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BEST PRACTICE? ELIMINATING MICROFINANCE SUBSIDIES IN POST-CONFLICT ENVIRONMENTS: THE CASE OF BOUGAINVILLE

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ABSTRACT

Microfinance can be harnessed to serve both relief and development purposes in post-conflict environments, supporting survival, reconstruction and social reconciliation objectives in the immediate conflict aftermath, as well as longer-term economic rebuilding through microenterprise development. Independence from donor subsidies is widely viewed as a desirable goal in the microfinance industry, and a number of donors are building full cost recovery objectives into their support for post-conflict microfinance programs. The appropriateness of the full cost recovery paradigm in post-conflict environments is questionable, given the high operating costs faced by post-conflict microfinance agencies, weak demand for the most profitable microfinance services, and limitations on rapid improvements in local economic capacity, particularly in remote areas. This paper reviews the issues raised by full cost recovery in post-conflict environments, with particular reference to a microfinance scheme in Bougainville, a province of Papua New Guinea currently in recovery from a prolonged period of armed conflict.

INTRODUCTION

The provision of effective development aid, as distinct from short-term humanitarian assistance, in post-conflict environments (PCEs) is an issue that has lacked adequate attention and reflection within the development literature. Microfinance — the provision of small-scale financial services to low-income clients — can be harnessed to serve both relief and development purposes. Carefully designed microfinance programs can support survival,
reconstruction and social reconciliation objectives in the immediate conflict aftermath. In the longer term, microfinance institutions (MFIs) can assist in the re-building of economic assets and social capital. Since the mid-1990s microfinance interventions have been implemented in several post-conflict countries including Rwanda, Mozambique, Cambodia, Bosnia and Kosovo.

Within the microfinance industry independence of donor subsidies is widely viewed as a desirable goal, and a number of donors are building full cost recovery objectives into their support for post-conflict microfinance programs. The appropriateness of the full cost recovery paradigm in post-conflict environments is questionable, however, given the high operating costs faced by post-conflict microfinance agencies, weak demand for most profitable microfinance services, and limitations on rapid improvements in local economic capacity, particularly in remote areas.

In this paper, issues in the application of a cost recovery model to post-conflict microfinance (PCMF) will be explored for Bougainville, a province of Papua New Guinea (PNG) currently in recovery from a prolonged period of armed conflict. Since 1998 BHM, supported by the official Australian aid agency AusAID, has provided small-scale savings and loans services to conflict-affected communities. The BHM is currently being redesigned, with a proposal to shift its funding base towards a cost recovery footing over the next three years. The following section reviews the emerging literature on PCMF and debates on the commercialisation of microfinance. The third section briefly describes the background to the Bougainville conflict. The fourth section introduces the BHM, highlighting issues and constraints facing the commercialization of microfinance in a PCE.

**Microfinance Commercialisation in PCES**

In recent years there has been considerable debate on the extent to which MFIs should aim to finance their operations without recourse to donor support. Practitioners distinguish three levels of financial sustainability. At the lowest level, subsidy dependence, an MFI is unable to cover any of its costs and relies entirely on donor funds. At the second level, operational self-sufficiency (OSS), the agency covers its operating costs from fees and interest revenue, but relies on subsidies, in the form of donor grants or low-interest loans, to meet its financing costs. At the highest level, full financial self-sufficiency (FSS), the MFI is entirely independent of donors, meeting its operating and financing costs from deposit mobilisation and/or commercial financial markets. Most observers agree that as a minimum requirement, MFIs should strive for OSS, aiming to earn enough revenue from fees and loan-interest to cover their day-to-day costs, but disagree on whether, over and above OSS, MFIs should meet the more demanding criterion of FSS.

Since the mid-1990s the ‘institutionist’ approach has emerged as the dominant paradigm within microfinance. Institutionists envisage an industry dominated by large, profit-seeking financially self-sufficient MFIs, arguing that microfinance is better served by market-based approaches than concessional donor support. They see a limited role for donor support in financing MFI start-ups and supporting technical and managerial progress towards FSS, but argue that in the long run, limitations on the magnitude and durability of donor support mean that broad, sustainable outreach can be achieved only by accessing commercial funding
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sources (Gibbons and Meehan 2002). For institutionists, the main role of donors is to assist in building FSS institutions: having assured viability in one, they can move on to the next. Thus, many MFls receive donor funds on the premise that external assistance is a temporary measure and that they will eventually become entirely self-funding, and the progressive achievement of FSS benchmarks is a condition of continued donor support.

Major donors such as the World Bank’s CGAP program and USAID, which are strong advocates of the institutionist position, support research and development programs aimed at identifying and promoting ‘best practices’ which facilitate commercialisation. A key theme of the best practices literature is the setting of fees and interest rates at full cost recovery levels which, given the cost structures of microfinance, are usually well above standard bank lending rates (Rosenberg 2002). Other themes focus on cost reduction through improved operating efficiency, the cutting of unprofitable ‘non-core’ services, and the identification of clients based on profitability rather than need.

The institutionist view is opposed by the ‘welfarist’ school, which holds that microfinance serves social objectives which usually justify ongoing donor support. Welfarists are concerned that in the push towards commercialisation, influential donors are steering MFls in a policy direction that is inconsistent with a social mission. They argue that profit-maximising MFls tend to move away from poor, high-risk client groups. As loan transaction costs are a more or less fixed quantity regardless of loan size, and as the most disadvantaged groups are relatively difficult to reach and likely to require more intensive interventions, programs concerned with their financial bottom-lines have a powerful incentive to avoid them in favour of larger, cheaper, lower-risk loans to non-poor clients. They point out that subsidies are necessary to support non-financial services such as training, business development and social intermediation, which by themselves are unlikely to generate commercial rates of return. Unsubsidised, these activities are likely to be reduced or discontinued by commercially-minded MFls, with adverse impacts on the poorest and most marginalised, who tend to be the main beneficiaries of non-financial services.

Welfarists argue that a ‘one size fits all’ commercial model ignores the diversity of microfinance services and of clients who can benefit from microfinance. They agree that there is room for commercially viable MFls that target the less poor. Fully commercialised business-oriented programs may generate significant social benefits by serving non-poor clients who are excluded from the formal banking sector, which in many developing countries caters only to elites. There is also a place for donor-funded programs, which operate from humanitarian motives and are not commercially profitable. The two should not be confused, however. There is a danger that pressures for the adoption of commercial practices will compromise the effectiveness of poverty-focused programs.

Evidence that some clients are willing and able to pay full cost-recovery interest rates indicates that FSS may be a realistic goal in certain development contexts (MicroBanking Bulletin 2003). There is ongoing debate however, over its appropriateness as a universal blueprint, with concerns that an exclusive focus on institutional performance indicators may jeopardise other social and poverty reduction objectives (Woller et al. 2001; Morduch 2000). As PCMF is a relatively new field, there is little data on the impacts of commercialisation on PCMFI operations and clients. ‘Best practice’ in a post-conflict context remains a largely unexplored field. The pursuit of FSS is likely to be problematic in ‘difficult environments’ – for example, communities in which HIV/AIDS is endemic, in recovery from natural disaster
or armed conflict, or simply where clients are very poor. Nevertheless, some donors have sought to build full cost recovery objectives into their support for post-conflict MFIs.

In fact, the pursuit of FSS faces significant hurdles in PCEs. Households and communities in recovery from conflict have specific requirements, which call for a shift in emphasis away from traditional income promotion toward the less profitable objectives of reducing economic vulnerability and building social capital. Furthermore, the post-conflict setting imposes additional costs on MFIs. The remainder of this section discusses each set of factors in turn.

**Reducing Economic Vulnerability**

The standard objective of most microfinance programs is income promotion: the creation of sustained improvements in household incomes through microenterprise development. Their focus is on microenterprise lending, sometimes supported by training, technology transfer and other non-financial business development services. More recently, practitioners have recognised the protectional capacity of microfinance. Protectional strategies aim not to increase incomes but to reduce economic vulnerability, ensuring continuity of access to basic needs through crisis periods. The focus is on the building of savings and small, short-term loans for consumption, housing, household assets, debt retirement, subsistence production and diversification of household income sources to spread risk (Sebstad and Cohen 2000). Protectional financial services may complement non-financial interventions supporting food security and the empowerment of particularly disadvantaged groups. They may provide a first step towards the re-building of livelihoods, assisting clients to reach a threshold of income security from which they can launch higher-risk, higher-return enterprises (Hulme and Mosley 1996, Sebstad and Cohen 2000, Zaman 1999).

There is considerable evidence that microfinance can play an important protectional role in PCEs (Sebstad and Cohen 2000, Doyle 1998, Wilson 2001). In the immediate conflict aftermath, households may exhibit a ‘post-war syndrome’ characterised by low confidence, trust and motivation and reluctance to take on debt. As asset depletion and income instability increase both the probability and the consequences of a loss, households are risk-averse, often stating a preference for reducing consumption or working for wages rather than taking loans. The microfinance products most in demand in PCEs are savings facilities, small, short-term cash loans and in-kind loans, used primarily for non-productive purposes. Where there is demand for microenterprise credit, the preference is for low-risk, low-value, fast-return working capital investments with low entry and exit costs, although demand for larger, longer-term loans for fixed capital investments increases over time (Wilson 2001, Williams et al 2001).

**Building Social Capital**

‘Social capital’ refers to norms and networks that foster trust, reciprocity and cooperation, thereby enhancing both efficiency and well-being. The building of social capital is generally seen as a complementary, second-order goal for microfinance, by contrast with
first-order promotional and protective objectives. In non-conflict environments, the interest of practitioners in social capital is primarily instrumental, stemming from recognition of its critical role in supporting effective microfinance. In PCEs, however, where reconciliation and the revival of cooperative activity are community development priorities, the social capital-building function of microfinance is accorded greater prominence as an objective in itself.

Social capital development is both a precondition for and outcome of microfinance. The great innovation of microfinance lies in its substitution of physical with 'social' collateral through joint liability arrangements, in which each borrower's loan is guaranteed by a group of her peers, thereby enabling borrowers and lenders to participate in transactions which involve an otherwise unacceptable degree of risk (Narayan and Pritchett 1997). In addition, solidarity groups reduce transaction costs for the lender by transferring loan appraisal, approval, monitoring and collection functions to cooperative peer groups (Ito 2003).

Reciprocally, the peer group model is well-adapted to support the building of social capital, and has been found to be particularly useful where programs seek to empower women and other marginalised groups (Anderson and Locker 2002, Rankin 2002, Barnes 1998). While practitioners are cautious about the use of microfinance interventions to 'engineer' reconciliation in PCEs, there is support for its use as a tool for reconciliation and the facilitation of grassroots cooperation, and evidence that peer group processes contribute to inter-ethnic cooperation between members, their neighbours and families (Doyle 1998, USAID 2001). The targeting of women is believed to promote reconciliation objectives through their empowerment as peace-makers (Doyle 1998).

**OPERATING COSTS**

PCMFIs face higher costs than their counterparts in non-conflict environments. Weak social cohesion requires them to invest heavily in social capital building. Demand for institutional financial services is often weak, in part because low levels of intra-community trust lead to reluctance to participate in solidarity lending and savings schemes (Doyle 1998, Wilson 2001, Williams et al 2001). Group-based methodologies require members to manage funds and maintain records, and to possess good information about other members. Where financial skills are scarce or, as in situations of high population mobility or unresolved intra-community tensions, levels of trust and information are low, groups may take some time to become functional, requiring extra social mobilisation efforts (Kuehnast 2001, Doyle 1998, Nagarajan 1999).

Staffing costs tend to be high, with competition for skilled development workers and shortages of staff willing to work in distressed areas. Additional staff resources are required for non-lending activities such as counselling, education and the marketing of financial services to a traumatised and suspicious population (Nagarajan 2000, USAID 2001c). The destruction of roads and telecommunications facilities increases transaction costs. Additional investment in security for program assets, staff and clients may be required. PCMFIs may find it necessary to incorporate additional emergency relief measures such as food donations, or social services such as primary health care and education. While such additions have the
positive effects of increasing client goodwill, outreach and loyalty, they add considerably to program costs (Doyle 1998).

**Commercialisation in PCEs: A Feasible Option?**

In the conflict aftermath, then, traditional promotional objectives assume a back seat in relation to protectional and social capital building objectives. This is of particular importance for the pursuit of FSS, as protectional and social intermediation activities do not generate the returns necessary to support full cost recovery and require a form of subsidy, either directly from donors or by cross-subsidies from more profitable activities.

Among the key success factors for FSS identified in the 'best practices' literature are minimalist ‘core’ financial services, interest rates and fees set at full cost-recovery levels, and low operating costs relative to portfolio size. There is great difficulty in adapting these features to protectional and social capital-building functions. As social development interventions do not generate direct financial returns, they are likely to be supported by profit-maximising programs only to the extent that they are seen as essential to the efficient delivery of core services. There is a risk that communities requiring substantial investment in social capital building will be avoided by such programs. Similarly, protectional strategies are unlikely to be profitable. Protectional loans are typically small, involving relatively high transaction costs, and they support activities which generate high social but low financial rates of return.

Furthermore, while an overwhelmingly promotional focus is necessary for FSS, it is not sufficient. The large unit transactions characteristic of FSS generally require a strong microenterprise sector, which in turn depends on the presence of vigorous markets, sound infrastructure, well-developed human capital and a stable economic, political and legal environment (Snodgrass 1996, Shaw 2004). Most FSS programs, such as BancoSol in Bolivia, target non-poor, urban microentrepreneurs. Others, such as the ASA in Bangladesh, target poorer borrowers with smaller microenterprises, relying on a streamlined cost structure, minimalist financial-services only approach and the economies of scale generated by great breadth of outreach (more than 8 million clients in the case of ASA) (Microbanking Bulletin 2003). In PCEs, the profitability of promotional interventions is hampered by the low absorptive capacity of the microenterprise sector, with human capital depletion and severe disruption to markets and infrastructure. The capacity to expand breadth of outreach may be limited by security and demographic factors. In addition, there is often a high demand for unprofitable ‘credit-plus’ services to promote microentrepreneurial capacity, with many new entrants to the informal sector, who need to learn new skills.

Thus, expectations that MFIs in post-conflict environments can become commercially viable may be excessively optimistic. Empirical findings indicate that FSS is an elusive goal even under optimal political and socio-economic conditions, with evidence from a recent cross-country survey of 124 MFIs that just over half meet strict tests of financial sustainability after a decade of more of assistance (Microbanking Bulletin 2003). Moreover, commercialisation may compromise protectional and social objectives, with findings that programs with explicitly social objectives are the least likely to cover their own costs (Morduch 2000), and that FSS institutions are less likely than other MFIs to target poor clients (Microbanking Bulletin 2003).
Nevertheless, some key donors build FSS objectives into their support for post-conflict MFIs. World Bank-supported MFIs in the Bosnia Local Initiatives Project, for example, were required to become fully independent of subsidies after two years (Kuehnast 2001). While there is little data on the impacts of commercialisation on MFI operations in PCEs, there are indications that full cost recovery is problematic (Nagarajan 1999; Frasier and Saad 2003). A survey of 14 MFIs in PCEs in six countries found that none were able to meet their operating and financing costs from earned income. Of the three which met the less demanding criterion of operational self-sufficiency (covering operating costs from revenue), two were located in urbanised middle-income European settings (Doyle 1998). In addition, there is evidence that the pursuit of full cost recovery in PCMFIs impacts adversely on social capital formation (Bateman 2003), poverty targeting and non-financial services (USAID 2001a).

THE BOUGAINVILLE CONFLICT

PNG lies to the north east of Australia and is the largest nation in Micronesia. Bougainville is one of 19 provinces of PNG. It is located 500 kilometers east of the PNG mainland, and comprises one large island, 200 kilometres long and 40 kilometres wide, and a number of smaller islands. Its population just under 200,000, with over 40 per cent younger than 15 years of age (NSO 2002). The conflict in began in 1988 as a localised reaction to the on-going negative consequences of foreign-owned mining. While under Australia’s administration in the 1960s, copper was discovered in Bougainville’s south eastern mountains. The ensuing mine was fully foreign-owned and while its profits were substantial, the royalties flowing to Bougainvilleans were insignificant. While other benefits from the mining included employment and some community development programs, the environmental exploitation and degradation caused by the mine over a twenty-year period was perceived by many Bougainvilleans to far outweigh these benefits. The PNG army and police reacted swiftly and harshly against the protestors and this response galvanised support resulting in a wider uprising centred on long-held claims for independence (Howley 2002; Spriggs and Denoon 1992).

Conflict between the Bougainvilleans and PNG forces continued until 1997. Between 15,000-20,000 people died, most of the island’s infrastructure was destroyed (including schools, hospitals and roads), and all government services (including health and education) ceased operating. Further, conflict between Bougainvilleans also occurred. Not all Bougainvilleans were in favour of independence and at times, traditional land disputes, ethnic rivalries and other grievances between Bougainvilleans resulted in fighting and often overshadowed the larger issue of independence in terms of motivation for violence (Howley 2002; Regan 1999, 2002; Ogan 1999).

The peace process was a protracted exercise taking nearly five years to complete. The final negotiated peace settlement, signed on 30 August 2001, allowed for an autonomous Bougainville government and the opportunity to vote on full independence within a 10-15 year timeframe. This outcome represented a compromise for both sides as Bougainville was seeking full independence, whilst PNG opposed any move towards secession.

The devastating consequences of the conflict, with the loss of physical assets, infrastructure and human support systems, and a severely traumatised civilian population,
constitute a major challenge to future economic development. Household asset bases including housing, land, livestock, tools and savings were partially or completely destroyed. Transport, power and communications facilities have been severely affected by combat damage. All significant roads were destroyed during the crisis, and the reconstruction program has been slow. Markets have been disrupted by population displacement, heightened poverty and the destruction of transport links. Human capital has been depleted by war casualties, psychological trauma, the loss of health services, lapses in formal education and emigration.

Scope for major economic development is limited. The almost complete reliance on the mine to underpin the economy meant that following the mine’s closure in 1989, nearly all economic activity other than subsistence farming ceased. Not only were 10,000 direct jobs lost, but all the indirect and associated industries also closed almost immediately (Regan 2002). Wage employment is still extremely scarce, accounting for only 10 per cent of males and 4 per cent of females over the age of 10 (NSO 2002). Plantation agriculture, a potential source of jobs and export earnings, remains underdeveloped. While fishing and tourism may become increasingly important in the future, they will not make a significant contribution to growth in the short-term. In the current political environment there is little prospect of a resumption of mining in the foreseeable future. The economy is heavily reliant on aid and on cocoa and copra exports from the smallholder farm sector.

**MICROFINANCE IN BOUGAINVILLE**

The Bougainville Hause Moni (BHM) is the largest microfinance program in Bougainville. It comprises a loose federation of grassroots microfinance institutions (GMFIs) located throughout the island, coordinated and supported by a central body. AusAID has supported BHM since its inception in 1996, with an Australian NGO, Australian Volunteers Abroad, assuming the role of the Managing Contractor. The project’s goal was to foster social and economic development through grassroots savings mobilisation, and its objectives focused on building institutional capacity, self-sufficiency and sustainability (AusAID 2001).

In the face of strong public demand for microfinance services, the geographic reach of the project, limited to four pilot regions in the initial design, was broadened to cover the whole province. Between 2000 and 2004 the number of GMFIs grew from 42 to 333, and membership grew from just under 6,000 to around 20,000. The rapid expansion in outreach confirms the strength of public demand for financial services and has firmly established BHM as Bougainville’s leading microfinance identity. Members see the program primarily as a tool for re-building social capital, providing savings facilities and small loans, primarily for non-enterprise and protective purposes such as school fees, customary obligations, and consumption-smoothing during lean seasons. Most have indicated strongly that their preference is for savings rather than loans, although some in the larger, urban GMFIs have indicated a preference for larger microenterprise loans.

With the termination of the current project in 2005, it is planned that BHM will move into a new phase, with the establishment of a Microbank. The emphasis of the forthcoming phase is on the achievement of full FSS by 2008. A further substantial expansion of scale is planned, with the goal of reaching 60,000 clients by 2008 (Asian Development Bank 2004).
While several key issues in the design of the next phase remain to be finalised, the general thrust of the proposal involves a significant shift in emphasis away from protectional and social capital-building services in remote areas, in favour of larger, promotional loans and a focus on clients in the island’s three major economic centres, Buka, Arawa and Siwai.

There is a case for sequencing PCMF interventions to focus initially on protection and social capital building, and subsequently, with the rebuilding of household asset bases and revival of economic activity, to shift the focus towards sustained income promotion. As the post-conflict trauma subsides, with the return of stability, normalisation of social relations and rebuilding of infrastructure, it is likely that improvements in operating conditions will reduce costs and improve client capacity to pay, allowing BHM to move progressively towards self-sufficiency.

The balance between re-building and development must be carefully managed, however. In Bougainville, the risk is that an excessive emphasis on cost recovery will compromise rural outreach. This risk arises from the high costs of meeting the specific needs of rural communities in the post-conflict environment. Remote regions are physically difficult and costly to reach, due to ongoing security concerns and dilapidated transport and communications infrastructure. Rural clients are poorer than their urban counterparts, less accustomed to the cash economy and in need of more intensive social intermediation and maintenance. There is a need for non-financial microenterprise support services, particularly in remote areas. The building of grassroots institutional capacity and of social capital and credit discipline among the membership will require substantial investments in training, social mobilisation, awareness-raising and ongoing monitoring and maintenance.

The remainder of this section describes other specific issues and challenges for the future development of microfinance in Bougainville.

**INSTITUTIONAL PERFORMANCE**

Substantial further investment is required in the building of grassroots institutional capacity if GMFIs are to expand into microenterprise lending. The rapid growth in outreach in recent years has outstripped BHM’s capacity to screen, monitor and support the large number of new GMFI entrants. As a consequence, there has been limited progress towards the building of GMFI capacity, and there little development in the quality and scope of financial services available to clients. Management performance at GMFI level is weak, with little standardisation of practices and deficiencies in record management and reporting. The limited management capacity of GMFIs has so far proved sufficient to handle small-scale savings and lending activities, but it will need to be upgraded to meet any expansion in the scope of financial services to GMFI members.

**Weak Credit Discipline and Distrust of Financial Institutions**

Particular challenges for microfinance in Bougainville are imposed by the chequered history of financial sector development during and after the conflict, which has contributed to a weak credit culture and widespread distrust of financial institutions. The post-conflict...
rebuilding of the formal financial sector has been minimal. Formal financial facilities, currently limited to a single branch of the South Pacific Bank in Buka at the extreme north of the island, are inaccessible to most Bougainvilleans as travel is prohibitively costly and time-consuming. The weakness of the formal financial sector during the conflict and its aftermath has contributed to the emergence of a spate of pyramid money schemes into which vast quantities of household savings disappeared in the late 1990s. The promotion of microfinance was further set back by these schemes, which led many clients to withdraw their savings from existing financial institutions, decapitalising MFIs and contributing to a loss of confidence in legitimate finance providers. During and after the conflict people buried large sums of money to safeguard their wealth, and it is estimated that up to 20 million kina remains hoarded by households.

The loss of confidence in financial institutions has been exacerbated by poorly managed donor-supported microfinance programs. The main alternative to BHM in recent years has been a credit scheme sponsored by the EU in collaboration with the Bougainville Provincial Council of Women, which is generally agreed to have been a failure, with large scale loan defaults and little evidence of client impact (Newsom 2002). Among the main factors in poor performance were weak management capacity and the failure of the solidarity group system (AusAID 2001). This poorly managed program has contributed to the growth of a ‘cargo cult’ mentality in which loans, especially those from offshore sources, are widely viewed as gifts.

Furthermore, in Bougainville, as in other Pacific island societies where social and economic transactions are conditioned by the ‘wantok’ system, the building of a credit culture faces particular challenges. There is a need for rigour in pre-credit training and social mobilisation to counteract sociocultural influences which encourage nepotism and poor repayment discipline.

Weak Social Capital

Prior to 1989, over 10,000 Bougainvilleans were employed directly by the mine, with salaries that were very high by local standards. A serious consequence of this influx of wealth was the challenge to traditional power structures and community spirit. Young men were able to gain great influence in their home villages by buying gifts and sharing their wages, challenging traditional social hierarchies. The conflict exacerbated this breakdown by placing greater pressure on traditional power structures, a problem which has not been resolved in the post-conflict aftermath. Intra-group conflict has a long history (pre-dating colonialism) in Bougainville (Regan 1999b), but the recent period of conflict has exacerbated this situation. Despite a weapons disposal plan being part of the peace agreement, the de-commissioning has not been entirely effective (Regan 2002a). The result is still a heavily armed population with a recent history of reverting to violence to resolve disputes. Violence and outbreaks of lawlessness continue to be a social problem (Howley 2002; Regan 1999b). Reconciliation and the building of trust and cooperation are central community development priorities.

There are indications of success in rebuilding social capital, with some GMFIs engaging in community projects such as the restoration of church buildings, and establishing small-scale cooperative economic ventures in animal husbandry and cocoa-drying. Expatriate aid workers report instances where GMFI participation has led to the re-establishment of relations between previously estranged families. While GMFIs have made significant contributions to
post-conflict reconciliation, levels of social cohesion and trust remain generally low, and need to be further developed to provide a viable basis for group-based lending, particularly in the rural central and southern districts.

Microenterprise Development

In the medium term at least, most households will remain reliant on informal sector livelihoods in the form of smallscale agriculture and non-farm microenterprises. The creation of sustainable local economic growth through microenterprise development is a key objective of BHM. However, microenterprise-based income generation faces significant constraints, with the loss of household assets and physical infrastructure, weak markets and depletion of human capital. Ongoing intra-community tensions and weak law enforcement are added disincentives to microenterprise investment. In a largely subsistence-based economy, the scope and scale of microenterprise opportunities is reduced, as customer demand tends to be limited to essentials. These obstacles, which are most severe in rural areas, impose severe limitations on development: while there has been some small business growth in Buka and Arawa in the post-conflict period, there is little evidence of microenterprise activity elsewhere.

Some constraints, notably deficiencies in infrastructure and the rule of law, are beyond the scope of microfinance. Another important set of constraints, however, relates to a lack of awareness, information and skills for microenterprise development within the Bougainville community - problems which can and should be addressed by microfinance providers. Given the underdeveloped state of the microenterprise sector in Bougainville, the building of microentrepreneurial awareness and capacity is key to the success of microfinance.

There is a need for a credit-plus program aimed at promoting non-farm microenterprises and non-traditional farming activities. Although the cocoa sector is currently performing strongly, over-reliance on a single export crop is a high-risk strategy. The current high world price of cocoa is the result of political instability in the cocoa-producing West Africa region, and should not be expected to continue. Moreover, while cocoa-growing currently provides a useful and widespread income source in Bougainville, high population growth and increasing pressure on land resources will restrict access to cocoa income in the longer term (Bourke 2003).

Despite scope for diversification into non-farm activities in both urban and rural settings, the non-farm microenterprise sector is remarkably under-developed in Bougainville. Potential microenterprise opportunities include animal husbandry, fishing, sustainable forestry, wholesale and retail trade, retail food production, construction-related activities, transport, services such as hairdressing and vehicle repairs, and handicrafts production. Credit-plus services targeting existing and prospective microentrepreneurs, particularly in rural areas, are key to the development of the microenterprise sector. Appropriate services in the Bougainville context include information on non-traditional opportunities, vocational and business management training, assistance in identifying and developing markets and in introducing sustainable low-cost technologies. Care must be exercise in the design and delivery of microenterprise development services, as a large influx of new entrants to emerging occupations may create a problem of oversupply.
CONCLUSION

Further research is required to analyse the feasibility and outreach implications of full cost recovery in PCEs, and to identify optimal sequencing arrangements and other best practices which minimise trade-offs between institutional financial viability and social and economic objectives. In post-conflict Bougainville, FSS may be a viable long-term objective. In the short- to medium-term, however, protective financial services, social capital building, credit-plus microenterprise development and the strengthening of GMFI capacity are strategic priorities for microfinance. This is particularly the case in remote rural regions, where the pace of economic rebuilding has been slowest. For the BHM, the question is the extent to which a cost recovery-based model can support an expansion in rural outreach. If microfinance is to have a significant economic impact beyond the mostly non-poor minority population around Buka and Arawa, the additional costs of these interventions must be factored in. The BHM has the potential to make a major contribution to post-conflict rebuilding and longer-term economic development, but it faces a range of complicated issues compounded by its location in a PCE and pressures from donors to adopt cost recovery objectives. These will require sensitive and careful management. Premature pressures to meet financial bottom lines introduce an added complexity which risks undermining this already complex process.

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