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Enrico Letta needs to push banking union

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Italy’s latest prime minister will need all the help he can get

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What exactly will be the job of [Enrico Letta and his new government](http://www.ft.com/cms/s/0/4467c146-af63-11e2-a020-00144feabdc0.html)? The intellectually lazy answer is reforms. But reforms are always a means to an end. So what is the ultimate goal of the exercise? I would interpret the prime minister designate’s mandate from President Giorgio Napolitano thus: “Do whatever it takes to make the country’s position in the eurozone sustainable, and do so without defaulting.”

The good news is that the Italian political establishment has finally accepted the logic of a grand coalition. As I have [argued before](http://www.ft.com/intl/cms/s/0/08e7b07c-7fb1-11e2-8d96-00144feabdc0.html), a grand coalition is the only possible constellation able to guarantee stable government following elections in February this year. It is not clear whether it can last. Silvio Berlusconi’s People of Liberty enjoys a strong lead in the polls, and the former prime minister could allow the government to collapse at any time, forcing new elections. In that case, I would expect Matteo Renzi, mayor of Florence, to make a run for the candidacy of the centre-left Democratic party. He would be best placed to take on Mr Berlusconi. He could capture many of the young voters who have deserted People of Liberty in favour of Beppe Grillo’s anti-establishment Five Star Movement.

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Mr Letta has already announced that his priority will be to [end austerity](http://www.ft.com/cms/s/0/8f182f04-acc6-11e2-9454-00144feabdc0.html). He has signalled willingness to implement People of Liberty’s pledge to abolish a primary residence property tax, one of the main elements of the outgoing government’s austerity programme.

The problem with austerity is not merely that it is socially unfair and politically hard to do. With interest rates close to zero, it also becomes self-defeating. So Mr Letta is right to prioritise an end to austerity. But he will require good diplomatic skills to win European assent for his promised regime shift.

The second priority should be to fix the banks. As long as small companies pay interest rates of 10 per cent to their zombie banks, the economy cannot recover. With a public sector debt ratio nearing 130 per cent of gross domestic product, the state does not have the resources to fix the problems in the banking sector. Unless the European Central Bank is ready for some extreme action – which does not seem to be the case now – the only solution to this problem would be a genuine and retroactive European banking union.

By “genuine”, I mean a banking union that accepts the principle of a joint ultimate backstop. And by “retroactive”, I mean a backstop that applies to existing assets as well. I cannot see how one can fix Italy’s banks otherwise.

Unfortunately, this is not an issue Mr Letta can sort out unilaterally. He will need to find a way to persuade the leaders of the so-called creditor countries to open up to such a union. I can see only one scenario under which that can happen. They will need to be confronted with a straight choice between a common backstop or a break-up of the euro.

It would seem to be the ultimate irony that the only way to render Italy’s position in the eurozone sustainable is through a readiness, in principle, to leave it. If, by contrast, you rule that out on principle, the actual probability of an exit rises, because there is less pressure on eurozone countries to make the necessary changes.

What about structural reforms? They are important, too, in the way that third-order priorities are. They matter once the two big issues – end of austerity and bank resolution – have been sorted. Good structural reforms are targeted at specific goals. If Italy wants to remain in an asymmetric monetary union with Germany at the centre, it should focus on a reform programme that facilitates adjustment.

The Italian establishment’s priority list of reforms starts with a change to the electoral system, followed by a series of mostly ill-defined structural steps including hire-and-fire legislation. My rather shorter list would consist of privatisation of state-owned companies, reduction of layers of public administration, and deregulation of the services sector, accompanied by specific labour market reforms to facilitate that deregulation.

There is a case for a limited political reform to redefine the powers of parliament’s upper house. Some of my Italian friends believe in the perfect electoral system that provides eternal stability. But would Mr Berlusconi not have been prime minister under most systems? Especially with Mr Grillo in mind, I think it would be mad to get rid of democratic checks and balances, even if they make governing a little harder.

In terms of the three priorities – ending austerity, standing up to German Chancellor Angela Merkel and structural reforms, I would expect Mr Letta to pretend trying the first, get scared of the second, and become stuck in the molasses of the third. The ultimate goal of attaining default-free sustainability in the eurozone may be beyond human reach even with the greatest efforts. For that view to turn out to be too pessimistic, Mr Letta will have to surprise us all. I wish him luck.

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