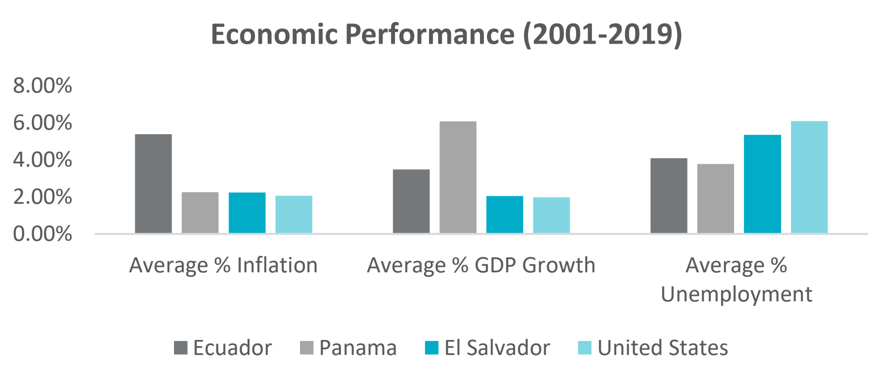
El Salvador: Bitcoinization Nation

On June 6, 2021, the President of El Salvador and junior *caudillo* in-the-making, Nayib Bukele, announced that Bitcoin (along with the U.S. dollar) will be accepted as legal tender for all transactions in El Salvador. The move has sparked a furor of debate over what such an experiment could mean for the economic future of El Salvador, as well as what it might mean for the future of Bitcoin as an alternative global currency. In this edition of our Thinking Man series, we explore the topic and offer perspectives on the implications and opportunities for the Salvadoran economy.

El Salvador's dollarization has been a mixed bag

For the most part, the monetary history of Latin America is comprised of expansive and often abusive policies that have resulted in inflationary spirals, currency devaluations and debt restructurings. Corrupt and ineffective institutions, combined with stagnant economic growth have prompted countries to, either officially (in the case of Panama, Ecuador, and El Salvador) or unofficially (in the case of Argentina and Venezuela) replace home currencies with the U.S. dollar. For the most part, the cost of having to "import" monetary policy (that is, of losing control over the printing press) has been more than offset by the benefit of price stability, even in the face of stagnating real economic growth.

On January 1, 2001, the right-wing government of the late, former president Francisco Flores (1999-2004) imposed the Monetary Integration Law, effectively replacing the colón with the U.S. dollar as the de facto currency. Like Ecuador, El Salvador adopted the dollar to fight chronic inflation (which at its 1986 peak reached 32%, relative to the 2000 peak of 96% in Ecuador) as well as to lower interest rates and stimulate growth by more tightly integrating itself with the American, and therefore global trade system.



The Thinking Man's Approach

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Ignacio Pakciarz | CEO & Founder
Rene J. Negron | Analyst

- El Salvador is marking the 20-year anniversary of dollarization to mixed socioeconomic results
- The Bitcoin bill allows Salvadorans to pay taxes in Bitcoin, requires merchants to accept Bitcoin as payment for goods and services, and suspends capital gains taxes on Bitcoin gains
- El Salvador's dependence on remittances makes the potential transfer savings on remittances using Bitcoin highly valuable
- Even if current savings aren't as meaningful today, the overall cost of remittances should go down over time
- Perhaps the highest impact opportunity resulting from Bukele's bitcoin experiment are the real economic gains that can result from "formalizing" El Salvador's financial system via the use of digital transactions
- Bitcoin price volatility is the primary economic risk
- A meaningful transformation will require more than Bitcoin-enabling legislation

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El Salvador is marking the 20-year anniversary of dollarization to mixed socioeconomic results. With dollarization the government promised to stimulate investment, increase exports and create new jobs. Though unemployment did decrease from 7.0% in 2001 to 4.0% just before the pandemic, and though inflation has averaged ~2.2% for most of the 2000's, the reality is that gang violence and insecurity remain potent and endemic forces within the economy. El Salvador is among the world's most violent countries in the world with a murder rate that is 10x greater than in the U.S. Just over 30% of El Salvador's 6.6 million inhabitants live below the poverty line, and average annual GDP growth has been 2% – a fairly anemic number for an emerging market economy that adopted the dollar in order to turbocharge growth.

As a result of the pandemic, in 2020 the economy suffered the steepest declines in four decades, with GDP falling by 9.0%, and the fiscal deficit widening to more than 10% of GDP, according to ECLAC (the UN Economic Commission for Latin America and the Caribbean). The economic landscape in El Salvador is further co'[pplicated by a public debt level that is currently around 90% of GDP.

Enter El Salvador's "Bitcoin Bill"

According to the bill, which was passed with a supermajority in El Salvador's legislative assembly and signed into law by Bukele, Salvadorans will be able to pay taxes in Bitcoin, merchants will be obliged to accept the cryptocurrency as payment for goods and services, and capital gains on Bitcoin will not be taxed, effective as of September 7, 2021. Additionally, the government will be rolling out a digital wallet for Bitcoin, called "Chivo." In order to stimulate adoption the government has agreed to deposit $30 worth of Bitcoin into every Chivo account opened by citizens (roughly $120 million in total), and will also offer permanent residency to any cryptocurrency entrepreneurs conducting business in El Salvador. To be sure, Salvadorans will retain the ability to elect using either dollars or Bitcoins for transactions, while the dollar will continue to be the government's primary unit of account.

Economic Opportunity of Bitcoin Adoption in El Salvador

From our perspective, there are two categories of economic effects likely to result from Bukele's Bitcoin initiative: the *structural* and the *circumstantial*. By *structural* economic effects, we mean any sort of real efficiency or productivity gain resulting from Bitcoin adoption. By *circumstantial,* we mean effects which might temporarily generate wealth in the near term, but which ultimately are subject to risk, and can just easily result in the long-term destruction of wealth.

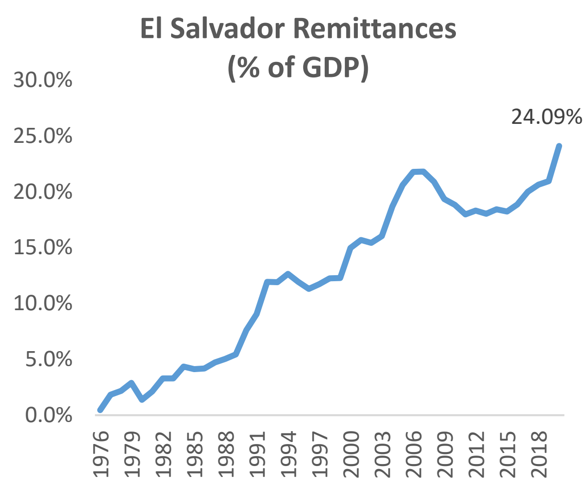
Structural: increased access to financial services could be transformational for the Salvadoran economy

Perhaps the highest impact opportunity resulting from Bukele's bitcoin experiment are the real economic gains that can result from "formalizing" El Salvador's financial system. According to data from the Global Partnership for Financial Inclusion, only 30% of Salvadorans age 15+ have accounts at banking institutions. Furthermore, only 24% of Salvadorans made or received digital payments in the past year, while only 12% of Salvadorans receive wages or government transfers into an account. This is in large part attributable to a lack of investment in banking infrastructure, as well as a lack of trust in retail banking products.

Our view is that adopting Bitcoin as currency will allow El Salvador to essentially *leapfrog* at least some of the costs and obstacles of developing a traditional financial infrastructure, namely physical infrastructure and customer acquisition costs. As of 2018, El Salvador had one of the highest mobile phone penetration rates, with almost 147 mobile cellular subscriptions per 100 inhabitants. El Salvador should be able to leverage its population's already high mobile phone usage to establish a payments ecosystem that is less reliant on traditional banking products and physical banking infrastructure. With time and the right leadership, more Salvadorans should be able to participate in the benefits of digital payments. These include: better financial tracking and accounting, greater savings and investment, and a generally more efficient financial system.

<u>Structural:</u> savings on remittance fees could be a significant boost to GDP

In the category of the *structural* we also include the whole host of transactional efficiencies attributable to transferring and transacting in Bitcoin. In addition to the operational simplicity and speed of transfers, it is also typically cheaper to send money overseas using Bitcoin. In the case of El Salvador, the economic value of these efficiencies is likely to be significant, given that remittances from Salvadorans living in the U.S. have averaged 20-25% of El Salvador's GDP over the last several years. El Salvador is the Latin American (LatAm) country with the highest volume of remittances as a percentage of GDP, amounting to $5.9 billion in 2020, or roughly 23% of GDP.



Source: World Bank

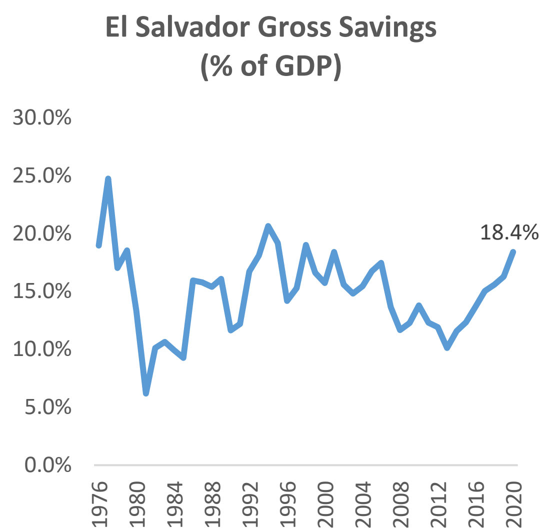
Legacy remittance companies like Western Union (the largest in the world), Wise, WorldRemit, Remitly, Xoom and Ria Money Transfer typically charge fees ranging between 4-5% of the value of the remittance, though the percentage charged can vary meaningfully based on country. According to a report from the World Bank, South Asia is the cheapest region for receiving money at 5.2%, while the most expensive region is Sub-Saharan Africa at 9%. Latin America stands as the second cheapest at 6.3%. In contrast, Bitcoin-based transfers can reduce the overall cost of remittances by 50-90% when compared to traditional methods, according to a report published by Coin Center, a leading cryptocurrency research center. In the case of El Salvador, the specific quantum of savings on remittance fees will, at least in part, depend on the development of a robust cryptocurrency infrastructure. As a conservative estimate, if the average Bitcoin remittance to El Salvador is charged a 1% fee instead of Latin America's average fee of 6.3%, and assuming $5.9 billion in annual remittances, then El Salvador would realize an annual savings of <u>$300 million</u>, or roughly <u>1.2%</u> of incremental GDP growth, just from transfer savings.

Even if the current savings from Bitcoin remittances are not as significant as Bitcoin advocates have suggested, we think that over time (or perhaps overnight) cryptocurrency fees are likely to decrease. Robinhood is leading the way, having already eliminated commissions from its cryptocurrency exchange. Our view is that, similar to how Robinhood's shift to commission-less equities trading prompted legacy broker-dealers to also scrap commissions, crypto exchanges like Coinbase will also be forced to respond in-kind in order to reduce or eliminate fees. Similarly, legacy money-transfer companies like Western Union might also be prompted to lower their fees if they were to start losing remittance business to bitcoin exchanges. With more attention on Bitcoin's role in overseas money transfers, we see a virtuous, price-reduction cycle as highly probable.

<u>Circumstantial:</u> economic volatility is a risk

The greatest economic risk we see to "Bitcoinization" is the volatility of Bitcoin itself, a challenge that could be exacerbated by the relatively low levels of financial literacy in El Salvador's population. If Salvadorans do indeed start keeping more of their money in Bitcoin, then consumer buying power, and economic output will become a function of wherever Bitcoin prices happen to be in any given week or month. That's great if Bitcoin prices are up, but potentially dangerous if prices were to crater. In our view, the magnitude of this risk will depend on the direction of Bitcoin prices in the months following legalization. Initially, we expect that the majority of Salvadorans will primarily use Bitcoin for purposes of saving money on remittances. They will receive Bitcoin and immediately exchange it for dollars, and most likely not use it to transact directly with merchants. However, if Bitcoin prices were to rise from September to year-end, then Salvadorans might elect to hold more of their wealth in Bitcoin, in the hopes of further price appreciation. It is at this point where we would see the potential for economic harm.

At lower levels of financial literacy, it is often harder for people to place their financial gains in the context of the possibility of losses. A person who has only seen an asset price go up, will start to believe that the only direction that asset prices *can* go is up. The magnitude of this risk will ultimately depend on the population's rate of Bitcoin adoption, relative to the direction and volatility of Bitcoin prices. Over the last five years, there have been five days where Bitcoin prices have decreased by more than 20%, with a largest single-day correction of 27.1%. We believe it will be extremely important for the Salvadoran government to accurately communicate the risks of concentrating wealth in Bitcoin, such that Salvadorans can both benefit from Bitcoin appreciation, while being sufficiently protected in the event of a sell-off.



Source: World Bank

Bitcoin is NOT a turnkey monetary solution

There is a tendency to view technology as a "one-stop shop" solution to a variety of economic maladies. As important as technological advances are in increasing the efficiency with which human wants and needs are satisfied, it is also important to create an institutional, cultural, and regulatory environment that allows technology to truly flourish. Below, we list the main categories of governance and social changes that we believe will increase the probability of Bitcoin's success in El Salvador.

First, there needs to be sufficient investment in basic digital infrastructure. Governments and private firms both need to collaborate and play a role, but governments should focus on investments that may be inaccessible or unprofitable for private capital.

Second, governments need to reconsider their regulatory frameworks and make sure they are conducive to private sector investment and innovation. Right-sizing regulation with an eye toward facilitating the entry of smaller firms is key. In the case of FinTech, mechanisms like guidance units set-up within regulators and so-called "sandboxes" can be used as stop-gap measures to encourage innovation.

Third, new firms need access to the right people. Developing human capital is key. Governments need to invest properly in education, particularly in STEM fields, while the private sector needs to assist by investing in employee training and development.

Lastly, investors and corporations need access to a sound and stable legal framework with a judicial system that understands and enforces property rights (including intellectual property). Safe, trusted, and reliable digital ecosystems lie at the heart of the adoption and usage of new digital products and services. To that end, a robust cybersecurity ecosystem will be vital to El Salvador.

BSP View: We should first note that our overall view on Bitcoin is cautiously optimistic. We are neither entirely convinced of Bitcoin's long-term value (either as a currency like the dollar and /or as a store of value like gold) nor do we believe that its demise is imminent. In our eyes, the long-term success of Bitcoin will ultimately depend on the size of the economy willing to trade in it. Said differently, Bitcoin will only ever *be* a currency if it is *used* as a currency (as opposed to a speculative asset to be traded in-and-out of depending on market sentiment). The challenge is a classic "chicken-or-the-egg" problem. Bitcoin has not yet been adopted as a currency because its value is volatile; but it is volatile, mainly because it is not yet used as a medium of exchange for a broad array of goods and services.

Though some of El Salvador's socioeconomic issues make it a less than desirable place to try out a next-generation technology, the reality is that no major, developed economy was ever going to assume the risks of being first. El Salvador's Bitcoin experiment will be an important testing ground for the growing list of countries exploring alternative monetary frameworks. El Salvador has the opportunity not only to alter its own economic destiny, but also to provide the rest of the world with the benefit of its learnings and experience.

Though we are unconvinced of how well President Bukele truly understands Bitcoin, our view is that his initiative is actually a fairly shrewd economic maneuver that creates the opportunity for economic upside with limited economic downside. Bukele has essentially created a free call option for the Salvadoran economy that depends on the value of Bitcoin. If Bitcoin prices continue their upwards trajectory, then the economy will grow faster than it has ever grown before. If Bitcoin were to stay flat or even depreciate significantly (even on the order of ~50%), then maybe the Salvadoran economy ends up marginally worse off. In a phrase: *what does El Salvador really have to lose?*

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BigSur Wealth Management, LLC
1441 Brickell Avenue, Suite 1410
Miami, FL 33131
Office (Main): 305-740-6777 ext. 8006
Fax: 305-350-9998
http://www.bigsurpartners.com