Enabling Small-Scale Enterprise and Microfinance in Fragile States

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by

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I. Introduction

Fragile states now occupy an increasingly important position among the key concerns of foreign policy, international cooperation, and especially development aid. A country is considered *fragile* when the state has a diminished capacity to govern, as in many situations of recovery from conflict, vulnerability to crisis, and prolonged stagnation. In these situations, questions arise concerning the state's capacity to manage aid inflows, and in particular the ability of the society to make a transition from humanitarian assistance to sustained development. Microenterprises, along with microfinance services, are critical to ensure livelihoods for much of the population, to enable them to secure basic goods and services, and to spur economic development and recovery.

An extensive literature has emerged concerning small-scale enterprise and especially microfinance programming in fragile and conflict-affected environments. This report, as with the underlying pilot activities, focuses less on the "how-to" of aid provision in this field, and more on *institutional reform and the enabling environment* relating to finance and enterprise growth in these settings. As elsewhere, sustainable development requires *institutions* – in the social scientific sense of rules, sanctions, and expectations, either formalized by the state or not – that support entrepreneurship, risk-taking, investment, and accountability. The *sustainability* concern arises sharply in fragile states, especially in connection with the transition from humanitarian to developmental assistance.

But how to address this in fragile states, where settled institutions have been degraded or destroyed, and where instability and uncertainty rule? And are not microenterprises and microfinance services themselves adaptive responses to harsh environments and failed institutions? Experience demonstrates that, while these micro-level activities are relatively resilient in adverse settings, like most economic activities, they thrive and achieve scale in an environment that creates stable expectations, imposes accountability, and thereby facilitates investment and sustainable operations.

The record also shows the range of humanitarian and developmental interventions that are possible even in the midst of conflict or disaster. A focus on enabling institutions is certainly possible, but requires flexibility and responsiveness, as well as program designs that incorporate institution-building wherever possible. Where effective national authority and policy coordination are absent, local institutions and enabling conditions can be one focus, with the rebuilding of central policy capabilities being another. Further, any major, permanent institutional reforms should normally be introduced only after a situation has stabilized enough for relevant officials and stakeholders to devote attention and capacity to them (for example, with a time lag of perhaps three years after the end of a violent conflict).

This paper offers a conceptual framework and a set of programmatic approaches to this area. It combines a literature review with insights from a pilot program carried out by the IRIS Center and its partners in the Academy for Educational Development (AED) consortium on the USAID FIELD-Leader with Associates agreement. The next section looks briefly at what constitutes a fragile state, and the causes and consequences of fragility. Part III examines the more specific impacts on small-scale enterprise and microfinance, along with their responses and relevant aspects of the broader economic picture. Part IV then reviews the experiences and lessons arising from the efforts of policymakers and aid donors to grapple with the institutional environment for small-scale enterprise and financial services in fragile settings. Part V brings these themes together into a framework for analysis and a set of programmatic guidelines for USAID and others. The annexes provide further background including summaries of the three pilot activities that IRIS carried out with its partners – World Vision in Angola, CARE in Mozambique, and Save the Children in Nepal.

II. Challenges of state fragility[1]

We begin with an examination of what a fragile state is, what makes it fragile, and what the broad implications of this are for development. Fragility denotes a profound weakness in a country's governance, entailing the crumbling of authority structures, policy failures, and a wide range of missing public goods – or the presence of public "bads." The core challenge of fragility is thus a state's – and therefore a society's – weak capacity to generate and maintain institutions that support coordination for economic and political development. Institutions unravel, and institutional reform becomes highly problematic. This part of the paper discusses relevant aspects of fragility and its impacts, also addressing the causes as well as approaches to the classification of diverse fragile settings.

The fragile state

No single definition of a "fragile state" has been adopted by international consensus, but some common features can be identified. Fragile states suffer deficits in governance that that hinder development. Conditions are too unstable for long-term planning and investment, with society focusing on near-term coping strategies to secure basic needs.

Operative definitions of fragility used by aid officials in the U.S. and U.K. (for example) emphasize the lack of *capacity* (capability, effectiveness) and *willingness* (will, legitimacy) to perform key government functions for the benefit of all.

- **Capacity** means having the core features enabling the state to mobilize resources for such key objectives as economic development and poverty reduction. These core features include territorial control and presence, effective exercise of political power, basic competence in economic management, and sufficient administrative capacity for implementation.
- **Willingness** refers to an explicit political commitment to policies supporting human welfare as reflected in actions and outcomes, implemented following an inclusive approach (non-discrimination). It relates to legitimacy, i.e., the sources of support for the state and the regime, and to the political basis for service delivery.

A state's fragility and its capacity to recover are a function also of the strength of civil society and the extensiveness of social capital. A strong society can reconstitute missing state functions – either in a new (or reformed) state or in the form of non-state alternatives, such as associations and other structures. Breakdowns reveal the intimate connection of state and social institutions.

> [S]ociety, as the generator of institutions of cohesion and maintenance, can no longer [function]…between them the links and overlaps of state and society fall away. The normal politics of demands and responses atrophies; the political processes for popular legitimization are discarded or prostituted; politics and economics are localized; and the center becomes peripheral to the workings of society.[2]

[1] This section is substantially based on Meagher (2005 and 2007).
[2] Zartman 1995: p.6.

Impacts of fragility

A fragile state lacks the capacity (effectiveness) and willingness (legitimacy) to sustain itself over time. It is unable to perform the basic functions of a state:

- to maintain security across its terrain
- to enable economic development
- to ensure the essential needs of its population are met

These three key state functions are, in economic terms, *public goods*. The cost to an individual or group of individuals who might attempt to provide such goods would far exceed their personal benefit. These goods will therefore be underprovided in the absence of effective and legitimate state action.

The state is built and maintained through the collective action of the public, or at least of a leading segment of the public whose interests encompass much of the nation. In a fragile state this "public" is missing or weak. This means that, although self-serving and perhaps market-based provision of goods may be possible, the more public aspects of service delivery tend to crumble or disappear (e.g., vector control, vaccinations, school curricula, teacher training, law enforcement, and water utilities). Coordinated policymaking and leadership suffers. Fragility also erodes the basis for efficient markets, making private enterprise more risky and costly.

State fragility can display a host of symptoms and effects: conflict, state collapse, loss of territorial control, low administrative capacity, extreme political instability, clientelist policies, and repression or denial of security and public services to subgroups of population. Fragility may reflect either the internal dynamics of the society or the impact of outside forces, such as natural disaster or regional conflict.

Central government in a fragile situation has little outreach to many areas outside the capital, and so a complex political, economic, and security situation prevails. Government has lost much of its de facto effectiveness and/or legitimacy. In the scale of public goods provision, those with the most 'public' characteristics -- such as country-wide security, infrastructure, and public/preventive healthcare -- are not provided. The following players often end up assuming what had been national responsibilities:

- local governments,
- indigenous social networks and NGOs,
- local user groups,
- microfinance institutions and
- private enterprise.

These groups can mobilize collective action, but only in a localized way. Goods and services with 'private' and 'club' characteristics predominate. Many of these organizations and groups assume, de facto, characteristics and duties of government. Some may grow to become large and powerful institutions.

It is the continuing lack of effectiveness – also referred to as 'limited reach' – that abets further violence and undermines rebuilding. In this situation, the cost to regime opponents of building up military strength in outlying areas is relatively low. These groups might be the militia forces of landed elites or revolutionary guerilla groups. To the extent the center and its allies are unable to outmatch these opponents militarily – that is, to control the national territory through a monopoly of violence – then government's ability to deliver other basic conditions of development such as public services, security, and a conducive economic environment is limited (Chalmers 2005).

The distinction between countries that are fragile and those that are simply poor may be elusive at times. As an approximation to fragility indicators, one could use the criteria proposed by Collier (2007) to identify countries at risk of violent internal conflict. These countries are not only poor, but they experience little or no economic growth and they often depend economically on natural resource exploitation. [3] The poorest billion of the earth's population, Collier suggests, tend to live in such settings. Some fragile states – for example, Zimbabwe – were stable and developing until they took a wrong turn or suffered a crisis (Commission on Weak States 2004).

Fragile states can be categorized as being on a downward path, in collapse, on an upward recovery path, or perhaps stalled at some precarious stage. A simple framework divides these states into two groups: a "Declining" group, increasingly at risk of failure; and a "Stabilizing" group, emerging from collapse. Several more specific scenarios can be described under these two headings, as illustrated in Annex 1.

Post-conflict settings

Unique governance challenges arise from the experience of conflict and the ensuing devastation. There is also an especially rich literature on post-conflict situations. A range of special problems arises in the wake of conflict. Haughton (2002) provides an overview of these. Key social indicators typically fall during conflict – in contrast to similarly poor countries that have not experienced conflict. Post-conflict states have fewer resources available for public health, as most funding is diverted to military spending – for instance many can no longer fund anti-malarial spraying and vaccinations. War will also cause qualified personnel such as doctors and teachers to emigrate. Large numbers of refugees, continuing civil disorder, run-down infrastructure, small industrial and service sectors, and very poor data collection capabilities cause further complications. In post-conflict countries, a large volume of foreign aid immediately following war is common. There is the danger that the influx of financial transfers will feed theft and patronage (Debiel 2000).

One pithy summary of the difficulties in post-conflict economies (Curtis 2006: 2) is as follows:

- Most things are broken (infrastructure, institutions)
- No-one remembers how to run things, let alone fix them
- Everything needs fixing before you can fix anything else
- The private sector is scared of taking big investment risks
- The private sector that survived did so in spite of the lack of systems and rules. That has become "the way we do business around here."

The difficulties of post-conflict existence may encourage social groups to withdraw altogether from engagement with public institutions, organizing matters privately on a family or ethnic basis. This will further weaken the legitimacy of the state and may enhance rent-seeking and corruption by officials. Trust between social groups – and even within groups – declines. In the presence of instability or violence the downward progression is still more extreme. Weak

[3] Rosser (2006: p.2) includes the experience of "severe violent conflict" (at present or in the recent past) as one of three possible indicia of a fragile state, along with lack of economic growth and failure to reduce poverty.

government begets weak security and a weak economy, in turn weakening society – the start of a vicious cycle. Persistent decline may undermine the social fabric itself, raising tensions further.

The breakdowns are most dramatically seen in the loss of state control over security forces. Public security and justice are central issues for poor people: without functioning systems, they are vulnerable to predation, violence and loss of assets. Other essential services, as well as economic development, depend on the establishment of at least rudimentary security. But in fragile states, the officials and agents responsible for these services are often the source of *in*justice and *in*security – especially in relation to security forces such as the police. Because the monopoly of force is a defining feature of the state, the central state is especially likely to interfere; and such intervention is likely to be ineffective or even predatory, since fragility compromises central policy coordination and disciplining functions. According to Hills (1996: 6), "When states are fragile and lacking in institutional capacity, their police are unlikely to be disciplined."

Moreover, although security and justice are central responsibilities of the state, in practice there is a diverse and extensive array of non-state actors.[4] In regard to justice functions, it is in fact normal (and beneficial) to have a diversified array of providers, from religious or customary mediators to civil courts. But fragility tends to reduce access to formal courts and increase reliance on the less formal local options. This makes it less likely that the formal judiciary will exercise a legal check on informal tribunals – just at the time when traditional rights are most likely to be overridden or abused.[5] And in a situation of violent conflict, greater insecurity means less access to services of all kinds, and greater risk to those seeking to provide services. Greater fragility can increase repression even as public security and justice systems weaken.

The end of conflict, however, also offers unique opportunities for rebuilding and reform. Research by Collier (2007) shows that the transition from conflict opens a short-term window to initiate a "turnaround," reversing fragile conditions and moving the country onto a developmental path.[6] This builds on the earlier insight of Olson (1982), based on the postwar economies of Germany and Japan, that the devastation of war radically changes the political economy. Defeat explodes the narrow interest groups that earlier controlled policy, opening the field for new entrants and approaches.

But turnarounds are hard to consolidate and sustain. The usual pattern, post-conflict, is for substantial amounts of foreign aid to flow into the country in the immediate aftermath, and then to decline precipitously as recovery takes hold. The paradox here is that aid is often highest when countries are least able to absorb it, that is, to make sustainable use of it, and it declines quickly as they gain this ability (Schwartz and Halkyard 2006). Post-war reconstruction can be surprisingly hard to achieve even under favorable conditions. War is more destructive than natural disaster in that it destroys not only physical infrastructure but productive capacity, social and organizational capital, and safety nets (Bruck et al). The big risk looming over any post-conflict economy is the threat of reversion to conflict – some 40% of post-conflict countries revert within a decade. There

[4] McLean and Scheye (2006).
[5] See, e.g. Hendricks and Meagher (2007).
[6] Rosser (2006) defines "turnaround" as the move from fragility to its opposite, that is (1) from no real growth to sustained high growth, (2) from failure to reduce poverty to sustained significant reductions, and (3) from current or recent violence to durable cessation of violent conflict. Some (e.g., DFID) agree with this explicit reference to poverty reduction in the definition of fragility/turnaround, but others do not (e.g., Collier, USAID, Commission on Weak States).

is a kind of 'Catch-22' here: economic recovery can bring down the risk of reversion, but the very risk of reversion interferes with the investment needed for recovery (Collier 2006).

Fragility and political economy

The state (more precisely, the governing regime) is involved in a political "game" that involves gaining and retaining power – which, among other things, depends on securing legitimacy. The source of legitimacy might be the leaders' success in delivering economic growth, national prestige, or public services. Alternatively, a more partial legitimacy might derive from signals of special allegiance to certain traditions or ethnic groups. Thus, legitimacy may or may not relate to equitable economic policies or public services.

The satisfaction of relevant stakeholders is at the core of the political "game" played in any society. The rules of this game arise from historical experience and become embedded as norms of behavior. Different societies have profoundly different legacies and capabilities in these areas, and these will naturally be reflected in the state. Even well-established states can fail to provide public goods capably and equitably. Public policies, institutions, and investments are always constrained by a range of influences reflecting the social and historical context. Important factors include the limits on voters' knowledge and information, the polarization of the electorate, and especially the credibility of political commitments. Such constraints are most difficult in low income countries and especially in fragile states: accountability is usually weak; government does not "listen to the people."

Where credibility is low (as in many developing countries), instead of making broadly beneficial policy commitments, politicians will focus their attention on specific localities or individuals, in the form of special projects and patronage jobs. This pattern, *clientelism*, tends to sacrifice collective benefit – or even to create public "bads" – in the service of favoritism.[7] In such a context, policies supporting the development of small-scale enterprise and microfinance are likely to be disfavored. Yet in certain cases public policies and investments can be inclusive even while serving clientelist goals. A good example is the drilling of wells in rural areas. The wells may be targeted to help particular political supporters (as they have in Pakistan, for instance) but the benefits are non-exclusive and immediately observable.

The economy itself may have a broad or a narrow base. The broader the base, the more limited the scope for government monopoly and exploitative regulation. A narrowly-based economy enables the regime to extract benefits or "rents" from its control over natural resource exports, industrial monopolies, or strategic infrastructure (canals, military bases). In this case, the state would be free to ignore the non-strategic regions and populations in favor of narrow interests. A broader economic base would offer fewer monopoly rents to the government, requiring the government to exert a broader effort to maintain effectiveness and legitimacy.

Toward the fragile end of the spectrum, the problem of clientelism is greatly compounded. The economy suffers from generalized risk aversion, short time horizons, and distorted incentives. The system spirals into greater dysfunction and possibly into crisis. The government may abandon the focus on development (if it ever had such a focus) to concentrate on the viability of the state itself – for example, devoting increasing portions of the budget to security forces and weaponry. In some cases, the society may have the resilience to fill the void, through voluntaristic provision of public goods or an orderly change of regime. "Survival strategies" may emphasize

[7] Keefer and Khemani (2003).

traditional patron-client hierarchies, entrenching them as alternatives to formal state authority and government service delivery (Brinkerhoff 2007).

III. Impact of state fragility on enterprise growth and finance

Within the kinds of fragile settings just described, how are small-scale enterprises and financial service providers affected? What strategies do they use to cope with instability, and with what results? We take up these questions in the present section, building on our prior discussion of fragility and its impact state and society. This discussion then leads into an analysis, in Part IV, of approaches to building enabling institutions in such settings, and the findings from experience.

Fragility and private sector development

Fragility, and especially conflict, weakens institutions that are required for the proper functioning of the economy and basic public services. Institutional weakness can include an inexperienced civil service, with severe lack of skilled local personnel, a tax system that collects a small share of GDP, and a police force that is inexperienced and overstretched. Roads, ports, and rail transport, all vital to the economy, may be disrupted if not destroyed. The collapse of formal state processes and institutions in post-conflict countries often forces entrepreneurs to rely on informal mechanisms. Often only the simplest of commercial processes, such as cash-and-carry, can be used out since breach of contract can not be enforced due to a weak or non-existent judiciary (Aron 2002, Haughton 2002), and non-judicial social norm enforcement has weakened.

The legacy of violent conflict includes key constraints to economic and private sector growth, including:

- damaged commercial networks
- loss of trust
- weakening of market institutions
- political uncertainty (Bruck et al. 2000).

Other key components of the investment climate affecting business include finance, labor, regulation, taxation, and governance. Fragility, particularly conflict, erodes these conditions, ushering in a situation in which instability and informality prevail, and corruption thrives. A lack of law enforcement, trained labor, and financial services, along with a weak (or barely existing) currency goes along with this. Private sector activity shrinks but continues on the 'conflict economy' pattern based on illicit trade and profiteering (Mills and Fan). These factors tend to reduce investment and therefore the 'peace dividend.' The dividend, usually thought of as the redeployment of capital from military to productive purposes, is usually hard to achieve because war *destroys the peacetime economy* (Bruck et al. 2000).

Formal business practices and rules give way in fragile environments. The pervasive informality that replaces them may have adaptive benefits, but is hardly benign. The population's increased vulnerability creates greater reliance on social networks, with businesses operating at smaller scale and serving a more localized customer base. New entrepreneurs enter the informal sector and adapt. On the governmental side, enforcement of existing rules often becomes arbitrary, even predatory, resulting in an 'informal' framework of rules. These may be highly restrictive and subject to rent-seeking (Mills 2006).

Coping mechanisms may require entrepreneurs to contain cost and risk through the use of organizational and transactional forms that limit growth potential – e.g. keeping business within a status network, avoiding illiquid investments, and requiring immediate payment or onerous credit terms ("hostage" collateral, risk premia). Institution-intensive enterprises will most likely degrade first – i.e. those that are sensitive to state-provided or state-regulated inputs such as business and financial information, contract enforcement, verification and conveyance of property rights, transport, communications, telecoms, power and water.

As fragility increases, both people and enterprises migrate – to more secure regions or countries, or into sectors and activities less dependent on formal institutional arrangements. Thus, forward contracts supported by medium-term credits and other financial instruments may be replaced by more cash, spot-market deals. Long-range coordination erodes in favor of short-term gains, whether in spot-markets or in corrupt dealings with government. Much of this will depend on the extent and quality of social cohesion, either in the community generally or within specialized (often ethnicity-based) commercial networks. In cases of severe fragility, basic farming and animal husbandry may be disrupted, and people either migrate or find some way to sustain themselves through foraging.

When security and infrastructure are degraded, property rights weaken. People have trouble gaining, conveying, documenting, and defending ownership rights as records are lost and systems crumble. In this vacuum of authority, opportunism gains momentum as interested parties use available leverage, bolstered by appeal to rules that may be outdated or misunderstood, to claim rights to property. Of course, there are also problems of displacement followed by return, at which point original owners clash with occupants. Land tenure becomes uncertain, and so may ownership in livestock, moveables, and other assets.[8]

Thus far, we have focused on the effects of political instability and civil war. In a natural disaster, the immediate effects on enterprise may be similar, but without the same breakdown of social relations and institutions that violent conflict begets. For example, in Sri Lanka after the tsunami, tens of thousands of MSMEs were harmed or destroyed. As emergency aid flowed in, the influx of aid workers and the demand for labor and materials drove prices up, making recovery more difficult. The fisheries sector recovered fastest, with assistance from the aid donors – although the resilience of fishermen and their families likely played at least as big a role (Weerakoon et al. 2007).

A similar dynamic seems to play out in other settings, where there may not be a state failure (imminent or already-concluded), but where certain regions or populations exist in conditions of fragility. An example is the plight of HIV/AIDs-affected widows in developing countries where the needs of this population outstrip the capacity or willingness of government to address them. Other examples could include pockets of extreme poverty or endemic disease, sub-regions affected by conflict or natural disaster, and groups that are geographically isolated or socially insular and therefore underserved.

Enabling conditions for micro and small enterprises (MSMEs) and microfinance are often categorized as micro (retail or household), meso (networks and infrastructure) and macro level (policy and governance). One could summarize the impact of crisis conditions on these levels as presented in the following table.

[8] Hendricks and Meagher (2007); "Afghanistan's Economy: Creeping Towards the Marketplace," *The Economist*, Feb. 4, 2006.

Table 1. Impact of fragility on enterprise-related activities

	Micro level	Meso level	Macro level
Disaster	Loss of assets Loss of skills due to migration Declines in productivity Disrupted markets Trauma	Weak marketing networks due to migration Damage to or loss of natural resources Infrastructure damaged or destroyed	Localized reduction in capacity to enforce laws and provide basic services
Conflict	Loss of assets Loss of skills due to migration or ineffective education Instability or loss of networks and increased operating costs limiting market scope Trauma	Infrastructure damaged or destroyed Licit networks disrupted, illicit networks strengthened	Reduced national capacity to enforce laws and provide basic services

Source: Nourse et al. (2006).

Despite the serious problems in these environments, fragile and failed states have strikingly high levels of enterprise activity. Nor are they devoid of services. Where major infrastructure is degraded, or where rehabilitation does not reach beyond major city centers, small-scale providers of infrastructure and services step in – especially in electricity and water supply – to meet pent-up demand. They can mobilize resources quickly. However, cumbersome delivery mechanisms, lack of alternatives, and sometimes regulation, can make prices for these services quite high. Post-conflict investment patterns show that mobile telephone services materialize quickly (sometimes before the end of conflict), followed by electricity generation and distribution a few years later, and then transport and water (Schwartz et al 2004).

Other post-conflict investment issues are examined by Bray (2005). Small, "junior" petroleum and mining companies are willing to take the security risks associated with operating in a post-conflict country. These niche companies seek to make natural resource discoveries in frontier areas before competitors are able to. The activities of the "junior" companies generally fall in the exploratory category. The "major" resource extraction companies are far less willing to begin operations in post-conflict countries. They operate large scale projects that require investments in the range of billions of dollars and have useful lives of decades. Also, general construction companies are willing to begin major reconstruction projects (such as power stations or roads) in post-conflict countries largely because the projects are financed by international donors – but this sector is especially plagued by corruption.

Mobile phone companies appear to be the least risk adverse of all private-sector service providers in post-conflict countries. Cell-phone infrastructure requires much less initial startup capital than other major projects such as oil extraction, and pay for themselves in a matter of years. Cell phone providers are also viewed as a public service. Since cell phones can become an indispensable part of life for all parts of the population – civilians, military, warlords, etc. – mobile phone companies are rarely targeted by violence. For example, despite not having a central government and being continually affected by clan warfare, cell phone companies are flourishing in Somalia (Bray 2005).

In conditions of protracted state failure or fragility, there has been a great deal of experimentation with enterprise development, market-based services, and localized governance and infrastructure. The large inflow of aid in the early post-conflict period is usually accompanied by an absence of investment in infrastructure and essential services. Small-scale private providers often take up the slack – for example, about half the countries with significant participation in electricity and water services by such providers are conflict-affected countries. In contrast to large investors, small private providers are quick to set up during and after conflict (Schwartz and Halkyard 2006).

Nowhere is this dependence on private service providers more striking than in Somalia. Entrepreneurs in Somalia have coped with lack of effective government since 1991 by: (i) outsourcing governance by relying on foreign institutions (e.g. company law, airline safety), (ii) using clans and other local networks of trust to ensure compliance with agreements, and (iii) simplifying transactions so that they do not require publicly-provided institutions such as rule systems and third-party enforcement. Examples where such methods have been used include the provision of cellular phone service, small electricity and water providers, and money transfer. But this approach leaves important gaps unfilled (e.g. provision of schools and roads), carries significant transaction and opportunity costs, and is incapable of addressing access and equity issues (Nenova and Harford 2004, Feldman and Slattery 2003).

While entrepreneurship is ubiquitous, even in conflict-affected settings, it may not always be for the good. Unproductive, predatory kinds of businesses may actually impede the resurgence of a viable private sector and even contribute to a relapse into conflict. Most small businesses in fragile states – particularly in Africa – are "survivalist" rather than growth-oriented, and will respond to available opportunities, regardless of whether they are good or bad from an economic recovery perspective. Post-conflict settings are full of uncertainties, and so entrepreneurs will often carry on with the methods they used successfully during wartime. This creates a "conflict overhang" or survival of war-economy business methods. Further complicating matters, these businesses may be criminalized in the early postwar period, before viable alternatives become available, thus helping create the huge shadow economies one sees in such places as Afghanistan and Angola. Continued war spending and high taxes will reinforce this pattern, spurring smuggling and other law-evading activities (Naude 2007).

Conflict thus shifts economic activity onto a different track from the peacetime economy. One observer (Studdard 2004) identifies three separate economies operating in war-torn areas: the combat economy, in which exchange is driven by the needs of militaries and militias; the shadow economy, where entrepreneurs seize earning opportunities created by weak authority; and the coping economy, involving diverse livelihood and survival strategies by hard-pressed populations. Each of these has a dynamic different from the peacetime economy, and each therefore presents a challenge to those attempting move the economy onto a sustainable long-term footing in the aftermath of war. Wartime incentives and patterns may persist, threatening economic recovery or even a relapse into conflict.

The destructive impact of war on entrepreneurship – including mortality and the removal of opportunities for training in business – makes a private sector turnaround still less likely. An influx of aid and investment, as peace returns and recovery gets underway, creates incentives for entrepreneurs to focus more on rent-seeking than business creation. Those successful in this game may emerge as "oligarchs" asserting power through lobbying, market and regulatory capture, and political influence (Naude 2007). Those who do not succeed may turn to illicit enterprise, crime, or even a return to fighting.

Financial sector and microfinance in fragile states

Financing involves transactions that are relatively dependant on institutions, whether informal and trust-based or formal and enforceable at law. This is because they incur risk and the obligation to repay at the end of a term. Still, they can range from low-risk / high-rate pawns to long-term unsecured credit lines and certificates of deposit that are available at reasonable rates only when supported by reliable information, reputation, and enforcement mechanisms.

In fragile settings, financing continues, but tends to bifurcate into banking with a limited group of trusted clients on one side, and low-risk / high-rate moneylending on the other – with some relationship-based trade credit mixed in. The pervasive opportunism of post-conflict situations undermines credit markets. In the most uncertain situations, people hide their money or send it abroad, and when loans are made, they are often not repaid. In early post-conflict settings, “forget credit markets,” says Collier (2006).

The institutional basis of transactions erodes, as property rights, insurance markets, and the records and other means to address asymmetric information become unavailable. Borrowers either fall into arrears due to the loss of income and markets, or they may take advantage of anarchic conditions and feeble enforcement to default. Banks are left with substantial levels of bad debt. They may curtail their operations, build up reserves, or invest their funds abroad. Those most dependent on formal credit, including small and medium enterprises (SMEs), are hardest-hit by the contraction of lending activity (Addison et al 2005).

Financial institutions are looted in conflict-affected states, and this pattern tends to continue after violence has come to an end. Instability changes people’s preferences about the kinds of assets to hold, and it also changes the governance of financial institutions for the worse. Frauds, insider lending, and other abuses proliferate, while repayment discipline tends to erode. Recovery requires new and better financial institutions, system oversight, and currency (Addison et al).

The early post-conflict period may involve such challenges as creating or re-opening a central bank, adopting a currency, and re-establishing the banking system. Not only are banks often looted during conflict, but their staffs may be decimated – a major Rwandan bank was left with only about 20% of its personnel after the 1994 genocide. The loss of assets capable of use as collateral, and the general climate of uncertainty and instability, will tend to choke off lending. In the recovery period, bank recapitalization often involves privatization, which can bring its own difficulties of non-transparent dealing and eventual financial crisis (Santos 2003).

Households in these situations of instability, and financial disintermediation, must find ways to cope. Wilson (2002) reports on coping strategies during and after conflict in Cambodia, Mozambique, and Rwanda. Households gravitate towards activities with low risk, low investment, and quick return. This generally means trading. Agricultural production, which requires investment and property security, generally rebounds only after conflict has ended and recovery gotten underway. In the unstable conditions of conflict and early post-conflict, people often try to avoid holding cash due to the risk of theft, but are forced to liquidate assets in order to survive. As for banking and credit, village banks become unpopular at times due to mistrust and the perception that people’s savings may not be sufficiently accessible. Still, small group, trust-based lending may continue in small amounts, though larger loans require collateral.

Microfinance challenges: Microfinance faces special challenges in post-conflict environments. These include the following (Microfinance Best Practices #5):

- severe human resource limitations due to the death or flight of skilled people and the competition from relief agencies,
- a similar difficulty in assembling local MFI boards,
- the diversion of resources toward the paramount need for security,
- higher costs due to this and other reasons such as poor infrastructure, and

- a delayed timetable for MFIs to reach sustainability.

The weaknesses of financial sectors and regulatory frameworks in fragile states constrain the scaling up and sustainable growth of the MF sector.

And yet, small-scale financial services are offered in conflict- and crisis-affected countries. According to some observers, the basic conditions required for microfinance operations are quite simple. They have been summarized as follows (MBP #4, Doyle 1998):

1. A degree of political stability, meaning an absence of total chaos but not necessarily a complete cessation of conflict; there must simply be sufficient security for microfinance institutions (MFIs) and their clients to transact.
2. Enough economic activity in the area of operation to support a demand for credit services; the key indicator here is active local markets.
3. A relatively stable population of clients; since high mobility in the wake of crisis or conflict undermines loan repayment, services should target returnees or at least displaced persons who have settled for the medium term.

The same analysis identifies 'preferred' conditions, i.e. ones that may be important for microfinance development but not necessary in the short term. First, a functioning commercial bank sector can provide vital services to MFIs such as storing and transferring funds. While the lack of such banks raises MFIs' costs and risks, it is not a bar to the provision of MF services. Second, trust or social capital is critical to many microfinance operations, but providers in low-trust countries emerging from conflict (e.g. Liberia) have still been able to operate, even if not optimally. Third, macroeconomic stability is important for financial operations at scale, but MFIs have been able to cope in its absence using tactics such as conducting business in hard currency (which creates its own risks, MBP#4). If these conditions obtain, MFIs insist that microfinance – including savings facilities – is indeed possible in conflict-affected environments, despite some observers' claims to the contrary. Notably, informal microfinance can subsist and even grow in very unpromising environments (SEEP no. 5 2004, Wilson 2002).

Other observers add that at least some level of trust, in addition to knowledge of the borrower's business, is essential for informal finance. Further, macro instability or especially demonetization leads to borrowers' preference for goods in kind rather than cash. The lack of a legal framework for microfinance does not constrain growth in the sector in the near term, but it will eventually be important once recovery is well underway and the sector is expanding. One of the key issues for donors to keep in mind is that microfinance revives and grows during the early post-conflict or 'relief' phase. Some aspects of humanitarian aid, notably extensive use of grants – especially if they are presented as soft microcredits – can undermine the market (Wilson 2002, MBP#2).

Thus, the literature suggests that the conditions for microfinance operations at fairly small scale, and not on a financially sustainable basis, are quite modest. This has been clear since the first Grameen loans in Bangladesh, and subsequent variants have made self-enforcement within solidarity and village banking groups an essential part of their methodology. These approaches are relatively resilient within a harsh, unstable environment, although the discussion above reminds us that constraining borrower opportunism, staff retention, cash transport, and outreach all pose serious challenges in fragile, especially conflict-affected, settings.

But going beyond such rudimentary operations requires more. For microfinance to bring the poor and unbanked into the financial system, and to enable them to capitalize on and expand their opportunities, calls for a complex of enabling institutions. The ability to access, document, leverage, and enforce property rights is fundamental for both financial institutions and clients. Stable expectations with respect to market development, contract enforcement, currency value, and the flow of information and trade are also critical. To reach scale and transform the lives of the poor, microfinance providers need to enter the banking sector, whether through alliances or licensing, and to access funds on a regular commercial basis. All of this calls for a facilitative regulatory scheme for institutions offering microfinance, including rules that differ from those typically applied to formal banks, so as not to stifle microfinance innovation and expansion. Along with this, supportive legal and regulatory frameworks, governance, and macroeconomic policies allow for a diverse array of financial providers and products. These things are clearly *not* normally available in fragile settings, and microfinance sectors in these sectors as a result appear to be only weakly developed in comparison to their potential.

The above problems are well illustrated in the activities carried out by IRIS and its partners under the FIELD-LWA pilot. The Nepal case study, led by Save the Children, focused on NGO development work in districts affected by the Maoist insurgency, primarily the provision of microfinance and related services. This work faced daunting obstacles of insecurity, with the consequent threats of violence and theft, potential loss of repayment discipline, difficulties in transport and communications, shortage of trained staff, weakness of demand due to constrained enterprise opportunities, and the need to triangulate politically for support among the communities, the government, and the insurgents. Over time, the NGOs adapted their operations and products accordingly, changing security procedures, loan approvals and terms, and other parameters. All of this, of course, imposed costs on both the providers and the recipients of microfinance services – an unavoidable cost in the circumstances.

The work in Angola and Mozambique, by contrast, involved not ongoing violence but a post-conflict setting, in the latter case especially punctuated by natural disasters and such crises as the HIV/AIDS epidemic. With hostilities having ended some five years ago (after an abortive peace settlement), Angola is in the middle of its all-important recovery decade. The protracted civil war left behind a dismal legacy of devastation, impoverishment, disrupted social ties, and the remains of a natural resource-driven conflict economy. Thus, together with its transition to peace, Angola has been grappling with a momentous economic transition, from a conflict to a peace economy, from state socialism to a more mixed and market-oriented order, and from a heavy dependence on petroleum revenues to a more diversified economy in which the abundant cash of the few is intermediated into enterprises and livelihood activities for the majority.

In this context, World Vision and IRIS convened key Angolan policymakers and other stakeholders to provide momentum and set an agenda for legal-regulatory reforms to facilitate microfinance. The aim here is both to encourage "downscaling" by formal financial institutions into microfinance services, and to provide a framework for NGO and informal services to tap wider sources of capital (savings and commercial investment) to gain scale and sustainability. The success of these efforts depends to a great extent on parallel efforts to improve agricultural production, build value chains and transport links, and bring related activities by state banks and credit programs into conformity with a market-oriented vision of microfinance.

Mozambique, among the three pilot countries, is the furthest along in its post-conflict transition, having achieved a peaceful resolution in the early 1990s. But the fragile conditions bequeathed by that conflict increased its vulnerability to the weather and health crises noted above. There are also legacies from the civil war period that dovetail with the HIV/AIDs crisis to create profound difficulties for microenterprise and microfinance development. The work of CARE and IRIS in Mozambique focused on one of the most important and intractable of these legacies – the uncertain property rights of HIV/AIDS widows.

Although protected by the Mozambican constitution, women's property is regularly expropriated upon the death of the spouse. This activity has intensified, affecting an increasing proportion of widows and a wider array of real property and moveables. The causes are complex, but include the sheer opportunism often displayed in such settings of deprivation and anomie, together with a loosening of the authority of both socialist-era standards of equity *and* of customary law rights and protections for widows. This in itself is a problem worthy of attention, but it gains still greater importance due to the central role of women as producers and household managers in many societies, especially fragile contexts in Africa. The CARE/IRIS team proposed a number of responses, including the expansion of legal aid programs, legislative advocacy, and outreach to affected communities through CARE-sponsored Village Savings & Loan programs to provide information and training on strategies to combat or prevent expropriations.

IV. Enabling growth of enterprises and financial services in fragile settings

Advancing recovery and development in societies unsettled by conflict, disaster, and other sources of fragility presents numerous challenges. This much should be clear from the discussion above. And yet, policymakers and NGOs in these countries, and their partners in the international aid community, must labor to re-establish stability and build the conditions for economic, social, and political development. Their efforts have increasingly been documented over the past decade or so, and some useful analysis and learning have been extracted, though much more remains to be done. This section of the paper draws on these findings, focusing on those most relevant to small-scale enterprise and microfinance. Beginning with a consideration of the inflection points in fragile situations and the ways in which these can be dealt with, the discussion then moves on to examine reforms and related aid efforts in this field. Throughout, the emphasis is on learning from challenges and responses in such areas as understanding the setting, adapting approaches to reform and assistance, and sequencing interventions accordingly.

Managing transition and turnaround in fragile states[9]

Fragile states are in flux – more so than other countries. Reformers and the international community constantly struggle to recognize and cope effectively with changed environments. Donor agencies must recognize when a country transitions to a new status – and adjust their strategies accordingly. This is especially challenging at the onset or the termination of a violent conflict or other crisis, as well as at times when fragility increases and stability takes a downturn. The recognition of these inflection points plays a central role in determining the design and sequence of interventions.

Conflict to peace: In a post-conflict setting, sound strategy requires the recipient country and its partners to maintain a consistent focus on the objective of turnaround. This means not only sustained peace but also continuous, shared economic growth – which, in turn, requires establishing the conditions for market-oriented reform. Early post-crisis livelihood support can focus on cash- or food-for-work. This is thought to be less distorting than unconditional aid transfers, and it helps households bridge the difficult period from the end of conflict to the re-emergence of retail and employment markets.

Aid to fragile, crisis-affected countries has been plagued by coordination failures in which, for example, grants, loans, and fee-based services overlap to the detriment of the local private sector.

[9] This section draws on Meagher (2007).

But lessons have been learned and new approaches are available. The distortion of local markets may not be an inevitable outcome of relief programs. Building a range of components such as business services, microfinance, value chain assistance, and especially the integration of local enterprise and labor, into recovery and development programming can make for more market-enhancing interventions. This – together with the building of a conducive institutional environment for development – is key to sustainable recovery. Used strategically, this market-oriented approach can make it possible to "build back better," by fostering greater entrepreneurship, more effective poverty alleviation, and a broader-based economy than existed pre-crisis. This is not to suggest the need for a whole new toolkit, but rather that such components as grants and infrastructure contracts can be targeted where they will be most effective in reviving large employers, supporting livelihoods, and fostering entrepreneurship (Nourse et al. 2006).

A decade-long perspective is needed for a post-conflict transition, to take into account the fragility of peace settlements and the importance of social cohesion and government legitimacy in all phases of programming. Too short a time perspective has led to regular failures in the "transition phase," when donor funding drops suddenly and the risk of renewed conflict increases.[10] It is essential to recognize that "transition" is a stage in itself, with a time frame that can last several years in terms of adjusting governance and service arrangements. The fragile political economy must be consciously addressed at each stage. Economic reform must be managed in such a way as to retain the support (or at least the neutrality) of elites, beginning with "zero generation" reforms, such as economic stabilization and basic restructuring, and moving on to more ambitious governance reforms (Rosser 2006).

There has long been a debate about sequencing and priorities for developing country institutional reform, about where to start and at what point to attempt certain kinds of reforms. Some institutional arrangements, notably legal and regulatory structures imported from large industrial countries, are found to be inapplicable in many developing settings. They need to be substantially adapted or delayed until ongoing development creates a need and a demand for them. Reform should be more modest, targeting relatively simple sets of rules and an array of adjudication forums building on indigenous practice. Fragility adds a further layer of difficulty. Early post-conflict situations, for example, may not be appropriate for ambitious reform projects such as the creation of an independent judiciary – and such a reform may not be relevant to the growth of the economy at such an early stage anyway. Also, consideration should be given to supporting, or reviving, what has worked successfully in a given society, such as a pre-conflict court system. This can afford a recovering country a head-start in institution-building (Aron 2002).

In areas related to enterprise and financial recovery, the sequence of post-conflict assistance priorities might look something like this (GTZ 2004):

- <u>Years 1-3: stabilization, identification of priorities</u>
    - Provide basic humanitarian needs
    - Identify and prioritize development challenges
    - Rebuild physical and social infrastructures
    - Repatriate and integrate refugees

- <u>Years 4-7: reorganization and institution building</u>
    - Regulate ownership
    - Dismantle economies of violence
    - Define development priorities in participatory fashion

[10] Laurence (2005); War-torn Societies Project (1993)

  - Stimulate the economy
  - Establish a tax system
  - Invest in education, health and income security

- Years 8-10: consolidation and return to normalcy
  - Establish effective macroeconomic management
  - Improve tax system
  - Provide legal security for foreign direct investment
  - Invest in education, health and income security.

A contrasting view is presented in a recent USAID report (USAID 2007) focusing on economic recovery and growth after conflict. It suggests less a linear sequence than an adjustment in relative priorities among a set of core objectives for the post-conflict era. Expanding physical security and providing jobs have urgent priority early on, but are less critical later in recovery. Building institutional capacity and restoring infrastructure and public services take higher priority as the recovery proceeds. Policy reform is important early on and remains so, with slight variation, over time.

This view appears to clash with the sequence described just previously, where the early focus is on restoration of order, meeting basic needs, and rebuilding. The USAID approach is notable for placing early priority on policy change, consistent with recent work (e.g. Collier 2006) emphasizing the opportunities for change thrown up by crisis and the importance of path-dependency as recovery reaches its late stages. But differences in approaches to sequencing are not hard and fast. Actual sequences will greatly depend on the angle of vision (e.g. recovery as a whole versus rebuilding the private sector) and the detailed circumstances. Principles and guidelines for ideal sequencing comprise only one among many sets of factors to be considered in post-crisis programming.

Increased fragility: The direction of change in a fragile state could also be in the opposite direction – not from crisis to recovery but from stability to increased fragility or crisis. Situations of deterioration pose special challenges. Governments may become increasingly unreliable as they yield to polarization, perhaps taking a side in a social conflict or engaging in repression. Or, a government with a credible commitment to shared development faces a natural disaster or challenge to its authority, internal or external. Here, the donor countries must make choices about reinforcing the sitting government, or conversely withdrawing support as a sanction and signal of distancing. An intermediate option is for donors to fund activities largely independent of government involvement, but in *alignment* with the state. This refers to donors' adoption of systems (e.g., project cyle, accounting) that fit with those of the recipient government, in order to ease the eventual hand-back of functions and activities.[11]

An accurate understanding of the situation and the motives of the actors is critical, and responses flow from this. Such adverse transitions, and the modes of adapting aid to them, are less well documented than the post-conflict transition. In declining situations where the threat of violent conflict or other crisis looms, donors are faced with major decisions concerning their program planning horizon. Should they continue to promote governance and economic reforms or shift their emphasis away from policy toward strengthening local communities, households, enterprises and MFIs? In the worst situations, all options for alignment with government may have to be abandoned, and programs must bypass state mechanisms (at least at the national level). Here,

[11] The term *shadow alignment* adds to this the idea of "shadowing" the cooperating ministries, in order to both build capacity and facilitate hand-off.

work on enabling conditions would need to shift from state policies and infrastructures toward "club" goods supported by the enterprise and finance sectors themselves, with input from any amenable ministries or sub-national governments.

Equally challenging is a sudden downturn in a country that has been stabilizing. Donors experience pressure for aid reductions based on human rights and governance criteria, even as urgent human needs call for continued engagement. There may be scope for working through selected ministries that maintain some credibility with donors and communities, and perhaps aligning aid-funded systems with government to ease eventual hand-back. Such initiatives may have the unintended effect, however, of enhancing the legitimacy of a disfavored government. Working with enterprises and microfinance providers poses fewer risks of this kind, but donors need to be careful where possible not to become entangled with entities that have official backing or personal ties to disfavored governments, officials, and politicians (or groups involved in terrorism). This poses additional complications for aid programming, but should be feasible in all but the most authoritarian settings.

Increased fragility may well persist. Donors need ways to determine how to work with chronic underperformers, such as Central Africa Republic, Republic of the Congo, Guinea, Myanmar, Uzbekistan, and Yemen. In some of these cases, the public sector is relatively large but performs poorly or even contributes to violence and injustice. Experience suggests that in such a declining context, donors could create an external group or "cabinet" for coordination on sector issues, without close engagement with government officials. Microenterprise- and microfinance-related assistance will need to be placed at a greater distance from government, focusing more on direct support and only those enabling conditions that are within the purview of the private sector.

Recovery and reform

Recovery depends on sustained peace and a secure environment for business. One part of this is monetary stability, but much more is required. In addition to such widely-cited conditions as infrastructure and rule of law, post-war economic recovery depends especially on small businesses to alleviate poverty and absorb the labor of ex-combatants and returnees. Further, a comparison of post-conflict economic reforms in Nicaragua and Mozambique indicates that the slower but more consensus-based reforms in the latter country led to a more dramatic recovery than the more rapid reforms in the former (Bruck et al 2000).

Analysts of fragile and post-conflict states increasingly call for early attention to private sector development (PSD) reforms. These tend to get 'crowded out' in the flurry of activity during the recovery period, which focuses on humanitarian relief, rebuilding, and macroeconomic stability. With PSD as an early target, reformers must then be careful to avoid setting in place an overly rigid framework. Modest, sequenced reforms built upon public-private dialogue will likely produce the best results – to the extent conditions permit (Mills and Fan 2006).

At least in the long term, reconstruction without economic policy reform does not work. Privatization, effective regulation, fiscal reform, strengthening public services, and securing access to land and other natural capital by poor communities are all critical to sustained economic recovery (Addison 2006). Two of the most important early steps, according to Collier (2006) are to bring security to property rights and to reverse capital flight. Uganda achieved these goals within a decade after the end of its civil war by creating a clear and predictable system for recognizing ownership rights, and offering incentives for the return and reinvestment of flight capital.

Economic recovery and growth require new business starts that bring innovation, employment, and growth prospects. This is an especially tall order in post-conflict settings, where enterprises have been for some time on a war footing. When new firms do emerge unencumbered by the conflict and survivalist methods of wartime businesses, they boost a broader recovery by reinforcing reforms, encouraging imitation, and spreading a sense of normalcy and trust. Aid in these settings can assist with reforms to "lock in" improved governance and to enhance transactional certainty and efficiency (Naude 2007). Institutional reforms to the enabling environment are especially important to promote business growth in these settings. The implications of this go beyond economic recovery to the sustainability of peace. Business growth is needed to provide employment for key groups such as ex-combatants (thus assuaging the 'greed and grievance' factors), and to deliver services that governments in these settings are often unable to offer on a wide scale (Mills and Fan 2006).

Indeed, instant results ('quick wins') and expedient near-term improvisations are likely to be critical. A 'proper' legal framework for investment may be neither desirable nor achievable in the near term. Similarly, contracting out key services and facilitating investments in particular sectors of near-term potential (e.g. telecoms, transport) may prove more practical than approximating 'best practice' across the board (Guislain 2006).

Part of the recovery involves the rebuilding of networks. This cuts in two directions – on the one hand, networks can transmit learning among firms, offer opportunities for synergy, and provide alternative frameworks to increase certainty when institutions are missing. On the other hand, networks can foster collusion, thereby reducing innovation and orienting business activity towards rent-seeking and patronage (ironically, this can have benefits, too, by distributing benefits to the needy and the potential "spoilers"). Networks can also link people with shared backgrounds and interests – especially ethnic business classes – when they have become dispersed as a result of conflict (Naude 2007).

The key question for reformers is whether to reinstate the pre-crisis enabling framework for PSD, or to seize the opportunity to build a better one (Mills and Fan 2006). Internationally, the consensus in this area is shifting toward a "build back better" approach. Not only is the economy likely to have changed as a result of the crisis – dramatically so if a civil war is involved – but shifts in the political economy and the sheer pressure of need may open opportunities for deeper reform than might have been possible before. But this is not always the case. It may be more advantageous in the near term to stimulate informal enterprise through regulatory forbearance and a reduced tax burden, even if the long-term goal is a growing formal economy (Mills 2006).

In any case, it is possible that radically changed circumstances after a crisis may call for a different kind of institutional framework than existed beforehand. Shifts in population, such as the rapid urbanization that took place during the conflicts in Angola and Colombia, may call for new rules dealing with land, property, services, financial transactions, etc. (Aron 2002). Changes in governance issuing from a conflict settlement may require different relations of ownership and production, privatization of state-owned firms and banks, and a judicial system capable of defending human rights and adjudicating commercial disputes in a liberal economy.

As fragile settings often give rise to illicit exchange and abusive behaviors, some observers call for donors to help the state take a more active role in managing the economy, for example in Afghanistan. Markets in this kind of setting are informally regulated already, and state intervention can help to increase accountability, spread opportunities and benefits more widely, and limit the influence of those who have gained control of markets through force of arms and illicit activities (Lister and Pain 2004). This approach would also support the long-term objective of state-building.

Financial services: The financial sector is of special importance to post-conflict rebuilding and growth (Switzer and Hussels 2007). But reviving or strengthening the financial sector presents serious challenges in these situations. On the 'supply side,' banks and other financial institutions may suffer loss of capital, due to looting, and personnel due to general conditions of instability. On the 'demand side,' conflict usually creates large numbers of distressed borrowers. Households struggle to cope, while once-sound enterprises lose markets, equipment, accounts, and employees.

In many countries, restructuring and recapitalization must take high priority even before or in the absence of violent conflict, where the system is misgoverned and the banks subject to plunder. This picture shows that law and market institutions must be reformed in tandem with bank restructuring, so that risk aversion and high lending premiums can be reduced and credit expanded (Addison et al 2005). Thus, a revived financial sector needs an appropriate regulatory framework.

A number of serious difficulties plague efforts to rebuild regulation and supervision. The private sector usually has the means and interest to move faster than governmental authorities, and so their efforts, and the risks thereby entailed, will outstrip official oversight. When government reform efforts get underway, the vast needs and limited resources often produce inadequate systems, including weak or incomplete laws and inadequate resources for enforcement. Building strong regulatory and supervisory capacities can take 5-10 years (Addison et al. 2005). The "perverse sequencing" problem, whereby financial sector development speeds ahead of regulatory capacity, occurs in much of the world but is especially severe in post-conflict settings. The private sector will often bid away personnel from the government, thus aggravating the problem. In this situation, powerful interests will shape regulatory policy and implementation to suit their needs, while the weakness of systems and capacities means faulty record-keeping and asset valuation. This can lead to a build-up of risk in the system leading to failures and crises later (Addison et al. 2005).

Microfinance has thrived under a variety of institutional frameworks, and so there is a choice of approaches available for fragile states. Recalling the three-level analysis of enterprise-related activities in Part III above, we can characterize the microfinance sector as having these components: (i) a *micro* level of retail institutions; (ii) a *meso* level of networks, apex bodies, and infrastructure (e.g. credit reporting, clearinghouse); and (iii) a *macro* level comprised of policies, legal-regulatory instruments, governance, and economic management. The quality of retail microfinance institutions, notably their management and technical proficiency, is everywhere a priority concern. In the most unstable settings – the steepest point of decline and the initial stages of stabilization – the micro level may be the only realistic target of intervention, and this perhaps only in the most rudimentary sense of supporting operations to reach the neediest clients, rather than more ambitious aims such as licensing and financial sustainability. Enabling conditions enter the picture at the meso and macro levels.

So, what can be done at the meso and macro levels in a fragile setting? Two of the principles that emerged from the previous discussion are relevant here. First, any robust institutional reform initiative will have to wait for an appropriate time when basic conditions have stabilized and the main crisis has passed. In post-conflict settings, this appears to come after a lapse of perhaps three years or so (GTZ 2004). In a situation of decline, any such initiative would probably need to have been taken early on, or after the crisis has largely been reversed.

This suggests that at other (more crisis-affected) times, the focus should rather be on more incremental or local reforms as well as on feasible meso-level issues. The former might address, for example, local tribunals for debt enforcement, or perhaps national "stroke of the pen" reforms such as adjustments to bank regulations that would facilitate bank "downscaling" into microfinance services (e.g. recategorizing group loans as low-risk, or allowing mobile banking). The latter could include the development of networks and information channels, perhaps also apex bodies to provide wholesale capital, codes of conduct, and other "public" goods (more precisely, "club" goods) for the microfinance sector. A further option would be to facilitate linkages to banks by NGOs and MFIs offering small-scale financial services. Note that all these options have an institutional dimension, in that they foster coordination, articulation of norms, and sectoral governance – and these efforts substitute to some extent for state-provided institutional reforms.

Every opportunity should be exploited for policy changes that enable economic recovery. USAID (2007) suggests that, while institutional capacity-building may need to wait until recovery is underway, policy reform should be pursued from the start (p. 12):

> Economic policy reforms, small-scale privatizations, market liberalization, and anti-corruption reforms should be pursued vigorously and early in the post-conflict period.

This is not to say that an ambitious program of 'best practice' policymaking is feasible as soon as the guns fall silent. Rather, every practical option should be explored to clear away inappropriate barriers to market exchange, to send a signal that the government encourages investment, and to put in place a few basic reforms to provide a modicum of necessary support for enterprise. The latter might involve some rationalization of tax and regulatory structures, or perhaps the establishment of basic financial services such as savings accounts and payment mechanisms. These changes may need to be made via 'placeholder' decrees initially, until recovery has taken hold sufficiently for the decrees to be replaced by enactments that are both substantively more appropriate and procedurally more legitimate (USAID 2007). In short, rather than follow a rigid humanitarian-to-development sequence, approaches to recovery must be alert to early opportunities to press for urgently-needed reforms in a pragmatic and iterative fashion.

The second of the principles that comes in here is to maximize the market orientation of relief and development aid in fragile states. This means building market mechanisms into aid, such as food- or cash-for-work, use of locally-recruited personnel, and non-distorting grant and credit packages. For the microfinance sector, the critical points are to help build up demand through the support of enterprise development, and to transfer aid in ways that avoid undermining microfinance repayment discipline. In the latter case, care must be taken to map the dispersion of grants and loans so as to avoid overlap, hence the substitution (or confusion) of free for borrowed capital, and the consequent unzipping of credit portfolios contaminated by access to grants. The concern here is less the failure of a particular MFI or credit program than the longer-term damage to the credit culture.

Also, credit programs must be handled carefully. Again, one should not win the near-term battle to disburse funds to the needy at the cost of losing the long-range campaign to establish high repayment rates and thereby extend more and better financial services to a wider population. The classic problems here, extending back to early development banking efforts, are the unfocused use of subsidy, the politicization of credit, and the mixed market/welfare signals that lead to mounting loan losses. Fragile settings pose a significant challenge here, and the record appears to be mixed at best.

Donor and provider approaches

We now move our focus from institutional reform proper to the role of aid agencies and their partners in the NGO and microfinance sectors. In general, the overriding goals in a context of post-crisis (e.g. post-conflict) stabilization are state-building and economic recovery and growth. Collier (in d'Epinay and Schnabel 2007) suggests that the priority focus areas to support economic growth in these situations are first, social policy, then structural and macroeconomic policies. Aid is important in helping stabilize living conditions and making it possible to address reform issues. But in order for it to have this effect without distorting markets and weakening government, it needs to taper in and then taper out over a period of about a decade. In terms of support for the reform of enabling environments, the discussion up to this point suggests broadly differing approaches in stable developing countries as compared with the main types of fragile settings (see the table below), and a sequencing strategy that limits major institutional reform initiatives to periods well beyond (or before) the depth of crisis.

Table 2. Comparing approaches to aid for institutional/enabling environment reform

	Stable developing countries	Fragile states: stabilizing	Fragile states: declining
Security	Emphasis on civilian oversight, professionalism, human rights	Focus on peace-keeping, building capacity	Protect budget from security build-up, encourage dialogue
Governance, rule of law	Judicial reform, capacity-building, anti-corruption	Crash training of lay judges, re-building of institutions	Protect judicial independence, access to conflict-resolution forums, restore human rights
Economic & commercial policy, legislation	Assistance to policy analysis, legislative & regulatory development	UN or aid contractors filling some policy roles, mentoring in others	Urgent dialogue with government to correct policies, seek accommodation & legitimacy
Infrastructure & services	Loans, grants, and/or TA for development	Emergency aid to essential services & infrastructure with capacity-building	Gap-filling and advocacy by donors and/or NGOs
Social safety net	Safety net policies, budget targets	Emergency aid	Protect safety net budget, emergency aid as crisis deepens
Enabling conditions for microenterprise, microfinance	Microfinance and MSME policy development, institutional reforms, meso-level capacity-building	Humanitarian aid with transition to microfinance and MSME development, limited institutional reforms, meso-level initiatives	Assistance to MFIs and BDS providers targeting crisis-prone populations, , limited institutional reforms and meso-level initiatives before/after depth of crisis

In the microenterprise/microfinance context, support for operations and for enabling conditions goes together. Indeed, the one implies and complements the other – with the former offering near-term gains and the latter building sustainability. Certainly, the experience with operational assistance is more ample and better documented.

DFID's analysis of its programs in Sierra Leone offer these lessons in the field of PSD (Curtis 2006):

- Focus on actions that build confidence in government's commitment to reform, i.e. high profile changes and quick-impact reforms in business registration, licensing, and tax administration;
- Involve and communicate with the private sector from the outset, mobilizing their input and support;
- Mobilize the diaspora, since they have commitment, resources, and expertise;
- Start with small things even if near-term impact is limited, e.g. liberalizing investment rules
- Integrate capacity-building with policy reform in donor programming.

In a fragile setting with a significant influx of relief, financial services – especially for MSMEs and low-income households – are likely to be viable only if coordinated with aid programming. Doing so would require, at a minimum, (a) overall and regional coordination of relief and finance provision, to ensure synergy and smooth the transition from the one to the other; and (b) determining in advance how to minimize the impact of grants and highly subsidized credit on market-based financial providers. On the side of MFIs, such a synergistic approach would require appropriate choice of outreach strategy and product offerings (Santos 2003).

A number of guidelines for the provision and support of microfinance services in fragile states emerge from the literature (CGAP 2005, Nagarajan 2004, SEEP no. 5 2004). Microfinance operations need flexibility to adapt to special conditions of fragile states. For example, standardized microfinance products may not be appropriate as a result of damaged infrastructure, disrupted social ties, etc. Products should build in personal guarantees, since physical collateral is highly subject to loss or destruction. Working closely with trusted social institutions and leaders can help to mitigate the effects of the disruption of civil society. Also, conflict may trigger other kinds of crises affecting clients, such as loss of livelihood and HIV infection. This situation requires MFIs to adapt to multiple sources of risk. Initial startup and operating costs are high in conflict (and post-conflict) environments, due in part to security costs and high loan losses. Physical security of staff and funds must be protected as a top priority, and this has special costs and requires special measures.

Donors must judge whether microfinance is an appropriate intervention to begin with – as opposed to grants in cash or in kind, or other kinds of support. Even if microfinance is found to be appropriate, it may be advisable to provide it in program form rather than to encourage the influx of microfinance institutions, which would find it difficult and dangerous to operate in many conflict-affected settings. In the same vein, donors and microfinance providers should take a flexible, context-specific view of what form of institution should be used to deliver microfinance services. Microfinance is best provided in a variety of forms to match diverse and shifting needs. Above all, microfinance and relief should be as clearly distinguished as possible in the activities of donors and NGOs (as discussed above). More generally, donor agencies can be most effective when they make long-term commitments. They should use funding mechanisms that are consistent over the long term, flexible enough to accommodate shifting needs, and at the same time resistant to lobbying pressure from narrow interests and politicians. Support should be designed to enable microfinance providers to develop their structures and sustain themselves beyond the close of any aid program (CGAP 2005, Nagarajan 2004, SEEP no. 5 2004).

By one account (Wilson 2002), the ideal approach to microfinance in conflict-affected societies is as follows:

- very small loans and deposits (with perhaps larger-scale options to attract richer unbanked clients)
- in-kind loan products, especially in rural areas
- very short terms with very frequent repayment
- no specification of loan use
- individual, rather than group, loans and savings (with limited exceptions)
- very frequent visits – or availability – by lender
- instant loan decisions
- some flexibility in repayment schedule.

Conditions in fragile states call for innovative approaches. One such approach is the bundling of financial, business development, and other services. State fragility may require a re-design of basic services packages in order to make wide coverage feasible in adverse conditions and with limited resources. This may mean paring down the array of services, limiting it to the combination of what is most necessary and feasible, or bundling them in new ways (Meagher 2005). Services such as health, education, water and sanitation are sometimes bundled with microfinance. An obvious synergy between health and finance is the provision of insurance. There have also been "credit with education" programs.

In such programs, financial and other services may be provided by the same organization or by separate, linked providers. The latter model is usually considered more conducive to the eventual achievement of financial self-sufficiency by the microfinance partner. In either case, the coupling of financial with other critical services offers synergies and efficiencies to the providers. Non-financial services providers can extend their outreach through the networks of clients and groups assembled by the microfinance institutions, while the MFIs themselves can build special lines of financial products targeted to the support of health care, schooling, and other services. There has been notable development in this direction as a result of HIV/AIDs, with financial institutions responding to the epidemic with new savings, medical insurance, funeral coverage, and other products (Donahue et al. 2001, Dunford 2001, Kariuki and Schwartz 2005).

Credit programs, as we have seen, are subject to the risk of loss of repayment discipline when loans are disbursed quickly and treated essentially as cash grants. Other programs suffer the opposite problem, where the requirements are too stringent. In post-tsunami Sri Lanka, for example, credit programs supported by the central bank required the use of commercial criteria in screening borrowers. Real property collateral and guarantors with steady incomes were demanded in most cases. This naturally prevented the programs from reaching those most in need (Weerakoon et al. 2007).[12] This illustrates the polar opposite of the usual easy money problem. The task for policymakers and donors is to craft an intermediate option, where the need for sustainability, and therefore for grants and credits to be sharply differentiated, is balanced against the need for outreach on feasible terms to the needy.

The Nepal case study supported by this project (Banjade 2007) provides another example of adaptive microfinance provision in a fragile setting. It shows that while households and enterprises affected by conflict were flexible in their coping strategies, the MFIs were initially slow to adapt their operations or products to the environment of conflict. Once the MFIs experienced problems, however, they modified their products and procedures, and made special efforts to improve employee morale as well as outreach to clients, communities, and the private sector. The service-level adaptations included strengthening branch security, modifying

[12] Adding to the difficulty was the need to coordinate programs with the LTTE in the affected areas of Eastern Sri Lanka – and the political impossibility of doing so (Weerakoon et al. 2007).

repayment schedules and procedures, decentralizing some management decisions, and minimizing the MFIs' holding and transport of cash. This last precaution seems to move the risk of cash-holding from the MFI to the client. The client, in turn, could be expected to manage cash in ways that reduced the risk of theft or confiscation by the insurgents. To perhaps take an imaginative leap, one could surmise that, had cellphone and smart-card banking been more developed in Nepal at the time of the insurgency, the burden on clients would have been less.

The conflict in Nepal also forced government and NGOs to deal with other threats by the insurgents. The Maoists opposed not only government but others such as businesses and MFIs that they viewed as capitalists, feudalists, or exploiters. Thus, government officials, local and national, had to pay protection money to the Maoists uniformly, whereas others might only be subject to it for special reasons, given the insurgents' desire for support from the population. The Maoists' opposition to most MFIs was based on their view that microfinance interest rates were exploitative. This made it relatively difficult for MFIs to gain the support or tolerance of the Maoists, whereas social services were seen by the Maoists as desirable or at least neutral, and the NGOs were able to mobilize communities for development work. This posed a choice to NGOs, as to whether in given communities to provide microfinance or to focus exclusively on other services. Last, government might have done more to enable households to gain access to essential goods and services. The government embargoed trade in many non-military goods to rebel-affected areas. As important, it missed opportunities to delegate essential service provision to NGOs and to facilitate bank-MFI linkages that would have made financial access easier (Banjade 2007).

Donor approaches to the enabling environment for microfinance should reflect the discussion (in the preceding sub-section) of reform targets and sequencing. This was the case in the LWA pilot activities conducted by IRIS and its partners in Angola (World Vision) and Mozambique (CARE).

Some five years after its final peace settlement, Angola is prepared to take on institutional reform to enhance microfinance development, and to benefit from it. In June of this year, the central bank and the leading state development bank, at the suggestion of World Vision and IRIS, supported a large conference of stakeholders to develop an agenda for microfinance legal-regulatory reform. This was the first high-level gathering on this topic. Not only the government, but the banking sector and the non-governmental stakeholders in the microfinance community agreed on the need for facilitative policies and institutions. Government took the lead in outlining the way forward, consistent with Angolan practice.

The twin challenges in Angola will be, first, to ensure that this agenda moves forward without undue delay, and second, that the non-governmental stakeholders are able to act as full partners in policy development. Such an approach would be consistent with what appears to be best practice especially in post-conflict settings, i.e. participatory and consensual reform processes in preference to narrowly technocratic ones. While this can be time-consuming, it meets the important objective of building legitimacy for the reforms across political lines. Mozambique benefited from such an approach during its period of post-conflict transition, but it is an open question whether Angola's governance structures and practices will make this possible.

In Mozambique, significant work has been done in financial sector reform and microfinance, but serious constraints remain for poor, especially rural, populations. There, recovery has been underway for some 15 years, but the legacies of conflict, combined with such setbacks as flooding and the HIV/AIDS epidemic, have trapped many households in conditions of poverty and extreme vulnerability.

As described previously, the work of CARE and IRIS focused on the seizure of widows' assets upon the death of the husband, a problem endemic in Southern Africa and greatly magnified by the HIV/AIDS crisis. Traditionally, widows benefited from customary protection from loss of livelihood and support, although this took different forms across the diversity of patrilineal and matrilineal ethnic groups in Mozambique. The civil war and other crises including HIV/AIDS eroded those protections. Further, the constitution and the civil laws of Mozambique both recognize customary law and protect women's property, but the adjudication and interpretation that would allow these principles to be harmonized has not really taken place. Expropriators avoid legal process, and those affected do not generally have the means, or often the knowledge, to file suit in the civil law courts most likely to afford them relief.

Here is a problem of general law and practice that apparently has little to do with the framework for microfinance – and yet it has a decisive influence. Widows who are expropriated are at grave risk of losing their livelihoods and falling into destitution. Their ability to obtain and to repay microfinance loans is thereby severely impaired. Not only that, but financial institutions must manage foreseeable risks. Thus, they are unlikely to rely on a household's property as security for credit where there is a probability that the husband may die young (that is, most low-income households) – even while both spouses are healthy. As a result, land tenure and inheritance rights in this instance assume an important role in the institutional environment for microfinance. As discussed in more detail in the Annexes, CARE and IRIS proposed an array of externally-funded interventions, from legal aid to short-form wills, test cases, and legislative advocacy.

In these and similar situations, donors such as USAID and their grantees have the ability to intervene and make a significant impact. There are two basic directions here. The first involves the adaptation of programs on microenterprise/microfinance enabling environment reform of the type used elsewhere in the developing world. Necessary adaptations would make this context-specific, and in particular would focus interventions in accord with the discussion, in the previous section, of reform components and sequencing in fragile states. Thus, in more crisis-affected settings, programming could focus on relatively simple administrative and regulatory changes, and on modest meso-level initiatives. In more stable settings, such as advanced recovery from conflict, interventions could target more ambitious reforms in such areas as microfinance regulation or property laws. But opportunities to press for feasible reforms should be pressed at any stage. Any such initiatives would need to take the difficulties of the fragile state political economy (see the discussion in Part II) fully into account.

The second direction involves building market-enabling ME/MF components into the humanitarian and development aid programs normally applied in fragile states. This would mean not only building market-based enterprise and financial components into the programs, but also incorporating the enabling component. One could, for example, design small infrastructure projects to draw on MSMEs as contractors, and to link these to MFIs. This could be coupled with such enabling reforms as streamlined permitting for the contractors, linkage to larger firms via subcontracts, improved loan information systems, and recognizing and supporting the use of building contracts as collateral for working capital loans. These elements would probably work best as part of an integrated approach toward building viable alternatives to the conflict and survivalist economies.

Lessons from Documented Experience

From the forgoing analysis emerge a number of lessons to be considered in dealing with enabling conditions for microenterprise and finance in fragile states, and especially in designing aid interventions:

Institutional reform is feasible but especially challenging in fragile states. These countries are often burdened by stagnant, clienteist political economy environments that militate against reforms threatening to impose costs on the advantaged and powerful. The anomie caused by crisis and especially war abets opportunism. This makes it difficult at best to enforce commercial and especially credit agreements, thereby sapping the potential of many institutional reform and microfinance/microenterprise capacity-building efforts. Further, postwar settings call for the transformation of conflict economies, perhaps state-dominated productive and financial sectors as well, into peaceful, productive, market-driven economies that afford livelihood and growth opportunities to the many. Illicit shadow entrepreneurs, criminal and insurgent networks, and war-economy oligarchs can divert reform and restructuring.

Early attention to private sector and microfinance development pays dividends. Attending to anything other than basic livelihoods is difficult at the depth of crisis and during conflict, to be sure. The counsel to "forget credit markets" (Collier 2006) applies to any effort to stimulate formal banking and commercial finance in such situations. But such a counsel of despair does not seem appropriate to microfinance, even in the worst conditions. The basic prerequisites for simple, retail microfinance services are few. Workable programs (even if not sustainable institutions) are feasible in situations affected by crisis and conflict, provided they focus where there is a modicum of order and safety, and client populations are settled. More complex services and institutions require a facilitative policy and governance framework that will have to wait for reasonable conditions. Enterprise, too, is ubiquitous and can benefit from support and modest adjustments to enabling conditions in very fragile settings. In both enterprise and finance, the key point is that one can start early, using both adapted programming on enabling institutions and market-enhancing relief and development interventions.

Moreover, early attention is needed to deal with path-dependent development. In other words, not only can one start early, but one should. The persistence of survivalist and conflict economies lends urgency to the need for alternative livelihoods. Also, the "credit culture" is delicate and subject to a cascade of change, for better or worse. These factors underline the importance of an early start, perhaps mixing direct enterprise development and financial services support with enabling inputs such as small regulatory adjustments and sectoral associations. These can start out modestly once there is sufficient stability, and build from there. In institutional terms, there is no need for a rush to set up "best practice" frameworks; it will often make sense to support the growth of informals, coupling this with non-state interventions such as market network and information inputs, then building up to more formal institutional reforms once stability has been established for some time. Getting into this early and keeping the focus on sustainable enterprise and finance will be key to ensuring a prompt transition from emergency aid dependence.

A range of meso- and macro-level initiatives is possible depending on the context. Enabling environment efforts need not focus solely on the formal institutional and policy framework, i.e. macro-level inputs. Meso-level interventions can include the development of networks and information channels, perhaps also apex bodies to provide wholesale capital, codes of conduct, and other "public" goods for the sector. It may also be feasible to facilitate linkages to banks by NGOs and MFIs offering small-scale financial services. All of these meso-level options have an institutional character because they furnish norms, governance mechanisms, information, and other means of dealing with uncertainty and stabilizing expectations.

Macro-level initiatives are much more difficult in situations that are closer to the depth of crisis, but become more feasible as stability takes hold (or before it is lost). Direct micro-level support and meso-level efforts are in a sense pre-cursors that can ease the way. Macro interventions might include, for example, establishing or strengthening local tribunals for debt enforcement, or perhaps national "stroke of the pen" reforms such as adjustments to bank regulations that would facilitate bank "downscaling" into microfinance services (e.g. recategorizing group loans as low-risk, or allowing mobile banking).

A change ongoing in many countries, and *that could have momentous benefits* for microfinance in fragile states, is *the move to cash-less and branch-less banking*. In particular, cellphone banking has particular appeal in crisis-affected areas because it improves efficiency, lowers risks for all and especially clients, and uses a platform that is readily available even in many of the most unstable and conflict-prone settings. In this scenario, cellphones may be used to deposit and withdraw funds, send remittances to other localities (or countries), and to draw loan proceeds. The relative security of this mechanism comes from the discretion it gives financiers and clients (and even non-financial retailers) to determine where and when they will handle cash. This, in turn, means fewer stationary branches and fewer vulnerable individuals carrying cash where criminals and warlords can swoop in.

But this change requires both a meso-level enhancement of infrastructure and a macro-level change in policy. The policy change is needed both to permit this methodology within the financial sector and to provide necessary safeguards, for example, against fraud or misuse of clients' positive fund balances. It would be hard to imagine finance ministries and central banks in the midst of a civil war or other national emergency taking this on. On the other hand, not only does such a change seem feasible when order is restored, but once it is in place, it is likely to be resilient – given the experience with cellphones in such places as Somalia, and with cellphone banking in very poor countries.

Once institutional reform is feasible, *the pace and style of reform must be carefully adapted to the fragile setting*. Fragile states are home to many potential "spoilers," including conflict-economy oligarchs, militia members on the verge of demobilization, and nationalist political blocs. Here is a situation where slow, consensus-based reform seems ideal – at least for the major economic and financial issues likely to create controversy. Such issues might include land tenure, privatization, bank recapitalization, and the framework for microfinance.

At the same time, there is a need to move quickly where possible. One reason is the problem of "perverse sequencing," where innovation by the private sector – with the creation of both benefit and risk – outpaces policy change. This is especially so in fragile states, where the capacity for policy development and implementation is often feeble. The donors could perhaps usefully step in here to build capacity or even to second qualified personnel on a temporary basis. The need to hurry grows still more intense with the build-up of expectations and frustration around the "peace dividend." Donors and policymakers need to identify areas where "quick wins" are possible, so as to build the legitimacy of the post-crisis order, even at the earliest stages, and to deflect grievance and impatience.

Lastly, aid designs and instruments need to be carefully adapted for maximum impact. One dimension of this is the bundling of enabling environment initiatives with direct services, as well as finance and small-enterprise promotion with relief, development aid, and essential services. So, for example, donors could design small infrastructure projects to draw on MSMEs as contractors, and to link these to MFIs. This could be integrated with enabling elements such as streamlined permitting for the contractors, subcontracting the smaller to larger firms, improved loan information systems, and supporting the use of building contracts as collateral for working capital loans. In addition, since basic services such as health care and water supply are disrupted in fragile states, enterprise and finance initiatives could link up to build viable markets for those services pending the extension or restoration of public sector provision.

The other dimension of effective aid in these settings is the range of mechanisms available. The fragile states experience is replete with illustrations of the need for aid to be coordinated across donor countries and international agencies, integrated in a "whole of government" approach to security and development, financed on a stable long-term basis, and planned so as to achieve the appropriate alignment with and hand-back to governmental authority. In the current context, this implies the need for microenterprise, microfinance, and institutional reform modules that can mesh well with the array of programs deployed in fragile states. Financing instruments are also a great concern at this level, from bilateral grants to concessional development bank loans and multi-donor trust funds. The right instrument is needed to gain the necessary coordination and long-term perspective. As important, the posture of the aid donor vis-à-vis the recipient country government requires candid and nuanced analysis. The approach must balance the need to build capacity in the duly constituted authorities with the imperative of enabling small-scale enterprise and microfinance through interventions at whichever level promises to be most effective: micro, meso, macro, or a combination.

V. Programming Guidance

Here our discussion of small-scale enterprise and microfinance in fragile states takes a more programmatic turn. How should aid donors and development practitioners understand the problems arising in these contexts, assess their institutional dimensions, and respond accordingly? We begin by distilling from the literature review and pilot activities a conceptual framework to guide work in this area. From this, we develop a set of programming recommendations or guidelines relevant to an array of enterprise and finance activities across the different fragile settings. We also suggest what the key questions should be in the assessment of institutional problems in these contexts. Throughout, we draw on the lessons and findings from the three country pilot activities conducted by IRIS and partners under FIELD-LWA.

Conceptual framework

Understanding and responding to problems, in this or any context, begins with a conceptual framework. Here, we offer such a framework, synthesizing and extending key ideas from earlier parts of the paper.

Fragility and institutional reform:
Economies in fragile states, especially post-crisis, exist in a state of flux not unlike the early years of post-socialist transition in the former communist nations. This involves a multi-layered change in economic structure, social norms, physical infrastructure, and other areas. The change is complicated by the inevitable patchwork of partial changes, leading to systemic inconsistencies, legal and normative uncertainty, and chaotic switches in behavior patterns. New rules and systems are laid down to respond to urgent needs, while older ones may remain in place. Behavior adapts, thus bringing progress but with it anomaly and path-dependency. In the post-conflict context, the survivalist and conflict economies, supplemented by humanitarian interventions and informal business, must be transformed into a developing economy.

This is a medium- to long-term transition. Fragile states experience transitions in both directions (from crisis to stability and vice-versa), although the pattern of post-conflict recovery is the best understood. In general schematic terms, this transition may take a decade, and can be divided into three phases:

1) the immediate aftermath (the first three years or so), in which the situation is stabilized and the priority needs for recovery identified;
2) the early to mid-recovery period (the following four years, approximately), where major restructuring, rebuilding, and reform takes place; and
3) advanced recovery, consolidation, and transition to stable development (the final three years).

In this and indeed any context, the growth of microfinance and small-scale enterprise requires an enabling environment. Such an environment comprises elements that support the development of enterprise and finance, notably *institutions*. Institutions are rules, organizations, and norms that increase transparency and certainty, thus enabling economic actors to transact on the basis of adequate information and stable expectations. It is important for practitioners to understand this function of institutions. Economically, the touchstone of successful institutions is not formal enactment or approximation to international best practice but rather their impact on transactions. Do they supply sufficient information and certainty for risk-taking and growth? The table below provides a general overview of enabling conditions for microenterprise and microfinance.

Table 3. Enabling Environment for Small-Scale Enterprise and Microfinance

Category	Enabling Environment Components
Macroeconomic and financial sector conditions	o Banking infrastructure – quality and extent o 'Credit culture,' market (or non-market) basis of development finance (including aid donor programs) o Monetary policy, interest rates, exchange rates, inflation o Taxes: incidence, levels, stability, application
Governance	o Political stability o Corruption, political interference o Security, law and order, crime o Rule of law o Capable and accessible courts/tribunals o Quality of legislature, executive, bureaucracy o Transparency & accountability in government o Civil and political rights
Infrastructure & services (accessibility & cost)	o Road and transport networks o Electricity, water, sanitation services o Telecommunications and information technology accessibility o Healthcare o Social safety nets, welfare & relief programs o Availability of qualified personnel
Commercial laws & policies	o Investment (domestic & foreign) law and regulation o Rules on company formation & registration (including non-profits) o Regulations affecting operations: labor, health & safety, competition, consumer protection o Commercial laws: contract, corporations, securities, bankruptcy o Secured finance law o Contract enforcement
Property rights & enforcement	o Property laws: immovables, movables, intangibles o Property registration, protection, conveyance o Family law: marital property, inheritance, divorce, legal autonomy of spouses & children o Customary/religious laws & practices on family/personal status
Financial law & regulation	o Banking and financial services law o Financial services regulation, including licensing & prudential standards o Specific provisions for microfinance o Supervision: quality, burden, cost o Deposit protection/insurance o Financial products accessible to the poor, e.g. inexpensive, low minimum-balance savings accounts o Operating rules including branching and agents o Provision for transformation to regulated status (e.g. by NGOs, coops) o Usury and moneylending laws, interest rate caps o Treatment of small/informal microfinance groups & providers
Meso-level support systems	o Clearing, transfer systems o Credit information system/credit bureaux o Enterprise development support & promotion o Infrastructure: marketplaces, information access (e.g. relative prices) o Associations/apexes for microfinance, microenterprise
Local governance and informal organization	o Local government: quality of administration & taxation o Local government: treatment of property rights o Local infrastructure, services, commercial/financial support systems o Informal norms, authority structures, dispute-resolution o Social capital, networks, associations, resource-pooling.

As the table indicates, most of the enabling conditions for microfinance are of the same general kind as those that are critical for microenterprise. In addition, once microfinance services become widespread and providers are striving to reach scale and sustainability, the need for a regulatory framework emerges. Financial services regulation supports the goals of maximizing the mobilization and intermediation of funds, enhancing efficiency in the allocation of capital, ensuring appropriate risk management, and protecting depositors. This same logic applies not only to banks but to MFIs once their growth leads them to look beyond government or donor support to attract private capital and to mobilize savings. To achieve this goal, they need an appropriate, facilitative legal and regulatory environment. Further, standard banking regulation and supervision tend to impose ineffective or overly burdensome requirements on MFIs if applied without modification, thereby raising costs and curbing innovation. An NGO microfinance provider under the pre-reform rules may be prevented from accepting even small savings deposits unless it becomes a commercial bank – an impossibility for most.

A number of special features of microfinance need to be accommodated within the regulatory structure:

- its attempt to deepen financial markets to serve microenterprises and poor households, physically taking banking services to clients who have few other options to receive financial services;
- its high unit costs of lending;
- the relatively undiversified and sometimes volatile nature of MFI credit portfolios;
- the fact that most MFIs began as unregulated credit NGOs, with a focus on social goals rather than financial accountability and sustainability, thus creating very different cost structures and funds sources; and
- the market risk posed within the microfinance sector itself when MFIs are not properly managed and monitored – but with low risk to the financial system as a whole due to the sector's relatively small scale.

Avoiding over-regulation is at least as important as putting well-tailored rules and systems in place. Regulation of microfinance can create problems due to a mismatch between regulatory and lending technologies as well as attempts to use the regulatory framework for objectives other than the core rationale of avoiding excessive risk.

Institutional reform initiatives in fragile settings must be sequenced in line with evolving conditions of security and political stability. The critical early steps needed to get economic recovery underway post-conflict, as mentioned before, are to secure property rights and stop massive capital flight. This helps to close off sources of conflict, stabilize investment expectations, and ensure a ready supply of capital. This does not necessarily mean establishing a 'proper' legal framework. More likely, rapid and expedient policy steps (e.g. temporary property tribunals, contracting services and infrastructure to private providers) will create enough certainty and stimulate enough activity to get things moving. Meantime, longer-term reforms can be formulated to deal with changed circumstances brought about by conflict and its resolution. The recent USAID (2007) draft on this subject advocates the use of policy "short-cuts" that make a difference to the business environment in the short term, including regulatory streamlining and alternative dispute resolution (pending longer-term court reform).

Fragile states present an especially challenging environment for enterprise and finance. One cannot assume a stable or effective enabling environment, nor a government with sufficient capacity or legitimacy to carry out institutional reforms. The state may indeed lie in ruins at the end of a conflict, and so building such governmental authority may be a long-term project. Social structures, public services, and infrastructure may also have fallen into chaos, and the population may be focused on short-term survival or speculation. In such a setting, the basis for transactional security must come from another source. Enterprises and households find methods to allay risk, whether through transacting within kin networks or limiting themselves to spot-markets and pawns.

Aid donors and practitioners must build on this weak foundation. This may mean supplying emergency aid and inputs, but with a planned transition to market-based finance and enterprise development. To make such a transition possible, aid programs need to incorporate enabling elements at each level – micro, meso, and macro. The overall objective here is to provide a basis for economic activity that incorporates longer time-horizons, the management of new kinds of risk, and greater potential for growth. Here, the short-term emergency activities backed by grants must be balanced with incremental improvements in the enabling environment for sustainable development in the long term. Policy and programming can make these elements work together, by building enabling components into direct assistance and by using grants to build legitimacy and political space for policymakers to undertake long-term reform.

Enterprise:
Small-scale enterprises in the most fragile environments tend to be 'survivalist,' enabling households to meet some basic needs and thereby cope with instability. The activities may include subsistence agriculture in very small, often scattered, plots; household labor; informal services; and barter. If the entrepreneur has connections or other assets, he or she may take advantage of opportunities created by conflict and breakdown, engaging in trafficking of drugs, weapons, smuggled goods, or persons. As the situation stabilizes post-conflict, many such activities may be criminalized, or extant prohibitions enforced. Unless alternative opportunities have opened up due to the revival of the economy, people may be forced into a choice between an illegal livelihood or none at all.

Governance in the initial post-conflict period may be chaotic, with existing rules inappropriate or impossible to enforce, no effective recognition of property rights, and only tenuous security. In this situation, authority creates opportunities to extract rents, and corruption becomes the norm. (This applies to both the state and to warlords and traditional authorities.) Entrepreneurs operating in the shadow face police officers and bureaucrats ready to apply existing laws and regulations that may be practically impossible to follow. The business regulations, licenses, taxes, inspections, and other formalities that may have had a rationale before the crisis now become so many control points to be negotiated through corrupt payments. Bribery in such settings becomes standard practice, indeed an essential tool for getting things done. Further, the tenuousness of property rights and the shortage of inputs stalls the recovery of agriculture, a necessary foundation for sustainable economic development. Fragile conditions generally leave room only for short-term, low-risk, high-reward activities.

Devastation, corruption, and the overhang of outmoded regulation may threaten to strangle small enterprise before it can gain traction. Added to the lack of security and certainty is an absence of public goods. In vibrant economies, businesses rely on (indeed take for granted) market-enhancing rule systems, norms of behavior shared with other market actors, credible systems for applying the rules and resolving disputes, functioning infrastructure, access to credit and business services, and general stability and security. During and after conflict, these things may be available only intermittently, if at all. The business may need to internalize them in its operations and transactions, or attempt to do without.

The integration option is expensive, but the top firms in chaotic settings find it worthwhile to set up their own electric generators, build wells, and self-finance activities. Poor transport links may require them to limit the scope of their trade and input markets. Shortage of inputs may lead to hoarding, including the retention of idle labor pending the receipt of other inputs. Transactions tend to migrate toward one of two poles, either one-off spot market deals ('cash and carry') or vertical integration (self-finance, self-service, wholly-owned input sources). Thus, instead of the heavy presence of mid-range transactions involving supply and credit over time, the market is characterized by many cash-only spot transactions and a few fully-integrated operations, along with some relationship-based operations (e.g. ethnic networks, crony capitalism). Business expansion is prohibitively expensive or unavailable to most.

The appropriate response to enterprise development needs will depend on the situation. In the highly fragile aftermath of conflict, the primary focus must necessarily be on the micro level. As households and enterprises struggle to cope, policy and aid should be framed to support that process, providing necessary inputs and working informally to enhance certainty, while the overall situation stabilizes. From supporting livelihoods and reconstruction through food-for-work, the emphasis can move toward market-based essential services and contracting out of public functions. Meanwhile, openings for feasible policy and institutional changes should be exploited. These might include simple 'stroke-of-the-pen' reforms to reduce red tape, promoting transparency through procedural and infrastructure improvements, and quick fixes in the area of dispute resolution such as the enhancement of informal or customary tribunals.

With this market-enhancing approach to relief, the stage can be set for the building of basic value chains and strengthening business development services during the next, recovery, phase. In that period, the main emphasis shifts to the meso level, with the building of associations, infrastructure, and business sector capabilities in standard-setting and dispute-resolution. Initiatives at this level can help create confidence and stable expectations to support the recovery of agriculture and investment in other areas. Again, reform openings should be exploited to the extent possible.

In the last period of post-conflict transition, the consolidation of recovery, the emphasis can be put more fully on policy development and institutional reform at the level of the state. Such issues as property registration and inheritance, contract enforcement, and corruption can be seriously addressed, and an enabling environment for enterprise established for the long term. More ambitious reconstruction or "building back better" can be undertaken, along with institutional reform and capacity building in the courts, public administration, and essential service delivery systems.

Finance:

Like other transactions, financing in fragile states migrates away from a healthy mix of deals in the middle range toward the extremes – in this case, pawn-based or relation-based credit. As indicated above, finance is institution-intensive because time delays are built in, the parties have differing incentives, and transparency is limited. Thus, some trust between parties, or at least trust in the institutions that compel compliance, is needed. This, of course, suffers badly in a fragile state.

Post-conflict, the situation tends to be especially dire because during the crisis, unrestrained opportunism will likely have produced distressed borrowers and lenders, and looted banks. It is critical in this setting to restore a "credit culture" that favors discipline, timely repayment, and enforcement of obligations. But this kind of social norm is precisely the kind of thing that conflict destroys, and so finance suffers. There is a feedback channel here: since functioning credit markets enable people to acquire assets, and since property tends to give the owner a stake in peace and prosperity, fragile conditions perpetuate themselves by making finance difficult.

Credit is also likely to be constrained by several of the other conditions obtaining post-conflict, and mentioned previously, such as poor governance and law enforcement. The survival of dated banking laws, in addition, may impose cumbersome requirements on banks and other financial service providers such as NGOs offering microfinance. Microfinance institutions (MFIs) suffer in the same ways that small enterprises do, from shortages of qualified personnel, diversion of resources to security and other needs, corruption, and other factors that raise costs and delay sustainable operation.

The prior discussion showed that microfinance can and does exist in fragile settings, including post-conflict. But it tends to function at a low, coping level in these situations. MFIs adapt to circumstances by, for example, requiring personal guarantees, linking to trusted institutions such as traditional authorities to ensure repayment, and adapting their methodology to stress very small transactions, in-kind products, very short-term loans, and individual credits. They may also integrate such components as security, transport, and other needs such as electricity. Where needed, they seek to gain the support of the population, and to avoid being seen as exploiters by insurgents and others who may pose a threat. This is one of the strategies used by the MFIs studied in the IRIS-Save the Children pilot in Nepal. In short, MFIs tailor their operations to make them resilient in unstable situations – and this inevitably means small scale and no sustainability.

We also saw that the basic conditions for microfinance to be feasible at this level are quite modest. They include sufficient security, enough economic activity (active markets), and a relatively stable population (i.e. not displaced persons unless they have been settled for some time). The preferred conditions that may make it possible for microfinance to expand somewhat include a functioning commercial bank sector, enough social capital for group functioning, and macroeconomic stability. Such conditions are not likely to obtain until post-conflict recovery is underway.

Beyond this, for microfinance to reach scale and become sustainable, other prerequisites need to be met – enforcement of property rights and contracts, facilitative financial regulation, and the avoidance or clear delimitation of soft credit provision by the state. These issues in most cases could only be addressed effectively once the basic and preferred conditions are in place, and state administrative and policymaking capabilities are equal to the task. In other words, these matters are normally best addressed in the last, consolidation, phase of post-conflict transition. Such is the case with the property and inheritance rights issues targeted in the IRIS-CARE pilot in Mozambique.

This discussion suggests an approximate sequence of institutional reform targets, based on stages of state fragility. We know that building a sound financial regulatory and supervision system takes many years, and that this can only be effective once a critical mass of financial institutions exists. Thus, this and other ambitious institutional reforms must wait for recovery to get underway, and their effective introduction can probably only happen in the later stages of post-conflict recovery. Early post-crisis efforts would need to focus largely on direct provision of financial services and support to MFIs, consistent with the coping strategies of the MFIs, enterprises, and households. A key objective would be to ensure that relief is market-friendly and non-distorting. Once recovery is underway (a few years after the depth of crisis, depending on conditions), a fuller range of micro, meso, and macro initiatives can be pursued. These can include capacity-building and TA for MFIs, meso-level infrastructure and apex functions, and policy reforms that are relatively simple such as 'stroke of the pen' changes in prudential rules or in regulations applied to firms.

A key target from an early point in the recovery period should be the meso level. While government policy functions may be weak or immersed in other emergencies, the financial sector and the MFIs in particular can get organized to provide some of the institutional framework the sector needs. There are some success stories with microfinance associations and apexes set up in post-conflict settings (Greely 2007). For example, in Bosnia and Afghanistan these organizations took a lead role in shaping the sector. They provided TA to the MFIs, offered legal protection to the sector while the banking and microfinance frameworks were being clarified by policymakers, and eventually supplied experts to help the government develop the relevant laws and regulations. They achieved independence and used it to promote objective good practice standards, and to resist political and social pressures to abandon sound practice in favor of short-term gain. Promoting the establishment of a microfinance association was also one of the key objectives of the IRIS-World Vision pilot in Angola.

From conception to program design

The preceding analysis suggests an approach toward programming in this area. This approach is laid out in Figure 1 and Table 4 below. The figure provides a schematic overview, and the table a more detailed presentation. These should by no means be considered 'blueprints,' although they do provide a conceptual logical framework that can be tailored to specific settings. Fragile settings in particular are highly idiosyncratic, and priorities must be quickly identified among a host of needs. The recent USAID (2007) draft on post-conflict economic growth shows that several areas, including policy reform, require attention from the start. Experience suggests that while *everything* cannot be done at once, *many things* can be pursued simultaneously. But this depends on careful strategic choices of emphasis being made and implemented.

Approaches to program design across fragile settings:
The critical ingredient for economic revival in fragile states, and more specifically of small-scale enterprise and microfinance, is the reduction of uncertainty. In conflict and immediately after, the most productive arena for intervention is likely to be the *micro level* – that is, households, microenteprises, and retail microfinance providers.[13] As violence is contained, and as stabilization and rebuilding get underway, the focus is on input supply including capital and know-how, and on resilient models. The latter point is clearest in the Nepal pilot case-study, where MFIs invested in security, adapted their operations to reduce cash-handling, and worked politically to ensure community support and at least a neutral attitude on the part of the insurgents. Resilience is also served by adapting financial products to the situation, such as by using personal guarantees, short-term individual credits, and in-kind transactions.

External to the enterprise or MFI, certainty can be sought in a combination of methods. First, operations must adapt to the evolving security situation, so that the promoters and clients are not subject to unnecessary risk. Second, in conjunction with this, enterprises and MFIs need local networks of businesses and traditional authorities to provide timely information as well as forums in which to assert informal pressure for contract compliance.

[13] For a depiction of the micro, meso, and macro levels, see Annex 5.A.2., slide 30 (on the vision of an inclusive financial system).

Figure 1. Small Enterprise and Microfinance in Different Fragile Settings - Overview of Conditions, Needs, Approaches

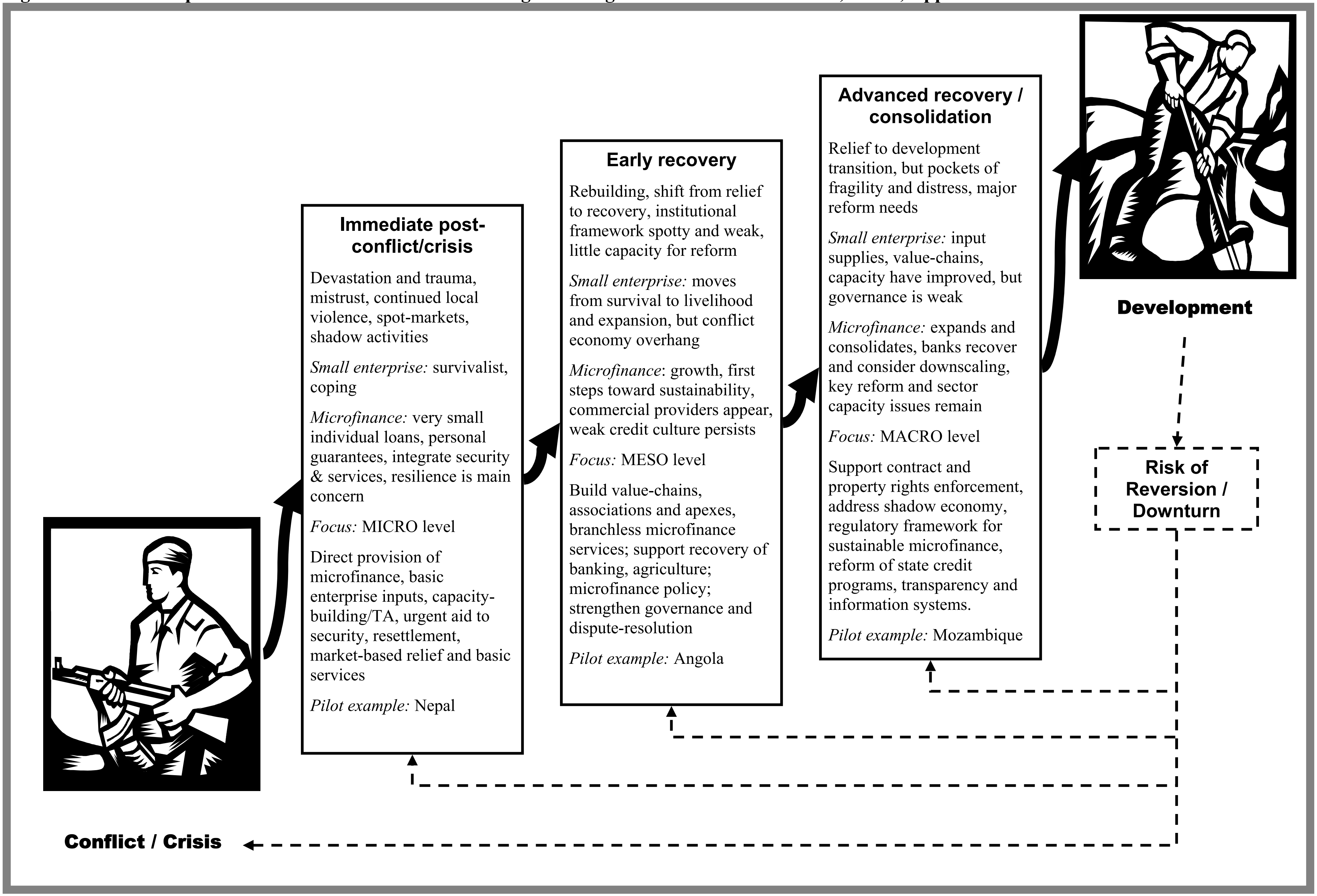

Table 4. Small Enterprise and Microfinance in Different Fragile Settings - Conditions, Needs, Approaches

Immediate post-conflict/crisis (approx. years 1-3)	**Early recovery** (approx. years 4-7)	**Advanced recovery/development** (approx. years 8-10)
Overall scenario: Hostilities largely ended, severely degraded security, services, infrastructure, and enterprise and finance sectors. Economic activity is survivalist with shadow and conflict entrepreneurs. Priorities: relief and stabilization.	*Overall scenario:* With stability largely achieved, focus can shift from relief to recovery. Degraded systems, infrastructure, social relations are being rebuilt or reinvented. Economic activity moves from survival to livelihood and growth, with some conflict economy overhang. Risk of reversal.	*Overall scenario:* Recovery has progressed so that relief can give way to development – but risks of setback and pockets of fragility exist. Economy may be growing rapidly from a low base, but unevenly, and with major policy and institutional reforms remaining to be addressed.
Small-scale enterprise: ➢ *Conditions:* Devastated infrastructure, services, and institutional framework, traumatized population. Survivalist, coping mode dominant; spot-market deals, relational transacting, and shadow activities prominent. ➢ *Needs:* Basic inputs, security, information, infrastructure, certainty based on informal coordination, simple legal rules. ➢ *Approaches:* MICRO focus, provide inputs, informal coordination with local authorities & firms, market-based relief and services, contracting out public functions, urgent assistance to security & basic services. Pursue 'stroke of the pen' regulatory reforms and 'placeholder' policies where feasible	*Small-scale enterprise:* ➢ *Conditions:* Infrastructure and services being rebuilt, but institutional framework is spotty and weak. Survivalist enterprise is giving way to sustainability and expansion. ➢ *Needs:* Enhanced information flow, value-chains, supportive policies and governance, contract enforcement, relief from red tape and corruption. ➢ *Approaches:* MESO focus, build value-chains, BDS, associations, infrastructure, dispute-resolution. Policies to support recovery of agriculture, market-friendly regulatory reforms.	*Small-scale enterprise:* ➢ *Conditions:* Recovery well-advanced, with pockets of distress. Governance and policy are weak and spotty, but efforts underway to improve. Input supplies and value-chains have improved, but need strengthening. ➢ *Needs:* Enabling policies, governance, market institutions and more advanced infrastructure. Major reforms still needed, e.g. property rights, commercial and banking laws, administrative streamlining, national growth strategies. ➢ *Approaches:* MACRO focus, push reform into contract and property rights, regulatory reforms to address shadow economy and remaining conflict economy oligarchs. Improve infrastructure, information flow, capacity.
Microfinance: ➢ *Conditions:* Instability means MFIs focus on very small short-term individual loans, require personal guarantees, link to customary authorities to ensure repayment, integrate security, transport, other services. ➢ *Needs:* Basic security, revival of markets, settled population, capital, human resources, operational models resilient in unsettled situations, understanding of local livelihood strategies. ➢ *Approaches:* MICRO focus, direct provision of microfinance, TA to support resilience, ensure that relief is market-friendly and does not distort credit markets, market information.	*Microfinance:* ➢ *Conditions:* Rebuilding and recovery underway, banks restructuring, microfinance market expanding, leading MFIs embark on path to sustainability, NGO provision of grants and credits less important as new commercial providers appear, but problems of conflict economy overhang and credit culture persist. ➢ *Needs:* A functioning commercial bank sector, enough social capital for group functioning, macroeconomic stability. ➢ *Approaches:* MESO focus, capacity-building and TA for MFIs, infrastructure and apex functions, initial policy reforms to support microfinance, develop mobile and electronic platforms for branchless microfinance.	*Microfinance:* ➢ *Conditions:* As recovery advances, microfinance sector expands and consolidates, banks have recovered and begin to consider microfinance options, but some populations remain distressed and key policy, institutional reform, and sector capacity issues remain. ➢ *Needs:* Enforcement of property rights and contracts, governance reform to streamline and increase transparency, facilitative financial regulation, state credit provision non-distorting and circumscribed. ➢ *Approaches:* MACRO focus, press for reforms to general enabling environment and development of legal-regulatory framework for sustainable microfinance, address continuing needs at micro level (e.g. MFI capacity, product development) and meso level (e.g. credit information, sectoral consumer protection standards).
Pilot case: Nepal microenterprise, services	*Pilot case:* Angola microfinance policy	*Pilot case:* Mozambique inheritance rights

Aid donors and development practitioners can add value in several ways. Most important of these is assistance in establishing security and a semblance of law and order, stimulating the revival of local markets, and long-term settlement or resettlement of populations. Assisting enterprises and MFIs in using the lessons learned in other similar situations to adapt their approaches would also be valuable. Further, ensuring that relief and rebuilding assistance is market-friendly provides a an important support for small enterprise as well as impetus for the donor community to avoid distorting and undermining markets as has often happened in the past.

As part of this market orientation, aid providers should where possible direct microenterprise and microfinance support to basic services. This could focus on the development of a sub-sector of SMEs to take on public functions through contracting out, and to provide fee-based essential services where other options are scarce. Microfinance can then be used to support households' access to these services. Also, as suggested previously, opportunities to effect policy and institutional reforms should be exploited to the extent feasible, even if the changes are only temporary expedients to create enabling conditions in an otherwise difficult situation.

As recovery succeeds stabilization, the main focus of efforts to reduce uncertainty shifts to the *meso level*. This is the level of financial infrastructure, including self-regulatory mechanisms, networks of service providers to the small enterprise and microfinance sectors, information and credit reporting systems, and federative bodies and apex institutions. Government is likely to be occupied with other emergencies, although it should be capable of articulating a policy on microenterprise and financial inclusion. But the impetus for development of supportive institutions comes from the increasingly robust and organized small enterprise and microfinance sectors.

The donors and practitioners can provide important help to such meso-level efforts during the recovery phase. Improvement in wider conditions, such as macroeconomic stability, renewal of agriculture, a revived and functioning banking system, and rebuilding of social networks and social capital, will be decisive. As these changes unfold, assistance to the self-organization of the small enterprise and microfinance sectors is critical. In addition to the strengthening of retail value-chains and MFI operations, a key target should be the building of the sectors' capacities for collective action. Whether this involves creating a formal organizational structure (e.g. federation or apex institution), the central concern is that the sector should articulate norms, standards, and dispute-resolution methods for its members, as well as press for a supportive policy from government. The Angola pilot shows an effort to develop both a microfinance sector association and a policy framework – an effort that appeared timely in light of both broad developments in Angola and the growth of the sector. Another area that warrants the attention of aid providers is branchless microfinance services. This not only expands access, but could provide MFIs and clients a resilient and secure form of service even if conflict and disorder return.

In the final, consolidation phase of post-conflict recovery, attention can turn more fully to *macro level* concerns of policy and institutional reform. At this point the transition from relief to development should be well underway. Enterprises' input supplies, value-chains, and capacities will have improved, while pent-up demand drives rapid economic growth from a low base. As commercial banking recovers, the microfinance sector expands and consolidates. Growing demand and competition lead to innovation, with banks and finance companies searching for opportunities to downscale, and NGOs and other microfinance actors striving to make their operations and capital sources sustainable. Still, the framework of governance may continue to be brittle and subject to setbacks or reversals. Pockets of misery and deterioration call for attention – whether regions, social classes, or sectors of public administration such as schooling or sanitation.

Thus, the evolving situation toward the end of the recovery decade presents a host of needs and pressures for institutional reform. Resolving the conflict or crisis, and supporting rebuilding and recovery, will have occupied the attention of policymakers and aid donors thus far. Certain institutional reforms may have been undertaken as part of this work, such as changes to the constitutional framework and new arrangements to adjudicate ownership rights or conflict-related crimes. But many critical matters usually remain unresolved, given the sheer mass of problems and the regime's limited capacity to deal with them. Thus, the final years of recovery will likely involve efforts to deal with festering issues that may be delaying economic revitalization or imposing hardship on vulnerable populations. The agenda might include improving the enforcement of property rights and contracts, governance reform to streamline and increase transparency, policies to transform the shadow economy, a new regulatory framework for microfinance, or changes to state credit programs to make them less distorting and more market-friendly. Government's capacity to take on these matters may be weaker than that of many stable developing countries, but not as dramatically as in earlier post-crisis phases.

In this situation, donor agencies and development practitioners have a range of programming choices. The strategic focus is likely to be best centered on the macro level. Programs can assist reforms of basic market governance, such as contract enforcement, and the clarification and strengthening of property rights. Regulatory reforms can be pursued to address the shadow economy and the remaining conflict entrepreneurs. Reform efforts can include the development of a legal-regulatory framework for sustainable microfinance. Continued support is also likely to be needed for meso-level improvements in such areas as market infrastructure, credit information, and adoption by sector associations of consumer protection standards and the like. The IRIS-CARE pilot in Mozambique focused on one of these institutional reform clusters – property rights. Specifically, we analyzed the problem of HIV/AIDS widows having their assets, including their homes and movables, expropriated by relatives, usually in-laws. We designed and put forward an assistance project with elements ranging from short-form wills to legal aid, training of local adjudicators, and legislative advocacy.

Illustrations from pilot projects:
The main points of the preceding discussion are well-illustrated by the three pilot projects:

Nepal saw violent rebel activity throughout its territory from the mid-1990s forward, with government and insurgent forces gaining the upper hand in different areas. It offers an example of a country during and soon after conflict. The actions of MFIs and NGOs in the regions studied show micro-level adaptations that help to reduce risk and uncertainty. One of the lessons of the case study is that, in conflict-prone settings, microfinance products should be designed with conflict in mind, rather than invented on the fly. Outward links to clients, rebels, government, and the banking sector need priority attention because they offer MFIs ways to build credibility, social support, and networks that can allay risk. Last, the neutrality of Nepalese MFIs vis-à-vis government and the insurgents was critical to avoiding costly and dangerous confrontations with either side. The MFIs realized this, and developed codes of conduct to guide employee behavior to make it consistent with the overall objective.

Angola illustrates the situation mid-way through the recovery decade, where meso-level efforts are especially relevant. Every country has a specific developmental path, with Angola having seemingly achieved peace in the 1990s, only to relapse into warfare until 2002. Now that the peace has been sustained, the sheer size of the challenge has come into view. More than 25 years of violent conflict left a devastated countryside in which agriculture, transport infrastructure, and social capital have yet to recover. Meanwhile, the state has been restructuring from wartime socialism and straining to employ its massive oil revenues to provide benefits and opportunities to the majority. This is a difficult struggle, compromised as it is by the corruption and elite capture of the public sector typical of natural resource economies. In this setting, the state development bank is in transition from its original mandate of directing subsidized credit to one of stimulating the growth of microfinance. It played a lead role in initiating policy development, including sponsorship of the June National Conference on Microfinance. Experience in the pilot also suggests that national policy development should go along with parallel and mutually-supportive efforts. In Angola, these efforts focused on the establishment of a microfinance stakeholder association ('Forum') to organize for collective action on policy and other issues, and on regional and local initiatives to improve enabling conditions for microenterprise.

Mozambique is much farther along in its recovery than the other two pilot countries, although the extreme fragility left behind by the conflict and the natural disasters and other setbacks have delayed the transition. The country is at the point where rapid growth and microfinance development have highlighted the need for reforms to consolidate and deepen the economic gains. Thus, the macro level becomes a focus. Our pilot project concerned one of the groups left vulnerable due to war-induced changes and the unevenness of transitional reforms – HIV/AIDS widows who lose their property. Mozambique is caught in a peculiar bind here. Socialism favored the equality of women, but the aftermath of war seemed to bring a backlash. In particular, the opportunism so characteristic of fragile states took hold as the AIDS epidemic expanded, resulting in a rising tide of property seizures by widows' relatives. The seizures are often justified on customary grounds, but are at least as often at odds with the limits and safeguards built into those very customs. Mozambique has written gender equality into national law, including in the property rights context. But as a frail developing country with plural ethnic governance, it has also recognized less equitable traditional laws as proper grounds for determining property rights. Further, parties aggrieved under customary law can bring suit in the civil courts, which are more zealous protectors of women's property than local tribunals. But civil justice is not easily accessible or affordable to most ordinary people. The next step in reform is a new inheritance law, which would provide the necessary civil law protections for widows, but may be blocked in its implementation by the same obstacles just discussed. Pending effective national reforms, we suggested reaching out to vulnerable women through village savings & loan networks, and providing such services as legal aid, training, and short-form wills.

Assessment of enabling environments:
Aid donor agencies and development practitioners face a number of assessment challenges in dealing with institutional enabling conditions. This is true whether programming objectives focus on the enabling environment itself or on enterprises and MFIs operating within it. In either case, practical approaches and tools are necessary to understand the constraints, opportunities, effects, and leverage points for change. Here, we offer guidance for identifying and prioritizing enabling environment issues for program design purposes.

Resources for assessment appear throughout this paper, offering materials from which to build field protocols. The two tables and the figure in this part of the paper outline the main issues, impacts, and approaches. Table 3 reviews the broad sweep of institutional issues affecting microenterprise and microfinance in developing countries. Table 4 and Figure 1 focus in on the major concerns arising in fragile states, showing the possible sequence of problems and responses across differing scenarios. Further, the Annexes contain the instruments that IRIS and its partners used in assessing the specific issues involved in the pilot projects. The materials included are those used for the Nepal case study of microfinance and related services in conflict-affected areas, and for the Mozambique project on widows' property and inheritance rights.

Drawing on these resources and others, the following table illustrates approaches to assessment in this field. It is by no means comprehensive, nor could it be, since the variety of scenarios and needs is virtually infinite. Those conducting the assessments have a choice of methodologies, with each having distinct advantages in particular situations. The basic choices include surveys, semi-structured interviews, focus groups, experiments, and documentary research – with variations available for each of these. Given the difficulties of fragile settings and the need to assess quickly and at low cost for programming purposes, rapid appraisals based on interviews, focus groups, and document review are likely to be the most practical in most such situations.

Table 5. Assessment - Illustrative Issues and Approaches

Situation and Effects	Issues / Possible Causes	Assessment Questions
Immediate post crisis: Survivalist microenterprises (MEs) predominate, inputs often unavailable, cash and carry deals only	Insecurity, poor physical and market infrastructure, weak social capital, disrupted input markets and commercial networks	Is security the main problem for MEs, input-suppliers, households? How do MEs adapt – integration, informal coordination – and at what cost? What was basis for old networks and what has replaced it? What opportunities lost due to security and network problems? What options to support: input supply, build networks, informal coordination with local firms and authorities, food- or cash-based rebuilding with local labor?
Immediate post crisis: Microfinance services highly constrained, localized, costly, and insecure, with poor loan recovery	Lack of stable law and order, governance fragmented by region / locality, opportunism and lack of livelihoods make repayment unlikely, while humanitarian relief meets some needs	Importance of law and governance for basic order, livelihoods, finance? How do MFIs cope – adapt products, operations, screening and guarantee methods? Any national / local opportunities to support law and governance strengthening? What scope and likely impact of training MFIs in methodologies used in other conflict-affected settings? Any sector-wide organizing efforts – and any scope to build on them? Can market-friendly relief programs, including fee-based services and contracting-out, help expand livelihoods and microfinance demand?
Early recovery: Enterprises seek to expand, but are deterred by lack of services, red tape, road blocks, corruption	Governance and law enforcement are weak, political economy does not support expenditures on basic services for the poor, outmoded regulatory framework imposes inappropriate rules on business start-ups, officials and gangs exploit the situation to extract bribes	Which is costliest to enterprises – services, red tape, corruption? What is source of red-tape and corruption opportunities? Are there feasible targets for 'stroke of the pen' streamlining reforms? Is small business sector organized, and could it support collective action to monitor officials, forward complaints, press for transparency? What informal coordination and conflict-resolution mechanisms exist, and can they be strengthened to provide alternatives to weak legal system?
Early recovery: MFIs operate in regulatory vacuum, cannot get approval to accept deposits, banking services limited, many unsustainable operations and failures	Government is attending to other urgent needs and has not made financial services reform a priority; banks are recovering but face little competition and little pressure to serve the low-income majority; microfinance sector has not effectively organized to create standards and infrastructure, or to advocate for policy change	Is the lack of a suitable regulatory framework a binding constraint for MFIs? Have alternative sources of capital been fully exploited – e.g. 'wholesale' borrowing, grants and guarantees, agency arrangements with banks? Are there micro-enterprise / -finance networks that can be strengthened to take on coordination and policy development? Any opening in sector and government to begin dialogue on vision and policy?

Advanced recovery / consolidation: Select regions and populations have no access to finance and weak livelihood options	Recovery of economy and public sector has left many gaps; rule of law, property rights and contract enforcement, regulatory development are all weak; overhang of conflict effects such as trafficking, gang activity, disease, and social disruption block development; elites and oligarchs have little interest in reform	Which legal-regulatory constraints are both binding and feasible targets for reform? Any opportunity at national level to use financial and political pressure to achieve legal-regulatory reform? Are alternative approaches likely to succeed – e.g. local-level reforms, sector-level arrangements, legal aid, material assistance, building social cooperation? How feasible and effective are micro-level interventions, e.g. integrating security, health care, training on legal rights with microfinance?
Advanced recovery / consolidation: MFIs seek to expand and become self-sufficient, but cannot get licensed as depositary institutions; public sector subsidized credit and informal moneylending capture clients; MFI recovery rates suffer	MFIs seek sustainability but a combination of weak development in the sector and the lack of a conducive legal-regulatory framework prevents it; state development finance is a political tool that the regime does not want to give up; many lenders operate 'under the radar' due to costs of formalization and opportunities for profit in predatory lending; retailers offer consumer credit to MFI clients and put themselves first in line for repayment, to the detriment of MFIs	Which is the priority target in terms of impact and feasibility – legal/regulatory reform, or strengthening MFI practice and standards? What leverage (or exchange) can be used to rein in politicized credit programs – and is this politically feasible? Is there a critical mass of capable MFIs that would benefit from reform to expand and deepen operations? Are the microfinance sector and its allies cohesive enough to mount an advocacy campaign, propose a policy change, and achieve a set of legal/regulatory reforms that address licensing of depositary MFIs and lending standards? Will this launch a harmful 'rush to regulate,' or are proponents and policymakers astute enough to achieve an effective reform?

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Annex 1: Fragile States Scenarios[14]

Fragile States Scenarios

Category	Scenario	
Declining	***Arrested Development***	Stagnation with low levels of effectiveness and legitimacy
	Deterioration	Declining levels of effectiveness leading to lower legitimacy; rising risk of violence or collapse
Stabilizing	***Post-conflict transition***	Low levels of effectiveness, transitory legitimacy, recent violence, humanitarian crisis
	Early Recovery	Rising levels of effectiveness and legitimacy; declining international resource requirements; emergence from conflict or other crisis

DECLINING.
Situations of stagnation or worsening conditions, where the risk of collapse is increasing:

Arrested development is one of two entry points into state fragility. Here, a state that may have been relatively capable has either stagnated for some time or has just experienced a major reversal, whether due to a shock or to rigid authoritarian rule. External shocks take various forms. The shock might be a major setback in the terms of trade, as where reliance on a limited range of commodity exports for economic growth and revenue exposes the state to severe risk. This commodity price shock may undermine the state's ability to perform core functions and thus challenge the legitimacy of the regime – whether or not it is formally democratic. A financial crisis may have a similar impact, especially if corporate and financial governance are weak and if there has been a build-up of risky (or even corrupt) undertakings in the banks. Another version of this scenario occurs when an authoritarian regime squelches economic and political initiatives that seem to threaten its control. In this setting, heavy-handedness, economic stagnation, and international isolation may sap the regime's effectiveness in maintaining itself.

The loss of capacity/effectiveness is the precipitating cause of fragility, but impaired will or legitimacy is also a factor. What may have been an acceptable level of progress gives way to stagnation. Mismanagement by a flawed or autocratic government is increasingly understood as the cause of the current malaise. This may result in further popular discontent and the defection of key elites. The critical issue is whether regular, institutionalized, processes can reverse the trend – before a coup or revolt occurs. In the authoritarian version of this scenario, political and social processes are not sufficiently free or developed to address the problem. Social capital is limited or degraded, diminishing the likelihood of either a peaceful alternation of power or adaptive non-state responses to the need for public goods.

Deterioration is the second entry point into state fragility. In this setting, low state capacity/effectiveness, whether chronic or due to a period of arrested development, combines with an erosion of legitimacy. Developmental indicators show a decline over time, and the state cannot control all of its territory or guarantee even an imperfect rule of law in core areas. Continued deterioration breeds hardship among the majority of the population, and the state's ineffectiveness leaves it unable to respond to voices of discontent – or even to suppress effectively. The state is on a downward slope towards failure, and an external shock or an

[14] Adapted from Meagher (2007).

illegitimate transfer of leadership could provoke a crisis. The misalignment between state policy and evident social needs, such as poverty reduction, shows the inadequacy of channels of political expression, mechanisms of accountability, and administrative capabilities. At the same time, the society may have the capacity to respond on a limited scale to government failures through voluntary self-organization.

***STABILIZING*.**
Situations of emergence from crisis, where the risk of collapse is static or receding:

Post-conflict transition describes the situation when a state has reached the nadir of violent failure. This is a precarious situation, where combatants have stood down but may not yet have disarmed. The devastation – physical and emotional – is raw, but the situation is stable for now. An accord on a new governing framework is in place, and perhaps an initial election may have taken place. But there is little in the way of effective government, beyond an international presence and the beginnings of a new regime. Will and legitimacy are not yet in evidence – although the population, exhausted by conflict, may be ready to place their hopes in the emerging new order. Recent experience of polarization and violence makes extensive social cooperation problematic, although informal coordination within status groups may be effective. Thus, the society's trajectory is essentially flat, with an equal chance of moving upwards to recovery or sliding back into failure.

Early recovery refers to a setting where failure has occurred (whether due to civil war, natural disaster, or economic meltdown), but the situation has stabilized enough that a government is in place and basic state functions are being re-established. From a modest starting-point the capability of the state is growing, and the national leadership is demonstrating will and legitimacy in helping the society re-emerge from crisis. This leadership may lead the way to full recovery – or it may have reached the limits of its capacity. The performance of government is extremely weak in terms of policy development and implementation. The society is still coping with trauma (and, if civil conflict was a precursor, mistrust). Depending on the nature of the recent breakdown, society may be either polarized (but exhausted) or united by a shared experience of suffering. The country is on an upward path from crisis, but is still at risk of slipping backwards.

Annex 2: Summary of Pilot Activities

In this project, IRIS and its partners carried out three pilot activities. IRIS worked with World Vision in Angola to build capacity and improve governance and implementation in the microfinance sector, with CARE in Mozambique to investigate options for protecting inheritance rights of HIV/AIDS widows, and with Save the Children in Nepal to capture lessons learned from navigating microfinance conditions in conflict situations. Brief summaries of the activities follow, and pilot reports, dissemination materials, and other associated literature are attached in the appendices.

Angola Microfinance Policy

In Angola, post-conflict recovery has brought oil and aid money, but the use of these resources to finance poor households and microenterprises is uncoordinated and suffers from lack of a legal and policy framework. The goal of the pilot activity in Angola was to build the capacity of government and its partners, at multiple levels, to make changes and improve the governance and implementation in the microfinance sector. In order to accomplish this, IRIS and World Vision convened a National Conference on Microfinance in Angola in June 2007. Over 100 participants from the banking, public, and private sectors gathered for two days to analyze constraints on the national expansion of the microfinance sector, exchange experiences, reflect on the need for microfinance regulation, and consider a microfinance forum to unite all major actors in the sector.

Outcomes of the conference included a position paper that recommended legislation regarding microfinance law and policy for the sector's sustainable growth and the promotion of credit to micro- and small-enterprises, while deemphasizing consumer credit. Participants also recommended moving the NGO MFIs towards sustainability and then transformation into regulated microfinance institutions and the creation of a Microfinance Forum. The Microfinance Forum would advocate regarding microfinance policies, promote discussions among practitioners, compare experiences, and coordinate outreach and coverage.

Mozambique Inheritance Rights

In Mozambique, the national constitution and laws mandate equal treatment for women in the area of property entitlements, but also acknowledge the role of customary law. The resolution of conflicts between formal and customary law – and, in effect, the formation of a policy on women's ownership rights – requires a level of consensus and coordination that are difficult to achieve in a fragile post-conflict setting. IRIS and CARE investigated options for addressing this problem, with a particular focus on the protection of the inheritance rights of AIDS widows from the deceased husband's family. The investigation included both a literature review and a field visit.

Based on the literature review and the field visit, IRIS and CARE made recommendations for action at the community, policy, and society levels. Recommendations at the community level, where most decisions regarding land tenure are made, include design of training programs for Village Savings and Loan Associations (VSLAs) and municipal and/or community leaders, development of legal protections for women's property and inheritance rights, and the use of VSLAs as safety nets. At the other two levels, the recommendations included documentation of cases of expropriation and defense of widows' inheritance, promoting awareness of inheritance rights and women's property rights, clarification of inheritance rights, international networking, and bringing test cases and appeals.

Nepal Microenterprise and Social Services
Save the Children, working with IRIS, studied the strategies used by Save the Children's partner Nirdhan in a region heavily affected by the Maoist insurgency in Nepal. The project team conducted interviews with service providers and beneficiaries. The case study examines the restrictions on service provider operations, imposed both by Maoist rebels and by Nepalese government security, the direct impact of the conflict on providers and beneficiaries, and the strategies that they developed in response to the conflict.

Based on these interviews, the case study report draws lessons for wider application by organizations operating in conflict areas around the world. These include the benefit of engaging communities and beneficiaries in project activities, the need for innovations in service design and delivery, the resources that partnerships with the private sector and other organizations can provide, and the definition of appropriate roles for agencies that may be party to the ongoing conflict.