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Latin America's digital currency challenge

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The digital revolution of the 21st century has altered the landscape of the financial sector. Digital currencies in particular have led to a seismic shift in banking, and Latin America is at the forefront of developing a new financial structure. Implementation of new services and applicationshave come to alter the status quo of the traditional financial system, together with the development of new technologies and a favorable context for the development of innovation. At the same time, the path to financial digitalization is accelerating, especially following the global pandemic.

Cash still prevails in Latin America, but the trend is progressively changing. According to the World Bank, 42 percent of Latin American adults make digital payments to retailers, and 11 percent have done so in response to the pandemic. Technological advancements and new forms of digital money led to a boom among users, particularly among the younger generations.

Cryptocurrencies too have impacted a significant portion of the Latin American population over the past five years. As a digital, encrypted, decentralized medium of exchange based on blockchain technology, cryptocurrencies have brought several advantages over the use of fiat money that have enabled them to gain traction among consumers rapidly in recent years. As a result of this, a new way of using and comprehending money has arisen.

There are a number of reasons why cryptocurrencies have made headway in Latin America in particular. According to a report by Chainalysisin October 2022, there are two key-use cases driving crypto adoption in the region, namelystoring value and sending remittances.

Indeed in April 2022, the IMF found that the combined inflation rate of the five largest regional economies—Brazil, Chile, Colombia, México, and Perú—had surpassed 8 percent, a 15-year high. Venezuela and Argentina, however, fared worse. In 2022, the two countries faced accumulative inflation rates of 142.6 percent and 76.6 percent , respectively, which means that their fiat currencies have already lost around half of their value within the last twelve months. As a result, stablecoins—or cryptocurrencies that are designed to stay pegged to the price of fiat currencies including the U.S. dollar—are popular in the most inflation-ravaged countries in Latin America.

Remittance payments are also a significant use case for cryptocurrencies in Latin America. Despite accounting for just 8 percent of the world's population, Latin America received 20 percent of its total remittance volume

in 2021, and over the last decade, inbound remittances to the region more than doubled[1]. Yet remittance fees for Latin Americans have remained high through the use of traditional payments rails., Blockchain technology has emerged as an alternative in the remittances market, enabling cheaper and faster cross-border money movement using cryptocurrencies, without geographic restrictions and at very low per-transaction costs.

As such, cryptocurrencies are having a significant market penetration. with In Argentina, which has moved forward in crypto adoption, the country is facing persistent inflation and monetary volatility, has numerous restrictions on the movement of capital inflows and outflows, and the ability to purchase foreign currency is extremely limited for most of the population. Despite the 2022 crypto crash, there are approximately 37 to 52 million crypto consumers in Latin America, or15to 18 percent of digitized consumers in the region[2].

There are other advantages to cryptocurrencies enabled by blockchain technology, including the lack of intermediaries, astransactions are carried out in a decentralized fashion. Since every transaction is registered on the blockchain and shared across thousands of computers throughout the globe, it is possible to track and trace the movements of cryptocurrencies.

Nonetheless, the downside risks to cryptocurrencies cannot be ignored, even as it could benefit many users in Latin America. The risks of crypto are universal: price volatility has been an intrinsic characteristic in cryptocurrencies since their inception, and price variation is highly marked by market cycles. In addition, cryptocurrencies are not backed by a government or central bank. Unlike fiat currencies, such as the U.S. dollar, the value of a cryptocurrency is unrelated to commitments made by a government or central bank. Finally, a major point of contention in the current debate is the fact that anyone having a crypto wallet can conduct a transaction without first requiring permission from any authority or undertaking identity verification. This has raised the alarm of governments, since one of their top priorities is to prevent money laundering activities. The case of Ross William Ulbricht, owner and operator of "Silk Road", a hidden website designed to enable its users to buy and sell illegal drugs and other unlawful goods and services anonymously using Bitcoin, is one of the most iconic examples of the illicit use

1 Americas Market Intelligence, 2022.
2 Americas Market Intelligence, November 2022.

of cryptocurrencies. It is estimated that approximately 173,991 Bitcoins were connected with the Silk Road case, which, at 2013´s average Bitcoin exchange rate, were worth over $33.6 million.[3]

In order to deal with the cryptocurrency risks, Latin American nations are focused on developing regulatory mechanisms for protection. Crypto regulation worldwide is varied, and Latin America is no exception. El Salvador is on one extreme of the spectrum, having passed a Bitcoin Law in 2021 and formally recognized the use of Bitcoin as legal tender. It is the archetypal example of the adoption of cryptocurrencies. The passing of this law was a clear manifest of the intention to incorporate cryptocurrencies into the traditional financial system, even though the outcomes to date in terms of adoption were not what the government of El Salvador had anticipated. After downloading and making their first Bitcoin transaction, only 10 percent of Chivo Wallet users, El Salvador's government-backed cryptocurrency payment app, continued to use it [4].

On the other hand, Ecuador has prohibited the use of cryptocurrencies as a means of payment, with the U.S. dollar the only authorized currency for the purchase and sale of goods and services. Similar to Ecuador, the Central Bank of Bolivia banned the use of crypto assets (digital or virtual currencies) at the end of 2020 because they do not qualify as legal tender. The two utterly opposed perspectives provide as a vivid illustration of the regulatory landscape for digital currencies in Latin America.

Brazil, Mexico, and Chile meanwhile have made progress in enacting their own laws that govern the use of crypto assets. The use of cryptocurrencies for operations carried out by financial institutions is regulated in Mexico through its Fintech Law; Brazil and Chile's regulations take a more global approach and define the range of activities for the major players in the industry. As for Argentina, Peru, and Colombia, they still lack a clear regulatory framework, and the goal of regulators regarding their stance on cryptocurrency is still ambiguous. As a very clear-cut case, Venezuela has adopted a policy of complete control on the movement of cryptocurrencies in the nation since 2017. So much so that it established SUNACRIP (National Superintendence of Crypto assets) in 2018 with the primary goal of regulating the creation,

3 FBI´s New York Office, 2013.
4 The New York Times, September 2022.

issue, management, and operation of exchanges, financial services involving crypto assets, and other activities.

In addition to the efforts to promote cryptocurrency regulation and to clarify gray areas, governments' responses to the development and adoption of new technologies like blockchain and cryptocurrencies in the financial system are developing rapidly. The key fear of the major participants in the traditional financial system and its regulators is the lack of control over these new, privately generated forms of digital money. In an effort to develop their own type of digital currency, governments are working on the launching of Central Bank Digital Currencies (CBDCs) in reaction to this movement. The United States Federal Reserve defines CBDC as a digital liability of a central bank that is widely available to the general public.[5] There are digital tokens that imitate cryptocurrencies but are issued by a central bank. Its primary feature is that they are tied to the value of the fiat currency of that country.

Differences between CBDCs and cryptocurrencies need to be made clear. The cornerstone of cryptocurrencies is essentially an alternative financial system in which they may or may not be regulated depending on the country in which they are issued. As for CBDCs , there are three main objectives namely: : (i) to reduce the use of cash; (ii) to improve the current monetary policy instruments; (iii) to improve the functioning of the payment system, especially cross-border payments to reduce transaction costs, lack of transparency, and improve the speed of transactions.

The implementation of CBDCs poses a major challenge for states as it could facilitate large-scale payments by working with a system that uses a single infrastructure, capable of enabling the hosting of multiple CBDCs, while at the same time being connected to traditional payment systems. Interoperability becomes fundamental to the implementation of CBDCs, and how states work together to achieve this goal at a cross-border level will be a major challenge.

Unlike the case of cryptocurrencies, the approach of Latin American countries seems to be more homogeneous in the case of CBDCs. Although each country is at a different stage in the implementation of its CBDCs, the trend is clear. In particular, the Argentine government has issued a decree

5 Federal Reserve Board, November 2022.

in April 2022 authorizing the Central Bank to issue its own CBDC. This decree is limited to the creation of a regulatory framework but constitutes the first step towards the implementation of a CBDC pilot. The Central Bank of Chile, meanwhile, delayed its plans to implement its CBDC in order to conduct a better analysis of opportunities and risks. Being the first of its kind in the region, Venezuela represents the pioneer in terms of CBDCs in Latin America with the implementation of its sovereign digital currency, the Petro, in 2017. The Central Bank of Brazil has already issued the first units of its CBDC, the "digital real", and the first tests are expected to start in early 2023. Mexico continues to make steady progress toward realizing the roadmap that would end in the issuing of its CBDC in 2024. Last but not least, two noteworthy cases are those of Montserrat, Dominica, Antigua and Barbuda, St. Kitts and Nevis, St. Vincent and the Grenadines, and Grenada, seven of the eight Eastern Caribbean Dollar-using countries that have adopted the use of the CBDC Diamond Cash, and the Bahamas in Central America, which introduced its own CBDC, the Sand Dollar, in 2020.

In the Latin American region, traditional financial system players are facing a structural dilemma. The fundamental questions that mainly banks and regulators keep asking themselves are these: what changes should be made to the current financial system to suit the recent emergence of new digitalization phenomena? Should the major participants in traditional financial systems include cryptocurrencies into existing organizational frameworks or should they maintain a binary system where in the conflict between CBDCs and cryptocurrencies will take center stage in this modern era?

There does not appear to be a clear answer to the question at the global level. The recent SWIFT system partnership with Chainlink (LINK) aiming to connect the international payment network with multiple blockchains so that traditional financial agents can access digital and traditional assets on the same network, is a clear example of attempts to integrate cryptocurrencies into the traditional system. While certain nations want to declare war on cryptocurrencies, other participants want to include them into the traditional financial system. In addition, since the various Latin American nations are still working toward a regulation that, despite being different in each country, seeks to meet the primary goal of establishing clear rules for all system components with the intention of ensuring user protection, the answer does

not appear to have a single voice. Everything seems to point to increased regulatory progress in cryptocurrencies over the next several years, especially in light of recent events like the bankruptcy of FTX exchange, the collapse of LUNA and TERRA project, and the bankruptcy of the crypto lending platform Celsius, one of the most important in the marke

Yet an increasing number of countries, especially in Latin America, are developing, testing, or contemplating the introduction of their own CBDCs. Whatever the case, there is no denying that Latin American users have benefited from the new digital money models and their advantages, which has led to a new paradigm shift in the supply of financial services.

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