To Be or Not to Be in the Ruble Zone: Lessons from the Baltic States

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To be or not to be, that is the question!
Shakespeare, 1604

Introduction

This paper discusses the experiences of the Baltic states in using the ruble before and after the break-up of the Soviet Union in 1991 and their subsequent decisions to leave the ruble zone and introduce national currencies. Estonia was the first country to introduce its own currency in 1992, with Latvia and Lithuania following shortly afterwards. The decisions of the Baltic states to leave the ruble zone were partly the result of political considerations, but the uncertainty and instability of the ruble after the Soviet break-up also made it practically infeasible for the Baltic states to continue using the ruble.

The collapse of communism in Central and Eastern Europe and the break-up of the Soviet Union after the coup in August 1991 are momentous historical events. These political processes were accompanied by similarly dramatic changes in the economic environment, including changes in the arrangements of international trade and investment. Trade between the CMEA countries, the socialist countries in Eastern Europe and elsewhere, had taken place using the transferable ruble, but this system started losing importance as of the end of the 1980s and ceased to operate altogether at the beginning of 1991 (Smith 2000).

The Baltic states were under occupation by the Soviet Union until August 1991. They were fully integrated in the Soviet economic system, which included the use of the ruble and participation in the external relations of the Soviet Union with CMEA and non-CMEA countries. When the Baltic states began the process of reforming their economies, the question was essentially whether they should continue to use the ruble and if not, then how it should be replaced. Such decisions involve economic, administrative and political considerations and typically entail thorny trade-offs. Moreover, the decisions had to be taken at a time when the Baltic states were experiencing a myriad of other economic and political challenges.

The rest of the paper is organised as follows: the second section provides a brief review of the literature on the choice of exchange rate system. The third section recounts the plans for separate currencies in the Baltic states before they regained independence. The fourth section discusses the developments in the period once the Baltic states had regained independence, but still continued to use the ruble. The fifth section describes the introduction of national currencies in these countries. Finally, the sixth section distils some lessons from the break-up of the ruble zone and the introduction of new currencies in the Baltic states.

Exchange rate systems

The use of money or currency is a key feature of the economy in all civilised countries including the communist planned economies. Money functions as a medium of exchange, a measure of value and a store of value. Money played a lesser role in the planned economies because the allocation of resources was partly determined by various plans, but households nevertheless used money in roughly the same way as households in market economies.

The exchange rate is the rate at which one currency can be exchanged for another. The exchange rate system refers to the arrangements or rules governing how the exchange rate is determined and managed. The choice of exchange rate system involves economic, administrative and political considerations and typically implies complex trade-offs (Staehr 2015a).

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The *impossible trinity* captures some key economic trade-offs. It posits that a country cannot have a fixed exchange rate, an independent monetary policy and free capital movement all at the same time, but must choose two of them. If the authorities cannot or do not wish to place effective restrictions on capital flows, the only remaining options are a floating exchange rate with independent interest rate setting, or a fixed exchange rate with the domestic interest rate shadowing the interest rate of the anchor currency. A floating exchange rate might lead to excessive exchange rate fluctuations and uncertainty may hamper international trade and financial transactions. A fixed exchange rate restricts the instruments available to policymakers and also carries the risk of exchange rate misalignment.

A fixed exchange rate works by the central bank standing ready to exchange domestic currency for foreign currency and *vice versa* at the stated exchange rate. A fixed exchange rate is vulnerable to speculative attacks if a capital outflow threatens to deplete currency reserves. One way to address this credibility problem is to run the fixed exchange rate in the form of a currency board, whereby the foreign-currency value of the domestic base money never exceeds foreign currency reserves (Kopcke 1999). There will then, in principle, always be foreign currency available to honour the commitment of the fixed exchange rate.

Another way of addressing a possible credibility problem is to unilaterally adopt the currency of another country or currency area. This policy means abandoning the domestic currency completely and makes it virtually impossible to alter the exchange rate, as this would require the introduction of a new domestic currency. One drawback of the unilateral adoption of another currency is that any seigniorage revenue is relinquished.

Yet another route to full exchange rate stability presents itself if it is possible for a country to join a currency union. Unlike unilateral adoption, a currency union affords the participating countries some influence over the monetary policy of the union, and typically also allows for seigniorage revenue to be distributed to all participating countries. The nature and formal rules of currency unions make it difficult to leave; and in this sense a currency union represents an extreme form of fixed exchange rate system.

Participation in a currency union eliminates all exchange rate uncertainty against other countries in the union, which may stimulate trade and cross-border investment and lead to efficiency gains as a result. A currency union, however, also functions as a straitjacket, ruling out that a participating country devalues or lowers its interest rate. Mundell (1961) argued that the lack of exchange rate and monetary policy instruments in a currency union means that it would only be advantageous to form or join a currency union if there were typically no need for different monetary policies in the participating countries. This may be satisfied if certain conditions are met and these have a bit confusingly become known as the theory of the optimal currency area (OCA).

The key OCA criterion is that the business cycles of the participating countries should be synchronised so that the same monetary policy would be appropriate in all of the countries (Mongelli 2002; Staehr 2015a). This may be the case if the countries are mainly subjected to economic shocks that are common across the union and have economic structures that propagate the shocks in relatively similar ways. It is notable that a currency union may help bring about synchronisation of the business cycles if it stimulates trades and financial flows between the countries of the union in ways that lead the economies to become more similar (Frankel and Rose 1998). Moreover, if there are flexible labour and product markets in all of the countries, various economic shocks would have limited effects on output and unemployment and a joint monetary policy would be unproblematic.

Even if business cycles are not synchronised there may still be other circumstances under which the loss from giving up independent monetary policy is limited. If labour mobility exists between the countries in the union, unemployed persons from a country affected by an adverse economic shock may migrate to countries with a stronger cyclical position. Finally, substantial fiscal transfers between the countries in the union will make it possible to pursue strongly countercyclical fiscal policies and this would reduce the costs of countries not having an independent monetary policy. A government that considers whether or not to be a member of a currency union may start by examining how well the country satisfies the various OCA criteria.[1]

The choice of a fixed exchange rate system, including currency boards and currency unions, reduces the set

[1] Other OCA criteria that have been proposed include financial market integration, economic openness, diversification in production, similarities of inflation rates, and fiscal and political integration.

of available economic policies, but may improve predictability and facilitate cross-border trade and investment. These positive aspects rely, however, on the notion that the economic environment of the anchor country or currency union exhibits an appropriate degree of stability and predictability. This implies that the trade-off between efficiency gains from exchange rate stability and the availability of economic instruments is altered if the anchor country or currency union features monetary instability and high and unpredictable inflation.

Countries or currency unions prone to monetary instability may experience 'dollarization' or currency substitution, whereby transactions are carried out using a foreign currency, or the domestic currency value of the transactions is indexed to the exchange rate. The main argument for a fixed exchange rate dissolves if the anchor country or union is prone to instability and widespread currency substitution.[2] The attractiveness of a fixed exchange rate is evidently dependent on the anchor country or currency union affording a high degree of monetary stability and predictability.

Before 1991

The Soviet ruble was the currency of the Soviet Union and, by implication, also the currency of the Baltic states. The Soviet economy was a planned economy where resources were allocated under a complex system of plans, so the exchange rate played a secondary role. The Soviet ruble was tied to the pound sterling until the beginning of 1992 at the rate of 0.4 rubles per pound, but it was not convertible with any other currency.[3] Prices were fixed with few exceptions and open inflation was low or non-existent; stable prices were indeed touted by the Soviet authorities as one of the great achievements of the planned economy. Alongside the standard ruble used in Russia, the transferable ruble was used for trade with the CMEA countries.

For decades repression in the Soviet Union ruled out any public discussion of independent economic policies, including exchange rate policies. This changed in 1986 when General Secretary Mikhail Gorbachev began wide-ranging reforms, the best known of which were perestroika and glasnost, economic restructuring and political openness. The reforms aimed to modernise the economy, speed up innovation and productivity growth, and make producers more responsive to consumer demands. The rigid planning system was decentralised and local authorities, including those in the Baltic states, gained more autonomy. Enterprise reforms meant that the remuneration of managers and workers could be determined to a larger extent at the enterprise level.

Gorbachev's reforms had a number of unintended consequences, both politically and economically (Conway 1995). The political liberalisation meant more coverage of corruption and the abuse of power in the media, but it also meant that a popular front or independence movement could form in each of the Baltic states. The initial objective of the popular fronts was increased self-rule within the Soviet Union, including a degree of economic self-governance, but demands for outright independence started gaining momentum from around 1987.

The second unintended consequence of Gorbachev's reforms was a rapid deterioration of the economic situation in the Soviet Union. An early anti-alcohol campaign reduced the tax intake from alcohol taxes. The enterprise reform, with its greater autonomy for managers, meant that wages went up, resulting in declining profits; and this led to further deterioration in the fiscal balance because profit taxes were a major source of revenue. Meanwhile production growth did not pick up as intended and there were large increases in social spending. These and other events led to severe budget imbalances that were eventually monetarised. The results were repressed inflation in markets with fixed prices, open inflation in *Kolkhoz* markets with free price setting, and rising premiums in the black exchange markets (Dabrowski 1995a).

The political thaw and increasing economic hardship were the backdrop to plans drawn up in all three Baltic states to introduce economic self-determination and some form of independent currencies. These currencies would have symbolic significance, but they also gained economic rationale during the period of declining growth and growing open and repressed inflationary pressures.

In the autumn of 1987 a group of four government officials and economists published an economic self-

[2] Taking this to its limit, membership of a currency union with extreme inflation and widespread currency substitution would effectively imply adoption of the substitution currency.

[3] The Soviet Union had a notionally fixed exchange rate and set interest rates independently; which was made possible by very tight restrictions on capital movements in and out of the country, see the impossible trinity discussed in the previous section.

management programme known by its Estonian acronym *IME* in a leading newspaper (Kallas *et al.* 1988). The programme called for a high degree of autonomy, meaning that economic decisions in the Estonian Soviet republic were to be governed at the level of the republic, and not by the union authorities. Moreover, the economy was to be governed by the principles of supply and demand, where prices reflect relative scarcities. The programme also suggested the use of an internationally accepted convertible ruble, but the specifics were not spelled out. Overall, although some elements were hazy, the IME programme effectively called for a market economy on the territory of Estonia (Lainela and Sutela 1995; Dabrowski 1995b). The IME programme became a key landmark for the popular front and the reformed Estonian communist party.

The programme may be seen as unrealistic or utopic given that Estonia was a Soviet republic at the time whose economy was tightly integrated into the Soviet planned economy. It is worth noting, however, that Hong Kong at this point in the 1980s had become a prosperous and fast growing country, largely through its economic intermediary role functioning as a bridge between communist China and the rest of the world. Hong Kong had its own currency linked to the US dollar through a currency board; and the convertibility and stability of the Hong Kong dollar was an important component in the emergence of Hong Kong as a key trading nation.

It is also notable that the IME programme stressed that production and trade should be based on market economic principles. This might potentially have led to large changes in trade flows and production. Given the proximity of Estonia to Western European markets, Estonia may have started trading with these markets, instead of almost entirely with other parts of the Soviet Union. Such a reorientation of trade could have changed the trade-offs involved in the choice of exchange rate system. Looking forward the Soviet ruble did not necessarily have to be the first choice.

The popular front in Latvia also gained momentum during the Perestroika period, but the communist party did not support the front in the same way as it did in Estonia and Lithuania, but it split in two instead. There were also less specific proposals for future economic reforms and it was only in 1990 that a specific proposal for an independent currency was put forward (Lainela and Sutela 1995).

The Sajudis movement in Lithuania was arguably the strongest proponent of independence in the Baltic states (Dabrowski 1995b). The movement published a programme in 1988, which stressed the need for increased economic autonomy, including a Lithuanian central bank and an independent currency.

Political developments in the Baltic states advanced rapidly in the years from the political thaw in 1986 to independence in 1991. The national fronts adopted platforms of national autonomy, market economic reforms and the introduction of independent currencies. The fronts became the dominating political powers and the parliaments or supreme Soviets had all passed legislation by the middle of 1989 setting out the foundations for independent economic policymaking and market economic systems.

Starting in 1990 the Baltic states introduced important economic reforms within business establishment, price liberalisation, taxation and public administration. Estonia was a front runner in liberalisation and freed many prices in autumn 1990, while Latvia and Lithuania followed suit in 1991. The reforms introduced what was effectively a nascent or hybrid form of market economy, and they also led to stronger economic contacts between the Baltic states and countries in Western Europe. The reforms also meant the re-establishment of central banks answering to local authorities, but new currencies and an independent monetary policy were clearly outside the realm of feasible policies.

The programmes for introducing independent currencies were never realised while the Baltic states were still republics in the Soviet Union, but they were nevertheless of significance. They meant that the Baltic states had planned ahead for a time when independent policy-making would be possible. They may also have contributed to the process of political change, given their strong symbolic connotations. Evidence of this contribution is that independent currencies would have required some political anchoring, and hence would only have been feasible in a scenario where the Baltic states would have substantial political autonomy.

By 1991 the Baltic states were in many ways caught in legal and economic contradictions. They had declared independence, but were still part of the Soviet Union. They had sought to reform their economies, but remained part of the Soviet planned economy and used

the Soviet ruble as legal tender. All of this changed after the coup in Moscow in August 1991.

The early transition phase

The Baltic states regained their independence in August 1991 and in a short period afterwards all of the former Soviet republics declared independence and the Soviet Union ceased to exist at the end of 1991. The 15 countries emerging from the Soviet collapse differed considerably in size, economic development and the degree to which their economies were distorted (de Melo *et al.* 2001). They were, however, tied by their history and close economic relations, including the continued use of the Soviet ruble.

The democratically elected governments in the Baltic states moved ahead as early as the autumn of 1991 with further liberalisation of price setting, trade and production, and initiated the process of privatisation. They also embarked on programmes of structural reforms that would underpin the emerging market economies.

An aspect of key importance was the choice of exchange rate system. The countries inherited the use of the Soviet ruble, and as such, participated in what could be labelled an accidental currency area. The ruble went by a historical incident from being the currency of the Soviet Union to being the currency of a ruble zone comprised of the 15 countries emerging from the Soviet Union. The question was then whether to remain in the currency union or to stake out other solutions; the main alternative being the introduction of some form of independent currency (Dabrowski 1995a).

There were arguments for and against remaining in the ruble zone. One key argument was that the overwhelming majority of trade by the Baltic states was with countries from the Soviet Union. Retaining the joint currency would reduce transaction costs and exchange rate uncertainty; and thus reduce the disruption of trade and financial ties between ex-Soviet countries. Moreover, countries would largely be affected by the same supply and demand shocks, one of the OCA criteria.

There were also arguments for leaving the ruble zone and introducing independent currencies. A least two of the OCA criteria discussed in the second section were not satisfied. The mobility of labour between different countries in the currency area would clearly not be present between the 15 ex-Soviet countries, and it was similarly unrealistic to expect financial transfers between countries in the ruble zone to continue.

The key economic argument for leaving, however, was the instability and monetary disarray that had already started to engulf the ruble zone from the autumn of 1991. The ruble zone became a source of extreme instability and unpredictability; and possible gains from ex-Soviet countries sharing the same currency were therefore nullified (Dabrowski 1995b). Another reason was the prevailing shortage of cash, which led several ex-Soviet countries to introduce cash substitutes in the form of coupons and vouchers (Medvedev 2003).

The instability of the ruble zone was partly a result of developments that occurred before the collapse of the Soviet Union. More important, however, was the lack of virtually any institutional underpinning or common governance of the ruble zone, which made it possible for individual countries to engage in free riding. By virtue of the common currency each of the 15 central banks in the newly independent countries could issue credit to banks, firms and national government. The national authorities earned the full seigniorage from the credit provision while the inflation tax was borne by the public across the entire ruble zone. The end result was very rapid credit growth, increasing hidden and open inflation, and eventually currency substitution (Conway 1995).[4]

Table 1 shows the annual consumer price inflation in the Baltic states and Russia.[5] Inflation was already high in 1990, but it increased in the following years. The Baltic states liberalised their prices before Russia did and this was why inflation was higher in the Baltic states than in Russia in 1990 and 1991.

Interestingly, while central bank credit grew rapidly in the ruble area, the supply of bank notes changed little, simply because the printing presses were situated only in Russia. This led to a cash drought in parts of the ruble area with resulting difficulties for everyday shop-

[4] The Russian central bank tried to restrict the issuance of credit by the 14 other central banks from the middle of 1992, but the measures were not very effective because there were many exceptions (Dabrowski 1995b)

[5] Monthly rates of consumer price inflation are available for the three Baltic states in OECD (2000). The monthly inflation figures exhibit substantial variability, partly related to rounds of price liberalisation.

Table 1

Consumer price inflation in Estonia, Latvia and Lithuania, per cent, 1989–1994

	1989	1990	1991	1992	1993	1994
Estonia	6.1	23.1	210.5	1 076.0	89.8	47.7
Latvia	4.7	10.5	172.2	951.2	109.2	35.9
Lithuania	2.1	8.4	224.7	1 020.5	410.4	72.1
Russia	2.0	5.6	92.7	1 526.0	875.0	311.4

Note: Annual percentage change in the average consumer price index.

Source: EBRD (1996).

ping and other operations using cash. Foreign currencies were increasingly used in transactions at all levels in the economies of the 15 ex-Soviet countries. Meanwhile, the emergence of barter arrangements and widespread arrears equally indicated that the use of the ruble did not facilitate trade and investment across the 15 countries emerging from the Soviet Union (Abdelal 2003).

The developments after the break-up of the Soviet Union in August 1991 showed clearly that the ruble zone was prone to free riding; and hence could not even provide a modicum of credibility or stability. A key weakness was the lack of any institutions for coordinated monetary policy-making and the sharing of seigniorage (Dabrowski 1995a).[6] Moreover, the use of the ruble did not bring any major benefits in trade with CMEA countries since the old transferable ruble system had essentially ceased to function by 1991.

Many experts, including the IMF, initially recommended that the Baltic states should remain in the ruble zone regardless of the problems afflicting it (Pomfret 2002; Boughton 2012). The key worry was that leaving the ruble zone would reduce already dwindling trade volumes and exacerbate substantial GDP contractions. This argument carried less weight as the instability of the ruble zone persisted and it became clear that it was not politically possible to establish the institutional framework for a functioning currency area in the 15 ex-Soviet countries.[7]

In conclusion, there were political, economic and institutional factors all suggesting that membership of the ruble zone would only be judicious for the Baltic states for a limited period of time. This does not mean, however, that it was simple for them to leave the ruble zone, as the Baltic economies were closely integrated into the Soviet economy and were in a precarious situation. The next section discusses the process of leaving the ruble zone for each of the Baltic states.

National currencies

The introduction of a new currency is typically demanding and involves a number of complex trade-offs (Staehr 2015b). The Baltic states chose different ways of exiting the ruble zone and introducing national currencies (Staehr 2015c).

Estonia left the ruble zone in June 1992, when it introduced its new national currency, the *kroon*. The currency was pegged to the German mark at a rate of eight kroons per mark through a currency board. This meant that the central bank would always hold foreign currency reserves at or in excess of the foreign currency value of the domestic money base (see also the second section). Eesti Pank did not set interest rates and had only a limited ability to act as a lender of last resort.

There are two striking features of the Estonian currency reform. Firstly, it went directly from inadvertent membership of the ruble zone to a very tight peg to another currency, the German mark. The authorities were not averse to a pegged exchange rate, but they preferred to peg the kroon to a stable currency with a history of low inflation. Secondly, when the currency board was introduced the only major economy with such an arrangement was Hong Kong. The choice of a tight peg of the kroon to a currency much used in international trade and investment suggests that the authorities drew inspiration from the then British colony. The choice was also in line with the IME programme; see also the third section.[8]

The experiences of autumn 1992 showed that the kroon was indeed a viable currency, and foreign capital started to flow into the Estonian economy (Korhonen 2000). Eventually inflation came down and positive growth was restored. The kroon also became a potent national symbol. The Estonian presi-

[6] It might be argued that the closest institution in which to anchor a common monetary policy would be the Commonwealth of Independent States (CIS). In practice, the decision-making of the CIS was limited and the Baltic states were not members of the organisation anyway.

[7] There were some attempts to reconstruct the ruble zone in 1992–94 but they were unsuccessful (Dabrowski 1995b). By May 1995 all 15 ex-Soviet countries had introduced their own currencies.

[8] Formal currency boards were later adopted by Lithuania in 1995, Bosnia and Herzegovina in 1997, and Bulgaria in 1999.

dent declared on the first anniversary of the new currency that "[t]he kroon is the anchor of Estonia's political and economic success… It is not just a piece of paper, it is a symbol of our independence" (*The Independent* 1992).

Latvia chose a more gradual approach to currency reform. The country launched a temporary currency, the *rublis*, in May 1992, which was meant to address the shortage of cash rubles and circulated alongside the ruble at a one-to-one conversion rate. Latvia introduced its own national currency, the *lats* in March 1993.

Latvia initially chose a floating exchange rate system, partly because its foreign currency reserves were low, but the country switched to a fixed exchange rate at the beginning of 1994 after an inflow of capital led to an unexpected appreciation of the *lats*. The lats was pegged to the Special Drawing Rights (SDR), an accounting currency devised by the IMF with a value computed as a weighted average of the exchange rates of key economies. The fluctuation band was very narrow and the reserve coverage very large, so it might be argued that the country operated a de facto currency board from 1994 (Wolf 2016).

Lithuania first introduced a temporary currency, the *talonas*, in August 1991. The talonas was to be used together with the Soviet ruble for purchases in Lithuania, in effect preventing people from other countries from purchasing goods in Lithuania. A new version of the talonas was put into circulation in May 1992 and it was made the sole legal tender in Lithuania from October 1992.

The national currency, the *litas*, was launched in June 1993. The currency was floated initially, but it lacked credibility in currency markets and the exchange rate fluctuated considerably. The authorities therefore decided to adopt a currency board and to peg the litas to the US dollar from April 1994. The fixed exchange rate led to a rapid decline in inflation, but the peg to the dollar meant that the exchange rate fluctuated a great deal against many European currencies (Korhonen 2000).

The Baltic states were among the first ex-Soviet countries to introduce new national currencies. By the end of 1994 all three countries had pegged their currencies to a stable currency through an outright or *de facto* currency board. The currencies became the backbone of stability oriented policies on which the countries developed in the following years. The systems were kept in place until the countries one-by-one adopted the euro in 2011–2015.

At the time when the Baltic states introduced their national currencies the ruble zone might have appeared to constitute a better 'fit' than the Western currencies to which they eventually pegged their new currencies. This was the case from a static perspective, but perhaps less so in a dynamic context. By pegging their currencies to Western ones the policy-makers in the Baltic states effectively expressed an aspiration to reduce their dependence on trade with Russia and other countries emerging from the Soviet Union, and orient their foreign economic relations towards other countries instead. This means that although the ruble zone might have been the closest to an OCA in 1992, it was not likely to have remained so in the longer term.

Final comments

The Baltic states were at the forefront of the Soviet disintegration in the years up to 1991 and were subsequently among the most determined of the newly independent countries in taking steps to break with the Soviet past. The choice of exchange rate system and whether or not to remain in the ruble zone were among the many contentious policy items.

It was not politically feasible to use any currency other than the Soviet ruble before the Baltic states regained independence in August 1991. Misguided policies meanwhile debauched the currency, leading to an accumulation of hidden inflationary pressures and gradually to open inflation. The outbreak of extreme inflation from 1991 meant that the costs of retaining the ruble increased markedly, while the benefits faded rapidly as trade and payment volumes declined. In June 1992 Estonia became the first country to leave the ruble zone and introduce its own currency, and Latvia and Lithuania followed suit shortly afterwards. When Russia eventually introduced its own currency in 1993 the suggestion of a common currency in the ex-Soviet countries was finally put to rest.

The developments in the late 1980s and early 1990s bear lessons of historical import, but they are also relevant for the choice of exchange system in small open economies and the operation of currency unions in general. Three key lessons stand out.

The first lesson relates to the applicability of the OCA theory, the theory addressing whether a country would be better off in a currency union or with independent exchange rate and monetary policies. The theory posits that there will typically be a trade-off. Participation in a currency union will improve predictability, and hence reduce risks and the transaction costs associated with international trade and investment. Fixed exchange rates will, however, rule out the ability of the country to use monetary or exchange rate policies as tools to stabilise the economy if the country is hit by idiosyncratic or country-specific shocks. This means that there may be a trade-off between the efficiency gains likely to arise from a fixed exchange rate and the loss of instruments that can stabilise the business cycle.

The experience from the years before and after the break-up of the Soviet Union showed that these considerations take second place if the currency of the currency union is debauched and subject to monetary and financial instability. The purported gains from the absence of an exchange rate are simply overshadowed by the costs of participating in a currency union with financial instability and high, erratic inflation.

The second lesson concerns the prospect of maintaining the ruble zone for a longer period of time. The ruble zone that emerged after the collapse of the Soviet Union was essentially the result of historical events and not the result of any concerted policy measures. The events during 1991-1993, and arguably also in the period before, suggest that the prospect of an enduring ruble zone was never realistic. In retrospect it is clear that the conditions for creating a common currency area in the post-Soviet space were never present. The economic, political and institutional upheavals were so profound that it would be impossible to put in place the institutional environment and governance structures that such a currency area would need for it to provide stability and predictability. Moreover, the centrifugal political forces and the very different orientations of the 15 ex-Soviet countries would have made it unrealistic in political terms to preserve the ruble zone anyway.

The third lesson concerns the sustainability of currency areas in general, and of the euro area in particular. History shows that many currency areas have disintegrated after operating for some time. The main reason is typically political disagreement and unilateral actions that preclude the measures needed to keep the currency union together after severe economic shocks or other disruptions (Bordo and Jonung 2003). The rapid disintegration of the ruble zone is a case in point. The ruble zone was exposed to severe economic and political disruptions, and there was no political will to address these challenges.

These lessons from the collapse of the ruble zone and other currency areas were indeed acknowledged when the euro area was drawn up (Issing 2008). A currency area can only be sustainable if there are clearly specified rules for its purpose, operation and joint decision-making and the political willingness to keep it together during periods of severe strain. Moreover, membership of a currency area is only attractive if it provides stability and predictability.

Estonia joined the euro area in 2011, followed by Latvia in 2014 and Lithuania in 2015. The Baltic states have thus joined at a time when the euro area is under strain from the sovereign debt crises, banking sector problems and low rates of economic growth. The challenges have been considerable and at times have imperilled the euro project. The Baltic states have brought with them their experiences from the collapse of the Soviet Union and the disintegration of the ruble zone. These experiences point to the need for determined and concerted decision-making to sustain the euro in the face of severe economic and political challenges. The demise of the ruble zone may indeed represent a reminder of the perils of free-riding and political inaction.

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