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## El Salvador legalises bitcoin: hype or breakthrough?



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# EL SALVADOR LEGALISES BITCOIN: HYPE OR BREAKTHROUGH?

On 7 September 2021, bitcoin became legal tender in El Salvador alongside the US dollar. According to the new law, all economic agents will have to accept payment in the popular cryptocurrency. In this issue of *Infocus*, Joaquin Thul looks at the reasons behind the adoption of bitcoin and why, in the short term, it is unlikely to be successful.

On 8 June, the Congress of El Salvador made bitcoin legal tender. The short text of the law allowed a 90-day period before its final implementation on 7 September 2021, during which shops, merchants and government offices would adopt the technology to make and receive payments in this cryptocurrency. El Salvador now has two official currencies – the US dollar and bitcoin – neither of which they actively control.<sup>1</sup>

According to the new law, all economic agents will have to accept bitcoin as payment for goods and services. Taxes can also be paid with bitcoin. The Salvadorean government plans to ensure liquidity of transactions through the creation of an escrow account, initially worth USD 150 million, which will automatically convert bitcoins into US dollars from users who prefer not to hold cryptocurrencies or be exposed to its price fluctuations. Apart from guaranteeing bitcoin transactions, this will also fund the USD 30 sign-up bonus that customers are expected to receive when they login to the government's electronic wallet app, which they will need to download to make transactions in bitcoins.

El Salvador's President, Nayib Bukele, stated that the use of bitcoin will help improve financial inclusion and generate savings in annual remittance fees when Salvadoreans send money from the US.<sup>2</sup> In this note we explore these two potential benefits and also consider whether bitcoin has the potential to replace the US dollar as the Salvadorean currency of choice.

## Financial inclusion

El Salvador, with a population of almost seven million people, currently has one of the lowest levels of financial inclusion within Latin America and the Caribbean. According to World Bank data, in 2017 less than 30% of Salvadoreans aged 15 or over had an account with a bank or a financial institution. This percentage is the third lowest on the list, higher only than financial inclusion in Haiti or Nicaragua, at 28.2% and 28.4% respectively – see Figure 1.

Only 23% of people in El Salvador have Internet access at home, one of the lowest rates in the region, although over 85% of people use a mobile phone. This supports the idea of investing in infrastructure to allow mobile payments as a means of increasing financial inclusion.

## 1. Bank account holdings in Latin America & Caribbean



To help promote this, in January 2020 the Salvadorean government approved the country's Digital Agenda 2020-2030, intended to incorporate new technologies, improve financial inclusion and economic development over the next ten years. However, the official agenda does not mention the adoption of cryptocurrencies.<sup>3</sup>

Furthermore, although the low levels of financial inclusion and high mobile phone penetration in the country could favour the adoption of a digital currency as a means of payment, the use of bitcoin seems to go against some of the country's long-term plans. For example, the unregulated nature of cryptocurrencies and their links with illegal activities contradict the transparency goals set by the digitalisation agenda. In short, people who are currently outside the financial system are unlikely to be included by the adoption of bitcoin.

## Remittance costs

Remittances represent almost a quarter of the country's GDP, the largest proportion of countries in Latin America and the Caribbean and the fifth largest in the world, see Figure 2.

Proponents of bitcoin believe its use could reduce the cost of sending and receiving money from abroad, possibly saving Salvadoreans around USD 400 million annually in remittance fees.<sup>4</sup> However, data suggests the cost of sending remittances from the US to El Salvador is already among the lowest in the region and has continued to decline over the last year.

<sup>1</sup> The Salvadoran colón, was the currency of El Salvador between 1892 and 2001, when it was replaced by the US dollar.

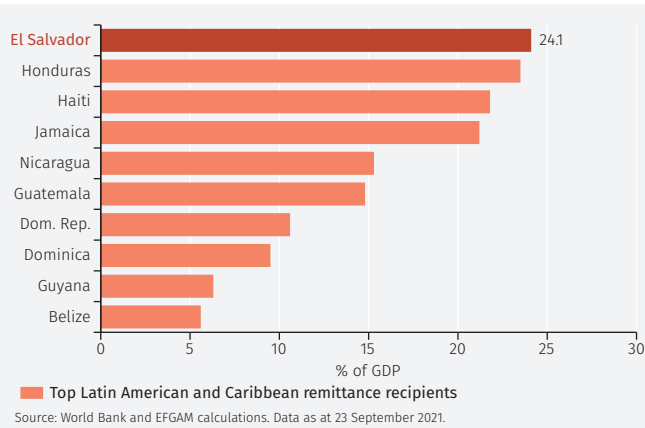
<sup>2</sup> <https://www.cnbc.com/2021/09/09/el-salvador-bitcoin-move-could-cost-western-union-400-million-a-year.html>

<sup>3</sup> The full digital agenda can be accessed at: <https://www.innovacion.gob.sv/> (in Spanish)

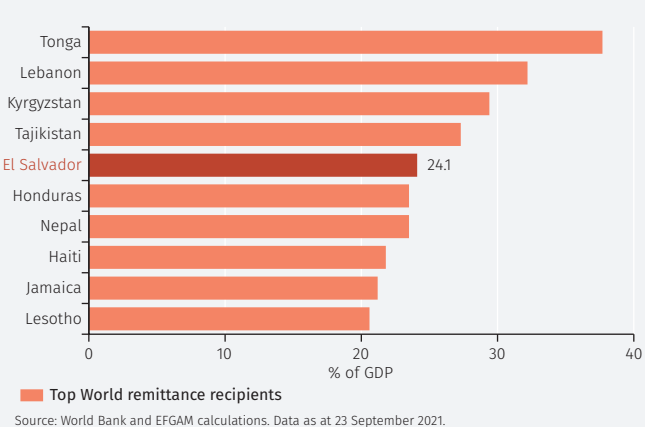
<sup>4</sup> <https://www.asamblea.gob.sv/node/11510>

# EL SALVADOR LEGALISES BITCOIN: HYPE OR BREAKTHROUGH?

2a. Top remittance receivers in 2020: Latin America & Caribbean



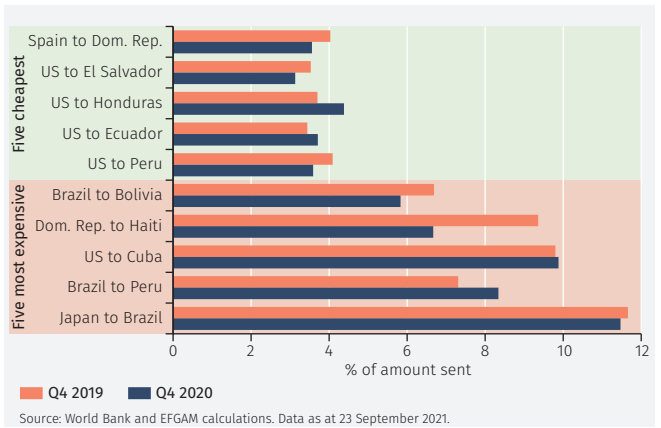
2b. Top remittance receivers in 2020: World



According to data from El Salvador’s central bank, remittances totalled USD 5.9 billion in 2020, a 5% increase from the previous year. The World Bank estimates the average cost of sending money from the United States to El Salvador represents 3.13% of the amount sent, equivalent to an annual cost of USD 185 million in fees, less than half the number quoted by the government – see Figure 3.

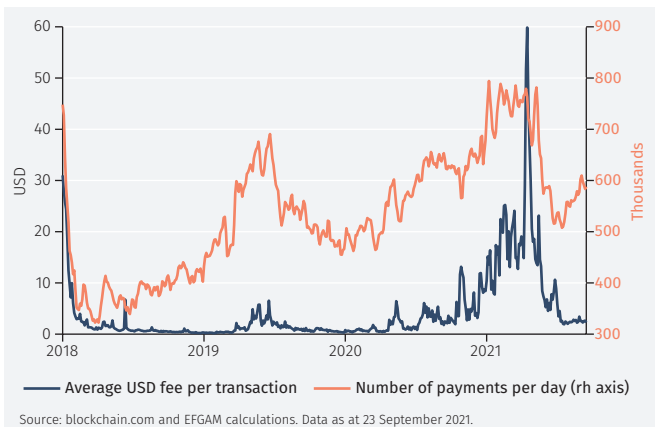
Competition among money transfer firms and the creation of new ways to transfer money electronically has reduced the cost of sending and receiving money from abroad. With bitcoin every transaction must be added to the blockchain, a public ledger of all cryptocurrency transactions. These are validated by miners, who spend large amounts of computer power and energy doing this in return for a fee. Given network limits, during times of network “congestion” these transactions will take more time and fees will vary according to traffic and transaction size.<sup>5</sup>

3. Average cost of sending money to Latin America & Caribbean<sup>5</sup>



In 2021, the cost of a bitcoin transaction ranged from \$2 to \$60, depending on the number of payments processed on the day, with an average cost of \$13 per transaction, see Figure 4.<sup>7</sup> Data from El Salvador’s central bank shows the average size of remittances received increased from \$280 per month in 2020 to \$300 per month in 2021, with fees averaging less than \$10 per transaction. Although the difference between fees is, on average, only slightly cheaper for regular money transfers, it nonetheless represents a disincentive to switch to bitcoin. Moreover, the unpredictable nature of bitcoin fees could be a headwind to widescale adoption by the public.

4. Bitcoin transaction fees vary according to network



## Will El Salvador eventually replace the US dollar with bitcoin?

A survey conducted in early September by LPG Datos, a Salvadoran polling firm, found that over 65% of the population rejected the introduction of bitcoin as legal tender in the country, and over 70% would refuse to receive payments in bitcoin.

<sup>5</sup> <https://remittanceprices.worldbank.org>  
<sup>6</sup> <https://support.blockchain.com/hc/en-us/articles/360000939883-Explaining-bitcoin-transaction-fees>  
<sup>7</sup> <https://www.blockchain.com/charts/fees-usd-per-transaction>

## EL SALVADOR LEGALISES BITCOIN: HYPE OR BREAKTHROUGH?

Moreover, it seems unlikely the country will replace dollars with bitcoin given the country's close commercial links with the US and the dollarised nature of the Salvadoran economy. El Salvador runs a persistent trade deficit with the US, equivalent to 18% of GDP.<sup>8</sup> Therefore, the use of US dollars to finance trade reduces the likelihood of fully adopting bitcoin, a currency which is not widely accepted in the US.

Additionally, the possibility of citizens paying taxes with bitcoin could hinder tax collection for the government given the fees associated with converting bitcoin to US dollars and the high intra-day volatility of its price. On September 7th, the day bitcoin became legal tender, the price of the cryptocurrency fell by 11%, registering one of the largest intraday price variations of the last five years – see Figure 5.

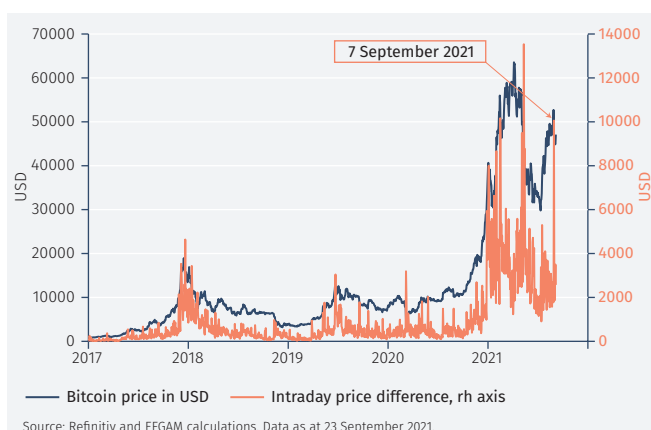
Problems associated with the reporting of transactions using bitcoin could lead to additional issues of tax evasion, as accounting systems and tax filing systems are not set up to incorporate the cryptocurrency, leading to a potential reduction in revenue collection by the government.

Therefore, it seems unlikely the country will move to a bitcoin-based economy anytime soon. Furthermore, problems encountered by users of the government's digital wallet app have discouraged its use in the first week. Additionally, the public's rejection of the new currency, either due to lack of information or negative perception of cryptocurrencies, is likely to hinder the success of bitcoin in the short term.

### Conclusion

Overall, President Bukele's decision to make bitcoin legal tender in El Salvador resembles more a marketing campaign for his government than a genuine attempt at improving financial inclusion or reducing transaction costs. Bukele's government has recently been criticized by international organizations for its authoritarian rule, forcing lawmakers to pass a budget law and controlling the judicial system to favour his policies. US President Joe Biden raised concerns over Bukele's respect for the rule of law and democracy, turning down a meeting request from El Salvador's president in February 2021. In this context, the approval of a cryptocurrency as legal tender seems questionable at best. It seems unlikely that bitcoin will either become a mainstream means for international payments or act as a catalyst for greater financial inclusion.

### 5. Price of bitcoin and intraday variation



<sup>8</sup> IMF and World Bank



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