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El Salvador: Dollarization, and Capitalism in terms of American Socio-Economic Influence

**INTRODUCTION**

Currencies vary greatly around the world and are more than a simple form of exchange and bartering. They hold an intrinsic value among society and economies; one in which can signify power, acceptance, unity, trust, as well as risk. El Salvador was taken off of the gold standard, a very conservative form of currency, in 1931. Their new legal currency was called the ‘colon’ and it was left floating with no gold standard to back or legitimize it on a global scale. In 2001, Sandista (ARENA) president Francisco Flores worked and advocated to be among the first Latin American states to dollarize. Leaving the gold standard and furthermore, the Colon behind helped ease the state into a more open sense of markets, allowed for devaluation, exportation, and ultimately import a more western form of capitalism.

In 2000, the year prior to dollarization, Latin Americas average GDP per capita was roughly 20% of that of the United States. Despite the regions non- competitive GDP per capita, El Salvador had previously experienced a period of stable economic growth in the 1990’s. A mixture of this growth and previous market failures Salvadoran policy makers turned to thinking systematically and transitioned into the world’s currency, or America’s currency (Johnny Jet.com 2013).

Salvadoran-American ties have always existed in good spirit as El Salvador is oftentimes regarded as Americas staunchest ally in the Latin American region. Its strong ties to the US as a state have significantly been amped up with the adaptation of the official American currency as its own. More so than simply having strong backing for the American government in regards to politics they now also reap the benefits of having a currency that is globally respected and has an open invitation for investors into the more ‘secure’ economy opposed to previous currency wherein it was easily over or undervalued depending on what the short term goal was.

Globally, hegemons emerge on different scales and in different sizes. It is well known that with its large commitment to the world’s well being, trend setting, and influence on various levels the United States is a global hegemon. In Europe, Germany has emerged as a regional hegemon with its influence in fiscal policy and market expansion. In Central America, a historically underdeveloped region, El Salvador is working towards reaching ‘hegemonic’ standing within the small region. Although it has a great tool to do so, the dollar, it is necessary to continue to work for a backing of an appropriate financial policy because simple structural adjustment carries the risk of proving ineffective (Berthélemy, Pg. 25). Moreover, “western modernity provides a challenge to less-developed societies, which pushes them ineluctably towards social change” (Trigilia 2002, 147), in El Salvador this social and economic change has begun to be manifested through dollarization.

**PROMOTING CAPITALISM AND LIBERALIZATION**

Furthermore, in seeking an international mediator for peace, El Salvador began their westernization. As they sought mediation, the United Nations was the organization that they asked for assistance from. As the United States is a permanent member of the UN Security Council as well as a charter member: posing an extreme amount of power and influence in all decisions that is made. Communist leader Shafik Handal opposed tremendously to having the United Nations as mediator between FMLN and Sandistas in seeking peace because of this very reason (Negroponte 2012). As the United Nations accepted to mediate, restrictions and conditionality were underlined and sought out by the western dominated institution. Within these conditions there were strict requirements for voting registrations and guidelines for candidates, incentivizing rather than demanding in peace keeping, as well as temporary demilitarization within borders and reconstruction with aid from the UN.

Prior to the 1990’s Latin America went through an era that was intended to be balanced mercantilism but in reality became harsh protectionist policies that hindered the growth of economies in the long run. As El Salvador was in a large civil war between extreme leftist and their democratic government, they seemed desperate for a way out. Prominent states in the region such as Nicaragua, Honduras, and Chile posed the idea of protecting their markets as much as they could in order to hinder competition from the outside, promote cheap products within its borders, import substitution, and secure a labor force. This, in turn did not work as they expected. Countries engaging in this were growing but at substantially lower levels than the Asian Tigers and other nations benefiting from interaction in a global marketplace. During this time, the 1980’s, import tariffs in Latin America were running at 24% on average while those of Asian Tiger nations were at 15% putting them at an extreme loss of business (Edwards 2009). This became very well known as “the lost decade” for Latin America, running from 1938-1980. In this period states with autarkic policies as well as those tied to OECD lagged in growth, and although this was not the brightest of their eras; it did set up for many positives outcomes in the future.

Directly after dollarization, much of the population was discontent and so seemingly upset at the decision that was ‘made for them’ instead of with them, that sandistas (ARENA) were voted out of office after their long reign of 20 years. Shortly after the conversion, Diana Negroponte noted “A reduced public sector made the traditional practice of rewarding loyal followers with jobs and improved economic standing significantly harder. As the state withdrew form the market place, there were fewer jobs to hand out and the private sector assumed a greater role” (Negroponte 2012). Although there were not as many traditional forms of employment, other sectors of employment were not recognized and as a symbol of rebellion *maras* (Negroponte 2012)began to emerge more frequently and abundantly than previous decades. This proves inefficient and was quickly identified as a market failure that could be detrimental if not fixed. After this market failure, transparency and accountability was added to the fiscal and governmental agenda.

As is noted by economic sociologist Neil Fligstein, the banking industry is key to fiscal policy, not only literally but is also a major player in sustainable and aggregate trust and overall profits in a society. In liberalizing their banking industry and implementing effective regulation and accountability, it is well noted that banks will be more profitable. This has been a challenge, as the banking industry was publicly owned for a large part of their history. However, “firms that were highly interlocked were actually less profitable in terms of returns on assets, sales, and equity, contradicting the bank control hypothesis that firms with interlocks would be more profitable” (Fligstein 2001, 136). The fact that the bank capital assets to ratio have increased significantly since the dollar and its capitalist implications have been presented which prove this to be true in the Salvadoran economy. From 2008 to 2012 the bank capital assets to ratio have increased from 8.8 to 13.9, creating more efficiency and hence, profits (The World Bank 2013). As profits increase, competition and be further noted in the following dichotomy presented by The Economist Intelligence Unit:

“ Small banks are feeling the effects of fragile investor confidence, as depositors have shifted their money from small banks to the three or four largest institutions, reversing an earlier trend of reckless rent seeking. The higher minimum reserve requirements announced in November are likely to further stretch the ability of small banks to compete for deposits by offering higher returns. Thus, these measures may enable the largest banks increase their hold on the market, pushing smaller institutions into bankruptcy or paving the way for takeovers.”

The interdependency between actors allows for better management of risk, the accountability that all levels have to respond to allows for positive movement towards efficiency and risk management. The separation between the banking industry and government has been recent compared to more developed nations. The relationship between government and this market or firms allow for close decision making that benefit governance to allow for division of labor and coordination within the industry, as well as those that are vicariously affected. The prior scenario has aided in incentivizing governments to further implement policies that diminish monopolistic behavior.

It is notable that since then, and in the last decade, El Salvador has transformed its economic policies tremendously through trade liberalization, deregulation of the financial sector, privatizing the banking sector, and adopting a currency with an intense amount of legitimacy—the dollar.

American political culture is engraved with a capitalism of its own. Taking in a currency of it as such implies a capitalist modeled economy if it wasn’t present before, as is the case with El Salvador. In presenting this symbol for capitalism, it has been a challenge, as was anticipated, in working towards a balance between and within institutions that allow competition but do not excessively reward guile and greed. Since adopting their new currency, Salvadoran legislative representatives and advisors have emphasized the amount of accountability that is needed in order to transition smoothly and ultimately have an efficient economy (Engel 2005). Among these is the privatization of necessary commodities, such as electricity.

Prior to trade liberalization credence goods, the opposite of searched goods, were not heard of in Salvadoran market place. People did not have the additional money to use on the goods. Beginning in 1999 as Salvadoran government planned a drastic change, electricity became a privatized commodity. In the first couple of years, the program was implemented and it has proved to drive competition and efficient (Engel 2005). Although El Salvador has a more expensive currency compared to its neighbors, Guatemala and Honduras, they continually buy electricity from El Salvador as they are connected through 230KV lines that transmit up to 120MW. In trading this commodity, interdependence has become a necessity and positive aid in an expanded market. As they interconnect with other central and/or Latin American states they will foster more competition, making it more efficient and ultimately better for the consumer. As competition increases within the electricity market, prices will be driven to a healthy and sustainable level. At this point, society will be at an advantage; especially compared to its neighbors in the long term.

If Salvadoran structure had chosen to maintain a public domain or government owned commodities it would be viable for them to move towards monopolistic industries (Engel 2005). Fostering competition per Eduardo Engel means, “having a well functioning antitrust legislation which deters anticompetitive behavior both by firms and by the government” (Engel 2005). Although the electricity sector is proving working towards efficiency, there is still work to be done in lowering tariffs for its tradable goods. Recently tariffs have been lowered to 15% for these goods but it is still higher than those economies with completely ‘liberalized’ trade (Engel 2005). As tariffs are lowered, and markets become more competitive, public spending will continually increase, and thus be used as a tool to sustain economic development (Trigilia 2002, 167).

This market, although it still needs improvement, has proven to be effective thus far with the diversification that they have achieved since its introduction. They use a mixture of hydroelectric, and geothermal mechanisms opposed to the traditional fossil fuels in order to keep costs down. There are seven various companies who provide electricity to the 20,721 sq. km country and neighbors. Despite these efforts, competitive behavior is lacking between the seven companies. This is a lagging symptom of long standing history of protectionism that has hindered trust in the economy. With hindered trust, corporations still perceive risk and do not seek to compete as rigorously despite the increased profits it has the potential to yield (Engel 2005).

Ultimately, the implications that the dollar has presented to the Salvadoran culture and economy have bred new and more abundant service sector jobs. New agencies, such as the DPC, advisors, and expansion on privatized sectors such as banking now require more broad, and specialized fields as they expand into more ‘western’ forms of business.

With the increased opportunity for employment in higher service sector markets, there are implications for the need of higher education in order to be viable candidates for the positions. This can be positively noted in the trends of students who are continuing onto secondary education levels as well as those who complete and go on to tertiary, collegiate level studies. Percentage of students who went on to secondary education (high school) in 1999 was noted to be at 87.68% while in 2011 it had increased to 92.55% (The World Bank 2013). Just as well, enrollment into tertiary education had a boom in enrollment of 191,825 students from 1999 to 2011 (The World Bank 2013). These trends are increasing and show no signs of stagnation in the near future, but rather steady growth. These metrics are able to demonstrate the risk that citizens are intending to mitigate and the movement from industrial sectors into those of more developed societies, services.

Although this has been a progression in the right direction, there are still structural policies and funding on the governmental level that must be addressed in order to continue to see growth and increased returns on investments. Despite the growing trend, El Salvador continues to lack the amount of funding they provide for educational purposes. As we can see in Graph 1, the Latin American collective effort is higher than that of the Salvadoran government (The World Bank 2013).

Graph 1: % of GDP Invested in education



(The World Bank 2013)

As dollarization has introduced new forms of markets privatization has ultimately been increased. such as housing as Carlo Trigilia presents and subsequently increase economic conditions. The Massachusetts sized state has been dissolved from communal landholdings to be expanded into private holdings. As the small middle and high class acquire these lands, the stratification of power continues to increase, making clear distinctions between socio-economic categories. Not only does this show the beginning for potentially large social disparities but also models the American model of private land ownership holding precedence over public ownership for national parks, land conservation, and culture safeguarding.

In an effort to increase purchasing power and invite consumerism among Salvadoran citizens, it is pointed out in “The Mystery of Capital” that although there are many efforts to promote credit and consumerism, there are some of the larger flaws in housing ownership and market. In intending to privatize land ownership processes in an effort to implement a more complex housing market, loaning, and equity system, similar that of the US, it was found that many families lacked titles for their homes (Edwards 2009). As it is well known, many loaning systems are based on trust and risk involved in the transaction. As homes are in large part most of the equity that citizens are able to secure their loans with, they are not able to seek loans of any size. Financing is hindered and with it is also the hope to use debt as an asset and invest it in education, entrepreneurship, or any form of building equity. In noting this inefficient system, or lack of, the ES-L1022 Housing Program and Integral improvement of Urban Informal Settlements was created (Inter-American Development Bank 2010) in order to deter away from an added class stratification and to improve aggregate social welfare and ultimately have increased net benefits to society as a whole (Frieden 2006, 40). With the implementation of this program that was approved in April 2012 32,000 families will have assistance in obtaining proper, legal documentation for properties, and help increase value for homes through restoration and subdivision improvement (Inter-American Development Bank 2010).

In taking in advantages of having the American dollar as its official currency such as lowered interest rates for firms, governments, small businesses, and individuals, El Salvador has begun but must persist in focusing on comparative advantage and not completely sway away from protecting their efficient handicraft markets that have had large gains through time such as coffee, and sugar cane. During the autarkic era, the Salvadoran economy strived majorly in their bean and sugar cane production. Although they have continued to do this well, their ties across seas are very limited; trust with international actors must be improved in order to continue their road to hegemony in the Central American region. In the span of six years taxes being paid on international trade have increased 15.5 million despite the opportunity to potentially pay less with stronger ties and risk mitigation (The World Bank 2013).

Although black markets are extremely prominent in lower income, developing economies, the rigidity of the currency has de-railed many of them out of the country. On the other hand, and on a smaller scale, peasant farmers and small business owners have gotten the shorter end of this stick. As the new currency was introduced, very little education was given on the currency that was being presented in terms of tangible, notable security differences, as well as conversion differences for its small businesses.

Money laundering has become an increased risk for the state and laundered money is particularly traded for goods and services from the more vulnerable counterparts. A phenomenon that has emerged since dollarization is the use of counterfeit bills made in America and later used in the Salvadoran economy, taking advantage of the fact that many small business owners were not aware of the risk involved.

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A priority for the Salvadoran government is to “recognize the value of private institutions and individuals as internal mediators” (Negroponte 2012). As well as accepting that international actors are not completely neutral, and that they have a need for “an international sponsor to sustain interest in the nation building enterprise for a reasonable period” (Negroponte 2012). Although the dollar has been introduced as well as mechanisms for capitalism they continue to yearn for aid in further development. These two items on their agenda are being worked on through loan, and trade processes with international actors. With these efforts, it is clear that they are intending to put butter over guns, opposed to their previous guns over butter viewpoint (Negroponte 2012). This dynamic has allowed for increased investor confidence not only in private acquisitions such as tourism, but have allowed for a growing in diversified markets to keep them from tourism dependency and ultimately, sway towards sustainability.

Deindustrialization and expanding service sector oftentimes relays the idea of westernization, and ultimately: modernization. Shipping, tourism, and communications are growing sectors since incentives for privatization and dollarization has been presented (Lyons 2005). In these industries, competition runs a slightly different route than tangible items. Competition authorities have advocated to eliminate regulations that impede competition or prove to be barriers to entry. For example, dentistry is a growing market in Salvadoran economy. In recent years it has grown into a great reason for tourism, today it is coined dentistry tourism (dentavacation.com 2012). Prior to dollarization, if industries as such complained of receiving too little for their services, government agencies would simply arrange a ‘meeting’ between parties to reach a “healthy medium.” To influence competition however, they have began to implement regulations against monopolistic and price fixing behavior overall (Engel 2005). In doing so, economies of scale are a large factor in price fixing because of the small amount of competitors that were involved in the beginning of the century. As market efficiency is only limited majorly by their size, the implementation of competition influencing policies as well as value added to sectors have allowed for growth resulting in a large portion of the 6 million American dental tourists to travel to El Salvador (dentavacation.com 2012).

**AMERICAS STAUNCHEST ALLY**

Long standing culture, society, and multiple niche communities that the population was accustomed to made it rather difficult transition into a new currency in terms of the trust that was demanded by the government in doing so. With a quick and little input that a society as a whole had in the transition, citizens chose to reciprocate in emotion because of the ‘trader’ policies that their government was implementing. As Paul Seabright has mentioned, emotions and intelligence reinforce the reciprocity that is found among institutions depending on the trust that is gained and risk that is mitigated, if any at all are present (Seabright 2010). At this point emotions become stronger than money in social judgment and governance and transparency are key in bridging the gap between citizens and government, as they work in large numbers.

As has been seen in history, autarkic regimes begin as balanced mercantilist but once they are put in the “sloppy hands of mediocre followers” it deters from being balanced and proves to be dangerous (Edwards 2009). In the 1960’s when protectionist policies were defined as balanced mercantilist still, there was an overall growth in population, industrialization, and political polarization. During this period, Salvadoran markets would import raw materials from neighbors and export manufactured goods to them but did not engage in global trade (Fisher 1982). GDP per capita increased from $170 in 1950 to $300 in 1970. With these gains, consumers gained trust in markets and became too comfortable, inviting autarky. By 1982, El Salvador had the lowest caloric intake of any Latin American state. Seventy-three percent of children were suffering from malnutrition by that time because of their market failures (Fisher 1982).

As they found themselves in autarkic and warfare quick sand that was depleting their sources, they sought out loans; primarily from the American government. During this period of desperation they borrowed $6.8 million in 1977, $10.9 million in 1978, and $10.6 million in 1979. As they decided to dollarize, this portion of loans was easier to repay because of their new currency. If not, repayment had been measured in Colones, at 8.75 for the dollar. Although debt continues to be accrued, the investments being made are those in which have future returns on investment. Until recently they were still in the trap of having loaned money that had not been used on infrastructure, education, social reforms, but rather military expenses. As of today, the debt that is being used is being done so more efficiently and effectively, intending to grow their economy for future competitiveness.

In allowing El Salvador to use the American currency, the US has posed it as an American investment that has the potential to yield high future returns on investment. This was previously seen during the Salvadoran civil war, the committee on foreign affairs U.S. House of Representatives mentioned on the intervention and aid given to the country and instead of viewing it as an expense, it was rather seen as “The best investment for the United States is to stop the Communist surge here” (Committee on Foreign Affairs U.S. House of Representatives 1983).

This strong connection, or ‘investment’ coming from the American government began with president Jimmy Carters’ administration supporting the Salvadoran government as the leftist guerillas intended to overthrow it. During this time of war, El Salvador was the Latin American nation with the most rigid class structure and worst income inequality: the richest 5% accounted for 21.4% of national income (Engel 2005). Why would a powerful state such as the United States aid a poor driven and potentially powerless state? It was socially, politically, and economically the best option for American government to keep from the communist disease from spreading north. The dollarization of the Salvadoran economy has been an investment that has helped further this initiative and not only mitigated risk on the Salvadoran side, but American as well.

**LEADING THE WAY**

Jeffry Frieden, in “Global Capitalism” explains to his audience the difficulty and turmoil that presents itself in changing fiscal policies. As these policies were implemented, the Salvadoran along with American governments projected GDP growth to temporarily decelerate to 1.5% due to inflation, and increase slowly and sustainably to 2.1% within the following two years and successively afterwards. In turmoil, it was accustomed to be able to artificially inflate or deflate currency depending on the states agenda, but this is no longer possible and a larger effort has had to be made to promote service industries, prior to the lagging time in GDP growth to minimize the time period of decreased growth (Lyons 2005). In promoting service sectors such as tourism, commodities, and credence goods large financing by long-term debt inflows and foreign direct investments inflows, or hot money, would decrease tremendously. Long-term financing promotes sustainability in economic sectors and markets as well as allows for more complex industries to be invested in as long as regulation is also present, such as electricity that has begun.

Frieden also emphasizes the harm that the practice of ‘beggar thy neighbor’ has on the implementing economy in the long run as well as to those surrounding, or those that they are ‘beggaring.’ Out of its more prominent Latin American traders, Guatemala, Nicaragua, and Honduras, El Salvador is the only that uses the American dollar. This poses what may seem to be a short-term issue with the ideology that neighbors have to pay more for products. It is however, a more positive aspect than not as these surrounding states are incentivized to become more specialized and have the ability to charge and pay more. In this dynamic, pure competition is strongly legitimized in doing so. Surrounding countries buy about one-third of Salvadoran exports even though the buying price is more expensive, 20.5 Honduran Lempiras and 7.86 Guatemalan Quetzal (es) for one American dollar (THE ECONOMIST INTELLIGENCE UNIT 2009). With these large and inefficient exchange rates of these currencies, particularly Honduran, El Salvador would run the risk of following the trend if not on its current rigid currency and hence detrimental to the triad, with no balance.

Prior to dollarization, the Salvadoran government faced much of what its neighbors face today, and as has been previously mentioned: inflation to extreme and unhealthy amounts. “Meanwhile, the strong colon hurts exporters and encourages imports, provoking local producers to complain of unfair competition. However, according to Finance Minister Manuel Enrique Hinds, the only way to lower interest rates while avoiding an inflationary spiral would be to replace the colon with the dollar as legal tender, copying the model pioneered by Panama ” (Oxford, 1999).

Similar to American culture, Salvadoran culture has grown to believe that any government assistance or decision that is not ‘the norm’ for the state is considered to be a form of communism or socialism. Any government assistance that intends to be provided is deemed to be communist actions. Fisher notes, “any political party which has advocated a program of social justice, especially when it involves land reform, has been accused to being communist inspired” (Fisher 1982, 6).

During the transition period, and during protectionism about 78% of arable land was dedicated to coffee and sugar cane, what they are really good at producing. As they became more efficient they continued to grow, trade it, and have begun to grow into other sectors such as electricity and dentistry.

**CONCLUSION**

Along with promoting competition, consumer protection, and market liberalization, El Salvador has taken a large step in inviting an American model of competition into and around its borders. Although sectors such as electricity, dentistry, and banking have surged and promote new job markets, it is a continued and collective effort moving towards efficiency. Within the competitiveness of corporations, there has also been and continues to be the need to regulate in order to promote a healthy amount of openness, stabilization, and integration on a regional, and global scale.

Dollarization has posed the strengthening and intertwining of many small ties that previously existed between El Salvador and The United States. More than a change in currency, the dollar has presented the restoration of trust in business, competition, equity building, and education. In adopting the American dollar, the country has also adopted a different form of economy and culture, capitalism. As many intergovernmental agreements, it has benefited multiple states in doing so and has been a sustainable investment on both the Salvadoran and American side.

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