the nearest future. The EU might link the establishment of the free trade area with Russia with the latter’s entry into the WTO, which at the moment also remains remote.

The agreement confirmed the MFN status for mutually traded products. Quantitative restrictions for Russian imports into the EU have been removed (with some exceptions). The agreement also contained standard safeguard provisions on possible introduction of commercial protection measures such as anti-dumping or countervailing measures. The EU has exploited these provisions to limit imports from Russia on a number of occasions. The agreement also included provisions for cooperation in different fields of economy, such as cross-border supply of services, establishment and operation of companies, labor conditions, payments, investment promotion, public procurement, transport, environment, energy, construction, etc. In terms of importance for future trade, intentions to reduce differences in the fields of metrology, standardization and certification and to start negotiating mutual recognition agreements should be noted.

Finally, another important provisions related to setting up of common institutions for a regular political dialogue. These included twice a year meetings between the President of the European Council and the President of the European Commission on the one side and the President of Russia on the other, meetings at the ministerial level within the Cooperation Council, biannual meetings at senior official level within Cooperation Committee, and meetings at parliamentary level within the Parliamentary Cooperation Committee. The agreement has been concluded for an initial period of 10 years.

As the Partnership and Co-operation Agreement has included provisions on cooperation in both political and economic spheres, it fell under the category of “mixed agreements” and on the part of the EU had to be ratified by the European Parliament and the parliaments of the Member States. To speed up the implementation of the provisions concerning trade and trade-related matters, the Interim agreement was signed and came into force in February 1996¹⁶. The Partnership and Co-operation agreement itself came into force in December 1, 1997. The EU has signed similar agreements with other CIS.

Tacis program constitutes another important element of EU policy towards Russia. In January 2000, a new Tacis regulation came into force¹⁷. It set the framework for 3.138 billion Euro assistance over the period of 2000-2006 to the CIS. The program aims at providing know-how to promote the transition to a market economy and to reinforce democracy and the rule of law. The Tacis program will be linked directly with achieving the goals foreseen in the Partnership and Co-operation agreements, and in reaction to the recent events in Chechnya contains a suspension clause. The new program is more restrictive in terms of essential cross-sectoral themes, with a particular emphasis on the area of nuclear safety, and more focused on investment financing.

Partly as a result of mutual reduction of barriers to trade, partly as a general reorientation of trade flows, previously negligible trade relations between the EU and Russia have been gradually increasing during the last decade. In the end of 1990s, the EU has become Russia’s main trading partner accounting for around 40 percent of Russia’s foreign trade. Russia has been relatively much

¹⁵ Ibid.

¹⁶ See the Interim Agreement on trade and trade-related matters between the European Community, the European Coal and Steel Community and the European Atomic Energy Community, of the one part, and the Russian Federation, of the other part, Official Journal L 247, 13/10/1995, p. 2-29.

¹⁷ New TACIS Regulation enters into force, Brussels, 21 January, 2000, IP/00/66.

less important for the EU. In 1998, imports from Russia have made up 3.2 percent of total EU imports and exports to Russia making up 2.9 of total EU exports¹⁸.

3.3. Recent tendencies in EU-Russia relations

During the recent years, links between the EU and Russia has intensified. On the one hand, this has been the result of the regular meetings taking place in the framework of the Partnership and Co-operation agreement between the EU and Russia. On the other hand, new policy initiatives have been drafted in reaction to a number of important developments in Europe. First, with Sweden and Finland becoming members of the Union in 1995, the EU has attained a 1300 km long border with Russia. Second, the decision of the EU to open membership negotiations with the applicant CEECs, first with a group of five including Estonia and Poland, and later with the remaining ones, including Latvia and Lithuania, raised further questions concerning appropriate policies towards neighboring Russia. As one study on the geostrategic implications of EU enlargement has stated, “the most direct impact of EU enlargement will be on the neighbors of the EU”¹⁹. The Northern Dimension initiative has been one of the examples of EU policy initiatives taken in response to its enlargement in 1995 and with a view to the coming accession of the CEECs. Third, expansion of NATO in 1999 to include Poland, Hungary and Czech Republic as well as conflict in Kosovo has increased tensions between Russia and the EU and strengthened the need of the latter for an inclusive policy towards Russia. Fourth, the 1998 crisis in Russia, domestic political instability and conflict in Chechnya also raised the issue of an appropriate EU response.

The EU responded to these geopolitical and economic changes by producing in the framework of its recently upgraded Common Foreign and Security Policy a Common Strategy on Russia. The Common Strategy of the European Union on Russia was adopted by the European Council in Cologne in June 4, 1999. The main rationale behind this strategy was to ensure Russia that it is included into the processes of integration and cooperation, that it will not be left isolated politically and economically, and that the EU is determined to pursue “ever closer cooperation between Russia and the European Union”²⁰. As the Part I of the Strategy stated, “A stable, democratic and prosperous Russia, firmly anchored in a united Europe free of new dividing lines, is essential to lasting peace on the continent”²¹.

The main objectives of the Strategy were the following: (1) consolidation of democracy, the rule of law and public institutions in Russia, (2) integration of Russia into a common European economic and social area, (3) cooperation to strengthen stability and security in Europe and beyond, and (4) to respond to common challenges, or interdependencies on the European continent such as energy, environment and illegal activities.

The Strategy reaffirmed that the Partnership and Co-operation agreement remains the main instrument to implement its objectives. In the sphere of economic cooperation its stated the need to promote approximation of legislation between the EU and Russia, in particular in the field of customs as well as standards and certification, to support Russian efforts to meet the requirements for WTO accession, and to examine how to create the necessary conditions, in addition to Russia’s WTO accession, for the future establishment of an EU-Russia free trade area. It also admits that the “macro-economic situation in Russia, experience in building European unity, the introduction of the euro and the process of enlargement reinforce the importance of specific consultations between the Union and Russia on economic issues”²². The importance of cross-border and regional cooperation,

¹⁸ Eurostat figures, Brussels, 30 September 1999, Trade DG T2/cg/rq.

¹⁹ Krezler, H. G. The geostrategic and international political implications of EU enlargement, Report of the second meeting of the working group on the Eastern enlargement of the European Union, Florence: EUI, RSC Policy Paper, No. 98/2, p. 7.

²⁰ The Annex II of the European Council on the Common Strategy of the European Union on Russia adopted in Cologne on June 4, 1999, p. 1.

²¹ Ibid.

²² Opt. cit., p. 9.

with possible reference to Kaliningrad region, is acknowledged, and in this area the Northern Dimension of the EU is supposed to play an essential role.

In the context of this paper, the Northern Dimension of the EU deserves to be addressed in more detail. As it was mentioned before, the last and to some extent the coming enlargements of the EU have been the main factors behind this initiative. The Northern Dimension of the EU has been initiated by Finland in 1997 and adopted on the EU agenda at the European Council meeting in Vienna in December 1998. During the first half of 1999, the Guidelines for the implementation of the Northern Dimension were prepared and the strong political backing was given to it at the European Council in Cologne in June 1999. It was further developed during the Finnish presidency, which discussed the initiative with the other countries of the region, including Russia, and in December 1999 requested the Commission to prepare an Action plan.

The Northern Dimension rests on the assumption of increasing interdependence between the expanding EU and its neighbors, Russia in particular. It focuses on the issues surrounding the political and economic developments in the Baltic Sea region and aims at enhancing security, stability and sustainable development of the region. The priority areas are energy, raw materials, environment and nuclear safety, cross-border cooperation, trade, transport, social issues, research and education. Further development of economic relations between the Baltic states and Russia is one of the challenges which, according to this EU initiative, need to be addressed.

To conclude, the process of EU enlargement as well as other economic and political factors have increasingly drawn the attention of the EU to the future of its relations with Russia and the place of Russia in the future institutional set up of Europe. The solutions of these issues are of strategic importance to the acceding countries, and Lithuania in particular. Lithuania has a border with Russia, which in the future will become EU border. The presence of Kaliningrad region raises additional challenges for the EU and Lithuania's policy-makers to find economically and politically beneficial solution for the status of the region surrounded by the EU. Taking into account importance of Lithuania's economic links with Russia, there is a need for Lithuania's policy-makers to monitor drafting of the forms of cooperation between the EU and Russia and to model the outcomes of possible solutions. This also implies taking into account the concerns of Russian leaders over the possible impact of EU enlargement.

3.4. Russia's attitude towards EU enlargement

Differently from their active opposition to the enlargement of NATO, for a long time Russia's leaders remained relatively indifferent to the process of European integration. However, with the acceleration of integration and the start of membership negotiations, Russian officials have raised concerns over possible negative economic implications of EU enlargement on Russian economy.

Russian officials have presented their concerns to the EU leaders in September 1999 during an EU Troika-Russia meeting and the tour of EU capitals²³. Most of their concerns have been related to trade matters. These include concerns over possible increase of restrictions to Russian imports to the Baltic states as a result of adopting the Common external tariff of the EU, possible trade diversion as a result of the Baltic states joining the Single market, negative effects of extending Common Agricultural policy to the Baltic states, extension of anti-dumping and competition rules, diversion of investment from Russia to the acceding states, negative impact of EU standards and certification procedures on trade with Russia. Concerns have also been raised over possible negative impact on movement of people, transit and trade between the main territory of Russia and Kaliningrad region. Finally, worries about respect for the rights of ethnic Russian population in the Baltic countries were expressed.

²³ See Euro-East, No. 80, September 1999, p. 15-16.

While some of these concerns seem to have little basis, the main message is that Russia intended to make clear it was willing to be consulted along the process of enlargement and might require compensation in the areas where it could suffer economic losses. It should be noted, that there are WTO rules on possibility to demand compensation for losses resulting from a partner country joining the regional block and diversion of trade. Although it is still unclear whether Russia will join the WTO before the enlargement of the EU takes place, the concerns expressed by the Russian authorities have been receiving attention in the EU.

Similar message has been delivered by the Medium-term Strategy for Development of Relations between the Russian Federation and the EU. It was presented to the 4th EU-Russia Summit in Helsinki on October 22, 1999, by then Prime Minister of Russia V. Putin. The strategy determines the objectives of Russia's relations with the EU for the next decade and means of achieving these objectives²⁴. In general, it reiterates many of the points stated in the Common Strategy of the EU towards Russia, while stressing the financial assistance needs and selected areas of particular interest to Russia.

The Strategy acknowledges the aim of Russia to become the member of the WTO, in some cases linking this process directly to economic cooperation with the EU, and to create a free trade area with the EU. However, it states, that in the transition period of reform, the protection of national production in certain sectors of economy is justified, reflecting the dominant economic policy of active state regulation in Russia. Importantly, it maintains that efforts will continue to be made for "protection of Russia's legitimate interests while further expanding the European Union and introducing the single currency (euro)".

The Strategy directly repeats the concerns over the possible negative enlargement of the EU on Russia. Among other things, it states that "before the next expansion of the European Union to conduct consultations with its individual members and candidates aimed at securing Russia's interests as the rules of the EU agricultural, technological and anti-dumping policies, its visa and border regimes, or preferences to the developing countries which are competing with the Russian exports are extended to the countries of Central and Eastern Europe and the Baltic states, as well as to safeguard, in the interests of stability, security and cooperation in Europe, the rights of the Russian-speaking population in the Baltic states"²⁵. Particular attention is drawn to the issue of Kaliningrad region and the need "to create the necessary external conditions for its functioning and development as an integral part of the Russian Federation and an active participant in the transboundary and interregional cooperation", and to conclude "a special agreement with the EU in safeguarding the interests" of this region "in the process of the EU expansion"²⁶.

The new position of Russia is important for Lithuania by becoming an external strategic factor, which has to be taken into account in implementing Lithuania's foreign policy goals. Although the process of Lithuania's accession into the EU in a strict sense depends on fulfilling membership requirements and the preparedness of the EU to enlarge, economic and political interdependencies create a need to take into account Russia's concerns. Evolving relationship between the EU and Russia clearly illustrate this need. While the role of Lithuania is mainly an adaptive one, the policy initiatives can be successful if they are based on a sound analysis of the impact of joining the EU on Lithuania's economy and its links with Russia.

4. Possible impact of EU membership on Lithuania's economic relations with Russia

4.1. Economic cooperation between Lithuania and Russia

²⁴ Unofficial translation by the Russian MFA of the Medium-term Strategy for Development of Relations between the Russian Federation and the European Union (2000-2010), 26.10.1999, <http://presidency.finland.fi/frame.asp>

²⁵ Ibid. p. 6.

²⁶ Ibid. p. 9.

After the re-establishment of Lithuania's independence, principles of economic co-operation between Lithuania and Russia had been first defined by the Agreement on inter-state relations signed in Moscow on July 29, 1991. While this agreement had an important political meaning by providing the basis for further development of relationship between two sovereign countries, its economic provisions have been relatively insignificant.

In the field of economic relations, the basis for mutual trade regime was laid in the Agreement on trade and economic relations signed between Lithuania and Russian Federation in Vilnius on November 18, 1993. The agreement has provided for the MFN status in mutual trade, which has been applied until now.

Further steps in advancing economic cooperation between Lithuania and Russia have been taken in 1997. The bilateral Commission on Trade, economic, scientific and cultural cooperation has been set. The Commission consisting of 10 working groups has been holding regular meetings to discuss the issues of mutual concern in the areas of trade, finances, transport, etc. On June 29, 1999, nine agreements between Lithuania and Russia were signed. These were the agreements on avoidance of double taxation, promotion and mutual protection of investments, co-operation in the field of fisheries, co-operation in the field of transit, long-term co-operation with Kaliningrad region. The prime ministers of Lithuania and Russia also announced a joint declaration on measures aiming at liberalization of trade between Lithuania and Russia. Only some of these agreements have been ratified by both parties, while mutual liberalization of trade has suffered a setback as a result of the Russian crisis and adoption of protectionist measures by both sides.

Lithuania's trade with Russia has experienced major changes during the last decade. From becoming the main exports markets of Lithuanian companies and the main source of imports, Russia's share in foreign trade of Lithuania has been constantly decreasing. Although the share of Russia stabilized in 1996-1997 and equaled around 25 percent of Lithuania's foreign trade turnover, after the start of the Russian crisis in August 1998, the exports from Lithuania to Russia decreased by almost 70 percent (see the Section 5). However, Russia still remains one of the main sources of imports for Lithuanian economy with the share of almost 20 percent.

4.2. Impact of EU membership on Lithuania's trade with Russia

Any estimates of potential impact of Lithuania's membership in the EU its trade with Russia depend at least on several factors, namely the trade regime of EU towards Russia, on Lithuania's trade regime towards Russia and trade flows between Lithuania and Russia. Although the discussion provided below is based on the current situation, it should be noted that some variables are likely to change. For example, it is likely that Lithuania's exports to Russia might gradually increase. EU policy towards Russia can evolve, depending on the internal situation in Russia and its economic policy stance.

As it was mentioned before, upon accession into the EU Lithuania will adopt the Common Commercial Policy (CCP) of the Union. In terms of economic relations with Russia, several aspects are important: adoption of the Common external tariff, becoming part of the EU agreements with Russia and adoption of EU unilateral commercial policy instruments. Apart from participation in the CCP, becoming part of the Single market also implies harmonization or the mutual recognition of the product and service standards which could impact on Lithuania's trade with Russia.

(1) *Adoption of the Common External Tariff (CET)*. Adoption of the CET will have an impact only on imports from Russia to Lithuania, because both the EU and Lithuania have the MFN treatment for goods exported to the Russian market. According to some estimates, the weighted

average tariff on imports from Russia to the EU is under 1 percent²⁷. Around 83 percent of imports from Russia into the EU are free of duty, and in addition the EU has been applying the Generalized System of Preferences to a number of goods.

Although there is no comparable figure on Lithuania's average tariff on imports from Russia, it is likely to be in the similar range. Therefore, while the macroeconomic effects in general are not likely to be significant, the impact will depend on concrete product groups. There is a tendency in both the EU and Lithuania to have higher protection on imports of so-called "sensitive" products, and in some cases these groups could be different depending on the competitiveness and the lobbying power of the producers. A rough picture could be drawn by looking at the main groups of imports from Russia to Lithuania and comparing the MFN duties applied currently in the EU and Lithuania (although this provides only a static picture of possible impact).

Table 3. Lithuania's main imports from Russia and conventional import tariff rates, January 1999 – November 1999

CN group, code and title	Million Litass	% from total imports from Russia	Lithuania's conventional import duty	EU conventional import duty
Total	3507.643	100	-	-
V chapter, 251020 Natural calcium phosphates, natural aluminium calcium phosphates and phosphatic chalk: Ground	205.268	5.85	Free	Free
V chapter, 270900 Petroleum oils and oils obtained from bituminous minerals, crude	1718.193	48.98	Free	Free
V chapter, 271121 Natural gas	494.827	14.11	Free	0.7
VII chapter, 390110 Polyethylene having a specific gravity of less than 0.94	55.726	1.59	Free	8.9
IX chapter, 440710 Coniferous	54.755	1.56	Free	Free
XVI chapter, 840130 Fuel elements (cartridges), non-irradiated (Euratom)	176.775	5.04	Free	3.7

Sources: Lithuanian Department of Statistics, Ministry of Economy, Commission Regulation (EC) No. 2204/1999

Table 3 presents the main Combined Nomenclature groups of products the imports of which exceed 1 percent share of Lithuania's imports from Russia. Altogether these groups constitute almost 80 percent of total Lithuania's imports from Russia. As the data illustrates, petroleum oils, crude oil and related products constitute almost half of Lithuania's imports from Russia, and for these products both Lithuania and the EU apply no conventional import duty. For several groups of goods, however, the EU applies import duties. The most important of these is natural gas, although the MNF duty applied by the EU to imports of this product is relatively

²⁷ Towards greater economic integration. The EU's financial assistance, trade policy and investments for the NIS, www.europa.eu.int/comm/dg1a/nis/econ/toward.eco.integration.htm, 10.04.2000.

low. Increases of import duties and some trade diversion is possible for some chemical products and imports for the Ignalina nuclear power plant.

- (2) *Joining EU agreements with Russia.* Upon accession into the EU, Lithuania will become part of Union's agreements with the third countries. This means the adoption of the Partnership and Co-operation agreement between the EU and Russia as well as political initiatives of the EU towards Russia. In the area of trade, this does not imply any significant changes for Lithuania as the MFN status is currently applied to trade with Russia. In the future, the best option for Lithuania in this respect is the creation of the free trade area between the EU and Russia, which would bring significant benefits for Lithuanian economy by facilitating trade, transit and economic growth. This is still only a distant possibility depending on external factors, in particular internal political and economic developments in Russia. By joining the political initiatives of the EU towards Russia, Lithuania might be able better to exploit the opportunities of cooperation to create conditions favorable to stability, certainty and economic growth. A good example of such an initiative is the recent joint proposal of Lithuania and Russia on Northern Dimension, namely the projects related to the Kaliningrad region, which was announced by the officials of the two Ministries of Foreign Affairs²⁸. The issue of the Kaliningrad region, however, will probably need to be settled before Lithuania becomes EU member.
- (3) *Adoption of EU commercial policy instruments.* Currently, the anti-dumping is the most frequently used commercial protection instrument by the EU against imports from Russia. There are more than ten cases of anti-dumping duties applied to the goods imported from Russia. Extension of these measures to imports from Russia to Lithuania could have a negative effect on Lithuania's trade with Russia. Although the basis of applying anti-dumping duties might disappear with liberalization of the Russian economy and reduction of state intervention into the economy, EU trade policy towards Asian and other WTO members illustrates that anti-dumping cases will not necessarily disappear.
- (4) *Joining the Single market.* The issue of quality standards and certification is not directly linked to the application of the CCP. However, application of European standards with all their positive impact on Lithuania's producers and consumers can become a non-tariff barrier for imports from Russia. This issue is on the agenda of EU-Russia relations and the impact of divergent standards of goods and services will depend on the development of mutual recognition and other related policies between the EU and Russia. Russia's accession to the WTO could be one of the factors facilitating the implementation of mutual recognition foreseen in the Partnership and Co-operation agreement between the EU and Russia. The implementation of the agreement on mutual recognition between the EU and Russia is in the interest of Lithuania and would facilitate trade relations with Russia.

This is by no means meant to be a detailed analysis or an exhaustive list of potential effects of EU membership on Lithuania's trade with Russia. There is always a danger that in considering concrete issues and effects of EU membership, the broader ones are left out. For example, becoming part of the EU itself might stabilize Lithuania's trade with Russia by reducing the potential for exploiting trade issues and supply of certain products by Russia to achieve political objectives in this region. EU membership might also increase competition, legal certainty and efficiency, which could strengthen Lithuanian companies' ability to compete and their presence in the Russia's market exploiting other advantages such as proximity, knowledge of the market, etc. With the expansion of the EU to include the Baltic states, the need for stable and open trade policies towards Russia for the whole EU is likely to increase, while the negotiating power of the EU 27 or more is likely to be stronger than that of Lithuania and could increase the bargaining power of the latter vis-à-vis Russia.

²⁸ Baltic News Service, Lietuva ir Rusija planuoja "Šiaurės dimensijai" suteikti stiprų postūmį, February 9, 2000.

5. Lessons for Lithuania from Russia's August 1998 crisis

5.1. Triggers of the crisis

The beginning of the economic crisis in Russia, which spilled-over into the neighboring markets is usually dated to mid-August 1998 when the Russian ruble was devaluated. However, the economic slowdown could be traced back to earlier developments. These included accumulating budgetary problems, problems in the banking sector and general disagreements among leaders about the economic reforms in Russia. As one analyst summarized, already in May 1998 five concerns about the state of affairs in Russia were apparent: “ Yeltsin’s unexpected dismissal of his government on 23 March had shown that the whole process of government in Russia was erratic and unpredictable. The continuing fall in world oil prices was reducing Russian budget and export revenue. Capital flight was continuing. Russia’s public finances remained in disarray after a year of the best endeavours of Chubais and Nemtsov to boost revenue and curb spending. And political support for liberalization and stabilization on the part of the business elite was declining...”²⁹.

Although privatization has progressed relatively far in Russia in comparison to other transition countries, the progress in liberalization and enterprise restructuring has been much slower³⁰. Transactions including both foreign and domestic trade were regulated, barriers to market exit have remained. High level of arrears in inter-enterprise payments, in tax payments, in wage payments and in the implementation of state spending commitments and chronically high general government deficit, which equaled -8.1 of GDP in 1997, have contributed to the difficulties that led to the financial crisis. In the Spring 1998 the government was losing confidence of the markets, the funds were flowing from Russia and the Moscow stock market index was continually falling. The rescue package agreed by the Russian government with IMF, World Bank and Japanese government in mid-July did not restore the market confidence.

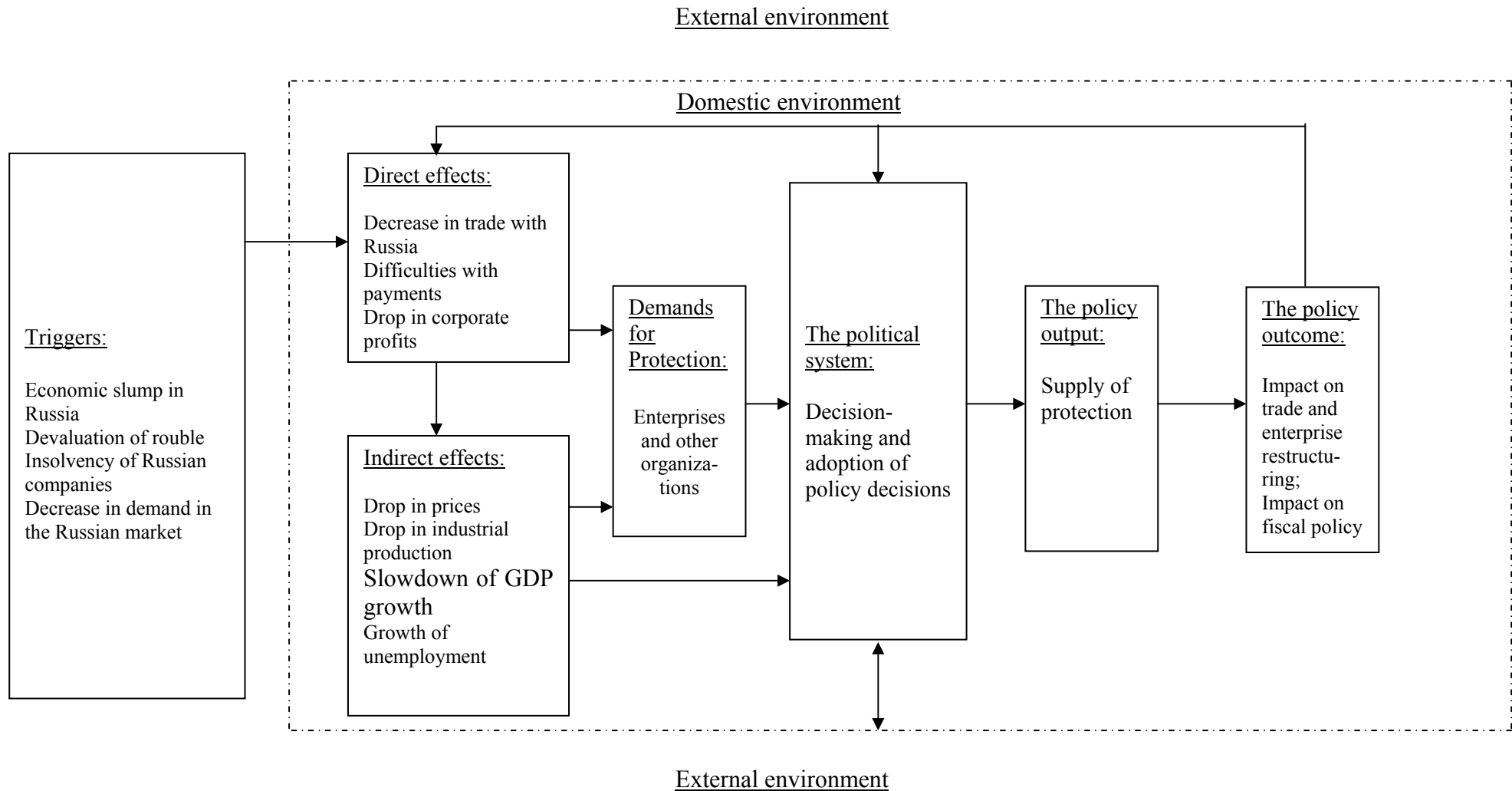
On 17 August 1998 the Government of S. Kirienko announced several policy measures which set of the chain of events that eventually led to the financial and economic crisis in Russia. These measures included the decision to devalue the ruble, the announcement of temporary moratorium on debt repayments and introduction of capital controls. This was followed by the real depreciation of the ruble, which soon fell below the new “floor” of 9.5 to 1 USD, and other CIS currencies; reduction in output growth in Russia and the CIS in general and the breakdown of trade finance mechanisms between economic agents. The economic effects of these factors through trade links have been transmitted to the neighboring transition countries, including Lithuania. Lithuanian economy, exposed to the Russian market by intensive economic links, have immediately felt the impact of Russian crisis.

The Picture 1 illustrates the linkages between the economic crisis in Russia and the resulting economic and political effects in Lithuania. It adopts the policy process perspective, which sets the domestic political process in the wider international environment and defines the causal mechanisms between political-economic processes abroad (in Russia) and the domestic economic and political effects (in Lithuania). The external environment includes Russia and other neighboring markets while domestic environment signifies the existing economic institutional structure in Lithuania (regulation of the economy, state finances, infrastructure, taxation, etc.). The economic crisis in Russia has impacted on Lithuanian companies and economy in general. The domestic companies and their associations have soon demanded the action from the government which reacted by unilaterally adopting a number protection measures as well as attempting to negotiate with the external actors (Russian central government, governments of its regions, the EU).

²⁹ Hanson, P. The Russian Economic Crisis and the Future of Russian Economic Reform, *Europe-Asia Studies*, November 1999, Vol. 51, Issue 7, p. 8.

³⁰ See European Bank of Reconstruction and Economy, *Transition report 1999, Ten years of transition*, London: EBRD, 1999, p. 24.

Picture 1. Impact of the Russian crisis – policy process perspective



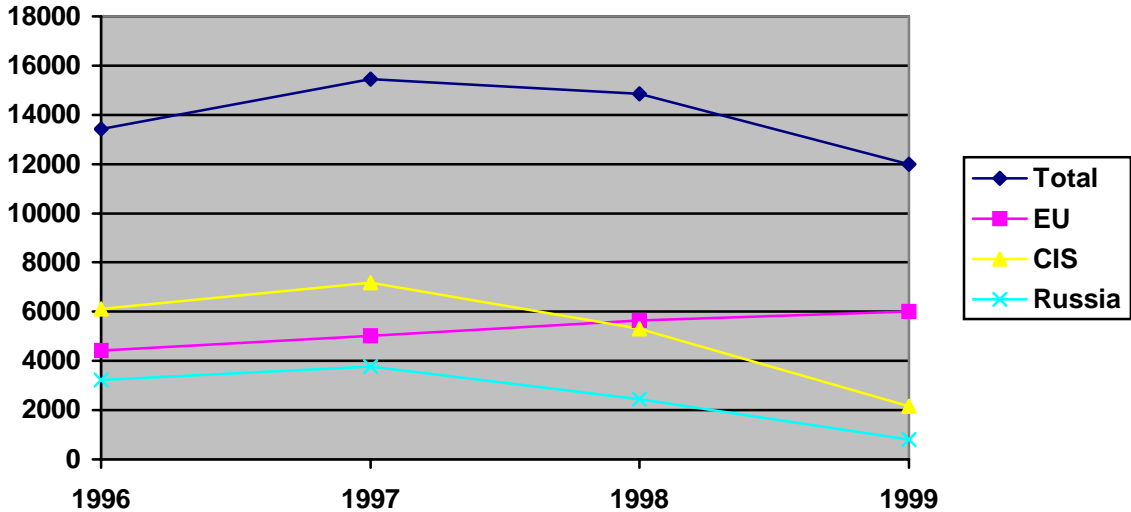
Source: adopted with significant modifications from Jenkins, B., Policy analysis. Models and approaches, in Hill, M. (ed.) *The Policy process. A Reader*, London: Prentice Hall, 1997, p. 35.

These measures as well as other parallel governmental decisions and non-decisions set in the general context of domestic economic structural reforms have produced the outcome which conditioned further economic developments, or secondary effects, in the country. The most important have been the effects on trade and restructuring of enterprises (market) and the state of public finances (state). The elements of this process are discussed in more detail below.

5.2.The transmission mechanism

The impact of the Russian crisis has immediately been felt on Lithuania’s economy directly through bilateral trade links between Russian and Lithuanian companies and indirectly through neighboring markets where economic slowdown has resulted in decrease in demand for merchandise of Lithuanian companies and problems of payments. Before the start of the crisis, the Lithuanian economy was linked by intense economic relations with the Russian economy. In 1997, exports of Lithuanian companies to Russia and the CIS constituted respectively 24.5 percent and 46.4 percent of total exports. Lithuanian imports from Russia and the CIS have equaled respectively 24.3 percent and 30.7 percent of total imports.

Diagram 5. Lithuania’s exports in 1996 – 1999, million Lit



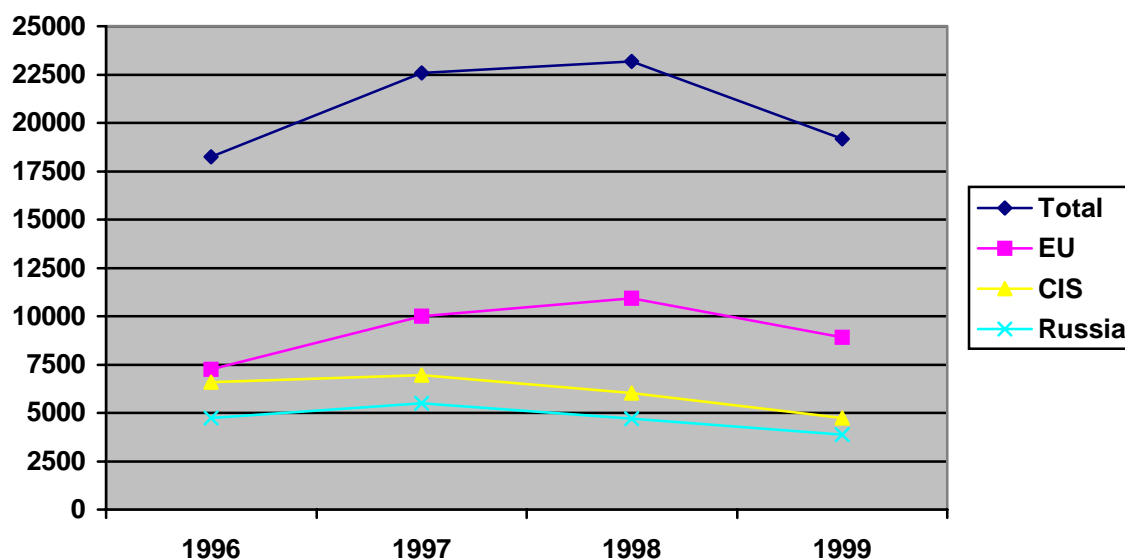
Source: Lithuanian Department of Statistics

As the diagram above illustrates, exports from Lithuania to Russia and the CIS in general have been increasing in absolute terms from 1996 to 1997. At that time the trend of decreasing share of these markets in Lithuanian exports which continued since the beginning of reforms in 1990s has been reversed, the share of Russia and the CIS has stabilized and even started increasing. However, the Russian crisis resulted in a rapid decrease of the share of Russia and the CIS in Lithuanian exports. Although the exports to the EU have continued to increase in both relative and absolute terms, they did not compensate for the decline in the Eastern markets. Lithuanian total exports started decreasing in the second half of 1998. In 1999, the decrease in exports in comparison to 1998 was 19.3 percent.

The imports from Russia and the CIS (and from the EU in 1999) have been falling since the beginning of the Russian crisis as a result of decreasing demand in the domestic market (see Diagram 6). The problems with exports experienced by the Lithuanian producers as well as a general fall in economic growth in Lithuania has resulted in the fall of demand for imported products. However, as the more detailed data on Lithuanian trade with Russia show, the main

variable affecting the fall in imports from Russia have been the disruptions in supply of crude oil to Lithuania, namely the enterprise Mazeikiu nafta.

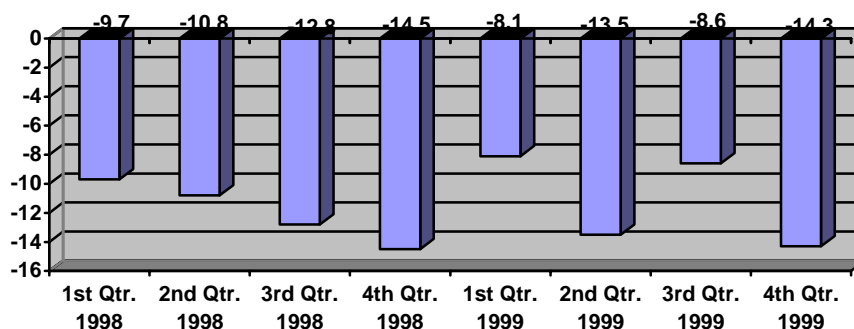
Diagram 6. Lithuania's imports in 1996-1999, million Lit



Source: Lithuanian Department of Statistics

These changes in foreign trade have had an impact on Lithuania's current account deficit. While it continued increasing in the second half of 1998, fall in consumption resulted in declining imports in 1999 and narrowing of the current account deficit. In 1999, the current account deficit decreased to 11.2 percent of GDP from 12.1 percent of GDP in 1998.

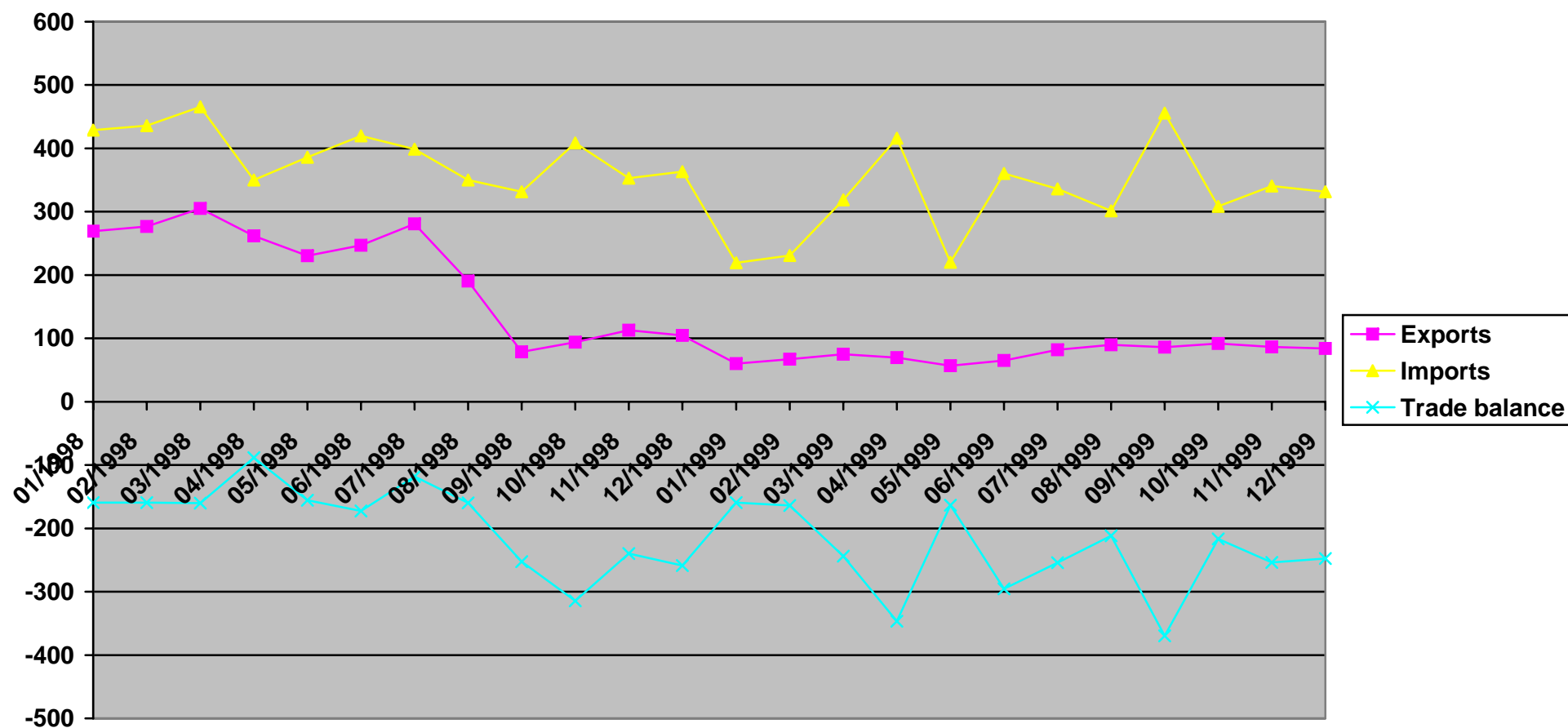
Diagram 7. Lithuania's current account balance in 1998-1999, % of GDP



Source: Bank of Lithuania, Lithuanian Department of Statistics

The Diagram 8 illustrates the impact of the Russian crisis on bilateral trade links. In two months following the decision to devalue the Russian ruble the exports of Lithuanian companies to Russia have dropped significantly. In 1999, Lithuanian exports to Russia were decreasing further in comparison to 1998. As a result of the Russian crisis, the exports from Lithuania to Russia dropped by around 66 percent increasing the negative trade balance. The share of exports to Russia decreased from 21.4 percent before the crisis to only 6.8 percent of total Lithuanian exports in 1999. Exports to the CIS remained relatively large and equaled to 18 percent of Lithuanian exports in 1999. Lithuania's exports to Belorussia and Ukraine made up respectively 5.9 and 3.7 percent in 1999.

Diagram 8. Lithuania's trade with Russia in 1998-1999, million Lit



Source: Lithuanian Department of Statistics

The imports from Russia, however, remained relatively important for the Lithuanian economy and constituted 20.2 percent in 1999. Imports from Russia to Lithuania have been by far the most important of all the CIS members. Imports from the CIS to Lithuania made up 24.6 percent in 1999.

The development of imports from Russia illustrate several aspects of economic relations between Lithuania and Russia. First, the Lithuanian economy is dependent on Russian imports of mineral products, and crude oil in particular. Second, the fluctuations in imports to a large extent depend on the supply of crude oil from Russia to Lithuanian oil processing company Mazeikiu nafta. The significant falls in imports from Russia in Spring 1999 and Autumn 1999 correlate with the interruptions of supply of crude oil from Russia.

Thus, while Lithuanian exports to Russia have been rather diversified, the mineral products, crude oil in particular, constitute the main imports from Russia. This has until now created a situation of dependency and uncertainty as the decisions to deliver supplies from Russia have so far been often based on political considerations. The interruptions of crude oil supply have had a direct effect on Lithuanian economy and GDP as Mazeikiu nafta input accounts for almost 10 percent of Lithuanian GDP. The situation of dependency might change, however, as the Butinge oil terminal with the annual capacity of 4 million tons started operating in July 1999, and if the main owner of Mazeikiu nafta Williams International reaches long term agreement with a Russian oil supply company.

The main groups exported from Lithuania to Russia have included road transport, live animals and animal products, food processing, petroleum products. The exports of these goods have recorded the largest decline. Trade in road transport, mainly re-exporting second-hand cars, has been particularly hit by the Russian crisis.

Table 4. Product structure of Lithuania's trade with Russia in 1998-1999, %

CN groups	Share of trade					
	Exports			Imports		
	1999	1998	Change	1999	1998	Change
Total	100	100	-66.8	100	100	-21.0
I Live animals, animal products	12.5	14.0	-70.4	0.3	0.7	-61.4
IV Prepared foodstuffs, beverages, spirits and vinegar, tobacco	9.7	7.2	-55.5	0.3	0.2	-0.9
V Mineral products	6.8	12.8	-82.4	72.2	67.4	-15.3
VI Products of chemical and allied industries	5.2	5.2	-66.6	2.4	3.7	-48.0
X Pulp of wood or of other fibrous cellulosic material, paper and paperboard and articles thereof	3.3	2.4	-54.6	1.4	2.1	-44.5
XI Textiles and textiles articles	9.1	5.9	-48.8	1.0	1.8	-56.3
XV Base metals and articles of base metal	4.4	3.2	-53.9	3.9	5.1	-38.8
XVI Machinery and mechanical appliances, electrical equipment, television image and sound recorders and reproducers	13.5	10.3	-56.7	8.3	6.3	3.3
XVII Vehicles, aircraft, vessels and associated transport equipment	14.7	24.4	-80.0	2.5	6.2	-68.5
Other	20.8	14.6	-	7.7	6.5	-

Source: Department of Statistics

5.3. The effects of the Russian crisis

The economic crisis in Russia was immediately felt by Lithuanian companies due to the intense trade links. The exports have decreased due to the fall in demand in the Russian and other CIS markets, and depreciation of ruble relative to the US dollar to which Lithuanian Litas is pegged³¹. The companies have experienced problems of payments and fulfillment of contract obligations by their partners in the eastern markets³². The banking sector, however, has been relatively unaffected by these problems as only 1.4 percent of commercial bank assets were directly linked to Russia at the start of the crisis³³. In 1998, the total profits of the banking sector in Lithuania amounted to 88.4 million Litas, while in 1999 this figure according to the preliminary estimates increased to 122.9 million Litas³⁴. The indirect impact on the banking sector has been felt through the sentiment of international markets (the risk premium to LIBOR increased after the Russian crisis from +0.5-1 to +2-2.5). Lithuania's ratings, however, remained stable.

The decrease in trade with Russia and other CIS has directly affected turnover and profits of Lithuanian enterprises. Two tendencies could be noted in this respect. First, the general profitability have recorded a fall in the period following the Russian crisis. Second, the gap between profitable enterprises and loss-making ones seems to have been increasing, i.e. the Russian crisis has played a role of a factor pushing for enterprise differentiation.

Table 5. Enterprise profitability (including loss-making enterprises) in 1997-1999, %

Source	1997	1998, I half	1998	1999, I half	1999
Central securities depository	4.2	-	2.5	1.8	-
Central securities depository (excluding loss-making enterprises)	7.5	-	6.4	8.7	-
National stock exchange	7.4	5.6	3.4	-1.9	-
National stock exchange (excluding loss-making enterprises)	9.9	9.7	8.6	10.1	-
Lithuanian Free Market Institute data base	5.8	-	3.8	-	2.2

Source: Lithuanian Free Market Institute

Although the data on enterprise profitability differs depending on the source, the fall of profitability from 1998 is a tendency common to all. The continuous fall in profitability is also recorded by business surveys conducted in Lithuania³⁵. The decline in profitability can to a large extent be attributed to the Russian crisis.

The data on enterprise profitability also shows increasing differentiation among profit-making and loss-making enterprises. Thus, data from the Central securities depository and the National stock exchange show that after the outset of the Russian crisis, the profitability of enterprises excluding loss-making ones has been increasing. The data on enterprises from the Lithuanian Free Market Institute show that while the difference in profitability between profit-making companies and general level profitability of all companies was 1.5 times in 1997, it reached 2.5 times in 1998 and

³¹ According to the Bank of Lithuania, from July to September 1998 only the Real effective exchange rate of Litas appreciated by 68.5 percent in respect to the main Eastern trading partners.

³² Baltic News Service, Rusijos krizė ir toliau slegia Lietuvos ūkį, November 30, 1999.

³³ Taro, L. Baltic economies in 1998-1999: effects of the Russian financial crisis, Helsinki: Bank of Finland, Institute for Economies of Transition, 1999, p. 13.

³⁴ Baltic News Service, January 27, 2000.

³⁵ See chapter on Enterprise indicators in Lithuanian Free Market Institute, Lithuanian macroeconomic indicators survey, Vilnius, 2000, forthcoming.

3.4 in 1999³⁶. The increasing differentiation of enterprises in terms of profitability is illustrated by the fact that, according to the Lithuanian Department of Statistics, the share of profit-making enterprises among the total number of companies surveyed in non-financial sector has remained constant and equaled about 50-60 percent³⁷. Therefore, while some enterprises managed to successfully restructure their activities and reorient sales towards other markets, the Russian crisis also revealed that a large share of Lithuanian enterprises experience problems of competitiveness and lack of ability to adjust. Problems experienced by the Lithuanian companies seem to be grounded in domestic institutional structures inhibiting ability to adjust and flow of resources between different branches of the market³⁸.

Although it should be noted that the number of bankruptcies has increased significantly recently. In 1999, according to the Ministry of Economy 247 enterprises were declared bankrupt, while in 1998 this number equaled 109. 207 enterprises were declared insolvent last and 94 of them started bankruptcy procedures in the beginning of year 2000³⁹. These factors have been reflected in the increase of unemployment (see below).

The downward trends have been recorded in dynamics of wages in Lithuania. The growth of wages, according to the estimates of the Department of Statistics, during the period of November 1998 – November 1999 have been only 4.2 percent against the forecasts of 14.2 percent growth that were released in March 1999⁴⁰. In the period from June to November 1999 average monthly net wages decreased by 1 percent⁴¹. Thus, the growth of wages has decreased significantly during the period following the start of the crisis. The household incomes in the fourth quarter of 1999, according to the estimates of the Department of Statistics, recorded a fall of more than 2 percent in comparison with the same period of 1998⁴².

The indirect macroeconomic effects of the Russian crisis have been reflected by low inflation, fall in domestic production and GDP as well as increase in unemployment. After the exports to the Eastern markets have decreased, the competition in the domestic market has been growing. The growth in competition accompanied by slowdown of income growth and real appreciation of Litas has resulted in decreasing inflation.

Diagram 9. Inflation dynamics in Lithuania in 1998-1999, %

³⁶ Lithuanian Free Market Institute. The data is collected from publicly available information provided by Lithuanian companies.

³⁷ Lithuanian Department of Statistics, Financial indicators of enterprises, Vilnius 1999.

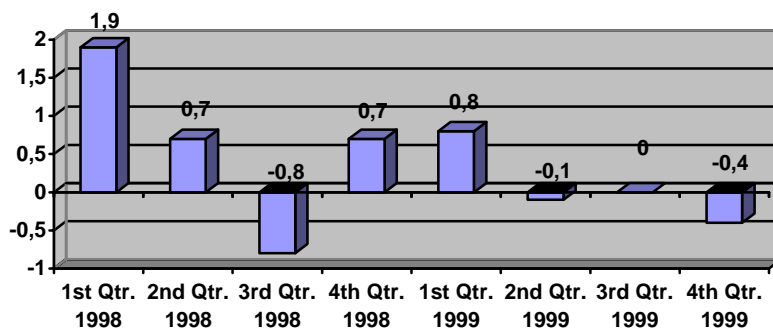
³⁸ For example the study conducted by several international financial institutions concluded that Lithuanian economy is the most regulated economy among the Central and Eastern European countries. See Foreign Investment Advisory Service, Lithuania. Administrative Barriers, Draft, July 1999.

³⁹ Baltic News Service, Daugeja nemokių ir bankrutuojančių įmonių, February 29, 2000.

⁴⁰ Ministry of Economy, Forecasts of Lithuania's economic and social development in 1999-2002, March 1999, 1 table.

⁴¹ Lithuanian Department of Statistics. Lithuanian economic and social development, 1999, No. 12, p. 53.

⁴² Baltic News Service, Lietuvos šeimų pajamos 1999-taisiais sumažėjo, February 29, 2000.

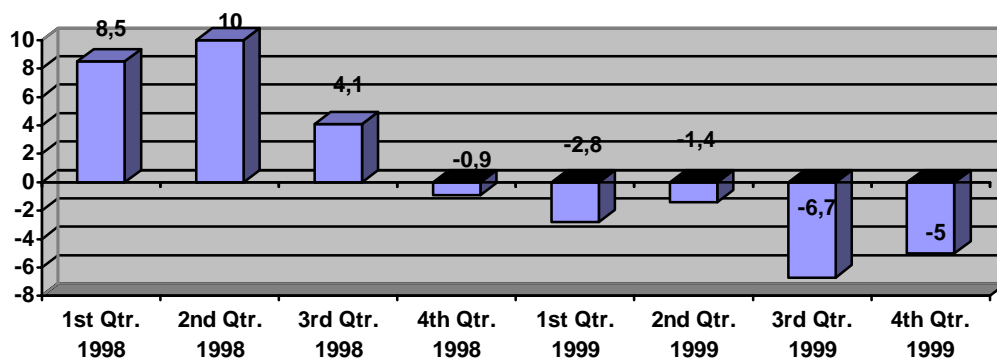


Source: Lithuanian Department of Statistics

In 1998 (December to December) the increase of general prices of consumer goods equaled 2.4 percent while in 1999 inflation was as low as 0.3 percent. This has been the lowest indicator among the Central and Eastern European countries.

The domestic production in Lithuania has been also impacted by the Russian crisis. However, it should be taken into account that oil processing plays a major role in Lithuanian industry. As it was noted before, the disruptions of crude oil supply represent a variable, which seems to be more important in its effect on industrial production than the Russian crisis. For example, during the period of January-November 1999 sales of oil processing industry have decreased by 35.1 percent in comparison to the same period in 1998⁴³. This factor needs to be taken into account also when assessing GDP dynamics in Lithuania.

Diagram 10. GDP changes in Lithuania in 1998-1999, % as compared to the corresponding period of previous year



Source: Lithuanian Department of Statistics

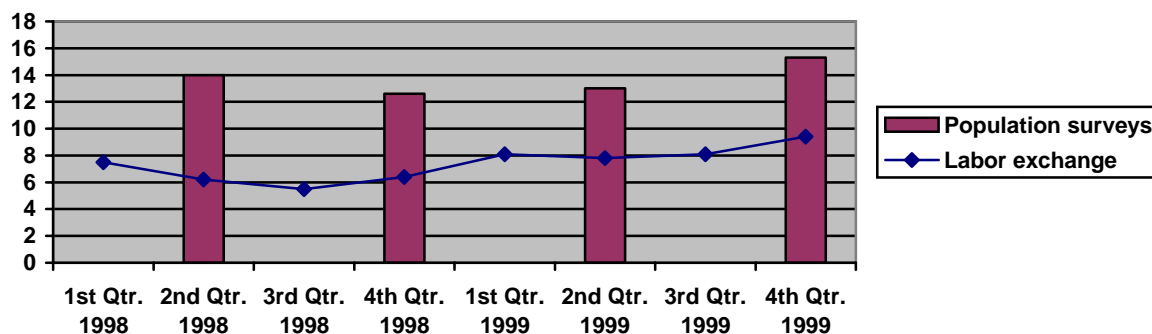
The GDP growth in Lithuania was positive in 1998 and equaled 5.1 percent, although decreasing from 7.3 percent growth in 1997. According to the recent estimates of the Department of Statistics, in 1999 Lithuania's GDP has declined by 4.1 percent. This compares unfavorably with Latvia where GDP increased by 0.1 percent and Estonia where the fall of GDP was limited to 1.5 percent⁴⁴. Even taking into account the weight of the oil processing industry and Ignalina nuclear power plant (which produces around 80 percent of energy in Lithuania and which was not operating for some time in Spring 1999) there seems to be a link between the external crisis and the level of the domestic economic activity.

⁴³ Verslo žinios, Pramonė augs nepaisydama valdžios strategijos, January 31, 2000, p. 8.

⁴⁴ Baltic News Service, Lietuvos BVP pernai smuko 4.1 proc., April 7, 2000.

This is also reflected by the data on employment situation in Lithuania. It has been noted that the effects of the Russian crisis have been delayed in Lithuania in comparison to the other Baltic states. The dynamics of the level of unemployment in Lithuania illustrates gradual increase reaching 10 percent level in the end of 1999 with possible further increase in year 2000. The reports from the companies also show a significant increase in a number of groups made redundant in the second half of 1999⁴⁵. In a survey conducted by the Lithuanian Department of Statistics in October 1999, 24.9 percent of enterprises polled indicated that they experienced problems because of the Russian crisis and took decisions to reduce a number of employees, to have them employed part time or give them unpaid leave⁴⁶.

Diagram 11. Level of unemployment in Lithuania in 1998-1999, %



Source: Lithuania department of Statistics

The level of unemployment in Latvia and Estonia has been somewhat lower than in Lithuania. In the end of 1999, according to the data of labor exchange the level of unemployment in Latvia stood at 9.1 percent while in Estonia it equaled to 5.2 percent. Statistical surveys show that unemployment level in Latvia was 14.5 percent, in Estonia – 11.7 percent⁴⁷.

The indicators show that since the end of 1998 economic recession has been taking place in Lithuania. It has been triggered by the external factor, namely the Russian crisis. However, the developments that followed after August 1998 have been affected to a large extent by the government policies taken in response to the decline in exports and demands of the interest groups as well as existing economic structures in Lithuania, some of which have been the legacy of uncompleted economic reforms. The latter refer mainly to the slow progress in restructuring the economy, in particular in sectors of agriculture and energy.

5.4. The political economy of the policy response

The decision to devalue the ruble taken by the Russian authorities in mid-August 1998 initially was not followed by any response from the government of Lithuania. The initial response of Lithuanian authorities consisted mainly of denying any impact of the Russian crisis on Lithuanian economy. The policy that followed later could be mainly characterized as (1) decisions concerning targeted protection measures, (2) decisions to negotiate with Russian authorities, and (3) non-decisions on adjusting fiscal policy to the changing realities of Lithuanian economy.

After Lithuanian exports have decreased significantly and a number of demands from enterprises for protection have been voiced, the government reacted by adopting a resolution which has set a number of protection measures and established a Crisis monitoring center in the Ministry of Economy. The Resolution No. 1122 on temporary measures to facilitate exports of Lithuanian

⁴⁵ Baltic News Service, Daugėja grupinių darbuotojų atleidimų, March 23, 2000.

⁴⁶ Verslo žinios, Daugėja nevisiškai užimtų žmonių, November 11, 1999, p. 6.

⁴⁷ Lithuanian Department of Statistics. Lithuanian economic and social development, 2000, No. 1, p. 124.

goods, protect the domestic market and strengthen the presence of Lithuanian companies in it was adopted in September 17, 1998. These measures included tax allowances for the local enterprises, extension of guarantees, trade protection measures (increase of import tariffs for agricultural and food products, non-tariff barriers such as customs evaluation, product quality standards, compulsory certification, antidumping and countervailing measures), discriminatory treatment against foreign companies in the domestic market (preferential public procurement rules).

These market protection measures have played a role of a factor, which postponed the transmission of the crisis effects to the Lithuanian economy in comparison to the other neighboring markets. However, they did not represent an adequate response to the external shock. By being selective they provided temporary protection only for certain enterprises, the choice of which was not based on transparent criteria. By protecting domestic companies and restricting competition in the domestic market they further postponed the restructuring which was in some cases already overdue, created false expectations and reduced incentives for protected companies to increase productivity. By providing financial incentives and guarantees they have strained the budget which soon became even more strained by the contraction of the economy. Finally, by being discriminatory, these measures have provoked negative reactions from other trading partners (for example, other Baltic states), international institutions and they would not be tolerated when Lithuania becomes part of the Single market.

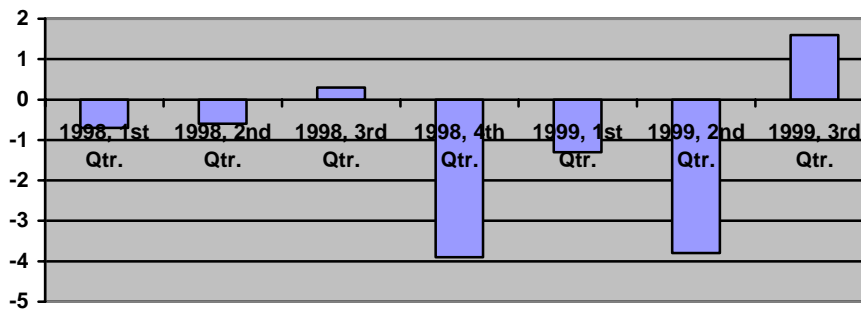
Another type of decision that was part of the government's response was directed towards external environment, namely the Russian authorities and the EU. It was intended to negotiate better trade conditions with the Russian authorities and sign agreements on liberalization of trade, removal of other barriers to trade, avoidance of double taxation, etc. It was also decided to start negotiations with the EU on increasing export quotas for certain food products. A number of agreements between Lithuania and Russian Federation were signed in 1999, although their impact remained negligible. Negotiations with the EU on liberalizing trade in agricultural goods have not been successful so far, although in 1999 the European Commission acknowledged the need to reconsider its policy on trade in agricultural products. At the same time, the EU initiated antidumping cases against several manufacturing companies in Lithuania.

Finally, the third characteristics of policy response to the external crisis have been non-decision on the budgetary issues. The government failed to react appropriately to changing economic situation and to reconsider its fiscal policy. Even in October 1998, the government officials including the Minister of Finance were still insisting that GDP growth in 1999 would reach 7 percent, and that taxes collected will increase by 14.1 percent⁴⁸. On the one hand, significant fall in exports and resulting contraction of economic activity and consumption reduced the tax base and revenues into the budget. On the other hand, increased support for enterprises, agricultural in particular, as well as continued financing of the large infrastructure enterprises have resulted in increasingly higher spending levels. For example, in 1998 direct budgetary support to agriculture increased by 25 percent in nominal terms, or around 20 percent in real terms⁴⁹. These subsidies have been channeled through the Rural Support Fund, Market Support and Export Promotion Agency, Agriculture Guarantee Fund and Marketing Regulation Agency. These factors led to the expansion of the fiscal deficit.

Diagram 12. National budget in 1998-1999, % of GDP

⁴⁸ Verslo žinios, Bus naujoviškas biudžetas, October 2, 1998, p. 2.

⁴⁹ IMF estimates.



Source: Lithuanian Department of Statistics

Consolidated budget revenues in 1999 went down by 3.8 percent in comparison to 1998 while expenditures increased by 20.6 percent⁵⁰. Excluding privatization revenue the deficit in 1999 increased to above 8 percent of GDP. The fiscal situation was also made more complicated by the commitment of the government to provide guarantees or loans for large infrastructure companies including Mazeikiu nafta. The precise amount of state financial support given after the August 1998 to the enterprises is difficult to estimate because it took different forms including refinancing of private loans with government loans, extension of existing government loans, guarantees on new loans, payment of called guarantees, writing down equity. To finance part of the deficit, the Lithuanian government has been borrowing extensively on both domestic and foreign markets. At the end of 1999 state debt has increased by 25 percent in comparison to the end of 1998 and reached 28.5 percent of forecasted GDP.

5.5. The outcome

The impact of the Russian crisis on the Lithuanian economy and the government response provides the ground for the following observations.

The negative impact of the crisis on Lithuanian economy to a large extent was inevitable due to intensive trade links of Lithuanian companies to the Russian market. The biggest declines of sales have been recorded in the sectors that had intense trade relations with the Eastern markets. These sectors include the processed agricultural products, meat, milk and grain in particular, processed oil products, machines and equipment, paper, textiles and chemical products. Enterprises that have been trading with the EU such as fur or clothing have been increasing their sales. In the end of 1999, some enterprises from electronics, food processing, textiles reported increase in sales to the EU and Russian markets. In general, there seems to be a relatively large number of competitive enterprises that have been possessing internal resources to increase their productivity, especially taking into account the fact that Lithuania's exports have increased in 1999 by almost 7 percent with US dollar appreciating against euro by about 15 percent during that year.

In general, the external shock increased the pressure to restructure, and there seems to be an increasing differentiation between competitive companies and those that experience further difficulties. There have been natural limits to the extent of the restructuring of the economy, because many of enterprises that were exporting to Russia did not possess the competitive advantages to be used in other, especially in the EU market. The adjustment of these companies requires major restructuring.

⁵⁰ See Hansabank Markets, The Baltic Overview, Tallinn: the Hansabank, Quarterly Macro Overview, 10.02.2000, p. 28.

The active protectionist policy of the government, however, have reduced the external pressure to adjust at the same time creating expectations that the responsibility for dealing with the difficulties rests with the government. The government intervention, which in some cases represented the continuation of previous policy, reinforced false expectations of enterprises and resulted in the sub-optimal solutions.

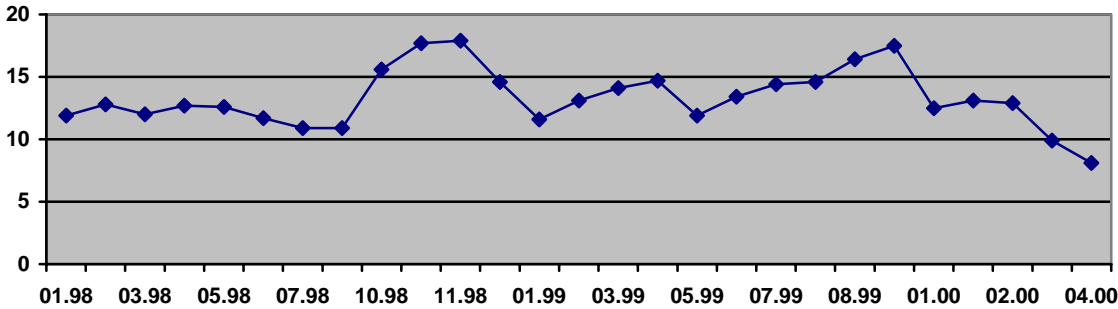
Active policy of support combined with inappropriate reaction in respect to the fiscal policy, have strained the budget and resulted in postponing the problems into the future. The outcome was delayed but the final result has been deeper economic decline, reduction of tax base and higher uncertainty about the abilities of the state to fulfill its obligations. The latter was reflected by increasing interest rates on T-bills. Interest rates on one year maturity T-bills reached 17.5 percent in September 1999, similar level to the one just after the start of the crisis in 1998 (see Diagram 13).

However, the following developments provide some ground for optimism. The new government formed in Fall 1999 headed by Prime Minister A. Kubilius declared the intentions to take necessary decisions including restrictive fiscal policy and restructuring of the economy. Already at the end of 1999 the cutting of some expenditure items, including wages in public sector, was undertaken. The program of compensating rube deposits, which was consuming 2/3 of country’s privatization revenue was frozen. This policy is likely to be continued after the stand-by agreement with the IMF was signed in March 2000.

The Memorandum of Economic Policies of the government of Lithuania and the Bank of Lithuania for the period January 1, 2000 – March 31, 2001, have set the measures that are supposed to end the financial instability and create conditions for sustainable economic growth. The strategy to be pursued consists of the three main items: (1) maintenance of the currency board in its present form, (2) a major reduction in the general government fiscal deficit (to 2.8 percent of GDP this year), (3) implementation of a set of structural reform policies, including the restructuring of agriculture and energy sectors.

The policy measures also include reduction of subsidies, ending the practice of using privatization proceeds to support companies, inclusion of extra-budgetary funds into the annual government budget and other measures to increase the transparency of fiscal policy. Finally, the program includes measures to expose companies to markets pressures, to eliminate the import protection which was introduced in the Fall 1998 and to deregulate business environment. These measures, if implemented, are likely to remove the major obstacles that impeded the adjustment of the economy in response to the external shock. As a result of these policy intentions, the interest rates have gone down significantly in the first months of 2000. The interest rates for one year maturity T-bills went down to 9.9 percent in March 2000.

Diagram 13. Interest rates of one year maturity T-bills, 1999-1998



Source: Bank of Lithuania

Aside from the prospects of improved government policy, the resumption of economic growth in Lithuania is expected to be facilitated by growth in the neighboring markets. Expected economic growth in the EU, Germany and Nordic countries in particular, will have a positive impact on Lithuanian economy as exports are likely to increase⁵¹. For example, the European Central Bank expects a growth of euro-zone GDP exceeding 3 percent⁵². Growth of Latvian economy which has become the second largest Lithuania's exports market is expected to reach 3 percent. Although the price of oil is not likely to grow further, both local and foreign analysts forecast growth of Russian GDP of around 2 percent after a growth of 3.2 percent in 1999⁵³. It should be taken into account, however, that in January 2000 Russia with 4.9 percent of the share of Lithuanian exports was not among the main export markets⁵⁴.

The growth of Lithuanian exports exceeding 30 percent in January 2000 and growth of manufacturing of more than 10 percent in the first two months of year 2000 could be indicating the recovery of the economy.

Table 6. Forecasts of Lithuanian GDP growth in year 2000, %

Source	Date of releasing the forecasts	2000 (forecasts)
European Commission ⁵⁵	2000.02 1999.08	2.8
The Economist Intelligence Unit ⁵⁶	2000.02 1999.09	1.0 2.5
International Monetary Fund ⁵⁷	1999.09	4.0
Skandinaviska Enskilda Banken (SEB) ⁵⁸	2000.02	0.5
ABN AMRO ⁵⁹	1999.11	3.5
"Williams de Broe" ⁶⁰	1999.11	3.5
Handelsbanken ⁶¹	2000.01	2.0
Hansabank Markets ⁶²	2000.02	2.8-3.4

It should be noted that these forecasts were released before the GDP data for the whole year 1999 was announced. The GDP decline, which was larger than expected might influence the revision of GDP forecasts downwards. The assumption of GDP growth of 2 percent in 2000 made in the Memorandum of Economic policies of the Lithuanian government announced in March 2000 seems so far to constitute the upper limit of most current forecasts of economic growth in Lithuania.

⁵¹ See Hasabank Markets, The Baltic Overview, Tallinn: the Hansabank, Quarterly Macro Overview, 10.02.2000, p. 3.

⁵² Financial Times, Euro-zone data lift growth prospects, April 3, 2000, www.ft.com.

⁵³ Deutsche Bank Research, Economic and Financial Outlook, March 20, 2000, p. 46.

⁵⁴ Baltic News Service, Lietuvos užsienio prekyba sausį atsigavo, March 10, 2000.

⁵⁵ Uniting Europe, No.50, 2000.02.07., p.11.

⁵⁶ EIU, Lithuania. Country Report, August 1999, p.10., Verslo žinios, 2000.02.09, p.12

⁵⁷ Ibid.

⁵⁸ Baltic News Service, Lietuva dar neveikė ekonominės krizės, teigia SEB, February 18, 2000.

⁵⁹ Verslo žinios, Vakari Baltijos šalis vertina skirtingai, 99.11.19, p.12

⁶⁰ Baltic News Service, Baltijos šalių ekonomikos atsigaua - vietos valiutoms pavojų nėra, 1999.11.02.

⁶¹ Baltic News Service, Lietuvos ekonomikos perspektyvos prasčiausias, 2000.01.25

⁶² Hansabank Markets, The Baltic Overview, 2000.02.10, p.29.

6. Conclusions

This study has addressed the impact of Lithuania's membership in the EU on Lithuania's economic relations with Russia as well as the impact of the Russian crisis on Lithuania. It also provided a framework for future studies that could investigate specific aspects of relationship between the changes in external environment and domestic economic and political processes in Lithuania. The main findings of the paper are summarized below.

- (1) The general economic impact of EU membership on Lithuania is likely to be insignificant. Both the EU and Lithuania apply relatively low import duties for Russian products. Major changes might be possible on the level of concrete products. Protection in the agricultural sector is likely to increase. While major Lithuania's import groups from Russia such as mineral products will not be affected, further analysis is needed to evaluate the impact on other product groups.
- (2) Another area where the potential impact on trade with Russia is still uncertain is the adoption of the Single market rules relating to the products quality standards, certification procedures, etc. These rules might turn into non-tariff barriers once Lithuania joins the Single market. The elaboration of the mutual recognition agreements between the EU and Russia is important for Lithuania in this field.
- (3) Adoption of the EU Common Commercial Policy will have an impact on use of commercial protection instruments and on preferential trading regimes. The use of commercial policy instruments might increase. Lithuania will have to abolish its free trade regime in industrial goods with Ukraine. It will join a number of preferential agreements that the EU has established with its trading partners. This will provide additional opportunities for Lithuanian enterprises.
- (4) Lithuania's membership in the EU will also change the institutional structure of foreign trade policy. The responsibilities for the formulation and implementation of the external trade policy will be delegated to the EU institutions. This is likely to affect the lobbying power of domestic interest groups. The resulting change in the relative lobbying power needs to be analyzed further. This could be done with the help of the Scheme on policy process presented in the Section 5.
- (5) EU membership will change the contractual basis of Lithuania's relations with Russia. Lithuania will join EU initiatives such as the Partnership and Co-operation agreement and the Northern Dimension and will denounce current agreements with Russia. Joining the EU provides an opportunity for Lithuania to strengthen its bargaining power versus Russia. It is likely to increase the frequency of official contacts with Russia in the framework of EU-Russia meetings. Currently, the issue of the status of the Kaliningrad region inside the enlarged EU provides an opportunity for Lithuania to establish its position in the context of EU-Russia relations. In the future, the most beneficial scenarios for Lithuania's economic relations with Russia is Russia's membership in the WTO and the establishment of the EU-Russia free trade area.
- (6) The experience of the impact of the Russia crisis on Lithuanian economy shows that there is a need for the completion of the structural reforms in Lithuania, including energy, agriculture, social fields, etc., and for the clear separation of the market sphere from the state functions. The main lesson is that transition reforms constitute an interrelated package and insufficient privatization and deregulation in some areas is likely to cause economic difficulties for the entire economy. The state institutions need to send a clear signal to enterprises that adjustment to the market changes need to be dealt by improving the productivity and competitiveness of the companies. The state institutions can contribute by establishing a predictable environment and equal treatment to all enterprises instead of providing targeted domestic protection. The measures taken in response to the Russian crisis have been both inefficient and would not be acceptable when Lithuania becomes part of the Single market.
- (7) The main priority for state institutions with a view to the future Lithuania's accession into the EU is to present the companies a medium-long term integration strategy based on potential impact of joining the Single market and Economic and Monetary union on Lithuanian economy.