CONTEMPORARY ISSUES IN BUSINESS, MANAGEMENT AND EDUCATION‘2015
eISSN 2029-7963/eISBN 978-609-457-867-0
doi:10.3846/cibme.2015.09

Foreign Market Selection Methods in a Changing International Trade Environment: the Case of Lithuanian SMEs

Sigitas Brazinskas

Faculty of Business Management, Vilnius Gediminas Technical University, Vilnius, Lithuania
E-mail: sigitas.brazinskas@vgtu.lt

Received 29 October 2015; accepted 27 November 2015

Abstract. International business environment is changing: globalization, trade sanctions, domestic regulations, international operations across different cultures, importance of communication, demand of sustainable supply chains and other factors force companies to diversify their markets continuously, adapt foreign market development strategies and meet market requirements at a large scale. A dilemma for SMEs is obvious as the future road in foreign market selection is uncertain: global or regional approach has to be followed. The objective of this paper is to unravel and assess market selection methods and market diversification situation as well as analyze their future strategic international trade trends in regional and global perspective. Implemented on-line survey of 450 Lithuanian vendors aimed to unlock and answer methods used in market selection, analyze market diversification situation and assess future approach towards regional and global development. The survey results reveal the perspective of Lithuanian vendors regarding their approach to use market selection methods, a demand of more formal and research based approach as well as development components versus promotion. By incorporating view on diversification, market selection methods and future market entries methods, the paper provides with a more complete view on international trade strategies development set for SMEs and their five-year vision of regional integration approach.

Keywords: exports, export driven, international trade, country studies, diversification, regionalization, regional integration.

JEL Classification: F100, F15, O18.

Conference topic: Internationalization Processes: Contemporary Challenges.

Introduction

World economies and global trade face continuous challenges. Bilateral sanctions have been applied by the EU and Russia. It caused changing trade between these large economies and made a significant impact in companies development where the trade nature has been steady and predictable for decades. The Transatlantic Trade and Investment Partnership (TTIP) is in negotiation process, the transatlantic relationships define a shape of the world economy. Despite a number of actors aiming to support the development of global trade, apply rules and monitor adherence of those rules, help resolve disputes and promote deeper integration of countries, however, the progress at the WTO in creating new rules and updating older ones has been slow (Koopman 2015). The current international business environment is uncertain and requires constant policies review by trade policy makers, implementers, facilitators and in particular business itself.

Under such circumstances the business and SMEs have to find and adjust to new market conditions, diversify existing and explore new markets. SMEs might have limited resources in production, R&D, financial and human capital, any new action requires to review and assess growth opportunities. Therefore the most efficient market entry tools have to be applied, costs saved and resources directed to implement the long term growth strategy. SMEs have to be assisted in guiding their international development strategies by knowledge based actors as universities, business promotion organizations, business advisers, trainers.

The benefits of entering new markets are tightly connected to risks and costs. It covers knowledge driven transfer of home-based competitive advantage to foreign markets. In general, being “foreign” sharply increases the challenge of being “new” to a market (Coeurderoy *et al.* 2012). There is a myth that only large MNEs usually do business abroad and SMEs mostly operate domestically. Even some start-ups attempt to do business abroad from inception (Peng 2011). A classic market development strategy is extending the geographical reach, either within home country or exporting. Any expansion is connected to a risk where market risk is the exposure of potential loss from diminishing sales or margins in market conditions, trade barriers, transport costs, cultural awareness (Chapman

2006). However, to apply the market expansion strategy, SMEs have to know, select, study and make a market research on which markets this strategy has to be directed.

There are different proximity dimensions such as cognitive, geographical, social, organizational and institutional. Such constellation reduce collaboration costs or risks. The proximity school has developed an idea that proximity is crucial for economic activities. Effectively utilized resources, saved time, assessed foreign market opportunities and focus on development strategy are key benefits for SMEs to adjust and implement their growth strategies. Market entry costs are often higher in developing countries because of weaker institutions and more cultural dissimilarity. These results suggest that economic diplomacy should be focused on countries with substantial market entry barriers such as developing countries and less focused on the type of firms (Creusen, Lejour 2013; Boschma *et al.* 2014).

Therefore the purpose of this paper is to assess market entry methods, share existing practice and identify suitable solutions to entry foreign markets. In addition, as it has been stated regarding the expectedly limited resources available by SMEs, a hypothetical approach has been developed on foreign market number covered by SMEs and 5-year strategic development towards global and regional approach.

Theoretical background on global and regional approach by foreign market selection methods

The latest statistics on global trade provide with insight and trends. There are clear signals that the trade after the dynamic growth and recovery after 2009 financial crisis has reached a stagnation or even decline in 2013–2014 (Table 1). On the global level the EU share has a tendency to be stable or even shrink. When foreign markets have opportunities with unclear future trends, business is forced to find a proper development strategy and focus on it by selecting foreign markets and apply respective market selection methods.

Internationalization is a process, end result, and way of thinking whereby a company becomes more involved in and committed to serving markets outside its home country through licensing, exporting, manufacturing in a host country and investing (Albaum, Duerr 2011). However, it is not a more precise definition than globalization. The geographic expansion in internationalization is more modest and open. Paradoxically, internationalization is a national or local phenomenon and the term local responsiveness reduces a globalizing trend (Sorge 2005).

When a firm decides to enter a foreign market, there are several methods to do it: exporting, turnkey projects, licensing, franchising, joint ventures in a host-country firm or setting up a wholly owned firm. Many companies start from exporting and only later switch to other mode. Exporting provides with two major advantages as it allows to avoid substantial costs in the host country and achieve experience curve (systematic production cost reductions which occur over the life of a product). On the other hand, this mode has significant disadvantages as high transport costs, trade barriers (Hill *et al.* 2014). A supplier direct model provides with high scalability, low operational and financial risk (Vashistha, A., Vashistha, A. 2006).

A number of case studies has shown that North American companies focus on following attractive areas: Eastern Europe (50%), North America (39%), China (38%), Central and Eastern Europe (28%), India (18%), Brazil (14%), Russia (11%) and are mainly expanding into Europe (Fortune 2015). In Africa, only 12% trade is done across African countries. Latin America, too is lagging behind, with only 21% of all trade being intra-regional compared to 50% in Asia and 70% in Europe (Hetland 2015). The level of regional cooperation on trade in services significantly differs in the EU (5%) and among Nordic countries (89%). Intra-Nordic service trade is greater by 84% than intra-EU trade by accounting economic and geographical conditions and cultural similarities. EU borders create more barriers to trade than the Nordic (Jervelund, Stefansdotter 2013). This has been the pattern over the period 2002 to 2013. Indeed there has been stability in partners within the EU over this period, particularly for the larger goods exporting countries. There is more change for smaller goods exporters, and in particular there is some evidence of a greater proportion of goods exported to geographically closer partners than was the case at the start of the period. For example the proportion of goods exported between Estonia, Lithuania and Latvia has increased while the proportion going to more distant EU partners has fallen (Eurostat 2015b). This was defined by a number factors and initiatives which led to closer regional cooperation. The Nordic countries, as well as the countries around the Baltic Sea, are part of not only regional integration but also globalization, The Nordic and the Baltic Sea Regions are linked together in many ways. On the way is to see which countries are included in both the Nordic and Baltic Sea cooperation, it is also expected to be seen an increased involvement of the private sector in the regional cooperation. Most of the countries around the Baltic Sea are relatively small with open economies in which trade and foreign investment are having great importance (Nordam 2014; Lindegaard 2014; Andersson 2015).

Seppälä (2015) argues that high exports do not always translate into high value added. Furthermore, changes in the share of exports do not necessarily lead to significant changes in national GDP. However, the findings also demonstrate that cooperation with Scandinavian companies can strengthen the competitiveness of Lithuanian vendor firms through increased value added in terms of their products and services and through their growing ability to take on not only routine transactional tasks but also more creative ones, including services and innovation (Slepniov *et al.* 2013).

Distance between two countries could manifest itself along four basic dimensions: cultural, administrative, economic and geographic (CAGE). This framework helps to identify and assess the impact of distance on various industries. In general, the farther a country is from a SME operating home-country, the harder is to conduct business in that country. Geographic distance might affect transport and communication costs or other transaction costs where cultural dimension would impact consumers preferences, way of doing business and other important areas such as way of establishing contacts, communication itself due to similar business culture, understood languages or social norms (Ghemawat 2001; Huwart, Verdier 2013).

Table 1. Global trade and share of regions and countries (Source: Eurostat 2015a)

	2011	2012	2013	2014		2011	2012	2013	2014
Global exports of goods, bn. EUR*	10347	11487	11332	11317	Global imports of goods, bn. EUR	10541	11717	11462	11469
Change to previous year, %	15.17	11.02	–1.35	–0.13	Change to previous year, %	14.39	11.16	–2.18	0.06
EU 28 share, %**	15.02	14.66	15.32	15.04	EU 28 share, %	16.36	15.33	14.70	14.65
China share, %	13.17	13.88	14.68	15.58	China share, %	11.88	12.08	12.81	12.86
USA share, %	10.29	10.47	10.49	10.79	USA share, %	15.43	15.52	15.29	15.81
Japan share, %	5.71	5.41	4.75	4.54	Japan share, %	5.82	5.88	5.47	5.39
Global exports in services, bn. EUR	2350	2682	2719	2839	Global imports in services, bn. EUR	2343	2666	2707	2841
Change to previous year, %	6.82	14.13	1.38	4.41	Change to previous year, %	6.60	13.79	1.54	4.95
EU 28 share, %	25.96	25.17	26.08	25.85	EU 28 share, %	20.15	19.28	19.62	20.52
China share, %	5.62	6.26	5.74	5.92	China share, %	7.30	8.21	9.20	10.14
USA share, %	19.19	18.98	19.01	18.81	USA share, %	13.36	13.13	12.86	12.67
Japan share, %	4.21	3.88	3.75	4.30	Japan share, %	5.38	5.40	4.77	5.07

Geographic proximity growth in neighbouring markets is a start in internationalization process for a SME. A domestic market is not excluded. However, often based on limited growth opportunities on a local market, firms consider market access potential in other markets where neighbouring countries are a potential destination in the first stages of international expansion (Brazinskas, Beinoravičius 2013). This approach is clearly demonstrated by benchmarking of three Baltic States and their export opportunities in regional dimension (Fig. 1). Estonian export potential in geographical proximity based countries by using distance between two countries is utilized by a much higher degree.

Total foreign sales (exports and sales related to FDI) fall with geographical distance, but it constitutes a larger cost for exports than for FDI. On the other hand, "soft" barriers, i.e. language, culture and institutions, are particularly important for international business. This can be explained from the fact that local presence entails a relatively deep involvement with and exposure to local cultures and institutions (Lankhuizen *et al*. 2011).

An analysis has shown that country-specific risk affects a firm's choice of serving a foreign market by exporting or by opening a foreign affiliate. It also has been found that cross-country risk patterns affect the firm's decision about the location of production and, thus, the patterns of trade flows and affiliate sales across countries (Ramondo *et al*. 2013).

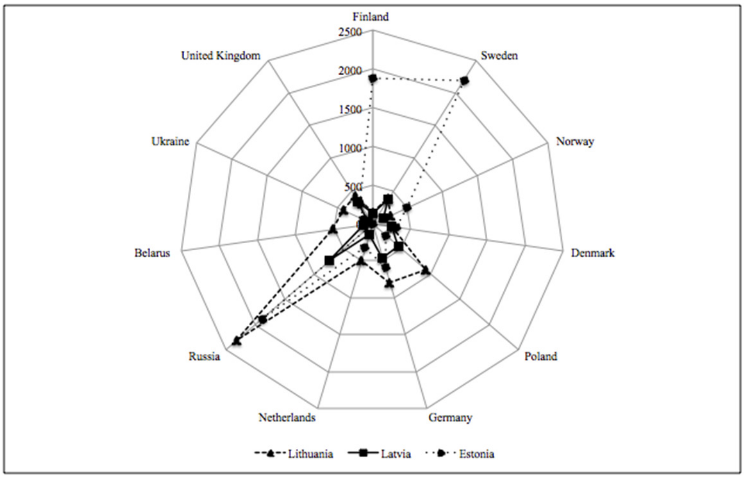

Fig. 1. Export per capita to different foreign countries among the Baltic States, USD (Source: Trademap 2014)

As indicated earlier, Lithuanian transportation, logistics and food processing sectors were hit my sanctions applied by Russia in 2014, it is much more difficult to substitute Russian market, because these sectors were for many years developed taking into consideration preferential Lithuanian geographic position between Russia and EU (Zdanavicius 2014).

Review of existing approaches has caused a need to compile a survey among SMEs by identifying their methods on market selection as well as assess the degree of global and regional approaches on foreign market selection.

Market selection research methodology and findings

The research goal was to meet hypothesis on market selection and entry methods by applying importance of geographic proximity, local approach and neighboring markets as deciding factors of international expansion. This approach was inspired by a need to diversify Lithuanian exports where the share of Russia has fallen by 33.6% in IQ 2015/2014 (Enterprise Lithuania 2015). Hence a stimulus appeared to diversify and find new markets. Just the question should be answered: where market growth efforts have to be directed? There have been different advices to look globally and explore markets which have not considered previously. Therefore, an on-line survey of 450 Lithuanian companies was conducted. They were approached during the period August–September 2015. The main objective of the survey was to discover the perspectives of companies regarding their relationships with methods used in foreign market selection, evaluate the degree of a perspective to regional integration and discover linkages between a hypothetical approach on market selection methods and survey results. The sample of vendors was selected from a group of Lithuanian companies (there are nearly 76,000 existing SMEs in Lithuania with 58% of international activities). In January–August 2015, total Lithuanian exports to Nordic and Baltic countries (Sweden, Denmark, Finland, Norway, Estonia and Latvia) accounted for 27% while additionally including markets on geographic proximity (Poland, Germany and Belarus), this figure is 50% (Debifo 2015; Official statistics portal of Lithuania 2015). In 2011, total exports to some findings in a previous research show that Nordic countries have slightly dominant roles as "bridges" for further regional and global integration of Lithuanian companies (Slepniov *et al*. 2013).

"Born global" approach is used when companies have more than 25% export in total turnover. Such number is in average 1/3 of all companies. The remaining companies are minor players on international markets or stay locals (Schröder 2014). The survey has shown that among companies such "stay local" were close to 40% where the remaining SMEs had global international operations, experience, capacities and a number of export markets served (Tables 2 and 3).

Table 2. SMEs export share and international operations (Source: own research)

Export share in total sales, %, 2014	<25	25–50	50–75	>75
Share of SMEs according to export sales, %	37	18	12	33
Local or global activities	Stay local	Born global		

The study used a new firm-level dataset with information on exports by product and destination country emphasizes that company's available previous export experience is an important success factor for future export decisions. The analysis shows that previous experience exporting a certain product, or exporting to a certain market, increases the probability that a firm will export those products to new markets, or export new products to the same markets. These findings suggest that previous experience may be an important way to reduce entry costs in new products, and in new markets, and that entry costs are product, market, and product-market specific. In addition, firm characteristics, such as the size of the firm (total exports), or its export concentration (in terms of product-market pairs), are important factors of the decision to export (Álvarez *et al*. 2013).

Table 3. Number of export markets, their share among SMEs and export concentration degree (Source: own research)

Number of export markets	Share of number of export markets, %	Degree of export concentration C
0	2	–
1	10	1
2	8	0.5
3	13	0.33
4	9	0.25
5	11	0.2
6	9	0.167
7	4	0.14
8	1	0.125
9	4	0.11
10 and more markets	29	0.1
Total	100	

As the survey shows 63% of SMEs are global players with international operations. The further goal was to identify number of foreign markets served and define market concentration. This is analyzed by using Herfindahl index.

Degree of export concentration is defined by Herfindahl index:

$$C = \sum S_i^2 \text{ , } i = 1, 2, \ldots, n \text{ countries,} \tag{1}$$

where C – the export concentration index for the firm;
S_i – exports to country i as a percentage of the firm's total exports:

$$\sum_{i=1}^{n} S_i = 1. \tag{2}$$

Maximum concentration ($C = 1$) occurs when all the export is made to one country only where minimum concentration ($C = 1/n$) exists when exports are distributed over a larger number of countries. In such way companies can apply market concentration strategy (resources are channeled to a small number of markets) or market spreading strategy (resources over a large number of countries) (Albaum, Duerr 2011).

The survey shows clear evidence that Lithuanian SMEs have substantial production, financial and human resources to cope with 10 and more export markets (Table 3). Close to 30% of companies cover such number. Other number of covered markets from 2 to 6 use more than a half of all companies. The results show that the majority of companies use market spreading strategy where the concentration index C varies from 0.1 to 0.5. Concentration $C = 1$ is taken by 10% of Lithuanian SMES only and this is a clear evidence on used diversified market approach as well as ability to replace withdrawn traditional export markets.

As market spreading strategy is dominating (companies cope 10 and more markets, other threshold is 2–6 markets), the further goal was to identify global or regional approach will be used within 5-year perspective.

By selecting markets, managers are influenced by three distances (psychological (uncertainty to find relevant information, low awareness of foreign markets), cultural (managers own attitude towards a certain market) and geographical (proximity)) (Albaum *et al*. 2005). From the point of view of location and distance from headquarters, companies can locate their activities: in close proximity (domestically), at a medium distance – nearshoring (narrow geographic scope); and at a great distance – offshoring (wide geographic scope) (Slepniov *et al*. 2013). This combined approach was observed by analyzing market selection methods applied by Lithuanian SMEs during market selection strategy and international growth (Fig. 2). While entering foreign markets with export operations, 60% of companies use neighboring markets (systematically and often, see left column, bottom). In contrary, market research and to follow other companies export strategies (to play a role of followers), are used by a one third of companies. Accidental market selection and external recommendations are used by 20% of companies only. The research has to draw attention to two methods as systematic market research and external recommendations used by 1/3 and 1/5 of companies respectively. There is a clear gap in knowledge based approach to use market research principles and analysis of other knowledge based stake holders and actors as consulting, research and training companies, universities. Companies prefer to enter, expand and use an understood and on cultural similarities and geographic proximity based foreign market selection methods.

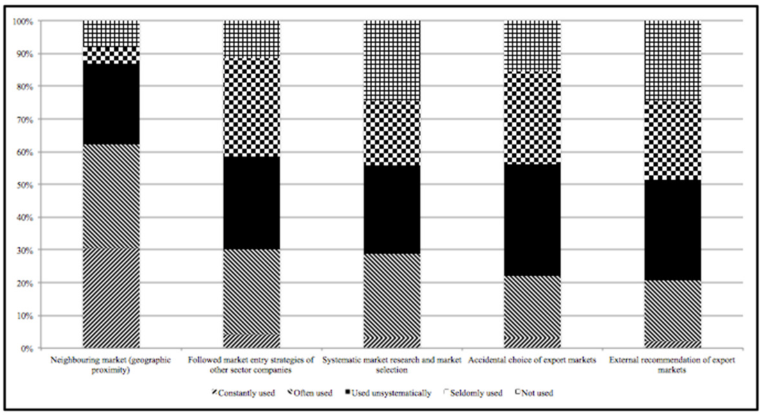

Fig. 2. Methods of foreign market selection (Source: own research)

Total exports to some findings in a previous research show that Nordic countries have slightly dominant roles as “bridges” for further regional and global integration of Lithuanian companies. The findings also show that closer cooperation with Nordic and Central Eastern companies can strengthen the competitiveness of Lithuanian vendors. In addition to gaining access to markets and opportunities to develop their brands, Lithuanian companies that have established relationships with Scandinavian firms have also had increased value added. It is widely recognized that a territorial and geographic proximity approach is crucial for the analysis and development trends and spatial differentiation (Slepniov *et al*. 2013; Camagni 2014). Many emerging economies have shifted their development strategies from simple export-oriented manufacturing to an emphasis on gaining access to higher value adding activities in global value chains (Seppälä 2015). As CIS markets provide with limited opportunities, there is a need to shift from these traditional markets to other with growth opportunities. However, they might be unknown, too demanding, traditional distribution channels created, high tech oriented. As research shows (Fig. 3), SMEs have chosen to expand in Nordic and Central European markets (geographic proximity based, neighboring) where this redirection has to be accompanied by two components: development and promotion. The first is a knowledge based, export potential strengthening through sustainable development principles, human capacity development, meeting market requirements, standards, based on awareness and research where the second is related to partner and distribution channels search, trade fairs and B2B missions. Only combined approach leads to a long term strategy development and implementation.

This research shows that there is an essential focus on five-year perspective strategy used by Lithuanian SMEs. Almost a half believe to continue their development based on regional approach (foreign markets in geographic proximity, neighboring, awareness based) and act locally. In addition, companies expressed their comments on international development. Market selection will be affected by perspectives of efficient transport costs, market share growth instead new markets expansion, further strengthening in host countries due to available experience. Export markets mentioned primarily were Nordic countries, United Kingdom where market growth strategy will be directed. Only 20% companies believe to be global players (Fig. 3).

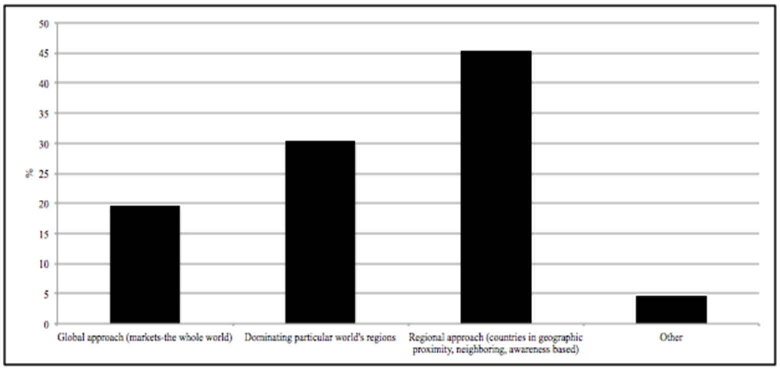

Fig. 3. Five-year perspective approach on international expansion of Lithuanian companies (Source: own research)

The 5-year strategy approach has set up guidelines and SMEs vision towards future development. It has to be admitted that companies started to assess growth strategies on a more systematic way by assessed growth opportunities worldwide and regionally.

Conclusions

The paper addresses the topic of trade development tendencies and foreign market selection methods used by SMEs. By incorporating the perspectives of regional integration through export related activities and market selection methods used by Lithuanian SMEs, the paper also provides with a more complete view of the geographic proximity and regional cooperation phenomenon. After imposed sanctions and when traditional long term markets provide with limited opportunities, SMEs are faced with a vital demand to redirect their export markets in a short period of time. Two components become essential: development and promotion. The combination of these components leads to successful international growth and entry strategies implementation.

The study has a number of limitations, which were beyond of the scope of this paper to address. First, the sectorial assessment on products and services export countries was not analyzed. Second, it has different market distribution rather than providing definite answers as SMEs are under time and market diversification pressure due to drastically changed traditional export routes. Third, there are several methodological challenges. The forth obvious limitation of the study is SMEs selection method where SMEs experience is rather dispersed. Although the participating companies represented different industries, future research should account for firm and industry specificity. The entry was not calculated when companies enter foreign markets (new starters or experienced exporters) as well.

It is strongly believed that findings and conclusions may be useful in informing SMEs on foreign markets selection and entry methods, number of export markets under secured risk and diversification.

The variety of market selection methods, used in international trade development, selection and use of the most appropriate, market strategies (spreading or concentration), number of export markets, regionalization, combination of development and promotion measures are key factors for SMEs to assess and grow internationally.

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