El Salvador's Bitcoin Case | High Risks Will Limit Benefits

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The risks associated with the adoption of bitcoin as legal tender in El Salvador seem to outweigh its potential benefits. There are immediate negative implications for credit, and wide usage of bitcoin is unlikely.

Bitcoin as legal tender

On Sept. 7, 2021, bitcoin became legal tender in El Salvador, following parliament's approval on June 9, 2021. The launch suffered from several missteps, especially around the use of the government-backed crypto wallet, Chivo, which had to go temporarily offline because of technical glitches. However, several merchants reported that they had started to process payments in bitcoin, especially larger corporates.

Wide usage of bitcoin is unlikely. The bill states that all economic agents, including the government, "must" accept bitcoin as payment with the exception of those lacking the technology to do so, but that prices "may" be expressed in bitcoin. A survey conducted by El Salvador's Chamber of Commerce and Industry showed that over 90% of respondents did not want the obligation to accept bitcoin as payment, and 75% said they will continue to use U.S. dollars. Widespread protests against mandatory bitcoin adoption have also taken place, both pre- and post-launch day.

It is unclear whether bitcoin really is legal tender. While the law defines the cryptocurrency as legal tender, not all economic agents are technically forced to accept bitcoin in exchange for goods and services. A clause states that those with insufficient technological capabilities to transact in bitcoin are not forced to accept it as payment. Economic agents that do not want to transact in bitcoin may claim that status, and there are no clear rules enforcing the acceptance of bitcoin as payment; although this, of course, could change.

El Salvador's small, open, dollarized economy status means bitcoin's impact could be sizable. The country's GDP is $25 billion (or about 600,000 bitcoins), with trade accounting for 60% of GDP (goods exports plus imports), and remittances close to 25% of GDP. This means that if bitcoin was widely used for cross-border transactions, the effect of the cryptocurrency's high volatility on the wider economy would be significant. While El Salvador's adoption of U.S. dollars meant that it didn't face exchange rate risk in the past, the introduction of bitcoin--if the cryptocurrency is widely used--would introduce exchange rate risk, with potentially disruptive implications for trade and cross-border financial flows. On the other hand, as a hedge against sanctions from the U.S. government and other extra sovereign risks, the move to bitcoin does have some advantages.

The current landscape

BTC's extreme volatility would drive large swings in prices, reducing the incentive to use it for day-to-day transactions or as a storage of value

Bitcoin's adoption comes at a high cost. Its extreme volatility would drive large swings in prices, reducing the incentive to use it for day-to-day transactions. There are also fiscal risks associated with the ability to pay taxes in bitcoin, and exchange rate mismatch risk in the financial sector if banks hold large amounts of bitcoin on their balance sheet but supply credit mostly in U.S. dollars.

The cryptocurrency's potential benefits are unlikely to materialize in the short term. Bitcoin could increase financial inclusion of the unbanked (70% of the population), and reduce costs on cross-border transactions, such as remittances. However, these benefits will only be realized if there is widespread trust in bitcoin--and surveys indicate the contrary. Without trust, bitcoin transactions are likely to be immediately converted into U.S. dollars due to exchange rate risk and the propensity by bitcoin holders to retain their bitcoin as a store of value as opposed to using it as a medium of exchange.

Financial integrity is also at risk. In the absence of effective anti-money-laundering and other measures that combat the financing of illicit activities, the adoption of bitcoin could facilitate these activities, contribute to tax evasion, and pose a risk to the country's financial system and its relationship with other countries and multilateral organizations.

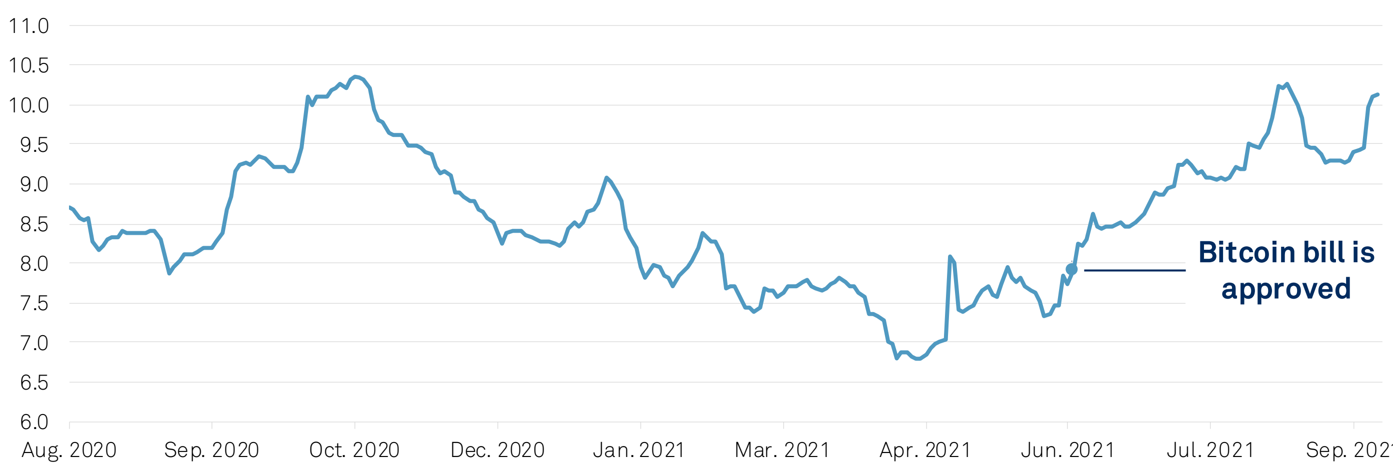
The credit implications

Bitcoin adoption threatens El Salvador's IMF deal. The country is in a tough fiscal position: the deficit is 10% of GDP, and public debt about 90% of GDP. With about $2 billion in debt repayments in 2021, the government is seeking a $1 billion IMF loan. Bitcoin's potential lowering of financial integrity, by indirectly encouraging illicit financial activities such as money laundering and tax evasion, could complicate ongoing negotiations. However, in practicality, all these illicit activities could also be conducted through U.S. dollars with limited oversight. Credit markets have reacted, with yields on sovereign bonds heading higher since the bitcoin law was approved (see chart).

Bitcoin adoption increases fiscal vulnerabilities. Allowing taxes to be paid in either U.S. dollars or bitcoin reduces visibility over the trajectory of fiscal revenue. The government, at its own cost, will transfer $30 worth of bitcoin to every national who registers to the Chivo crypto wallet--a de facto fiscal transfer. Furthermore, the government announced that it will fund a $150 million trust fund to mitigate volatility in the bitcoin-U.S. dollar exchange rate, and it is unclear whether it will commit to replenish the trust fund if it falls below a certain U.S. dollar balance.

We see potential disruption to credit from domestic banks if bitcoin is widely used. Assuming banks continue to supply loans in U.S. dollars but are forced to accept payments and deposits in bitcoin, this could generate balance sheet currency-mismatch-related vulnerabilities. The availability of bitcoin futures provides a means to manage exchange rate risk. However, the costs of managing bitcoin futures, and concerns over the underlying volatility of bitcoin, may ultimately encourage banks to automatically convert all bitcoin received into U.S. dollars. Otherwise, banks could act to reduce exposure to that risk by reducing lending activities.

El Salvador Sovereign 2035 Bond Yield (%)



Sources: Bloomberg, S&P Global Ratings.