

**MANAGEMENT RESPONSE TO THE PROJECT PERFORMANCE EVALUATION  
REPORT FOR THE RURAL ENTERPRISE DEVELOPMENT PROJECT IN UZBEKISTAN  
(Loan 1504-UZB)**

On 7 March 2007, the Director General, Operations Evaluation Department, received the following response from the Managing Director General on behalf of Management:

1. Management agrees with the overall findings and assessment of the report, which rated the Project as partly successful. Management agrees that more attention should have been paid during project design to (i) financial sector and banking intermediation related issues, particularly in transitional economies, and (ii) handling of foreign exchange risk by subprojects and particularly so by those engaged in import substitution. Management agrees that financial and risk management covenants should have been incorporated into the project's design. Improved overall financial sector legislation and fixed policies in Uzbekistan could improve the enabling policy and regulatory environment for small and medium enterprises, which could improve REDP's sustainability.<sup>1</sup> Management concurs with the PPER's assessments on its lessons learned. Comments on the various issues raised in the PPER are stated below.

**A. Exchange Risk Borne by the Sub-borrowers**

2. Para. 18 states that given the early stage in Uzbekistan's transition to a market economy, it was not reasonable for sub-borrowers or the National Bank of Uzbekistan (NBU) to appreciate the magnitude of the foreign exchange risk. Depreciation of the local currency could create exchange risk for the sub-borrower and a credit risk for NBU. Management agrees that ADB should have incorporated a risk mitigating mechanism into the project design.

**B. Institutional and Policy Impact**

3. Paras. 68 and 69 point to NBU's non-banking activities (inherited from the era of central planning) impinging on its overall effectiveness. While this may be true, its impact on the subprojects financed under the ADB loan remains tenuous. Subloans to subprojects were granted in foreign exchange, with NBU adding a margin over its cost of funds, depending on the risk of each case. There were no subsidies in lending to subborrowers under ADB's loan. However, ADB's loan could not have helped NBU generate customer deposits in Uzbekistan given the banking sector's trust gap as is manifested by the low M2/GDP ratio (at less than 15%)<sup>2</sup> in Uzbekistan. Indeed, NBU's lack of adequate dollar customer deposits coupled with high demand for credit by small and medium enterprises justified the ADB loan.

**C. Conclusion**

4. Management otherwise generally concurs with the PPER's thrust.

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<sup>1</sup> This argument is supported by the PPER's observations in para. 32 that Uzbek companies have a competitive advantage in processed food and vegetable products' exports with professional management and raw material supply.

<sup>2</sup> Para. 77.