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SDRs are inflationary helicopter money, and IMF aid does more harm than good.

With the explosive growth of the Fed's balance sheet and the easy policy stances of most of the other major central banks, it would seem the last thing the world needs now is another contributor to a potentially sharp inflation spike. But at the G-20 summit early this month, that's what was delivered, with the IMF gaining authorization for a $250 billion allocation of Special Drawing Rights.

Update to strategic view

EMERGING MARKETS MACRO: The $250 billion SDR allocation granted to the IMF by the G-20 is the wrong step at the wrong time. Though portrayed as a means to help relieve deflationary influences, it further feeds into mounting inflation risks. And the assistance that will be doled out to emerging market economies through the IMF program is more likely to retard growth than to serve as a catalyst for it.

[see Investment Strategy Dashboard]

The IMF came away from the G-20 confab in London as a huge winner, tripling its lending capacity to $750 billion, in addition to enabling it to inject $250 billion into the global financial system through SDR issuance. Quite apart from the inflation issue, we do not view this dramatic expansion of the fund's resources as good news. Its history is marred by repeated instances in which its intervention sparked economic calamity and social unrest. Currency devaluations, higher taxes and harsh budget austerity have typically been its poisonous "conditionality" recipe. In response to the current financial and economic turmoil, the IMF has announced that it is "revamping" its lending program with "streamlined" conditionality to help recipient developing countries "weather the crisis and return to sustainable growth." We'll believe it when we see it.

The SDR program has been in place for some 40 years, with outstanding balances of $32 billion. The fund sought to double that starting in 1997, but was blocked by Congress, due in part to inflation concerns. But with heavy Democratic majorities and the Obama administration's backing, there's not much doubt that this expansion will be ratified.

SDRs are distributed proportionately to all 185 IMF members based on their quotas, so industrialized countries would get the largest shares of the allocation. The expectation is that the larger economies would grant their allocations to emerging market countries, giving them what would amount to a claim on hard currency balances from the IMF. The US, for example, could grant SDRs equivalent to $1 billion to the Republic of Belarus. Belarus could then submit those

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SDRs to the IMF, asking for the payment of $1 billion. To satisfy the request, the IMF would present the SDRs to the US Treasury, which would then issue "SDR certificates" to the Fed in exchange for a money credit in the Treasury's Fed account. The Treasury would then withdraw $1 billion from its Fed account and send it to the IMF, which in turn transmits it on to Belarus. At the end of the process, the Fed's balance sheet would show a new asset of $1 billion with no corresponding liability -- pure money creation, unless it had done something outside the process to sterilize it.

But it seems unlikely that the Fed -- or whatever central bank is involved in a particular instance -- would sterilize such a transaction, considering that having liquidity added through the IMF, thus having the fund act as a quasi-global central bank, is a key objective of the exercise. IMF managing director Dominique Strauss-Kahn highlighted this in his celebration of the fund's expanded powers, boasting that with the SDR allocation "you will see that it's the beginning of increasing the role of the IMF, not only as a lender of last resort…but also in providing liquidity to the world, which is the role finally and in the end, of a financial institution like ours." Strauss-Kahn acknowledged separately that the "only drawback is the inflation risk, but it's limited at the moment."

Indeed, other proponents of the SDR expansion are making the case that the rights would be useful in helping quell whatever deflationary forces continue to linger. Ted Truman, the Fed's former long-time head of international finance, now an outside adviser to Treasury Secretary Tim Geithner and a key advocate for the G-20 action, said the SDRs would provide an "economic boost" at a "time of global concern about deflation." Inflation, he said separately, is "not today's problem. The more likely problem is deflation."

Even if Truman were to acknowledge the inflation risks, he likely would see it as a small price to pay relative to the benefits that he sees flowing from the rights issue. The SDRs would "provide immediate aid, about $17 billion, to the poorest countries -- substantially more than their total annual disbursements" from the World Bank, Truman said. "More than $80bn would flow to other developing countries that have besieged multilateral development banks for large sums…" In other words, the SDRs would amount to a large back-door distribution of foreign aid and "development" assistance, which has proven time and again to entrench bureaucracies and promote statism, fostering monopolies, corruption and stagnation. For example, Pakistan has been a large recipient of US foreign aid for six decades, and it remains as much of an economic and political basket-case as ever. Malaysia, on the other hand, has never been a recipient of aid, and its entrepreneur-driven economy has been one of Southeast Asia's fastest growing.

As for the argument that inflation is not a relevant concern in the current environment, we recently noted that the deflationary plunge in velocity seen in the panic of the fourth quarter last year has already been significantly relieved (see "Transmission Not Broken" March 31, 2009). With the central banks of the world continuing to add liquidity at a prodigious pace, this trend toward rising velocity is likely to be maintained for the foreseeable future, eventually giving rise to an inflation breakout, unless the Fed and the world's central banks aggressively reverse their present postures of extreme ease. The $250 billion SDR allocation may seem relatively minor in the context of the trillions being injected by central banks. However, the sum doesn't seem so minor when it is recalled that prior to the extraordinary actions undertaken beginning last fall, that $250 billion would have represented nearly a third of the total size of the Fed's assets. In any case, even if the SDR allocation is only a marginal contributor to the inflation outlook, it still represents at least an incremental aggravation of a potentially significant threat.

BOTTOM LINE: The $250 billion SDR allocation granted to the IMF by the G-20 is the wrong step at the wrong time. Though portrayed as a means to help relieve deflationary influences, it

further feeds into mounting inflation risks. And the assistance that will be doled out to emerging market economies through the IMF program is more likely to retard growth than to serve as a catalyst for it.