Adjusting to Trade Wars*

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Abstract

We investigate how firms adjust to a sudden, unanticipated and eventually long-lasting negative export demand shock resulting from a trade war. We explore a unique event when due to political reasons, unrelated to the underlying economic conditions, the exporters lost access to a major foreign market. In particular, in 2014 Russia introduced sanctions on imports from Europe and this caused abrupt negative trade shock to food production sector in Lithuania. We are guided by a theory where firms are forward-looking, make investment decisions, face nonconvexities in the labor market along with heterogenous variable costs of revenue-increasing prospects. In the data consisting of all exporters in the country, we find that part-time employment is used as the first shock absorber, followed by investment and full-time employment. At the same time, firms adjust by expanding to new export markets.

JEL classification: D22, D25, F14, F16

Keywords: unanticipated demand shocks, firm adjustment margins, part-time employment, non-convex adjustment, trade war

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