This document is part of the Microenterprise Best Practices (MBP) Project's series of Technical Briefs on post-conflict microfinance, available at www.mip.org. The series discusses whether and how to use microfinance in post-conflict settings. The first seven briefs are designed primarily for microfinance practitioners. The final brief (#8) is designed for relief organizations considering microfinance for the first time. While experienced microfinance organizations are unlikely to find new information here, they may share this brief with non-microfinance organizations experimenting in this technical area.

- *Brief #1: Microfinance Following Conflict: Introduction to Technical Briefs*
- *Brief #2: Developing a Post-Conflict Microfinance Industry: The Case of Cambodia*
- *Brief #3: Developing Post-Conflict Microfinance Institutions: The Cases of Liberia and Kosovo*
- *Brief #4: Environmental Preconditions for Successful Post-Conflict Microfinance*
- *Brief #5: Searching for Differences: Microfinance Following Conflict vs. Other Environments*
- *Brief #6: Security Issues for Microfinance Following Conflict*
- *Brief #7: Microfinance for Special Groups: Refugees, Demobilized Soldiers, and Other Populations*
- *Brief #8: Frequently Asked Questions on Basic Microfinance Concepts*

Environmental Preconditions for Successful Post-Conflict Microfinance

As shown in the cases described in Briefs #2 and #3, and as seen in numerable other situations, microfinance can be implemented successfully in post-conflict environments, particularly if the implementing institution is willing to face higher costs and higher risks. Yet, are there some settings or times where even the most seasoned professionals would argue that the environment is inappropriate for microfinance? When might it be best to wait, or to choose another intervention? This brief will examine the environmental conditions considered "essential" and "preferred" for success in microfinance. While not cast in stone, these conditions serve as a useful checklist to those assessing a post-conflict environment for microfinance.

"ESSENTIAL" CONDITIONS

Required environmental conditions are remarkably few. Only three environmental conditions appear to be so important that—without them—microfinance should not be undertaken. First, the program area must have a certain degree of political stability. Second, the program area should show sufficient economic activity that can use credit services. Third, the client population must be relatively stable. Each of these is examined in detail below.

POLITICAL STABILITY

Program areas must offer a reasonable degree of security and safety to potential MFIs and their clients. Put negatively, there must be "an absence of chaos." Clients must be able to carry out business activities with a minimum level of assurance that they can do so profitably. Likewise, MFIs must feel that they can operate without disproportionate danger to their staff, assets, and clients.

This does not necessarily mean that there must be a total absence of *conflict* or of the possibility that conflict might flare up again. As described in Brief #3, LEAP in Liberia showed that microfinance can be done successfully in one area of a country, even while conflict rages in other parts.

Likewise, decision-makers may need to consider a certain "chicken and egg" logic. In some cases, especially in those of the prolonged low-intensity fighting that characterizes many African conflicts, microfinance and other developmental interventions may help to bring the conflict to a close by providing populations with more economic optimism and opportunities.

What is "Sufficient Stability"?

While it is easy to say that political stability is a necessary precondition for successful microfinance, it is difficult to determine exactly when many situations have become sufficiently stable. This is partly due to the frequent phenomenon of fighting breaking out again following the apparent end of fighting.

World Relief Rwanda started Urwego, a microfinance institution, in 1996, nearly two years after the genocide of 1994. Even then, many observers questioned whether Rwanda was sufficiently stable for microfinance, given the existence of insurrections in certain parts of the country then and which have continued to this day. Urwego's response was simply to stay away from those areas, focusing on the more stable areas of the country.

ECONOMIC ACTIVITY AND DEMAND FOR FINANCIAL SERVICES

Microcredit only works when people have access to economic opportunities requiring credit, and are actively engaged in economic pursuits. This is not always the case in immediate post-conflict environments. Some displaced populations may find themselves without access to physical assets or rights to undertake economic activities. Returning populations may, for some period of time, remain economically inactive while they assess the security and permanence of their new situation. In search of "sufficient" economic activity and demand for microfinance, microfinance practitioners' rule of thumb is that if local markets are active, then the population is economically active enough to benefit from appropriate credit products. This is also the signal that the MFI may find sufficient numbers of customers to create a small portfolio.

POPULATION STABILITY

For microfinance programs to become part of the permanent institutional fabric of an emerging post-conflict economy, loan recovery must be a key goal from the outset. This is hard to do with mobile populations, who may at any time literally walk away from their loans. Thus, many practitioners have concluded that it is usually best to work with relatively stable populations.

The need for relative population stability has led some microfinance practitioners to focus more on *returnees* than on refugees, especially if the displacement of the latter is expected to be a short-term affair. It is felt microfinance can be more effective in helping returnees rebuild in permanent locales than in assisting refugees cope with temporary, short-term displacement.

For those working with displaced populations, there appears to be a practitioner consensus that MFIs should work with displaced people only if they feel that the population is likely to remain in the programming area for at least 18 months (as reported by Doyle in the MBP paper "Microfinance in the Wake of Conflict," www.mip.org). There are a range of institutional benefits to serving a relatively stable population, such as a higher proportion of repeat customers, a higher likely repayment rate, a longer period over which to spread fixed costs, etc. From the client perspective, a certain level of stability is also helpful: 18 months is considered sufficient to allow clients to not only make, but reap the benefits of, business investments.

But with displaced populations, there is always an element of uncertainty. In 1995, a Mozambican MFI, Fundo de Credito Comunitario (FCC), experienced a sudden exodus of several hundred clients from its initial program area in Chokwe town, Gaza Province. This occurred over a period of only a few weeks approximately two years after fighting had ceased. Apparently, a consensus emerged that it was safe for displaced people in Chokwe to return to the homes that they had fled as many as 15 years previously, leading to a "stampede" to get back before others claimed their land. Although some had been clients for 18 months at that point, others had as little as a year or less of experience in the program. Nevertheless, 100 percent repaid their loans before departing. Clients interviewed said that they hoped that FCC would follow them back to their home areas. This example shows how difficult it can be for an MFI to estimate the amount of time in which resettled or refugee populations will remain immobile.

"PREFERRED" CONDITIONS

In addition to the "essential" conditions of political and population stability and economic activity, there are three conditions that have been deemed preferred but not absolutely necessary, at least in the short run:

- **Functioning Commercial Banks**. Commercial banks provide critical services to microfinance institutions. Among other tasks, they store loan funds and move money electronically within and between countries. As shown in seen in the Brief #2 on the Cambodian experience (and discussed in greater depth in Brief #7), some MFIs have been able to function temporarily without a functioning commercial banking system. However, the lack of commercial bank services does significantly increase the costs and risks facing the MFI. Since it appears that commercial banks eventually emerge even in the most conflict-devastated countries, it is felt that MFIs can get along without them temporarily by taking appropriate steps and precautions—and by accepting the additional costs and risks involved.

- **Social Capital, or Trust**. Due to the mutual-guarantee mechanism used by most MFIs, it has been argued that microfinance would not be successful in countries

where conflict has been internal and thus distrust has developed or been exacerbated. In the Kosovo example in Brief #3, for example, a group-based mechanism was unpopular with clients, and the program shifted to individual loans. While low social capital has slowed the growth of MFIs in some post-conflict situations, it has proven usually not been an insurmountable obstacle, as illustrated in the Liberia case in Brief #3. Even with individual loans in the Kosovo case, clients were able to find co-guarantors for their loans.

- **Macroeconomic Stability**. A steady currency and other characteristics of macroeconomic stability certainly make the business of microfinance easier. Unfortunately, inflation and foreign exchange fluctuations are often part of post-conflict economies. Nevertheless, ways have been found in most cases to deal with hyperinflation and foreign exchange risks. One way is to use (as law and/or practice allow) a hard currency for lending and repayments. In Besëlidhja/Zavet Microfinance in Kosovo (see Brief #3), for example, the entire operation—along with the bulk of the Kosovo economy—is conducted in deutsche marks. When client business activities are conducted in local currencies, however, such use of foreign currency loans has the unfortunate effect of shifting macroeconomic risk onto an already vulnerable client. This is illustrated in the forthcoming MBP paper on hyper-inflation (VanderWeele, 2001, www.mip.org).

CONCLUSION

The primary argument of those who have advocated against post-conflict microfinance has been that the environment preconditions are insufficient. What is remarkable instead is how short the list of preconditions truly is, whether looking at either essential or preferred conditions.

Even when most of the above preconditions hold, there are some environments in which most decision-makers will choose not to invest in microfinance. The risks of these environments may prove too high for the institution to bear; the costs may be unacceptable; or the profits too little when richer markets beckon. But these choices—based on risk, cost, or profit calculations—should not be used as arguments that post-conflict microfinance cannot succeed. Every year, seasoned microfinance professionals push out the frontiers of environments where microfinance can flourish. The key to their success is not only their willingness to work in high-risk and high-cost environments, but their institutional commitment to sound principles and practices of microfinance.