Crypto as a Global Reserve? Considerations from El Salvador Adopting Bitcoin as Legal Tender

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Bitcoin and other cryptoassets have rapidly moved from a relatively niche investable product and asset class to a mainstream economic force. Recent moves and developments by global financial institutions beginning to offer bitcoin and other crypto products and services are a clear indication of this global trend. Especially as global coordination on tax and other financial markets issues continues to increase, the pivot toward global regulatory treatment over the fast developing asset class seems logical. Against this backdrop, however, a dramatic change occurred in June 2021, when the first country ever passed national legislation to recognize bitcoin as legal tender within its jurisdiction. Without context, one might suppose that the nation leading this adoption would either be the United States, the mainland Chinese government, or other member of the G-7 or G-20.

This would be a logical, but incorrect supposition. El Salvador has the distinction of the first mover status in this space, which was initially announced at Bitcoin 2021 in Miami, Florida. As the excitement, debate, and conversation around this event begins to subside, however, three fundamental questions are increasingly being asked.

1) What are some of the longer effects of this adoption by a sovereign nation of a cryptocurrency as a legitimate currency alternative?
2) Is it possible to develop a framework or pathway with which to analyze what nations might be following this pathway?
3) Are there quantifiable pros and cons around this transition that can be applied across different jurisdictions or must it be taken as a case-by-case basis?

There are a few characteristics of El Salvador that made the adoption of bitcoin not as far-fetched as it might have initially appeared. A significant percentage of the population in El Salvador, which is not a wealthy nation, is unbanked. Additionally, remittances sent back to El Salvador total approximately one-fifth of GDP on an annual basis, and have rebounded from a pandemic-induced decline during 2020. Interestingly enough, and something that makes El Salvador a unique case, is the fact that the current functional currency in the country is the U.S. dollar. Much has been written about cryptocurrency serving as a logical option for nations and currencies experiencing bouts of high inflation, but there are also other ramifications of this development.

Policy actions taken by the United States do not occur in a vacuum, and the inadvertent potential weaking of the purchasing power of the dollar could actually encourage countries with more stable currencies to adopt bitcoin. In other words, this development opens the door to nations with higher profile and more stable currencies to have them be augmented or replaced by bitcoin or potentially other cryptocurrencies. That said, such a pivot and development are not without risk and opportunities. Let's take a look at some of those risks and opportunities that should be a part of any robust policy conversation.

Opportunities

Clearly the most obvious opportunity connected to adopting bitcoin as the functional, or reserve, currency in a certain nation is gaining access to a 21st century payment system and solution. The benefits of blockchain based payments are well acknowledged and have been thoroughly documented; more transparency and traceability, lower fees and costs, and increased speed with which transactions can be approved. Building on the decentralized idea of bitcoin also means that even if a nation lacks an established commercial banking system available to most citizens, anyone with a mobile device can access the bitcoin network. It is worth pointing out that while the global unbanked population is 1.7 billion, two-thirds of this population has a mobile phone and connectivity. In other words, the implementation of bitcoin would allow individuals that – until now – were excluded from the banking and financial services space, an opportunity to gain access to these services. Add in the reality that there is a fixed amount of bitcoin that will ever exist, and the potential for bitcoin to serve as an effective hedge and reserve asset makes logical business sense.

Challenges

For every opportunity or benefit, however, there are certainly going to be challenges that will accompany any nation seeking to adopt bitcoin as a reserve asset or functional currency. Outside of the rather obvious risk connected to the price volatility that continues to be seen in the bitcoin and cryptoasset marketplace, there are a few other risks that should be taken into account. For example, even if a specific jurisdiction decides to authorize or legitimize bitcoin or some other cryptoasset as legal tender or a functional currency, that does not mean other nations will follow suit. Secondly, and based on some recent commentary from institutions such as the International Monetary Fund (IMF), there are going to be institutions and players that will not be responding in a positive manner to these developments. Lastly, the technical complexity and features of blockchain and bitcoin technology might make the implementation of such a currency alternative more complicated than might initially be thought. To sum up, the very innovation and creativity that has driven the cryptoasset space forward in terms of development are also some of the very traits that can prove to be significant obstacles to implementation.

Path toward implementation

The implementation and onboarding of a new currency alternative or option will invariably be a complicated and multi-faceted process that every nation will have to approach from an individual perspective. That said, there are several considerations that could and should be taken into account regardless of what specific country is being examined.

Firstly, an assessment around the interest and appetite for cryptoassets among law makers and policymakers needs to be conducted. This assessment should include lawmakers, financial markets experts and regulators, academics, as well as numerous representatives from the private economic sector; such a combination will provide a robust and well-rounded conversation around the multitude of issues that invariably arise whenever blockchain and cryptoassets are discussed.

Secondly, how will the adoption of cryptoassets impact and potentially influence the rest of the financial markets, i.e., how will the marketplace be able to reconcile and interoperate between fiat and crypto based systems. There are numerous private sector solutions that are available to assist in addressing these issues, but these solutions are neither guaranteed nor have they been – to date – implemented at the level of a nation state. The considerations around interoperability have to be assessed not just for jurisdictions seeking to implement bitcoin as legal tender or functional currency, but also must factor in the effects of stablecoins or government issued cryptoassets.

Lastly, how will tax and other regulatory authorities treat and categorize the array of cryptoassets? While in El Salvador the proposal includes initiatives to minimize, and potentially eliminate, taxes on crypto transactions, this is not the case in every jurisdiction. The United States, for example, has ended up with a patchwork of regulatory and interpretive regulatory policies that includes virtually every agency with authority in the U.S. Ensuring a consistent and understandable regulatory approach, while also minimizing political interference over the process, is an integral part of any adoption plan.

In conclusion the news from El Salvador is certainly exciting news for the cryptoasset ecosystem at large, but is only a first step in a much longer journey toward crypto adoption. Adopting a new currency option, or fundamentally changing the currency options available in a nation, is no simple matter, and must be addressed with the care it deserves. That said, the pathway and factors incorporated into this recent decision do present a potential path forward for implementation both now and in the future.