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El Salvador: a safe haven for Bitcoin?

El Salvadorian President Nayib Bukele's legalisation of Bitcoin as an official tender has raised many eyebrows. But what's behind the move?

High waves and a casual atmosphere – that was the trademark of El Zonte, a small surfer's paradise on the Pacific in El Salvador. But over the past two years a very discreet experiment has been taking place that has now moved into the world spotlight. In this fishing village you can pay for your coffee with bitcoin or use it to shop in the corner store.

It competes with the US dollar, which has been the country's official currency since 2001. In El Zonte, young people and a few entrepreneurs in particular are enthusiastic about Bitcoin. Others, however, considered the whole thing to be just an exotic craze – until President Nayib Bukele legalised bitcoin overnight at the beginning of June. But what prompted him to take this step?

The story of Bitcoin in El Salvador

The search for clues leads to Mike Peterson, a Californian surfer, who moved to El Zonte in 2005. The convinced Christian set up a youth project called Hope House and trained lifeguards, among other things. Two years ago – around the same time that Bukele took office – he told the *Los Angeles Times* that he had been contacted by an anonymous donor who had promised him USD 100,000 – in bitcoin on the condition that the money be distributed to the population and would turn El Zonte into a 'bitcoin lab'.

From then on, Hope House distributed bitcoins for collecting rubbish, for getting good grades and for residents who became ill or unemployed during the pandemic. Local businesses accepted bitcoins after Peterson's painstaking efforts to convince them. Hope House even installed a bitcoin machine where you can use an app to exchange dollars for bitcoin or to get credit for transferred bitcoins or have them paid out in dollars.

The experiment solved practical problems. Many Salvadorans who live in

El Zonte receive dollars from relatives in the US. But there is no bank branch in the village. Half of the Salvadorans don't have a bank account anyway and so they withdraw money – for hefty fees – at intermediaries such as Western Union. To do this, they had to drive from El Zonte to the neighboring village.

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For the youth, bitcoin was the entry into the financial world, into concepts like saving and investing. The USD 100,000 converted into bitcoin flooded the village with liquidity. The experiment worked – in a way similar to how solidarity currencies work anywhere in the world – because it set a local circular economy in motion.

Bitcoin insiders suspect that the figure behind it could be cryptocurrency guru Jack Mallers. Mallers developed, among other things, Strike, an app that enables people to pay and receive bitcoins and then immediately exchange them for a virtual stablecoin tied to the dollar called Tether, thus hedging against fluctuations. The *Los Angeles Times* learned that Yusuf Bukele, the brother and advisor to the president, contacted Mallers in February. They met and discussed a bitcoin law. Four months later, the country the size of Israel became the first in the world to legalise bitcoin.

Bukele, the hip President

Many initially thought this was a PR stunt by the impulsive head of state. Bukele has ruled since 2019 and has a reputation for being fashion-conscious and for cultivating his nonchalant millennial image. His Bitcoin announcement at the Bitcoin Congress in Miami on June 5, was surprising. After China had previously banned cryptocurrencies and shut down bitcoin farms, legalisation in El Salvador was welcomed good news to cushion the plummeting prices.

Three days later, the bill, was presented to Congress and passed the following morning. Starting in September, Salvadorans will be able to pay their taxes in bitcoin and use it to shop in the supermarket. A state trust fund worth USD 150 million is intended to absorb the currency risk and, if the merchants wish, immediately hedge the bitcoins in dollars. In addition, Bukele wants to grant bitcoin investors a golden visa and exempt them from capital gains taxes.

Bukele makes two arguments in favour of bitcoin. First, the cryptocurrency has a market capitalisation of USD 680 billion. 'If one per cent of that is invested in El Salvador, our GDP would increase by 25

per cent,' he said, referring to mining farms that are now looking for other locations after the ban in China. But that is only the case if bitcoins generate new added value, say experts such as John Hawkins. For many investors, however, bitcoins are only a means of storing value.

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Bukele's second argument is aimed at a sector that has been in the sights of alternative financial service providers for several years: migrants' remittances from abroad. These make up a billion-dollar business worldwide. Some 1.5 million Salvadorans live in the US alone, and last year they sent nearly USD 6 billion to their families back home. That is 20 per cent of the country's GDP.

However, not even half of Salvadorans have a bank account, because the account management and transfer fees are high. The rest of them resort to money transfer services. But even these collect between 4 and 50 US dollars, depending on the amount transferred. It's a lucrative business – especially for international and local elites. Bukele's narrative is that, for the benefit of the poor, he wants to cut off the monetary flow to these elites.

El Salvador's remittances problem

The problem is real and has already preoccupied institutions such as the World Bank, but has also fuelled windy business ideas such as Wirecard. At first glance, bitcoin as a remittance seems seductive: a money transfer via app in just seconds. But upon closer inspection, it's a chimera. Hawkins writes that only 33 per cent of Salvadorans have internet access. 'How many street vendors or farmers are technically equipped for Bitcoins?' he asked.

The argument that bitcoin transfers are free is also wrong, according to financial expert Steve Hanke. Fees would be charged for virtual bitcoin transactions on the internet or for exchanging them for dollars – money that would end up with app developers such as Mallers instead of the banks. In addition, there are the familiar problems with cryptocurrencies such as high volatility. Last month, bitcoin fluctuated between USD 58,000 and 31,000. In a country where 35 per cent of the people are below the poverty line, such fluctuations can trigger social disasters. The USD 150 million in the state fund seem low compared to the total amount of remittances.

'Bitcoins are a means of payment, but there is no credit market for them.

Economic development will therefore be difficult,' said financial expert Carlos de Sousa. But right now, the highly indebted state needs fresh capital to cope with the pandemic. However, that is now in jeopardy. The IMF, with which El Salvador is negotiating a loan of USD 1 billion, described the bitcoin law as an 'incalculable risk'. The World Bank declined to help El Salvador implement it.

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International investigators are concerned about the law as a possible gateway for money laundering – especially since El Salvador has just pulled out of a regional anti-corruption accord and is a hub for cocaine smuggling. 'Attracting international tech entrepreneurs is one thing; attracting international money launderers or tax evaders is another,' warned Julia Yansura from the Global Financial Integrity Institute in Washington.

Experts fear that the state fund has no way of determining the origin of the bitcoins. Presumably it will be tapped within a very short time – and not by Salvadoran street vendors. In this context, evidence of secret negotiations between the government and the country's criminal gangs inspires very little confidence. And there is also the fact that one of Bukele's advisors, José Luís Merino, is himself under investigation for drug and arms smuggling.

That being said, there are two reasons for Bukele to have embarked on this adventure. He is under increasing pressure from Washington because of his authoritarian conduct and the corruption in his administration. Although there is no current threat of sanctions, they cannot be ruled out in future. And therefore, the US dollar amounts to a straitjacket. Bitcoin would make it easier for Bukele to circumvent possible US sanctions.

The second reason is economic. Bukele's high popularity of 90 per cent is based on a generous government spending policy without tax increases. However, because of the dollar peg, the growing deficit cannot be offset by the printing press. And government debt securities are also subject to an increasingly high risk premium, which is becoming more and more expensive for the government.

The IMF loan would be a lifeline. But if it fails – due to resistance from the US, for example – bitcoin could be a Plan B. Bitcoin critic David Gerard considers the whole thing to be the pipe dream of libertarian technology freaks who are out of touch with reality, and politically playing with fire. 'I'm pretty sure both Bukele and the bitcoiners who

sold him this scheme are each convinced they're going to screw over the other. It's possible both will lose, of course.'



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