Stressing the positive

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Hooray! The banking crisis is over! Let's party! OK, maybe not.

In the end, the actual release of the much-hyped bank stress tests on Thursday came as an anticlimax. Everyone knew more or less what the results would say: Some big players need to raise more capital, but over all, the kids, I mean the banks, are all right. Even before the results were announced, Treasury Secretary Tim Geithner told us they would be "reassuring."

But whether you actually should feel reassured depends on who you are: a banker, or someone trying to make a living in another profession.

I won't weigh in on the debate over the quality of the stress tests themselves, except to repeat what many observers have noted: The regulators didn't have the resources to make a really careful assessment of the banks' assets, and in any case they allowed the banks to bargain over what the results would say. A rigorous audit it wasn't.

But focusing on the process can distract from the larger picture.

What we're really seeing here is a decision on the part of President Barack Obama and his officials to muddle through the financial crisis, hoping that the banks can earn their way back to health.

It's a strategy that might work. After all, right now the banks are lending at high interest rates, while paying virtually no interest on their (government-insured) deposits. Given enough time, the banks could be flush again.

But it's important to see the strategy for what it is and to understand the risks.

Remember, it was the markets, not the government, that in effect declared the banks undercapitalized. And while market indicators of distrust in banks, like the interest rates on bank bonds and the prices of bank credit-default swaps, have fallen somewhat in recent weeks, they're still at levels that would have been considered inconceivable before the crisis.

As a result, the odds are that the financial system won't function normally until the crucial players get much stronger financially than they are now.

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Can the economy recover even with weak banks? Maybe. Banks won't be expanding credit any time soon, but government-backed lenders have stepped in to fill the gap. The Federal Reserve has expanded its credit by $1.2 trillion over the past year; Fannie Mae and Freddie Mac have become the principal sources of mortgage finance. So maybe we can let the economy fix the banks instead of the other way around.

But there are many things that could go wrong.

It's not at all clear that credit from the Fed, Fannie and Freddie can fully substitute for a healthy banking system. If it can't, the muddle-through strategy will turn out to be a recipe for a prolonged, Japanese-style era of high unemployment and weak growth.

Actually, a multiyear period of economic weakness looks likely in any case. The economy may no longer be plunging, but it's very hard to see where a real recovery will come from. And if the economy does stay depressed for a long time, banks will be in much bigger trouble than the stress tests — which looked only two years ahead — are able to capture.

Finally, given the possibility of bigger losses in the future, the government's evident unwillingness either to own banks or let them fail creates a heads-they-win-tails-we-lose situation. If all goes well, the bankers will win big. If the current strategy fails, taxpayers will be forced to pay for another bailout.

But what worries me most about the way policy is going isn't any of these things. It's my sense that the prospects for fundamental financial reform are fading.

Does anyone remember the case of H. Rodgin Cohen, a prominent New York lawyer whom The New York Times has described as a "Wall Street eminence grise"? He briefly made the news in March when he reportedly withdrew his name after being considered a top pick for deputy Treasury secretary.

Well, earlier this week, Cohen told an audience that the future of Wall Street won't be very different from its recent past, declaring, "I am far from convinced there was something inherently wrong with the system." Hey, that little thing about causing the worst global slump since the Great Depression? Never mind.

Those are frightening words. They suggest that while the Federal Reserve and the Obama administration continue to insist that they're committed to tighter financial regulation and greater oversight, Wall Street insiders are taking the mildness of bank policy so far as a sign that they'll soon be able to go back to playing the same games as before.

So, as I said, while bankers may find the results of the stress test "reassuring," the rest of us should be very, very afraid.