OPINION | COMMENTARY

A Global First: Bitcoin as National Currency

El Salvador puts the digital money on par with the U.S. dollar for all public and private debts.

By Max Raskin
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A local business accepts bitcoin as a payment method in San Salvador, El Salvador, June 9.
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Central banks around the world have been scrambling to co-opt digital currencies for their own purposes. El Salvador beat them all to the punch by passing a law that makes bitcoin legal tender for all debts public and private.

Through this law, El Salvador's legislators essentially voted to begin the process of outsourcing the country's monetary policy to a decentralized network of computers governed by a fixed set of rules. This is an important step toward a world where money is sound, not subject to the vagaries of politics.

Most proposed central-bank digital currencies would be tightly controlled by governments. These currencies would reinforce the status quo, not revolutionize monetary systems. That's because the overwhelming majority of money in existence issued and controlled by central banks is already digital—only a small share of global money supply exists as paper money and coins. When most people talk about a digital coin issued by the Federal Reserve, they do not have in mind a rules-based, censorship-resistant money like bitcoin, but rather a mechanism for the Fed to control the money supply directly without private banks serving as intermediaries.

One huge concern about granting the Fed this much power is the distinct possibility of weaponizing the money supply. Certain parts of the country could be targeted with lower interest rates to spur economic growth selectively, creating opportunities for partisan conflict.

El Salvador, which doesn't have its own currency, is avoiding this risk by making bitcoin legal tender alongside the U.S. dollar. The law provides that any economic actor technologically able to accept bitcoin is required to do so for payments of goods and services. It also permits bitcoin to be used to pay taxes and exempts bitcoin transactions themselves from capital-gains taxation.

To deal with bitcoin's wild price fluctuations, the legislation establishes a free-floating exchange rate determined by the market. If someone immediately transfers his bitcoins to dollars when he receives them, then it shouldn't matter how volatile the exchange rate is because he'll always have the equivalent in dollars. Salvadorans are free to hold their savings in either currency; the legislation simply puts bitcoin on par with the U.S. dollar and doesn't disadvantage the cryptocurrency with higher transaction costs.

There are distinct advantages to this dual-track system. In a recent National Bureau of Economic Research paper, David Yermack, Fahad Saleh and I use an economic model to show that the existence of private digital currencies not controlled by the state has important implications for countries in the emerging market. They discipline the government and encourage local investment. Throughout history, central banks have devalued their currencies or tried to maintain untenable exchange rates to the detriment of investors.

This isn't the first step El Salvador has taken away from monetary uncertainty. In 2001 the country officially dollarized its economy. The colón was taken out of circulation and all prices, including taxes and wages, became denominated in U.S. dollars. Among other effects, this decision limited the discretion of the Central Reserve Bank of El Salvador to manage monetary policy, essentially outsourcing the function to the Fed.

El Salvador has the right idea here. In "The Denationalization of Money" (1976), F.A. Hayek questioned whether government control over the money supply was necessary and argued that competition in money had the same benefits as competition in goods and services. It disciplines economic actors and gives them incentives to serve consumers better—in this case by acting as a check on governments' tendency to inflate and forcing innovation in payment systems.

Central banks want the benefits of digital currency, but they also want to control the system and not cede their monetary tools. This makes the concept of a central-bank digital currency inherently contradictory. Bitcoin was created to provide an alternative to a currency managed by the state.

Sound monetary policy isn't a magic solution to a country's every economic woe. El Salvador needs to embrace the rule of law, private property and limited government. But having faith in a sound currency is going to become more and more important as the inflationary costs of monetary stimulus become known.

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