MICROFINANCE

IN EAST TIMOR:

Relief, Reconstruction and Development

A Draft Report of
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THE FOUNDATION FOR DEVELOPMENT COOPERATION LTD ACN 011 025 997
PO Box 10445 Adelaide Street, Brisbane QLD 4000 AUSTRALIA
Tel: 61 7 3236 4633 Fax: 61 7 3236 4696 Email: info@fdc.org.au http://www.fdc.org.au

Preface

This document has been prepared by the Foundation for Development Cooperation as a contribution to planning for the reconstruction of East Timor. It is a concept paper directed to a particular need, one among many. We see microfinance as important for the restoration of economic activity in the post-conflict situation, and as vital for the maximum participation of the poor in economic rehabilitation. And we see the creation of a viable microfinance system in East Timor as a contribution to the rehabilitation and further development of its broader financial infrastructure.

We have set out principles for the introduction of microfinance into East Timor, with particular reference to criteria for the selection of communities and social groups capable of benefiting from it. We are also concerned with the need to achieve sustainable delivery of microfinance, and have considered how best practice principles of service delivery might be applied in the specific circumstances of East Timor.

Our initial goal is to have the necessity for a substantial microfinance initiative accepted in principle by representatives of the Timorese people and by the agencies which will collaborate with them in the reconstruction effort. Further, we aim to direct their attention to the principles and criteria to be applied for successful microfinance.

This concept paper is not yet a step-by-step plan for the introduction of microfinance into East Timor, but it is a necessary preparation for it. A detailed plan will require consultation with the various agencies, multilateral, bilateral and voluntary, which are presently preparing for emergency relief operations and reconstruction, as well as with Timorese political leaders and professionals. A comprehensive plan will require knowledge of the resources these agencies will bring to the process and of the division of labour to be agreed among them. We also intend to contribute to that further process of detailed planning, and in doing so to support the reconstruction and further development of East Timor's financial sector, with particular emphasis on its potential to serve the poor.

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Acronyms

ADB	Asian Development Bank
AusAID	Australian Agency for International Development
BPR	Rural Bank (in Indonesia)
BRI	Bank Rakyat Indonesia
CAA	Community Aid Abroad/Oxfam Australia
CGAP	Consultative Group to Assist the Poorest
CRS	Catholic Relief Services
EBRD	European Bank for Reconstruction and Development
ESCAP	Economic and Social Commission for Asia and the Pacific
FDC	The Foundation for Development Cooperation (Australia)
GRDP	Gross Regional Domestic Product
GTZ	Deutsche Gesellschaft fur Technische Zusammenarbeit (Germany)
IDP	Internally Displaced Person
IFC	International Finance Corporation
MFI	Microfinance Institution
NGO	Non Government Organisation
QIP	Quick Impact Project
SHG	Self Help Group
UN	United Nations
UNAMET	United Nations Mission for East Timor
UNDP	United Nations Development Programme
UNICEF	United Nations Children's Fund
UNHCR	United Nations High Commission for Refugees
UNTAET	United Nations Transitional Administration for East Timor
USAID	United States Agency for International Development

Executive Summary

East Timor faces an enormous challenge following the devastation of the recent conflict. Microfinance (defined as the provision of financial services to poor and low income households that do not have access to formal financial institutions) has the potential to play a significant role in reconstruction and development. The Foundation for Development Cooperation has prepared this report to argue for the inclusion of microfinance as an element in the relief and reconstruction program for East Timor.

In a normal development context, microfinance can assist in poverty reduction and promote economic and social development. In post-conflict situations, microfinance can also provide liquidity to get economic activity going again in the informal sector. It can also help to promote a smooth transition from short-term humanitarian assistance to longer term development programs.

Microfinance in the post-conflict situation

Introducing microfinance in post-conflict settings gives rise to complications not found in the normal development context. Nevertheless, programs can start up and operate in situations where there is surprisingly little political and financial infrastructure. In the literature, there appear to be only three essential preconditions for establishing microfinance activities in a conflict-affected area:

- the absence of extensive, ongoing conflict
- the re-appearance of open air markets, and
- in the case of displaced persons and refugees, an expectation that displacement will be relatively long term.

However, the literature also suggests that programs are not likely to become sustainable unless a number of other conditions are established. Some of these preferred conditions are likely to remain problematic in East Timor, even after the three preconditions discussed above are reestablished. They include:

- a functioning commercial banking system
- the absence of hyperinflation
- trust in the currency and financial system
- a relatively high population density
- a skilled, educated workforce, and
- social mechanisms that facilitate trust between people.

There is a wide variety of approaches to microfinance, including the Grameen Bank model, the village bank model, the credit union model, the self-help group model and the rural financial systems model. In broad terms any or all of these would appear appropriate to East Timor, but they may need to be adapted to take account of the specific environment there. Practitioners should be encouraged to establish a variety of models to develop a greater understanding of what works in East Timor.

Some adjustments would be necessary to reflect the post-conflict situation in East Timor. Most importantly, programs would need to be highly flexible. Lack of security in post-conflict situations often necessitates significant departures from typical microfinance operations. Precautions to increase security may result in significant

cost increases. Other modifications may be needed because of the lack of financial systems and low levels of trust.

A number of programs in post conflict situations have incorporated emergency relief measures or goals relating to social and political development. Evidence on the effect of such measures is mixed. While some practitioners report that emergency relief can create goodwill and increase client loyalty, others find that it can create an entitlement mentality. Multiple goals can increase complexity and make it harder for programs to focus on outreach and sustainability.

Demand and outreach

Immediately after the conflict in East Timor subsides, demand for microfinance services is likely to be low. But as the 'postwar syndrome' fades, the demand for credit can be expected to increase dramatically. During the reconstruction phase, there is likely to be a very strong demand for credit to rebuild productive assets. Evidence on demand for savings services in post-conflict situations is mixed. Some practitioners have found strong demand; others have not.

In post-conflict situations it is often best to avoid very specific client targeting, in order to avoid creating tensions or ill will towards program clients. The literature identifies five different groups of potential clients. These are inhabitants, returnees, internally displaced persons (IDPs), refugees and demobilised soldiers. This taxonomy is very useful in considering potential microfinance clients in East Timor.

Inhabitants are those individuals who have remained in their home communities during most, if not all, of the conflict. They are potentially easier to serve because they may have some assets. They have an incentive to stay and earn a living. In East Timor, inhabitants are likely to comprise the largest number of potential clients for microfinance, at least initially. Returnees are likely to be another important client group.

There are estimated to be more than 200,000 IDPs in East Timor, and 230,000 refugees in West Timor. Microfinance programs would only be appropriate for them if they were likely to be displaced for periods of six to eighteen months. Refugees pose particular difficulties; microfinance programs can collapse when camps break up or are disrupted, and host countries may prohibit refugees from participating in the host economy. At present, it is impossible to predict whether the refugee camps will become permanent or whether large numbers of refugees will be able to return to their homes in East Timor in the relatively short term.

In the context of East Timor, demobilised soldiers include the pro-autonomy militia and the forces of Falintil. It would not be advisable to design programs specifically for these groups, although they may be able to participate in more general programs.

In normal development contexts, most microfinance programs serve women predominantly. This is because they repay loans better and are more likely to use borrowed funds to benefit the household. In post-conflict East Timor, there may be additional reasons for targeting women. They represent a safer, less political client group than men, and may have better potential as peacemakers.

Sustainability

Attaining self-sufficiency is important if programs are to be sustainable beyond the withdrawal of donor funds. Donor funding is a limited resource, both in quantum and duration. The greater its level of self-sufficiency, the more a program can leverage donor grants by accessing funds from more commercial sources, thereby increasing its outreach.

It is unclear whether programs will be able to attain full financial self-sufficiency in post-conflict East Timor. They will have to adjust their procedures to the operating environment, and timelines for reaching self-sufficiency are likely to be much longer than in the normal development context. Nevertheless, it is important that programs seek to maintain normal standards of program pricing, scale, and operational efficiency to the maximum extent possible.

The greatest challenge may be developing local institutional capacity. This challenge is likely to be particularly acute in East Timor, where there was a severe lack of skilled professionals prior to the current crisis. It may be necessary for donor agencies to establish programs from scratch while at the same time building local commitment to and ownership of such organisations. Over time, it would be desirable if operations could be transferred fully to local ownership and control.

Funding and the role of donors

Initially, the establishment of microfinance programs in East Timor will rely heavily on funding from donor agencies. A large number of multilateral and bilateral donor agencies and international financial institutions are likely to participate in East Timor’s reconstruction and development. Many of these agencies have considerable experience in implementing microfinance programs, in some cases in post-conflict situations. It is important that donors employ best practice principles and that they coordinate their strategies, in consultation with local people.

Policy and regulatory environment

It would be appropriate for microfinance programs in East Timor to operate in a largely deregulated environment. It is generally accepted that microfinance institutions (MFIs) should not be subject to prudential regulation and supervision, so long as they do not accept deposits from the general public. Another important element of the policy environment relates to interest rates. It is important that the government not impose ceilings on the interest rates that MFIs can charge, or at least that any ceilings be set at levels that are consistent with sustainability.

Given that most microfinance programs will probably be operated by NGOs, it is also important that the policy environment for NGOs be as supportive as possible. More generally, there should be a supportive policy environment for microenterprises, to enable clients to make effective use of finance in pursuing income generating activities. It will also be necessary to rebuild the formal financial system as soon as possible. Where possible, the regulatory framework should not discourage banks and other regulated financial institutions from engaging in microfinance.

1 Introduction

East Timor faces an enormous challenge following the devastation of the recent conflict. It will be necessary not only to reconstruct the vast amounts of physical and social infrastructure that appear to have been destroyed, but also to develop economic and social institutions that were largely undeveloped even before the current crisis. Microfinance has the potential to play a significant role by providing the opportunity for low income households to establish and grow profitable microenterprises, thereby promoting development at the grassroots level.

This discussion paper considers a range of issues relevant to the introduction of microfinance in East Timor. Given our self-imposed timetable for the production of a preliminary report it has not been possible to visit East Timor, and the paper relies on secondary sources. It is therefore not intended to be a feasibility study or an action plan. Nevertheless, it considers a wide range of conceptual and practical issues that will be critical to the establishment of microfinance programs in East Timor. As such it is a necessary preliminary to a concrete action plan.

Following this introduction, section 2 provides some background information on East Timor. Section 3 discusses the potential for microfinance in post-conflict situations, both as an aid to the short-term amelioration of economic stress and as a contribution to the rehabilitation of financial services for rural and low income households. A number of approaches to microfinance that may be appropriate in East Timor are considered in section 4, as well as adjustments that may be necessary in the post-conflict situation.

Section 5 discusses a number of issues relating to the demand for and outreach of microfinance in East Timor, while questions of financial and institutional sustainability are the subject of section 6. Section 7 looks at funding and the role that donors might play in the establishment of microfinance. A brief overview of some of the policy and regulatory issues that will need to be addressed by a new East Timor administration is provided in section 8. Finally, section 9 offers some concluding comments.

2 Background to East Timor

Brief history

The island of Timor has long been inhabited by a number of ethnic groups, the largest of which are the Tetum and Atoni. The earliest recorded outside contacts date back to around AD 1,000 when Javanese and Chinese traders visited the island. In the early 16th century East Timor was colonised by Portugal. In 1974, following a coup in Portugal, the new government began the process of decolonisation.

Within East Timor a number of political parties formed, including the Revolutionary Front for an Independent East Timor (Fretilin). In August 1975 Fretilin took control of Dili, and in November it declared the establishment of a Democratic Republic of East Timor. On 7 December Indonesia invaded, and drove Fretilin from Dili. By the end of 1975 Indonesia occupied most of East Timor, and formally absorbed it into Indonesia on 17 July 1976.

Opposition to the occupation led to ongoing fighting between Fretilin and the Indonesian military and contributed to famine. Some estimates place the death toll at as many as 200,000 people over the period 1975 to 1979, although it is not possible to verify these. Until 1988 East Timor remained closed, with access rigidly controlled by the Indonesian military. The Indonesian Government focused on education, agriculture and infrastructure development to develop East Timor and in an attempt to gain popular support for the occupation. There were also reports of widespread human rights violations.[1]

In 1997 Indonesia was plunged into economic crisis, and President Suharto resigned in May 1998 following widespread protests. The economic and political crisis gave renewed impetus to the independence movement in East Timor. The new President, BJ Habibie, publicly suggested that East Timor might be given a new ‘special’ status within Indonesia.

In January 1999 Indonesia first raised the possibility of independence for East Timor. On 5 May Indonesia and Portugal signed an agreement for the United Nations to oversee and conduct a secret ballot on whether to accept or reject an Indonesian proposal for special autonomy within Indonesia. The agreement placed responsibility for security in the hands of the Indonesian authorities, in particular the Indonesian police. However, tension remained high and there were widespread reports that elements of the Indonesian military were arming and training anti-independence militias.

Despite poor infrastructure and continued violence by the militias, nearly 451,800 potential voters registered for the ballot. On 30 August some 98 per cent of registered voters went to the polls. They voted by a margin of 78.5 per cent to 21.5 per cent to reject the proposed autonomy and begin a process of transition towards independence.

The crisis

Following the ballot, the violence escalated dramatically. The United Nations Mission in East Timor (UNAMET) estimates that as many as 500,000 people fled their homes. More than 200,000 people are believed to have fled into the hills and jungles of East Timor, while an estimated 230,000 fled to West Timor. In some areas, it is estimated that 80 per cent of structures have been destroyed. It is not known at this stage how many people have died.

On 15 September the United Nations Security Council adopted a resolution to establish a multinational force for East Timor, with Australian leadership. On 5 October the United Nations High Commission for Refugees (UNHCR) commenced a program to return refugees to East Timor, but at the time of writing only a tiny proportion had returned. On 20 October the result of the secret ballot was ratified by the Indonesian parliament.

An initial estimate by UN agencies, issued on 28 September, put the cost of assistance and protection to displaced persons in East and West Timor at around US$135 million

[1] See Amnesty International (1994).

for the coming six months. Humanitarian agencies are concerned about the threat of a malaria outbreak during the coming rainy season and the lack of medical supplies and personnel. The World Food Program estimates that up to 80 per cent of the population may require food aid in the next six months. From a longer term perspective, homes have been burned and livelihoods destroyed. Economic and social development has been seriously set back, perhaps by many years.

Economic and social conditions

East Timor is situated in the eastern part of the island of Timor in the Timor Sea. It is surrounded by the islands of eastern Indonesia to the east, north and west, and Australia to the south. With an area of 14,874 square kilometres, it is in the transitional region between humid Southeast Asia and dry monsoonal northern Australia, which it closely resembles.

In 1995, the population was estimated at around 840,000, with a population density of 56 persons per square kilometre.[2] Around 7.1 per cent of the population were immigrants from other provinces of Indonesia. The population was predominantly rural, with only 9.5 per cent living in urban areas. Before the current crisis the population was spread fairly evenly throughout the country, with population densities generally higher in the north and west and lower in the south, central and east. The population had been increasing rapidly, with an average annual growth rate of 2.4 per cent between 1990 and 1995 and a total fertility rate of 4.4 in 1995.

Even prior to the current crisis, economic and social conditions in East Timor were poor. Gross Regional Domestic Product (GRDP) in 1995 was US$303 million, or around US$360 per capita, the lowest for any Indonesian province except the adjacent province of Nusa Tenggara Timur. It is estimated that 31 per cent of people lived below the official poverty line in 1996, the highest percentage for any province. And in 1993, 71 per cent of the 442 villages in East Timor were classified as ‘backward’, based on isolation and available infrastructure, housing and physical environment, and birth and death rates (Mboi, 1996).[3] This was the highest percentage for any province except Irian Jaya.

By industry, agriculture accounted for 29 per cent of GRDP in 1995, with the shares of manufacturing 3 per cent, construction 21 per cent, trade 10 per cent and other industries (largely government) 37 per cent. The large shares of construction and government reflect the effect of disbursements from the Indonesian Government, discussed below. In terms of employment, 73 per cent of the workforce was employed in agriculture, with 14 per cent employed in services, 6 per cent in trade, 4 per cent in manufacturing and the remainder in other industries.

The proportion employed in agriculture was much higher than in most other provinces of Indonesia, with the gap between the shares of GRDP and employment in agriculture reflecting the reliance on subsistence production and the low productivity of much agricultural production. The major food crops were rice, maize, cassava and

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[2] Unless otherwise stated, the statistics in this section are derived from Statistics Indonesia (1999) or Tandjung & Sutomo (1998).

[3] This classification formed the basis for a nation-wide program of poverty alleviation known as *Inpres Desa Tertinggal* (IDT).

sweet potatoes. Agriculture is largely shifting cultivation, with only a small amount of wetland cultivation.

Indicators of human development were also poor. Life expectancy at birth was 57 in 1990, while the infant mortality rate was 85 per 1,000 live births. Education participation rates were 79 per cent at junior high school and 41 per cent at senior high school. In 1995, 48 per cent of the population aged 10 and over were illiterate, comprising 57 per cent of females and 41 per cent of males. Only 23 per cent of households had electricity, while 49 per cent had fresh water and 15 per cent had sanitation. Again, East Timor was the least developed or one of the least developed provinces on each of these indicators.

The development challenge

Economic and social development for the future administration of East Timor will be a major challenge. East Timor will be a small country located far from major centres of economic activity. Soils lack volcanic ash deposits and are generally of low quality and heavy texture. In the central uplands the quality is somewhat better but the soils are subject to erosion. East Timor has low rainfall, with a short and uncertain rainy season.

In recent centuries, East Timor has never been economically independent (Soesastro 1989). Since 1976 it has relied heavily on expenditure by the Indonesian Government. For instance, in 1992 central disbursements were equivalent to 60 per cent of GRDP, more than double the share for any other province (Barlow 1996). The departure of Indonesians will also leave serious gaps among skilled occupations such as engineers, technicians, medical workers, teachers and administrators (Gittins 1999).

At a conference held in July 1999, East Timorese economist Joao Mariano Saldanha of the University of California, San Diego commented that he saw coffee, sandalwood, livestock, textiles and tourism as the industries with greatest potential, with such industries operating on a small to medium scale (Hull 1999).

Much recent comment on the prospects for the economy has centred on the potential for revenues from offshore crude oil resources and development assistance. While such revenues will clearly be important, Duncan (1999, p.130) argues that over the longer term, development will depend more on the policy framework than on the mere availability of such revenues:

> *The development experience of the past 40 years or so shows that exploitation of mineral resources and accumulation of aid is not the route to economic growth and development. Institutions and policies favourable to private sector development, together with the provision and maintenance of physical infrastructure and human capital (the good health and education of the people), appear to be the critical ingredients. These should be the focus of East Timor's governing bodies.*

Clearly, the reconstruction and development of the East Timorese economy will pose major challenges. As noted above, it would appear appropriate to emphasise private sector development and investment in physical and human capital. By encouraging the establishment of micro and small enterprises, microfinance is integral to a focus on private sector development. Moreover, by targeting poor and low income households, microfinance can be one element in a strategy to ensure that inflows of development aid and development more generally benefits the whole community. These and other benefits on microfinance are discussed in section 3.

The financial system

Prior to the recent escalation of conflict, the formal financial system in East Timor consisted of 18 branches of commercial banks, comprising five branches of state banks, ten branches of the regional government bank, and three branches of private national banks.[4] This represented one branch per 46,650 people. In March 1999 total outstanding credit was Rp158 billion (US$18.2 million), or around US$21.6 per capita. Total outstanding savings were Rp594 billion (US$68.4 billion), or around US$81.4 per capita. It is not clear if any of these branches are still operating, or if there are any realistic prospects that they will be reopened in the future. It is also understood that only two of the former branch managers were East Timorese.[5]

In addition, Bank Rakyat Indonesia (BRI) operated a number of *unit desa* (village units) in East Timor. The *unit desa* provide basic deposit and loan facilities on a commercial basis through the use of highly decentralised and cost-effective operations. It is understood that BRI pulled out all of the BRI Unit and Branch personnel when the violence began, taking their records and computers with them.

Unlike all other provinces of Indonesia, there were no licensed rural banks (BPRs) in East Timor prior to the current crisis. Evidence from Indonesia and other countries suggests that such banks are much more likely than commercial banks to provide financial services to low income and poor households.

Another key financial issue facing East Timor relates to possible monetary options. At the conference referred to above, Saldanha noted that a relatively small nation such as East Timor could simply adopt a major foreign currency overnight, as has occurred with other smaller Pacific states. He concluded, however, that establishing a national currency would be the best option, and that this currency should be linked to a major international currency. Clearly, the transition to a new currency will pose significant issues for microfinance programs. This issue is discussed in more detail in section 4.

3 Microfinance in Post-Conflict Situations

Introduction to microfinance

Definitions of microfinance differ. Microfinance is generally taken to refer to the provision of financial services to poor and low income households that do not have access to formal financial institutions. For instance, according to the Asian Development Bank (1999, p. 1):

> *Microfinance is defined as the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to the poor and low-income households and microenterprises.*

[4] The statistics in this section are derived from Bank Indonesia (1999).
[5] Jeremy Wagstaff, 'An Independent East Timor Seems a Costly Proposition', *The Asian Wall Street Journal*, August 27-28, 1999.

In practice, microfinance institutions (MFIs) have tended to concentrate mainly on the provision of savings and credit services.

It is now widely accepted that microfinance can play an important role in poverty reduction and in economic and social development more generally. In most developing countries, opportunities for wage employment in the formal sector of the economy are extremely limited, and the vast majority of poor people rely on self-employment for their livelihood. For many microentrepreneurs, lack of access to financial services is a critical constraint to the establishment or expansion of viable microenterprises. Microfinance can therefore contribute significantly to increasing the productivity of self-employment in the informal sector of the economy.

Microfinance may also enable small and marginal farmers to purchase the inputs they need to increase their productivity, as well as financing a range of activities adding value to agricultural output. Access to savings facilities also plays a key part in enabling the poor to smooth their consumption expenditures, and in financing investments which improve productivity in agriculture and other economic activities. In an environment where economic growth is occurring (or as is likely in East Timor where the economy receives substantial injections of external resources), microfinance also has the capacity to transmit the benefits of growth and/or external injections more rapidly and more equitably throughout the community.

Microfinance can also reinforce other development programs, and vice versa. Many microfinance programs encourage members to develop a broader agenda covering matters such as health, nutrition and children's education. Even where such an emphasis is not explicit, increased empowerment and higher incomes from participation in microfinance programs can reinforce other policies. At the same time, microfinance programs are likely to be more effective in raising members' incomes where rapid growth in the economy and in agricultural output, and better infrastructure, create a demand for the products and services provided by microentrepreneurs. Microfinance programs will also be more effective where inputs such as education and training enable members to use their loans more productively.

Why introduce microfinance in post-conflict situations?

In large part, the reasons for introducing microfinance programs in post-conflict situations are the same as those for introducing microfinance in other settings.[6] The primary goals of programs are economic – to enable the economic survival of poor and low income households, to strengthen the economic base of households and communities, and to facilitate the establishment and growth of viable microenterprises.

There are also some more specific reasons why microfinance may be appropriate in post-conflict situations:

- Microfinance can provide much needed liquidity to facilitate the resumption of economic activity in the informal sector, and/or assist in the remonetisation of

[6] Doyle (1998) has conducted an excellent review of microfinance in post-conflict situations, based primarily on the experience of 16 programs in four countries, namely Bosnia-Herzegovina, Cambodia, Rwanda and Mozambique. This paper draws heavily on her findings.

such activity. Self-employment is especially important for income-generation in post-conflict settings.

- There is often a strong demand for financial services during periods of reconstruction. At the same time, the conflict is likely to result in other formal and informal financial service providers having ceased operation.
- As reconstruction progresses, microfinance is likely to be a better long-term option than continued humanitarian assistance. Delaying development until a country has emerged fully from reconstruction can be a wasted opportunity. Microfinance can help to promote the smooth transition from short-term humanitarian assistance to longer term development programs.
- The establishment of microfinance programs in the early stages after the conflict may give practitioners the ability to influence future policies regarding microfinance and microenterprise development more generally, and to contribute to the overall reconstruction of the financial system.

In addition to the primary economic goals, microfinance programs in post-conflict settings may have secondary goals relating to social and political development. Some practitioners have become involved in addressing non-economic issues that inhibit program performance or impact, such as the spectre of renewed violence, human rights abuses and the effects of trauma on clients. Some agencies have even used microfinance to facilitate reconciliation and conflict resolution. Nevertheless, some programs have decided not to address social and political development goals explicitly. Having multiple goals increases complexity and makes it more difficult for programs to focus on increasing outreach and sustainability.

Essential conditions

Clearly, introducing microfinance in post-conflict settings gives rise to a number of complications that are not present in normal development contexts. It is too early to start microfinance programs during the immediate post-conflict stage. Nagarajan (1999b, paragraphs 42-43) comments that:

> *There is no magic clock or calendar to indicate the right timing for intervention. Starting microfinance immediately after the conflict has subsided is found to be disastrous. Grants may be better tools at this stage than microcredit.*

Nevertheless, she adds that the immediate post-conflict stage is suited for initiating efforts for capacity building to promote financial services once minimal conditions are met.

Moreover, Doyle (1998) notes that programs can start up and continue to operate in situations where there is surprisingly little political and financial infrastructure. She found that there are only three minimum preconditions that practitioners state must be in place to institute microfinance activities in a conflict-affected area.

Low intensity of conflict. The absence of extensive, ongoing conflict is essential to start a program. The complete absence of conflict is not necessary. But where conflict persists, staff security becomes a very important issue. Moreover, programs need to be prepared to lose everything. There is a chance that program assets will be destroyed, so programs need to judge whether the likelihood of success makes the risks worth taking.

Reopening of marketplaces. If there is a single factor that signals the possibility of initiating microfinance activities, it is the re-appearance of open air markets. Some practitioners state that they wait for the return of about 30-40 per cent of the market traders before establishing microfinance programs.

Long-term displacement. Many potential target areas include a significant number of internally displaced persons or refugees. Where such persons are highly mobile, microfinance may not be an appropriate intervention. Practitioners state that to provide microfinance to such groups, displacement should be expected to last 18 months or longer. As discussed in section 5, this may have significant implications in East Timor. [7]

Preferred conditions

Where these essential conditions are met, programs may be able to operate and provide some basic financial services. However, Doyle (1998) notes they are not likely to be able to develop into sustainable institutions unless a number of other conditions are reestablished or alternative solutions are found. Many of these issues are discussed in more detail in subsequent sections.

A functioning commercial banking system. Although programs manage to operate in the absence of a banking system, they do so at increased administrative costs and at greater risks to staff and clients. The reestablishment of a banking system is necessary if programs are to develop.

Absence of hyperinflation. Hyperinflation is a common phenomenon in post-conflict situations, and greatly increases the challenge facing microfinance programs. Programs must adapt every financial transaction to protect savings and loan funds from losing their value. Hyperinflation also reduces the scope for mobilising savings.

Trust in the currency and financial system. Related to the above points, microfinance (and economic activity more generally) is greatly facilitated where clients have trust in the currency and financial system. Frequently in conflict situations, the currency changes and the banking system collapses. This may make clients wary of financial institutions and services in general, including microfinance programs. Even with sound management of the currency and the financial system, it takes time to reestablish trust.

Relatively high population density. Population density is always a significant issue for microfinance programs because it affects the scope both for programs to achieve sustainability and for clients to establish viable microenterprises. In post-conflict situations, a reasonably high population density may also lessen security risks.

Skilled, educated workforce. While the lack of qualified people to staff microfinance programs is sometimes an issue in normal development contexts, it is generally even

[7] The 18 month period is arbitrary. Nagarajan (1999b) suggests that microfinance can be successfully implemented if refugees are allowed to stay in camps for a minimum of six months, are provided with reasonable security and are permitted to engage in income generating activities.

more of a constraint in post-conflict situations. Finding hard-working and committed field staff is generally not a major problem, but there is often a scarcity of middle and top level managers.

Social capital. Social capital (ie social mechanisms that facilitate trust between people) is often seriously eroded in post-conflict situations. This has serious implications for microfinance programs in terms of demand, lending methods (eg the use of groups), training needs and operational efficiency.

4 Approaches to Microfinance

Models of microfinance

Since the late 1970s, there has been an emphasis on establishing financial systems able to reach poor and low income households on a more sustainable basis. A range of different models has developed, and it is clear that no one model is suitable for all situations. Nevertheless, the successful models have a number of key principles underlying them (Rhyne and Otero 1994):

- Successful MFIs know their market. Lending outlets are located near the client, application procedures are simple, and loans are disbursed quickly.
- They use special techniques to slash administrative costs. Simple procedures are used and approvals are decentralised. Borrower groups often handle much of the loan-processing burden.
- They use special techniques to ensure high repayment rates. These include the use of self-selected groups in which members guarantee each other's loans, intensive motivation and supervision of borrowers, incentives for borrowers, progressive lending and compulsory savings requirements.
- They are able to cover both their operational and financial costs by charging market-related interest rates. The poor are willing to pay for access and convenience.

This section provides a very brief introduction to a number of leading models. In broad terms these models would appear appropriate to the conditions in East Timor. However, they may need to be adapted to take account of the specific environment in East Timor. For instance, the relatively low population density compared to most countries in Asia, the lack of infrastructure and reliance on subsistence agriculture may well have implications for the design and location of programs. They would also need to be adapted to take account of the nature of the post-conflict economy.

In many cases institutions proposing to establish microfinance programs in East Timor will employ models that they have used successfully in other settings, which may or may not be based on one of the models described below. Practitioners should be encouraged to establish a variety of models to develop a greater understanding of what works in East Timor.[8]

Grameen bank model. The Grameen bank model, developed in Bangladesh, has been adopted in numerous countries with a variety of physical, cultural and institutional

[8] There are a number of guides to assist practitioners to establish microfinance programs, including UNDP (1997), and CGAP (1998a) and (1998b).

settings, and is by far the best known microfinance model. There is careful targeting of the poor through a means test, generally with a strong emphasis on poor women, and intensive promotion of the program by field staff. Borrowers organise themselves into groups, generally consisting of five members, who guarantee each others' loans. Program staff are also involved in intensive motivation and supervision of borrowers, including through weekly meetings. The model emphasises compulsory savings mobilisation, but there is generally little or no emphasis on voluntary savings. Sustainability is achieved through scale and by decentralised and cost-effective operations. Unlike the other models discussed below, individual borrower groups are not expected to become autonomous institutions. The highly structured operations generally make it easier to ensure high performance standards. On the other hand these same factors increase costs, and the model is likely to be most effective in areas with reasonably high population densities.[9]

Village bank model. The village bank model has also been widely replicated, mainly in Latin America and Africa, although the total outreach is only a fraction of that of the Grameen bank model. In the basic model, the implementing agency organises individual village banks with 30-50 members, and provides a loan for on-lending to individual members (the external account). These individual loans are repayable weekly over 16 weeks, at the end of which the village bank repays the entire loan plus interest to the implementing agency. If the bank repays in full it is eligible for a second loan, with the size of the second loan dependent on the amount that members have accumulated in savings. This process continues through subsequent cycles. Hence there is peer pressure to ensure full repayment so that the bank can receive subsequent loans. At the same time, the bank can lend members' savings (the internal account). At the end of three years, the bank should have accumulated enough savings to enable 'graduation', with the internal account sufficient to meet members' credit needs. This model is less structured than the Grameen bank model and aims to develop autonomous institutions, but is more structured than the other models discussed below.[10]

Credit union model. Credit unions are democratic, non-profit financial cooperatives owned and governed by their members. They mobilise savings and provide loans for both productive and provident purposes. Membership is generally based on a common bond (eg employment, geographic location, etc). In many developing countries there are credit unions operating in the rural areas, and membership may include poor and low income households. There is generally also an apex body that promotes primary credit unions, provides training and monitors financial performance. Rural credit unions have been successful in some developing countries such as Sri Lanka, but have been less successful in most other developing countries in the Asia-Pacific region.

Self-help group model. The self-help group (SHG) model is most prominent in India. It has some similarities with the village bank model, but is less structured. SHGs have around 20 members. They are based primarily on the principle of lending their members' savings, but also seek external funding to augment these resources. The SHGs themselves determine the terms and conditions of loans to members. A number of non government organisations (NGOs) specialise in promoting and motivating

[9] For detailed manuals on the establishment and operation of Grameen Bank replications, see Grameen Trust (1994), (1995a), (1995b), (1995c) and (1995d).
[10] For a detailed guide to village banking, see Hatch (1989).

SHGs, but the goal is for SHGs to become autonomous institutions. Some NGOs operate as financial intermediaries, while others confine themselves to social intermediation, seeking to link SHGs to regulated banks or other funding agencies. The SHG model is well suited to combining microfinance with other interventions in areas such as health and education, but the relatively loose structure makes it harder to increase outreach quickly and to maintain high standards of performance.

Rural financial systems model. A very different approach to those discussed above is the rural financial systems approach practised in Indonesia. In this model, there is a range of regulated financial institutions that provide financial services in the rural areas. By far the largest is Bank Rakyat Indonesia (BRI), which has established a network of *unit desa* (village units) to provide financial services in the rural areas. The *unit desa* provide basic deposit and loan facilities on a commercial basis through the use of highly decentralised and cost-effective operations. They are particularly successful in mobilising savings. In addition to BRI, there is a large network of rural banks (BPRs) and other small financial institutions operating at the local level. While BRI and these small banks do not target the poor explicitly, their clients include many poor and near-poor households, the equivalents of which in most other countries would not have access to the formal financial system.

Adjustments to strategies and operations in post-conflict settings

In general, microfinance programs in post-conflict situations employ similar strategies as in normal developing settings. However, they need to be willing to be highly flexible. Some of the main differences are discussed below.[11]

Modifications reflecting low levels of security. Safety and security often necessitate the most drastic departures from typical microfinance operations. Some programs have suffered human and material loss operating in insecure areas. For instance in 1996 two employees of a program in Cambodia were killed. Precautions to increase security in post-conflict areas may result in significant cost increases, and have included the following:

- Using sturdier, more reliable vehicles when disbursing loans.
- Reducing frequency of disbursements and repayments.
- Spreading equipment and cash throughout agency offices.
- Equipping staff with radios.
- Developing contingency plans for leaving operations to local staff in the event of an expatriate evacuation.
- Providing loans in-kind or through transfers.
- Restricting hours when staff can visit borrowers or promote the program.
- Requiring staff to travel in pairs or groups.
- Visiting borrowers on random days.
- Opening satellite offices to reduce travel time.
- Recruiting more male staff than would otherwise be the case.
- Maintaining a low profile and not advertising the presence of branch offices.
- Keeping expatriate visits to clients’ homes and businesses to a minimum.
- Keeping monitoring low key.

[11] This discussion is adapted from Doyle (1998).

Modifications reflecting the lack of financial systems. Programs often devote considerable resources to protecting the value of loan funds and savings when the banking system is not functional and/or hyperinflation is present, as is frequently the case during post-conflict reconstruction. Approaches include:

- Keeping cash in safes and/or recycling it immediately back into the program.
- Expressing financial transactions in a foreign currency, although this may impose a significant currency risk on borrowers in the event of depreciation.
- Providing savings products that protect clients from hyperinflation by compensating them for depreciation of the currency.

Clearly, in the event of hyperinflation considerable care needs to be used in designing products to ensure an appropriate sharing of risks between savers and borrowers, and between the program and clients. It is likely that programs will be in a position to bear a greater share of these risks than clients.

A particular challenge may arise in East Timor if programs commence operations before the question of the currency to be used in East Timor is settled. While economy-wide measures would have to be adopted to ensure a smooth transition to a new currency, it would also be necessary for microfinance programs to ensure both that their own balance sheets and the position of their clients were protected.

Modifications reflecting low levels of trust. Many programs have modified program strategies because low levels of trust make it difficult to attain group solidarity. This may well be the case in East Timor after the period of intense violence. Modifications may include the following:

- Some programs reduce the size of borrower groups. In Cambodia, for instance, a village banking model was transformed into a hybrid village bank / solidarity group model. Nagarajan (1999b) has suggested that small solidarity groups may be more effective than larger groups in post-conflict situations, at least until the later stages of transition.
- Some programs target rural areas where trust levels are generally higher than in urban areas.
- Other programs offer individual lending and ask for soft collateral or one or two personal guarantees, instead of asking clients to form groups.

At the same time, group-based activities such as microfinance can play a role in rebuilding trust and social capital after a crisis, as examples in Rwanda and Bosnia have shown.

Incorporating emergency relief measures. One possible difference from normal development contexts is that a number of programs have incorporated emergency relief measures in response to intermittent disasters. For instance, in the 1997 coup in Cambodia, one program sold food to clients at reduced prices. Clients had the option of either eating or reselling the food. Another program in Liberia donated rice to 250 of its clients after the May 1996 violence.

Evidence on the effect of such measures is mixed. Doyle (1998) reports that practitioners have found that such measures create goodwill and increase client loyalty. Moreover, it appeared to her that as long as programs made a clear distinction between the emergency relief and the financial services, the emergency relief element did not jeopardise the commercial focus of the financial services. On the other hand, Nagarajan (1999b) found evidence from Uganda, Ethiopia, El Salvador and Nicaragua that donor grants and concessional credits provided at the emergency stage were not repaid and tended to create an entitlement mentality.

Different mixes of products. Programs may also offer a different mix of products to what they would in a normal development context, reflecting the nature of the post-conflict economy. For instance:

- Programs may consider offering agricultural loans, with longer maturities and less frequent repayments than normal microfinance loans, to meet the huge demand for financing agricultural rehabilitation. Nevertheless, caution is required in this area, as agricultural loans have very different characteristics to 'traditional' microfinance loans.
- Interest rates may start out low during the early stages of reconstruction, and be adjusted upward quickly as the economy picks up.
- Programs may defer focusing on savings mobilisation, reflecting exposure to violence and crime, the absence of a legislative framework and the lack of a banking system. At the same time, from the perspective of clients exposure to crime may increase the demand for secure savings facilities.

Increased training. Programs tend to offer more training in post-conflict environments than they might in other contexts. This often includes training in establishing a microenterprise. Many clients may previously have been in the subsistence sector or in wage employment, and have no experience of self-employment (the former is more likely to be the case in East Timor, reflecting the low level of development prior to the conflict). Training may also be provided in physical and mental health education, human rights awareness, reconciliation and conflict resolution. On the other hand, Nagarajan (1999b) argues that training may increase costs with no consequential improvement in the effectiveness of financial services, and suggests that training should be provided separately from financial services.

5 Demand and Outreach

Demand is discussed here in terms of effective demand for financial services, credit and savings, among the population of post-conflict East Timor. Outreach is a term used in technical discussions of microfinance and relates to the coverage or quantum of microfinancial services supplied. In broad terms, therefore, this section is concerned with issues of the demand for and supply of microfinance in East Timor in the post-conflict situation.

Compared with the more normal 'development' situation, several distinctive factors influence demand for microfinance services in a post-conflict scenario. There is often increased mobility of people, with possibly a large percentage of the population either displaced or moving voluntarily. Doyle (p.13) notes the further difference that

> *[m]ore people in the post-conflict society are poor – a man-made disaster, such as a major conflict, makes the poor even poorer and drops most of the middle class down.*

Initially, immediately after the conflict, demand for microfinance services is likely to be low. Practitioners have observed that potential clients tend to suffer from a 'postwar syndrome' typified by lack of both confidence and motivation. Not surprisingly, the sheer effort expended in surviving results in feelings of passivity and inertia. Trust in others is usually very low and personal security is a problem for many survivors (Doyle, p.23).

However the informal sector is the first to revive after the destruction of war as, in the absence of formal sector alternatives, people turn perforce to self-employment. This implies a need for financing of informal activity from the early stages of recovery, while traditional sources of such finance (family, friends, moneylenders) may still be closed. Further, if incomes start to recover first in the informal sector, then secure, accessible, low-cost and liquid forms of deposit –taking will be needed by informal sector entrepreneurs.

The demand for microcredit in post-conflict situations

Doyle (p.23) notes the difficulty of distinguishing between the demand for cash and the demand for credit in post-conflict situations. The former is a demand for liquidity to finance transactions and is a necessary element in restoring and/or remonetising economic activity. The latter is a demand for capital, including working capital, to finance investment for the expansion of economic activity. With regard to the demand for credit, anecdotal evidence gathered by Doyle from Rwanda and Liberia suggests that where microcredit programs had been in place prior to the crisis, 'clients value access to microfinance services over a handout, even immediately after [the] crisis.' Whether a similar observation would hold true in areas where microfinance programs had not previously existed remains untested.

Practitioners working in a post-conflict environment have found it necessary to diverge from their traditional market assessment processes by taking a more proactive approach to identifying borrowers and nurturing their activities. Apparently the underlying level of demand is not revealed until a few practitioners and borrowers are able to demonstrate tangible results to their communities. In these circumstances microfinance can play an important catalytic role, in that 'the disbursement of a few loans in communities can jolt other residents out of an emergency mentality and stimulate them to assist in reconstruction (Doyle, p.23). As the 'postwar syndrome' fades, the demand for credit increases dramatically. During the reconstruction phase, there is a very strong demand for credit to rebuild productive assets that have been destroyed. Moreover, there may still be a lack of formal employment options and the informal sector may expand considerably. At this stage practitioners regard the problem not as one of marketing but rather one of funding the required loan capital.

The demand for savings services in post-conflict situations

Doyle, in reviewing experience in a number of post-conflict situations (p.24), did not find a consensus on the demand for savings services. Some practitioners observed that people in areas of conflict were more inclined to save than to invest. Others were 'so preoccupied with the seemingly more urgent demands for credit, that they were not prepared to experiment with different savings products.*'* In some cases, however, it was not possible to judge how people might have preferred to act, because of regulatory impediments which prohibited experimentation by MFIs. Restrictions on deposit-taking by nonbank microfinance service providers, combined with the lack of a formal banking sector for which MFIs might have acted in an agency role, has inhibited programs from accepting deposits.

In cases where savings have been incorporated into programs, it is usually because deposit-taking is compulsory; hence the real level of demand may be difficult to judge. Even where high levels of demand for savings services can be identified, the costs and complexity of administering the services can be prohibitive. In the absence of formal banking facilities and reasonable levels of security, MFIs face problems in ensuring the safety of cash deposits and the staff who collect and carry them. There is also much concern over how to ensure the value of client savings is not diminished by inflation; donor guarantees expressed in hard currency could be useful here until monetary stability is reestablished.

The general level of economic activity and the degree of its monetisation also affect the demand for savings services. In the early post-conflict situation, MFIs may find that their ability to mobilise cash deposits is limited. Constraints on their ability to mobilise savings have significant implications for practitioners. In a normal development context, most programs require some element of compulsory saving before clients can access credit services. In post-conflict situations, program practices may have to be adapted, at least initially, to ensure that individuals are not excluded from the service because of their inability to meet this requirement.

The demand for nonfinancial services in post-conflict situations

In this context ‘non-financial’ services are services ancillary to or supportive of the financial services provided by an MFI. Very few practitioners have assessed the demand for nonfinancial services (such as training in management, marketing, accounting, etc) prior to launching programs in a post-conflict environment. However, once programs are established, practitioners find themselves increasingly having to offer these services in response to client demand. Doyle (p.25) presumes that

> *…nonfinancial services are in demand because many individuals take up self-employment out of necessity, having never worked outside of the formal employment sector. As they attempt to grow their enterprises, their need for nonfinancial services increases.*

Once again, practitioners will need to tailor their normal programs to the requirement of a post-conflict clientele.

Potential target groups

In a normal development context, programs are often very specific in targeting their services to meet the needs of a particular group (the ‘poorest of the poor’, women, etc). However in post-conflict situations, best practice principles appear to suggest avoidance of such client targeting. Practitioners appear to accept that services should be open to a mixed group and should appeal to a broad range of individuals, rather than to any one subgroup (such as landmine survivors, rape victims or war widows). This avoids creating tensions or ill will towards program clients.[12]

[12] Doyle (p.13) discusses recent policy changes by UNHCR and a donor in Liberia who, she says, are realising the logic of targeting communities as a whole when trying to facilitate return to conflicted areas.

The avoidance of client targeting also helps to sharpen institutional focus. Rather than tailoring programs to particular client needs, MFIs tend to adopt more of a financial services perspective (Doyle, p.14). Given the additional costs of operating in a post-conflict situation, this streamlined focus accompanied by broadened outreach is especially important.

Doyle (p.15) identifies five different populations created by conflict situations which can be viewed as potential clients. These five specific populations are Inhabitants, Returnees, Internally Displaced Persons (IDPs), Refugees and Demobilised Soldiers. Table 1, adapted from Doyle, to address the East Timor context, lists these populations, their characteristics, and the services that each might typically demand, as well as particular program design issues arising in each case. The following is a discussion of these five groups. Definitions and general characteristics are drawn from Doyle's paper. In each case, however, we have attempted to characterise the population as it might occur in the current post-conflict situation in East Timor.

Inhabitants

Inhabitants are those individuals who may have remained in place in their home communities during most, if not all, of the conflict. They are potentially easier to serve because of the likelihood that they may have some assets and have an incentive to stay and earn a living. They are the group that is most likely to be closest in character and circumstances to clients in normal settings. They often act as a stabilising influence in programs, particularly where communities are receiving large numbers of returnees and demobilised soldiers.

While program designers may be inclined to limit their services to groups which they perceive as having a more urgent need, Doyle (p.15) advises that inhabitants should be included in microfinance programs. Inhabitants are more likely to understand the need to come up with viable business ideas, and to appreciate from the outset the need to repay loans. They also have 'the most solid stake in the community's success and can represent a strong, positive force for easing reintegration, community rebuilding, and reconciliation.' Because of the relative stability of these households, Doyle notes that most MFIs working in post-conflict situations will set up programs in communities where inhabitants are in the majority.

In the East Timor context, although it is difficult to tell as yet, inhabitants are likely to comprise the largest number of potential clients for microfinance programs. Many will have claims to land through customary title. However, as a result of the scale of the destruction, ownership of productive assets is likely to be affected to varying degrees in the subregions of the Territory. When combined with a lack of formal employment opportunities and an eagerness to seize the economic opportunities that will arise as conflict subsides and aid inflows commence, this should ensure a growing demand for microfinance services

Returnees

Returnees are defined as former refugees or internally displaced persons (IDPs) who may be returning to their original homes or to a new area within their home country.

TABLE 1

EAST TIMOR: POTENTIAL CLIENT GROUPS FOR MICROFINANCE AND MICROENTERPRISE DEVELOPMENT SERVICES (after Doyle, 1998)

Potential Client Groups	Characteristics	Possible Services that Potential Client Groups might Demand	General Risk Assessment
Inhabitants	▪ Have remained in place during most, if not all, of the conflict. Most stable group. ▪ Likely to have title to land, housing and/or productive assets (where they still exist). ▪ Likely to be the most supportive of efforts to regenerate independent livelihoods. ▪ Could include both pro-Independence and pro-autonomy supporters. ▪ May have previous experience of self-employment and business enterprise. ▪ May not have much cash.	▪ Initial grants to "kickstart" enterprise. ▪ Short-term microcredit initially, with the prospect of larger, longer-term loans as the situation stabilises. ▪ Voluntary deposit and savings services. ▪ Where compulsory savings are a normal part of the lending model, modifications may be required. ▪ Loans for repair of housing and productive assets. ▪ Agricultural credit. ▪ Some individual lending. ▪ Business development training and assistance.	▪ Likely to be the most stable, least risky client group. ▪ Group lending may be possible but models may need to be adapted in view of underlying political tensions. ▪ In the absence of political tensions, owing to the small population numbers in rural settlements and the small size of urban centres, social cohesion may be good.
Returnees	▪ Individuals (either former refugees or IDPs) who have left their homes as a result of the conflict and are now returning. ▪ May have title to land or housing and/or productive assets (where they still exist). ▪ Depending on length of stay away from their homes, may have characteristics similar to those of inhabitants. ▪ Could include both pro-Independence and pro-autonomy supporters. ▪ May include relatively wealthy individuals who left during the period from 1975-1998 and have returned from Portugal, Australia, Indonesia. May carry savings or continue to receive overseas remittances.	▪ Initial grants to "kickstart" enterprise. ▪ Short-term microcredit initially, with the prospect of larger, longer-term loans as the situation stabilises. ▪ Voluntary deposit and savings services (to protect remittances or savings gained while overseas). ▪ Loans for repair or construction of houses. ▪ Loans for repair of productive assets (where they still exist). ▪ Legal services to assist with claims for land and/or housing ownership. ▪ Business development training and assistance. ▪ Returnees may demand individual loans if remittances or recouped assets are available to serve as collateral.	▪ A relatively low risk group depending on ease of re-integration. ▪ The length of enforced separation from their homes may give individuals within this group either the characteristics of inhabitants (if separation is relatively short) or those of refugees (in the case of longer-term separations). ▪ Group lending may be possible, but models may need to be adapted depending on the degree of successful re-integration.

IDPs	▪ Individuals who have remained within East Timor but have been displaced from their homes (such as those who have fled to the hills). ▪ May not have access to land or productive assets (where they still exist). May still have title or customary claims. ▪ May be able to earn income during their displacement. ▪ Could include both pro-Independence and pro-autonomy supporters.	▪ Depending on the length of their displacement, services demanded by IDPs may be very similar to those listed above for returnees. ▪ May need grants, not credit, initially, followed by short-term microcredit for working capital. ▪ Delivery by mobile programs that can move with IDPs, when and if they return to their homes. ▪ Microcredit, for subsistence agriculture production and market, adapted to the agricultural cycle.	▪ The level of risk to MFIs depends on the probability of IDPs returning to their original homes or of their integrating into the economic life of the area into which they have been displaced. ▪ MFIs risk the collapse of their programs depending on the level of mobility. MFIs may need to design programs that will move with IDPs if they relocate. ▪ Lending models may need to be adapted in the absence of assets or other collateral, and depending on the degree of social cohesion within the group.
Refugees	▪ East Timorese who are outside East Timor, for example, in West Timor, other parts of Indonesia, and Australia ▪ Often living in camps with a high degree of instability and uncertainty. ▪ Often are prohibited from participating in economic activity in their locale and cannot earn an income. ▪ Could include both pro-Independence and pro-autonomy supporters	▪ Grants, not credit, initially. ▪ Possibly, short-term microcredit for working capital for microenterprise activities within living areas or if allowed to participate in economic activity in present locale. ▪ Microcredit for subsistence agriculture production, possibly also for market, adapted to agricultural cycle and local circumstances.	▪ MFIs risk the collapse of their programs depending on the stability of population and predictability of movement. MFIs may need to design programs that will move with IDPs if/when they relocate. ▪ Opportunities for legal microenterprise activities may be limited where participants do not have scope to engage in economic activity. ▪ Group lending models are likely to be most applicable in the absence of any other collateral.
Demobilised Soldiers	▪ Former Falintil fighters, ex-militia. ▪ Possibly very few, if any, business/entrepreneurial skills. ▪ May have an ‘entitlement mentality’.	▪ Individual loans. ▪ Business development assistance and training. ▪ Counselling and reintegration assistance.	▪ The most difficult and most risky group to serve with microfinance. Limited (or complete absence of) prior civilian employment or entrepreneurial experience poses a high risk for microfinance. ▪ Programs will need to factor in higher operating costs for counselling, training and business guidance services. ▪ MFIs may need to assess the wider ramifications of serving groups with particular political associations.

The length of the enforced separation from their homes will determine into which of Doyle's special population groups East Timorese returnees may fit. A shorter separation from their homes may result in the return of groups with essentially the same characteristics as inhabitants. Longer separations may lead to groups displaying characteristics closer to those of refugees.

Depending on the continuing situation and makeup of the camps on the border in West Timor, returnees to East Timor may comprise former inhabitants, supporters of Independence, who had been forced to leave their homes temporarily. Other returnees may include former inhabitants who were pro-autonomy and who fled during the conflict or left following the withdrawal of Indonesian troops although it is perhaps too early to say how important this political distinction will be in practice. Others may be people who left East Timor between 1975 and 1999.

Not all these returnees will have the same needs. As Doyle (p.16) says, 'program implementers will need to have a keen understanding of the political implications of lending to the various groups, while retaining an apolitical outlook and image'. Returnees from outside East Timor may have a particular need for savings services as a result of benefiting from remittances from other overseas family members or because they returned with savings.

Internally displaced persons and refugees

Internally displaced persons (IDPs) are those who fled their homes but remained within their country of origin. In the context of East Timor, the IDP group might feasibly include inhabitants who are unable or unwilling to return to their homes because of destruction and loss of assets. At present, UN estimates suggest that over 200,000 people are missing, believed hiding in uninhabited hill areas waiting for security to be restored. It is unclear how long these people will remain displaced. Some may be pro-autonomy (or pro-independence) supporters who are restricted from returning to their homes because of community tensions. Once again, this group may not necessarily be distinguishable from the wider group of IDPs.

The level of credit risk in serving IDPs depends very much on a case-by-case assessment of their own expectations and those of the host community concerning whether they will either return to their original areas or integrate into the host community. In general, loans to IDPs tend to be short-term to mitigate the risks of service delivery. IDPs who live in collective centres or isolated camps also pose high credit risks for microfinance practitioners.

Microfinance practitioners have observed two main limitations when trying to establish legitimate business enterprises within refugee populations. Microfinance programs can collapse when camps break up or are disrupted. In addition, host country regulations may prohibit refugees from participating in the host economy. Doyle observes (p.19) that, in some African refugee camps, this restriction has inadvertently resulted in microfinance programs supporting illegal economic enterprises, such as the supply of drugs and alcohol.

Given the uncertainty of the current refugee situation in West Timor, it is difficult to assess the potential for microenterprise development and microfinance programs within these refugee populations. At present, it is impossible to predict whether the refugee camps will become permanent or whether large numbers of refugees will be able to return to their homes in East Timor in the relatively short term. (As we write some are already returning). It is also difficult to assess how many within the camps are East Timorese pro-autonomy supporters or militia who, following the independence vote, will fear returning to East Timor and will remain as refugees or attempt to integrate into the West Timor community. In the short-term at least, there is also the question of whether the Indonesian government is likely to be receptive to any microfinance initiatives targeting refugees on its soil.

Demobilised soldiers

Disarming and demobilising military forces is a key task for facilitating regional stability but finding an alternative means of livelihood is a primary concern for this group. According to Doyle (p.20), demobilised soldiers typically need education, mentoring, and counseling rather than simply access to economic opportunity. It is difficult to assess the needs of this group within the context of East Timor. The withdrawal of official Indonesian troops leaves, broadly speaking, two groups of armed combatants – the pro-autonomy militia and the forces of Falintil (although the latter have not been active for some time). At the present time, it is impossible to determine the demand for microenterprise development services from either of these groups.

Should services for relatively large numbers of demobilised combatants ever become necessary, most practitioners would advise against designing programs tailored specifically for this group. In other situations, the political nature and entitlement mentality of excombatants has tended to undermine the core values of microfinance institutions that have sought to serve them. Doyle (p.21) notes, however, that demobilised soldiers who have undergone initial reintegration programs and been held to the same standard as other client groups have responded well to microfinance programs. MFIs aiming to include this group within their programs should consider the cost of providing additional counseling and training inputs as part of their microenterprise development support. Such costs are not usually necessary in the normal development context and can have a significant effect on an MFI's drive to self-sufficiency.

Apart from the potential target groups already discussed, two other factors need to be considered when assessing the potential demand for microfinance and microenterprise development services. Practitioners need to consider whether the program should be located in a rural or an urban area and must appreciate the difference in serving male or female clients.

Urban or rural?

Rural areas may present problems of access because of unrepaired infrastructure. In sparsely populated rural areas, programs may find it harder to achieve breadth of outreach. The safety of rural-based staff is also an issue as staff tend to have to travel through isolated areas with cash. On the other hand, rural programs generally experience fewer problems in client turnover and practitioners have found it easier to create client ownership, which aids in sustainability.

Urban areas, with their greater population density, will generally be the first to see a return of banking infrastructure. Higher population density and easier access should result in lower transaction costs and more rapid attainment of self-sufficiency. Security may, however, be a problem in the face of crime. Furthermore, in urban areas the absence of a coherent social fabric may require program adjustments.

In the East Timor context, the rural/urban dichotomy may be quite blurred given that prior to the conflict, only 9.5 per cent of the population lived in urban areas. It is also likely that urban areas may display some rural characteristics. For example, residents may have access to food gardens and other sources of 'urban subsistence' income. The absence of a coherent social fabric may also not be such an issue for program design, given that the urban areas are very small and may be composed largely of 'inhabitants'.

Male or female?

In a post-conflict environment, there is demand for microfinance services from both *women* and *men*. Nevertheless, to quote Doyle (p.22) '…most programs designed for economic development purposes serve women. This is because agencies operating in normal, as well as post-conflict, contexts employ women-focused methodologies'. Practitioners cite a number of other reasons for directing services towards women. Many programs are motivated to serve what they see as the most vulnerable group post-conflict: the often high number of new heads of households who are women (such as in Rwanda and Cambodia). These households are seen to be far less resistant to disaster than male-headed households. Practitioners also perceive women to represent a safer, much less political client group. They believe that, as in the normal development context, women use loans for family improvements to a greater extent and repay at a higher rate. Finally, programs have targeted women in order to promote their potential as peacemakers in societies destroyed by conflict.

6 Sustainability

Self-sufficiency: why is it important?

An organisation is self-sufficient[13] when it can sustain its own operations using its own internal resources. When the concept is applied to an MFI, its levels of self-sufficiency are assessed in terms of how reliant is the continuation of its programs on donor or other soft funding.

The attainment of self-sufficiency is important if MFIs are to be sustainable beyond the eventual and inevitable withdrawal of donor funds. It is equally important if MFIs expect to expand their client outreach significantly. Donor funding is a limited resource, both in quantum and duration. If MFIs wish to serve more than a small proportion of potential microfinance clients, they will need to access alternative sources of funds to finance both their day-to-day operations and their lending portfolios. The greater their level of self-sufficiency, the more they can leverage donor grants by accessing funds from more commercial sources, such as commercial

[13] The terms sustainability and self-sufficiency are often used interchangeably.

and concessional loans, client savings and funding from institutional investors, thereby increasing their outreach.

Some might argue against an emphasis on self-sufficiency on the grounds that it is not the purpose of microfinance programs to make profits but rather to support poverty reduction. While Gibbons and Meehan[14] agree that the purpose of MFIs is 'not profit as an end in itself,' they argue that only by achieving self-sufficiency and accessing commercial funds can MFIs sustain and expand their efforts in poverty reduction. In their view, the attainment of self-sufficiency 'should be pursued at a rate that is consistent with substantial poverty reduction.' In a post-conflict situation, expansion of outreach by MFIs is necessary to support any significant generation of informal sector income.

Two measures of self-sufficiency are generally calculated.[15] MFIs that are able to cover all of their administrative costs and loan losses from operating income are judged to have reached 'operational self-sufficiency.'[16] The second measure, 'financial self-sufficiency,'[17] requires MFIs to cover not only administrative costs and loan losses from their operating income, but also financing costs after adjusting for inflation and subsidies. In this instance, all funding is treated as if it had a commercial cost.

Based on international experience, successful MFIs should be able to reach operational self-sufficiency within three to seven years under normal circumstances. Financial self-sufficiency might be expected within five to ten years, again under normal circumstances. Timetables for the achievement of operational and financial self-sufficiency are, however, extremely speculative. In some cases, MFIs have achieved one or both of the self-sufficiency levels within much shorter time periods. In other cases, depending on specific operating circumstances, the expected time frame has been extended considerably.

Achieving both operational and financial self-sufficiency is not an easy task. However, an increasing number of MFIs working in many different operating environments, delivering services to widely different client bases and using a variety of lending models, have shown that operational and financial self-sufficiency can be achieved. Similarly, as discussed previously, some regulated financial institutions have proved successful in providing microfinance services on a commercial basis. Cost-effective targeting, well-managed service programs, efficiency and innovation at the program level, and the application of cost-recovery interest rates are crucial.

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[14] Gibbons, David S. and Jennifer W. Meehan, 1999

[15] See CGAP's Technical Tool Series No. 4, Format for Appraisal of Microfinance Institutions, July 1999. The MicroBanking Bulletin, a semi-annual publication from CALMEADOW (via the CGAP-funded MicroBanking Standards Project), gives both operational and financial self-sufficiency measures for (currently) 86 leading MFIs.

[16] Operational self-sufficiency is calculated by dividing Operating Income by Operating Expenses (i.e. administrative costs and loan losses). If the resulting figure is greater than 100 per cent, operational self-sufficiency has been achieved.

[17] Financial self-sufficiency is calculated by dividing Adjusted Operating Income by the sum of Adjusted Operating Expenses (i.e. administrative costs, loan losses) and financial costs. Both income and expenses are adjusted for inflation and subsidies and treating all funding as if it had a commercial cost. If the resulting figure is greater than 100 per cent, financial self-sufficiency has been attained.

The notion of setting interest rates at a level to cover operating and financial costs is controversial in some circles. Yet it is at the very heart of the self-sufficiency argument. If programs do not charge interest rates to cover their costs, how can they sustain their operations upon the withdrawal of donor funding?

Alongside interest rates, cost-efficient program operation is the other component of the self-sufficiency equation. In situations where there is little or no competition between MFIs, as is likely to be the case at least initially in East Timor, MFIs must not allow cost-recovery interest rates to disguise an unacceptably high cost structure, characterised by inefficient service delivery and program operations, and poor portfolio management.

Self-sufficiency: can it be achieved in post-conflict situations?

The question of whether operational and/or financial self-sufficiency can be achieved in post-conflict situations is largely untested.[18] Yet Doyle (p.46) notes of the country cases she reviews that ‘implementers are resolute in their intention to maintain normal standards of program pricing, scale, and operational efficiency to the maximum extent possible’.

Most programs in post-conflict zones take a long-term view of financial viability. They give greater weight to the potential for impact than to the increased difficulties and costs of providing the services. MFIs working in post-conflict circumstances have been forced to adjust their operating procedures in accordance with the operating environment. Some have had to modify or adapt their lending models. There are also likely to be abnormal operating costs such as providing additional security for staff. Hence the timelines for reaching operational and financial self-sufficiency must, by necessity, be much longer in a post-conflict environment. This is not to say that programs should choose to abandon best practice in program establishment and service delivery. Rather, flexibility and a longer time horizon are key.

It should also be noted that the timeframe for achieving self-sufficiency may depend on a range of factors beyond programs’ control. Unlike the normal development context, it is likely that programs will not enjoy a steady advancement to self-sufficiency. For instance, a renewal of conflict may threaten, or even close, a program’s operations. It may sometimes also be necessary to make self-sufficiency goals secondary to ensure that the safety of customers and staff is not compromised.

Institutional sustainability

Perhaps the greatest challenge to sustainability of programs in a post-conflict situation is that of developing local institutional capacity. The need to build institutional capacity has implications for both practitioners and donors. Institutional sustainability requires establishing an MFI that is locally based and staffed by people who understand both the local microenterprise environment and the economic and financial requirements for running a microfinance program.

[18] See Doyle (1998, pp. 48-49. Table 3) for a review of operational self-sufficiency trends among 14 microfinance programs operating in post-conflict situations.

One of the characteristics of a conflict environment is the loss of skilled middle managers and leaders. Thus, organisational management and systems may either need to be re-established or built from scratch. These problems may be particularly acute in East Timor, where there was a severe lack of skilled professionals prior to the current crisis. This shortage will be exacerbated by the departure of skilled Indonesians.

Even where local NGOs exist, it may not be prudent for international MFIs to consider partnering with them. Often local organisations will be overwhelmed by competing requests for relief and development assistance; this ‘splintering’ of goals does not bode well for institutional focus and sustainable microfinance delivery.

It may be necessary for donor agencies to establish local MFIs from scratch rather than relying on pre-existing local NGOs. This is an extremely difficult process. It is necessary to build local commitment to and ownership of the organisation if it is to be sustainable when the donor agency leaves. There are a number of examples of this approach in Pacific island countries, including Papua New Guinea and Vanuatu. It would be appropriate for donor agencies considering this approach in East Timor to consider the lessons from these examples.

Donors may also consider a number of other cost-effective ways to increase institutional capacity in East Timor. The use of UN volunteers from MFIs in other Southeast Asian countries such as the Philippines has been successful in a number of Pacific island countries. In addition, the establishment of a small technical assistance unit to coordinate short-term technical assistance and training programs for MFI staff may be beneficial. Donors may also find it useful to consider the approaches adopted by the UNDP Microstart program for the Pacific island countries. Some of these approaches may be appropriate in the East Timor context.

Even more so than in the normal development context, donors may find that support for capacity building is an appropriate use of their funds both immediately post-conflict and at other stages in the life of an MFI. Donors may also find that their involvement is required for a longer time than in countries where reasonable local capacity existed pre- and post-conflict (Nagarajan, p.17).

As conflict subsides and relief assistance becomes less urgent, some relief organisations may be tempted to transform themselves into microfinance service providers. A number of problems arise in this scenario which will impact upon the capacity of such ‘transforming’ organisations to achieve sustainability in the new role of MFI.

The ‘new’ organisation may face difficulty in terms of client perceptions. Clients who have been receiving relief grants and non-tied aid from an organisation may not differentiate the purpose of, or see the need to repay, monetary loans from that same organisation. Practitioners have also found it extremely difficult to ‘reprogram’ relief staff to a microfinance mentality. Instead they should attempt to hire totally new staff as far as necessary. Finally, donors and clients in relief situations have needs vastly different from those in a microfinance environment; the required change in organisational focus is usually very difficult to achieve.

7 Funding and Role of Donors

The World Bank's Post-Conflict Unit advocates early involvement of donors and development agencies in the reconstruction process. In the Unit's experience, such early involvement improves project analysis and increases the chances for sustainable development. Doyle (p.6) notes that:

> *[p]ractitioners working on both ends of the relief-to-development continuum calculate the real and opportunity costs of delaying development until a country has emerged fully from reconstruction are far too high. Development donors bear these costs when later confronted with widespread and entrenched poverty.*

Potential Official Donors for Microfinance in Post-Conflict East Timor

This section of our report, written from an Australian perspective and with limited information concerning the current planning of interested international and bilateral donors, represents a necessarily partial and incomplete understanding of the situation. However, on the basis of such information as we have been able to gather and given that Australia is likely to be a leading bilateral actor in the reconstruction process, we offer the following observations.

Post-conflict, both emergency relief funds and donors interested in assisting the transition from relief to development are likely sources of financing for program start-ups. A rudimentary check of the literature on this subject reveals the following agencies which have supported microfinance projects in post-conflict situations: The World Bank, IFC, EBRD, UNHCR, UNDP, USAID, ESCAP, UNICEF, European Union, various governments through their bilateral aid programs, other governmental technical assistance programs (e.g. the German government agency, GTZ), and non-profit organisations.

At an informal meeting organised by the World Bank in Washington in late September 1999, a number of bilateral donors pledged their support for reconstruction efforts in East Timor. Countries represented at the meeting included the US, Britain, Canada, New Zealand, South Korea, China, Singapore, Australia and Portugal. Portugal is reported as offering to fund the bulk of East Timor's development needs.[19]

The Asian Development Bank (ADB) has also signaled its intention to contribute to the reconstruction efforts, stressing that its assistance would focus on rehabilitation and development, rather than relief.[20]

Over the last two decades, Australia has contributed more bilateral aid to East Timor than any other donor country.[21] Funds have supported agriculture, water supply, sanitation, education, training and health projects. Prior to the conflict, the Australian Agency for International Development (AusAID) funded a large rural development project in the districts of Bobonaro and Covalima along with other small-scale community development activities undertaken by local NGOs. The Bobonaro project, which commenced in 1998, was specifically aimed at improving rural incomes. The

[19] Michael Casey, 'New Economy Has Meaning in East Timor,' *The Asian Wall Street Journal*, 7/10/99
[20] 'Business urged to rebuild territory,' *The Australian*, 20/10/99
[21] Peter Cole-Adams, 'Price of freedom certain to climb,' *The Sydney Morning Herald*, 20/10/99

Australian government has already paid out approximately $14 million in emergency aid in reaction to the conflict. While the disorder has caused long-term development projects to be suspended, AusAID hopes to re-establish these projects as soon as possible.[22]

Both UNHCR and UNDP have supported microfinance in post-conflict situations. UNHCR has used Quick Impact Projects(QIPs) and UNDP has a program called MicroStart which may also be applicable. QIPs, in particular, are designed to inject immediate support for rehabilitation and development activities but do not provide funds for continuation of projects one they have begun. Clients therefore seek alternative funding sources, very often from MFIs. Thus, QIPs have been used to smooth the transition between short-term humanitarian assistance and longer-term development programs.

Role and plans of international NGOs

Doyle (p.29) notes that NGOs with humanitarian and development missions are usually willing to test microfinance projects in post-conflict situations. These organisations, and their clients, see microenterprise assistance as preferable to continuing dependence on aid assistance.

Coordination between relief organisations and MFIs can be essential in the establishment of successful microfinance programs. Relief agencies that have extensive field experience can provide information and advice to MFIs on where economic activity is occurring and where populations are settling down. As appropriate, there may be opportunities for their clients to progress to becoming beneficiaries of MFI services.

At present, the NGO focus in both East and West Timor is on humanitarian and relief assistance. AusAID has provided $3million to UN agencies, $0.5million to the International Committee of the Red Cross and a combined total of $1million to CARE Australia, World Vision, the Australian Red Cross and Community Aid Abroad/Oxfam for emergency relief activities.[23]

CARE Australia has been working in East Timor since 1994. Prior to the conflict, it was working in all thirteen districts employing 80 local staff in water, sanitation, health education, and agriculture projects.[24] Opportunity International, which had microenterprise support programs in place in both West Timor and Dili prior to the conflict, has temporarily extended its focus and is using its local networks to provide humanitarian assistance. According to its website, Opportunity intends to continue its microenterprise operations in East Timor as soon as the situation stabilises and is actively raising funds in support of this aim.

Although ‘officially banned’ from working in East Timor and Indonesia for many years, Community Aid Abroad/Oxfam Australia (CAA) have remained active by working through local organisations. Currently, CAA is acting as the ‘lead agency’ for Oxfam International’s humanitarian and relief efforts in East Timor. Prior to the

[22] AusAID website at www.ausaid.gov.au
[23] www.ausaid.gov.au
[24] Care Australia’s website at www.careaustralia.com.au

conflict, CAA projects encompassed human rights, women's health, natural resource exploitation, and disaster preparedness training.[25]

A number of international NGOs with strong Australian affiliates have extensive experience with microfinance in post-conflict situations. Catholic Relief Services (CRS), CARE, Plan International, World Vision and World Relief have worked in post-conflict environments in Angola, Bosnia-Herzegovina, Cambodia, Rwanda and Mozambique.

Donor coordination

The United Nations Transitional Administration for East Timor (UNTAET) is expected to be the interim administrative authority for East Timor.[26] This body will take over from UNAMET. Pending ratification, it is expected to be in place by the end of this year or 'early next.'[27] Coordination arrangements, both for the totality of relief and development assistance, and for particular sectoral activities, should follow. An umbrella organisation or working group might be established to coordinate the work of relevant agencies in support of microfinance and microenterprise development. Previous experience shows that collaboration is important and should occur.

Not surprisingly, planning for microfinance in post-conflict situations has been found to be 'significantly enhanced' (Doyle, p.46) when donors, (both relief and development), link and coordinate strategies. Donors should therefore build in time and funds for coordination activities at all program stages. Nagarajan (p.7) notes that:

> *[c]oordination may not confine all the actors in the field to a single mold but it should add value to financial intermediation. It may encourage experimentation with new methods, information exchanges, regular consultations and joint needs assessments so that duplication of efforts can be avoided and returns from the use of scarce resources can be maximised. Coordination can also facilitate establishing some baseline standards to avoid negative externalities.*

8 Policy and Regulatory Environment

The policy and regulatory environment for microfinance can have a significant influence on the development of the microfinance sector.[28] This section provides an overview of some of the policy and regulatory issues that will need to be addressed by a new East Timor administration.

An enabling environment for microfinance

Initially it is likely that microfinance programs in East Timor will be established by international NGOs or with the support of aid donors. Over time, it would be desirable if operations could be transferred to local institutions, such as NGOs or other

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[25] Community Aid Abroad/Oxfam Australia's website at www.caa.org.au
[26] At the time of writing, the UN Security Council has not yet officially voted on its establishment.
[27] Comments by Alexander Downer, Australia's Foreign Minister, as reported in *The Australian*, 20/10/99, 'Canberra ready to head transition.'
[28] For a detailed discussion of the policy and regulatory environment for microfinance, see McGuire, Conroy & Thapa (1998).

community based organisations. It would also be desirable if local financial institutions could enter the market and provide microfinancial services on a purely commercial basis.

Given that most microfinance programs will probably be operated by NGOs, it is important that the policy environment for NGOs be as supportive as possible. In large part, this means that the government should encourage the establishment of an active NGO sector and minimise interference in NGO operations. International experience suggests that the climate for NGOs has an important effect on the development of the microfinance sector. For instance, Carpenter (1997, p.15) notes that:

> *In Bangladesh, the unique circumstances of no regulatory oversight and a large, well-funded NGO community have resulted in the ad hoc evolution of sophisticated and innovative MFIs seeking to alleviate poverty.*

In many other countries, NGOs are subject to unnecessary and burdensome rules and regulations that inhibit their activities. In Indonesia, for example, government officials are often suspicious of NGOs because of their perceived political agendas, and there are relatively few NGOs engaged in microfinance.

It is hoped that the future administration of East Timor will encourage a more constructive relationship between NGOs and government. More generally, it is also important to establish a supportive policy environment for microenterprises, to enable clients to make effective use of finance in pursuing income generating activities. In establishing a framework for private sector development, it is important to pay particular attention to the needs of microentrepreneurs and avoid any unnecessary restrictions on their activities.

NGOs and MFIs should not operate in a totally deregulated environment. It would probably be appropriate to require NGOs engaging in microfinance to be registered, to make it clear that they are permitted to engage in microfinance and to reduce scope for fraud. Over time, it would also be appropriate to clarify the conditions under which MFIs can offer savings facilities. While savings products provide a valuable service to clients, mobilising savings places a very strong responsibility on institutions to ensure that the savings of poor clients are not at risk. This is unlikely to be an issue while programs (and hence client savings) are underwritten by international NGOs and aid donors, but would become an issue if programs were operated by local institutions with fewer resources. As a general rule, institutions that are not subject to supervision should be restricted in the types of savings products that they can offer.

Interest rates

One important element of the policy environment relates to interest rates. Microfinance is an inherently costly activity, requiring intensive inputs in motivating and training clients and in program management. And loan amounts are small, implying low interest income per loan. To be sustainable, microfinance programs must charge higher interest rates than those charged by conventional financial institutions. Moreover, international experience has shown that for the poor, access to credit is more important than the interest rate charged. Hence it is important that the government not impose ceilings on the interest rates that MFIs can charge. At the very least, any ceilings should be set at levels that are consistent with sustainability.

Standards for microfinance programs

It is generally accepted that MFIs should not be subject to prudential regulation and supervision, so long as they do not accept deposits from the general public. Subjecting them to such regulation and supervision could lead to unnecessary restrictions on their activities. In any case, it would further increase the burden on a new East Timor administration.

Over time, it may be appropriate to develop performance and reporting standards for MFIs operating in East Timor, to encourage MFIs to maintain high standards in their operations. Such standards could be given effect through self-regulation, the establishment of a rating agency, or some other mechanism. However, it is premature to start considering such a system. Programs supported by international NGOs and aid donors will no doubt be subject to monitoring and evaluation in any case. It would also not be possible to develop standards until there is sufficient experience of microfinance in the environment of East Timor.

Regulated financial institutions

Experience in other post-conflict situations suggests that microfinance programs are likely to be established well before regulated financial institutions can be rebuilt. Hence microfinance programs are likely to constitute a major component, possibly the major component, of the rural financial system in the short to medium term. As noted by Nagarajan (1999b, paragraph 4):

> *While the creation of financial infrastructure in terms of regulatory capacity and increased transparency could be attempted at a later date, it may be essential to create/build mechanisms that provide financial services such as microfinance soon after the immediate post-conflict stage.*

At the same time, it will clearly be necessary to rebuild the formal financial system on a sound basis as soon as possible. As the system is rebuilt, the East Timor administration will also need to establish an appropriate regulatory framework. Establishing such a framework will involve considerations that go well beyond the realm of microfinance. Nevertheless, where possible, it would be desirable to ensure that the framework does not discourage banks and other regulated financial institutions from engaging in microfinance.

Ideally, minimum capital requirements for the establishment of new banks would be set at a level that is realistic for small banks wishing to operate at the local level. International experience suggests that such banks are much more likely than commercial banks to provide financial services to low income and poor households. On the other hand, the new administration will need to establish a monetary authority to manage monetary policy and regulate the financial system. Provision for the establishment of small banks could increase significantly the already substantial burden on this fledgling institution. Another option, if relations with Indonesia permit, would be to encourage Bank Rakyat Indonesia (BRI) to re-establish its *unit desa* system in East Timor. It would also be appropriate to ensure that interest rates are deregulated, and that there are no other unnecessary restrictions which may inhibit regulated banks from engaging in microfinance.

9 Conclusion

The enormous challenge of relief, reconstruction and development which East Timor now faces will require a substantial and coordinated response. Many pressing needs will have to be met, amid the displacement of population, destruction of physical capital, and economic atrophy which characterise the post-conflict situation. Some of these needs, such as rebuilding infrastructure, creating institutions and investing in human capital, will require long-term programs. Others, commencing directly with relief operations, will be more immediate both in focus and in impact.

The transition from an initial phase of relief operations to a later phase of developmental programs should be made as smoothly as possible, with the foundations for development being laid early. The Foundation for Development Cooperation has prepared this report in the belief that microfinance is an intervention which has the potential to contribute both to the immediate relief of distress and to the longer term development process.

Microfinance can provide liquidity to assist in remonetising subsistence production and in reviving economic activity in the informal sector more generally. It can assist in financing the reconstruction of households and livelihoods. It can help in nurturing the private sector by financing microenterprise, and in reconstructing the financial sector, both from the bottom up. And, by targeting poor and low-income households, it can be one element in a strategy to ensure that inflows of development assistance benefit the whole community.

A number of models or approaches to microfinance appear suitable for trialing in East Timor. Diverse approaches should be encouraged to see what works best. Experience in a number of other post-crisis situations suggests that where essential preconditions are established (absence of ongoing conflict, reopening of marketplaces, sufficient stability of displaced and refugee populations) microfinance can be commenced. Creating sustainable MFIs requires other conditions which may be satisfied with time and recovery, as well as flexibility and inventiveness on the part of implementing agencies.

In the beginning, the establishment of microfinance programs in East Timor will have to be driven by donor agencies, especially those with experience of this intervention in post-crisis situations. It is important that donors employ best practice principles, with sustainability as their goal, and that they participate in a coordinated approach to this subsector, as with others. Policy dialogue, conducted to ensure that the creation of new legislative and regulatory frameworks does not throw up unintended barriers to microfinance, will be an important outcome of such coordination, as will the avoidance of duplication and the exchange of experience.

In this initial report, The Foundation for Development Cooperation has argued the necessity for a substantial microfinance initiative as an early part of the relief and development effort in East Timor. Once this is accepted, the next step should be to draft a detailed step-by-step plan in consultation with the various agencies now committing resources to East Timor and with the representatives of the Timorese people themselves. FDC hopes to contribute to that further process of planning and, by contributing to the emergence of sustainable microfinance in East Timor, to contribute also to the creation of a financial system which serves the poor.

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THE FOUNDATION FOR DEVELOPMENT COOPERATION LTD A.C.N. 011 025 997
PO Box 10445 Adelaide Street, Brisbane QLD 4000 AUSTRALIA
(Street Address: Level 2, 283 Elizabeth Street, Brisbane, Australia)
Telephone: 61-7-3236 4633 Facsimile: 61-7-3236 4696 E.mail: info@fdc.org.au Internet: http://www.fdc.org.au

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