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Szkoła Główna Handlowa w Warszawie

Implications of the European debt crisis for the eurozone entry conditions

The aim of this paper is to present the changes in the EU framework for the evaluation of the progress made by the countries aspiring for the eurozone in order to respond to two main questions: first, what is the nature of these changes and do they reflect the optimum currency area (OCA) theory better than before? And secondly, have these changes made the accession into the eurozone more difficult? First of all, we present the main elements of the new European governance that impact a country's accession into the eurozone and the consequent evolution of the concept of a 'high degree of sustainable economic convergence'. Then, we show whether the current conditions for sharing the euro satisfy the OCA theory to a higher degree than before. We observe that although the OCA criteria can hardly be found in the modified framework for the assessment of economic convergence in the EMU, the efforts that have been made so far towards fiscal integration make the euro membership less challenging. When considering the changes in the entry conditions from the eurozone enlargement perspective, an ambiguous picture emerges.

Keywords: eurozone, convergence criteria, European economic governance, optimum currency area

JEL classification: N14

Wpływ europejskiego kryzysu zadłużenia na warunki członkostwa w strefie euro

Celem artykułu jest przedstawienie zmian, jakie nastąpiły w zakresie ram oceny konwergencji osiągniętej przez państwa kandydujące do strefy euro, aby odpowiedzieć na dwa główne pytania. Po pierwsze, jaka jest natura tych zmian i czy nastąpiło szersze uwzględnienie dorobku naukowego pod nazwą teorii optymalnego obszaru walutowego (OOW)? Po drugie, czy zmiany te oznaczają, że kandydatom do unii walutowej coraz trudniej będzie do niej wejść? Punktem wyjścia analizy jest przedstawienie zmian wprowadzonych do ram oceny osiągniętego stopnia zbliżenia gospodarczej pod wpływem reform zarządzania gospodarczego w UE. Następnie oceniony został wpływ zacieśnienia koordynacji polityki gospodarczej w UGW na stopień zbliżenia kryteriów konwergencji do warunków OOW. Można zaobserwować, że chociaż zmienione ramy oceny osiągniętego stopnia konwergencji nie odzwierciedlają bardziej warunków OOW, działania podjęte na rzecz zacieśnienia integracji fiskalnej w strefie euro powodują, że członkostwo w niej stanowi mniejsze wyzwanie. Ocena zmian warunków wejścia z perspektywy poszerzenia unii walutowej prowadzi natomiast do niejednoznacznych wniosków.

Słowa kluczowe: strefa euro, kryteria konwergencji, zarządzanie gospodarcze w UE, optymalny obszar walutowy

Klasyfikacja JEL: N14

Introduction

In January 2015, Lithuania became the 19th member state of the EU to join the euro area. The very fact that a country decided to switch to the euro despite the recent crisis developments in the euro area can be seen as a sign of confidence in the euro project. This view on the membership in the eurozone as a strategic priority is not, however, widely shared among other EU countries that still use their national currencies. The United Kingdom should probably be listed first on the list of single currency sceptics, taking into consideration its special status within the Economic and Monetary Union (EMU), its position not to sign a treaty for closer cooperation of the EU member states in fiscal domain and, more recently, the renegotiation of its status within the EU. The British government is largely supported by the British public opinion [EC]. Opposition against the euro is also strong in the Czech Republic (like in the UK, only 20% of the Czech respondents are in favour of the euro), Sweden, Denmark, Poland and Bulgaria. These 6 countries form a group where majorities of respondents oppose the euro. It is interesting to note that the United Kingdom is the only EU 'pre-in' country in which the opponents of the euro have always outnumbered its supporters. In the other countries, reticence regarding the single currency has increased significantly only in the aftermath of the global financial crisis.

Whatever the approach of an EU member state with a derogation¹ to its place within the EMU will be, there is another important aspect of entering into the euro area that requires attention. According to the Union's *acquis*, a country may adopt the euro on the condition of fulfilling certain criteria. The rationale behind this is to allow into the euro area only those countries that have the properties adequate for 'the maintenance of price stability and the coherence' of this area [ECB, 2013]. The state of economic convergence is examined by the European Central Bank (ECB) and the Commission. As a tool they use a common framework based on the Treaty on the Functioning of the European Union (referred to hereafter as TFEU or Treaty) provisions with regard to developments in prices, fiscal deficit and debt ratios, exchange rates and long-term interest rates, as well as in other factors considered to be relevant to economic integration and convergence.

The reforms introduced in the EU to strengthen the supranational control of economic policy in response to the crisis have impacted on the conditions for accession into the eurozone. Although the key convergence criteria remained the same, new legislation has changed the application of some of these criteria. As a result, the notion of 'a high degree of sustainable economic convergence' which allows

¹ Member state with a derogation is a member state that has not yet met the entry conditions, except for Denmark and the United Kingdom which have 'opt-outs'.

an EU country to join the euro area has evolved over the last years and requires clarification. Since all 7 EU member states with a derogation have committed to adopt the euro, this issue deserves careful attention.

The aim of this paper is to present the changes in the EU framework for evaluation of the progress made by the countries aspiring for the eurozone. This should allow to respond to two main questions: first, what is the nature of these changes and do they reflect the optimum currency area (OCA) theory better than before? And secondly, have these changes made the accession into the eurozone more difficult?

A central problem with answering these questions is that the process of admittance to the eurozone has not been based strictly on the formal provisions from the very beginning. Hence, delivering the list of the main changes in the existing formal framework for the assessment of economic convergence should be accompanied by a presentation of how it works in practice, and especially of how this modified framework has been implemented. In addition, in order to get the whole picture of the challenge of joining the eurozone, it would be wise to look not only at the fulfilment of the criteria by candidate countries but also at the eurozone itself, as it has also been transformed as a result of the debt crisis.

Therefore, the structure of this article is as follows. First of all, we present the main elements of the new European governance that impact a country's accession into the eurozone and the consequent evolution of the concept of a 'high degree of sustainable economic convergence'. Secondly, we show whether the current conditions for sharing the euro satisfy the OCA theory to a higher degree than before. Then, we discuss the implications of the recent developments in fiscal integration in the EU for the eurozone membership. The study was mainly conducted on the basis of analysis of EU documents including ECB convergence reports from the period from 1998 to April 2016.

1. Economic convergence criteria and their pre-crisis application

Each of the EU countries that wants to adopt the euro has to meet, in principle, certain entry conditions known as the convergence criteria. Introduced by the Treaty on European Union signed in Maastricht in 1991, these criteria are now replicated in the TFEU. There are four main economic criteria concerning price stability, the government budgetary position, participation in the exchange-rate mechanism, and the convergence of interest rates. Review process takes place at least once every two years, or at the request of a member state. The Commission and the ECB examine economic convergence and the Council decides which member states fulfil the necessary conditions. In their reports, the Commission

and the ECB use a framework based on the above-mentioned criteria as well as on other factors outlined in the Treaty such as the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices. Compliance with the convergence criteria is reviewed from both a backward- and a forward-looking perspectives in order to examine the sustainability of convergence using a range of additional economic indicators.

Formally, the convergence criteria are not hierarchically structured. The principle that 'the convergence criteria constitute a coherent and integrated package and they must all be satisfied' is one of the EMI/ECB general guiding principles set out in the 1995 Report and regularly cited in consecutive reports. From the 1996 Report onwards, this principle states additionally that 'the Treaty lists the criteria on an equal footing and does not suggest a hierarchy'. However, in the past, i.e., in the pre-crisis period, all factors were seen mainly as a source of potential pressures on inflation. It reflected fears existing in some countries, especially in Germany, prior to the introduction of the single currency that it would not be a strong currency. ECB Convergence Reports contain many clear indications of this attachment to price stability. For example, in its first report of 1995, the European Monetary Institute (EMI), the predecessor of the ECB, described the fiscal criteria as an indicator of whether economic policies contribute sufficiently to the achievement of price stability over the medium term and thus ensure sustainability of the European currency area [EMI, 1995]. Another example of the same concern about price stability can be found in the regulations forming the Stability and Growth Pact (SGP) adopted in 1997 that aim to prevent and correct excessive government deficits.

The practice of the pre-crisis period of allowing member states to pass to the third and final stage of EMU, i.e., introduce the euro, did also confirm this different attitude towards individual economic criteria. In 1998, when the ECB examined the state of convergence in the Union, only three member states fulfilled the criterion on government debt and, moreover, only four were not placed under the excessive deficit procedure (EDP) which meant that they did not fulfil the criterion on fiscal discipline. Despite this fact, most of the EU countries willing to join the euro area in the period under discussion were admitted.

The interpretation of the convergence criteria in convergence reports and the experience of the admittance of new members to the eurozone suggest that the criterion which deals with inflation can be perceived as the most important among all conditions in the pre-crisis period. The reflection of this hierarchy within the convergence criteria can be found in the relevant literature. Baldwin and Wyplosz [2012] even argue that the concern of price stability lays behind all entry conditions.

2. Economic convergence criteria in the aftermath of the crisis

Since 2012, the framework used for the examination of economic convergence has undergone modifications. All these changes were a mirror of the reforms introduced in the EU as a response to the crisis developments in the eurozone. The main legal basis for these was the so-called six-pack made of five regulations and one directive. It entered into force in December 2011 and introduced a closer coordination of economic policies within the EU. Two major changes were introduced into the framework of the assessment of convergence criteria on this basis. These were: the application of the criterion on fiscal discipline as well as the Treaty provisions related to the so-called other factors.

The rules on fiscal discipline have been already developed with the SGP in 1997. The Council Regulation No. 1177/2011 from the above-mentioned 'six-pack' brought further developments in this area, amending the SGP. First, it sets out that compliance with the criterion on the government budgetary position should be examined on the basis of both the government deficit and the government debt criteria. Second, it clarifies when the ratio of the government debt to GDP which exceeds the reference value should be considered as sufficiently diminishing and thus fulfilling the requirement under the debt criterion. In this regard, it requires that the difference in relation to the reference value should decrease over three years at an average rate of $\frac{1}{20}$ per year. The assessment of compliance with the deficit and debt criteria, and the numerical benchmark for debt reduction are not, however, automatic. Under this act, and similarly to the earlier regulations of the SGP, when establishing the existence of an excessive deficit, the Commission and the Council should take into account the whole range of relevant factors.

In addition, in 2012, 25 EU countries² agreed to adopt in their national legislation a set of budget rules agreed upon under the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG). In particular, they agreed to implement a 'balanced budget rule' under which the structural deficit should not exceed 0.5% of GDP and concurred that the deficit should also be in line with the country-specific medium-term objective (MTO). In the event of a significant deviation from the agreed medium-term objective or the adjustment path, countries should automatically implement a correction mechanism.

Another set of rules concerning budgetary positions in the EU has been introduced by the Regulation No. 1175/2011, in particular by the norm for the growth rate of government primary expenditure. For those EU member states that have achieved their MTO, annual expenditure growth should not exceed a reference medium-term rate of potential GDP growth. For those who have not, this growth

² Except the United Kingdom and the Czech Republic, which did not sign the agreement, and Croatia, which became an EU member after it had been signed.

rate should not exceed a rate below a reference medium-term rate of potential GDP growth. Further, EU member states that have not yet reached their MTO should take appropriate fiscal measures to match discretionary reductions of government revenue items. For the euro area, but also for EU member states that are participating in the ERM II, the regulation has defined the range for their country-specific medium-term budgetary objectives of between -1% of GDP and balance or surplus, in cyclically adjusted terms. The regulation has also set out a benchmark for the adjustment path toward the medium budgetary objective for member states with a debt level exceeding the reference value.

Apart from the changes in the requirements for fiscal discipline within the framework for the analysis of economic convergence, an enhanced economic governance in the EU has also resulted in new provisions on the above-mentioned additional factors referred to in the TFEU. The so-called Macroeconomic Imbalance Procedure (MIP) was introduced and if a member state is subject to it, it will be considered as not having achieved a sufficient degree of sustainable convergence needed to enter the euro area. The MIP applies to all EU member states except for those which are under an international financial assistance programme and thus under a closer control. The framework for preventing and correcting excessive imbalances was introduced by the Regulation No. 1176/2011.

The detection of macroeconomic internal and external imbalances is based on a scoreboard consisting of a set of indicators with corresponding thresholds differentiated for the euro and non-euro area. What is interesting, unlike the main convergence criteria, these indicators are not goals for economic policy. Neither are they applied in a strict manner. According to the regulation, the crossing of indicative thresholds does not imply that macroeconomic imbalances are emerging. What is more, the indicators and thresholds may not remain the same over time as the Commission should adopt them to the changing challenges that the EU economies face. The initial design of the scoreboard was presented by the Commission in November 2011 [EC, 2011] and the final version the next year in its first Alert Mechanism Report [EC, 2012a]. In February 2012, the scoreboard consisted of 10 indicators divided into two categories [EC, 2012a]: external imbalances and competitiveness, and internal imbalances. In November 2012, the scoreboard published in the second Alert Mechanism Report consisted of 11 indicators; an indicator related to the financial sector was added to the initial set. Three years later, in 2015, three more indicators relating to labour market issues were added [EC, 2015].

Economic reading of the scoreboard also include some additional so-called reading indicators. In Alert Mechanism Report 2014 there were 28 of them – over twice as many as the scoreboard indicators and 10 more than two years earlier³. In

³ And yet the regulation on macroeconomic imbalances states that the scoreboard shall comprise a small number of indicators. The complexity of this tool seems to contradict the will of the legislator.

Alert Mechanism Report 2016 there were 25 auxiliary indicators. Regarding the scoreboard indicators, the ECB takes note of the fact that most macroeconomic indicators have been referred to in its convergence reports in the past [ECB, 2012].

The analysis of the existing MIP reports indicates that the identification of developments which are adversely affecting, or have the potential to affect the proper functioning of EU economies or of the EMU, does not follow any mechanical approach. For example, Denmark experienced negative developments in two areas: export market shares and private sector debt with alert levels crossed from the first alert report, with values for 2010 [EC, 2011]. Values for 2011 amounted, respectively, to: -16,9% and 238% of GDP [EC, 2012b] and for 2012 to: -18,6% and 239% of GDP [EC, 2013a]. However, the results of in-depth reviews concerning Denmark following these reports diverge completely. In 2013, the Commission acknowledged that Denmark was experiencing macroeconomic imbalances which deserved monitoring and policy action. One year later, according to the Commission, the macroeconomic challenges in Denmark were no longer identified as imbalances in the sense of the MIP.

When it comes to the EU member states with a derogation, five of these countries, namely Bulgaria, Croatia, Hungary, Romania and Sweden, were identified in the Alert Mechanism Report 2016 for in-depth reviews. They subsequently concluded that Hungary, Romania and Sweden were experiencing macroeconomic imbalances, not excessive but 'which require decisive policy action and monitoring'. Bulgaria and Croatia fell under the category of 'excessive imbalances, which require decisive policy action and specific monitoring', not triggering, however, the Excessive Imbalances Procedure.

Until now two countries: Latvia and Lithuania, have been accepted into the euro area on the basis of this modified framework for the analysis of economic convergence. In both cases, the ECB stated that although the country was within the reference values of the convergence criteria, there were concerns regarding, in particular, the sustainability of inflation convergence [ECB, 2013; 2014]. Regarding macroeconomic imbalances, the European Commission did not select Latvia or Lithuania for an in-depth review. On this basis, the Commission proposed to the Council that Latvia adopted the euro in 2014 [EC, 2013b], and Lithuania in 2015 [EC, 2014].

3. Maastricht criteria and the OCA properties

The theory of optimum currency area sets out properties that reduce costs of giving up independent national monetary and exchange rate policies [De Grauwe, 2014]. The OCA criteria seem to be crucial at times of crisis. There are two

aspects that need to be addressed in this context: the similarities between those criteria and their relevance. For simplicity, let us confine our attention to the main OCA criteria. Baldwin and Wyplosz [2012] enumerate four economic conditions: openness, product differentiation, flexible wages and prices, and labour mobility; and three political ones: fiscal transfers, homogeneous preferences and solidarity. El-Agraa [2011] lists additionally: financial market integration, similarity of production structures and similarity of inflation rates. The logic of the OCA theory is as follows: if certain conditions, such as openness, product differentiation, or similarity of production structures, are not satisfied, a monetary union shows greater vulnerability to adverse asymmetric shocks (shocks that affects members of a monetary union differently). When such a shock arrives, there is a need to adjust, and integrated financial markets, flexible labour and product markets reduce the costs of adjustment to an asymmetric shock. Political criteria 'act' as a last resort. They consist in political support that helps a hit country to face a shock.

At first sight, there are few common points between the Maastricht criteria and the OCA criteria, except for 'the integration of markets' and 'open economies'. The modified framework for the assessment of economic convergence seems not to bring the convergence criteria much closer to the OCA properties either. Many economists propounded that due account for this negligence of OCA criteria would be paid [Krugman, 2012]. Not entering into the discussion where the relations between the EMU and the OCA criteria are seen as competitive, it would be worth emphasising two issues: a high business cycle synchronisation and structure similarities did not prevent macroeconomic imbalances in some EU countries [MF, 2013]; and financial markets throughout the euro area, rather than succeeding in the role of an insurance against the shock [De Grauwe, 2009], were actually involved in negative spillovers [Alter, Beyer, 2013]. Taking a larger perspective, one can see an important similarity between the OCA theory and the rationale of the discussed EU reforms in fostering internal and external balance and reducing the impact of asymmetric shocks. This is why, against this background, it is important to point to these OCA criteria that have proved to be especially relevant in the period of crisis.

The issue that has become very significant in the EMU is fiscal integration with market pressure as a key driver for EU reforms in this area. In January 2008, the spread between the Greek and the German government bond rates amounted to 37 basis points and, in October 2012 (when a permanent stabilisation mechanism was inaugurated in the EMU), the differential was 1649 basis points. Fiscal burdens, in part created by the debt dynamics imposed by financial markets, were so hard that the question of government solvency was extensively raised in economic debate [R.A., 2011]. At the same time, a peculiar paradox was observed in the EMU: sovereign default risks for countries with smaller debt ratio but partici-

pating in the monetary union were evaluated by markets higher than risks in countries with a heavier debt burden but that remained outside the eurozone [De Grauwe, 2011].

Deepening fiscal integration in the EU was inevitable in this context. Mutual financial assistance to euro area countries in difficulties has taken form of an inter-governmental financial institution – the European Stability Mechanism (ESM). Financial assistance of the ESM may take the form of various instruments, such as: loans, financial assistance for the re-capitalisation of financial institutions, purchase of government bonds on the primary or secondary markets, and direct recapitalisation of banks under the Single Supervisory Mechanism. The ESM direct recapitalisation instrument forms one of the blocks of the EU Banking Union, along with the Single Resolution Mechanism, with its Single Resolution Fund, and, in the near future, with the European Deposit Insurance Scheme [Szypulewska-Porczyńska, 2015]. Besides stronger fiscal stabilisation tools, adjustments to crisis developments in the EMU also involved actions of the ECB, including, above all, the interventions of the ECB indirectly buying government bonds via loans to private banks.

These two kinds of shock absorbers provided for member states participating in stage three of EMU in case of asymmetrical developments, one by the ECB and the other by the ESM, are not, of course, part of the euro area admission rules. The two EMU procedures: the procedure of admission and that of financial crisis support, complement each other. Thus, the criticism that the situation in the euro area has been shaped or might be shaped mainly by entry criteria misses the point. Economic dynamics that exist at the level of EMU countries may be exacerbated by the monetary union with one interest rate and one exchange rate for countries with different macroeconomic conditions.

Conclusions

With changes in economic governance in the EMU that followed the crisis in the eurozone, the framework for the assessment of economic convergence in EU countries aspiring to the euro area has become largely more complex. That was a consequence of the following modifications: (1) the application of the EDP has been extended to debt criterion; (2) the list of economic indicators considered to be important to economic convergence in the EMU has expanded (especially by those introduced with a new surveillance procedure for the prevention and correction of macroeconomic imbalances); (3) what is more, the new set of indicators is not fixed – up to now, there have been several such modifications; (4) the application of new factors is not clear. The Commission and the ECB underline that it cannot be interpreted mechanically, as it may result in different interpretations.

One must also consider the fact that results of macroeconomic policies are rather of medium-term character; (5) entry conditions are embedded in complex procedures; (6) with the introduction of new regulations, especially the TSCG, there no longer exists a single track for assessment of economic convergence in the EMU.

So, on the one hand, the framework used to examine economic convergence has become more complex. In addition, at the present time, an effective application of the convergence criteria is an easier task than before. All this might be taken as evidence that the conditions to join the eurozone became more severe. The framework for euro accession could be strengthened further in the process of reinforcement of the credibility of the EMU. On the other hand, however, the circumstances of the changes in the entry conditions [Hubner, 2013] and, above all, a high level of discretion the European institutions retained when assessing the state of economic convergence in EU member states seeking to adopt the euro suggest that eventually the discussed modifications may have a moderate influence on the process of enlargement of the euro area. What is more, the changes in the design of the eurozone itself make the challenge of euro membership easier. Being more political than technical, it is difficult, however, to predict the prospects for future enlargement of the European monetary union to new members. Nonetheless, given a low level of public support for the euro in other member states with a derogation, Lithuania could be the last new eurozone member for several years.

The new rules introduced into the framework for the examination of the economic convergence, not being directly designed for euro area admission issue, must show some inadequacies. In particular, the erratic framework related to the MIP can hardly be considered a 'missing part' of entry conditions. Given that the old convergence criteria have already been the object of criticism [Mulhearn, Vane, 2008], it can be postulated that the time has come for a review of the framework for the assessment of economic convergence in the EU.

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