

**MANAGEMENT RESPONSE ON THE PROJECT PERFORMANCE EVALUATION
REPORT FOR THE RURAL CREDIT PROJECT
(Loan 1457-VIE)**

On 6 January 2006, the Director General, Operations Evaluation Department, received the following response from the Managing Director General on behalf of Management:

1. We note that the PPER is well written containing thoughtful analysis that highlights many serious constraints in Viet Nam's rural finance sector. We agree with many of the issues and lessons suggested in the PPER. We also note that the Project is rated successful and there is no specific follow-up action identified for ADB and the responsible local agencies. However, there are several contradicting aspects in PPER's conclusions and recommendations. We would like to discuss these and suggest some alternative recommendations.

2. The PPER recommends that the AgriBank and the People's Credit Funds (PCFs) pilot "interest coupons" as a way to deliver subsidized credit to the poor. It is not clear that this scheme would suitably address the problems that are inherent in subsidized credit. It could be equally subject to abuse by the nonpoor, who may have greater access to such coupons because of their political connections or absorptive capacity for larger loans. It could entail additional administrative costs to the banks, which would discourage their use or create incentives for the AgriBank to make large loans with them. It is also not clear that Government's reimbursement of such coupons would be faster or easier than government's reimbursement of interest rate subsidies. Moreover, this proposal contradicts the statement in the PPER (Appendix 1, para 17).

3. The PPER recognizes the non-optimal use of the long-term ADB funds provided to the Government by the Project and recommends auctioning of future subsidized credit lines to participating financial institutions (PFIs) to address the problem. It found that the Project had a limitation in promoting longer-term credit to households (see para 35 and Appendix 5, para 23). It also found that despite the greater access to long-term funding, both from deposits and from the ADB credit line, overall long-term lending has not changed in the PFIs. The PPER findings provide evidence of the lack of effectiveness of the credit line under this Project, and evidence that long-term lending is not constrained by a shortage of long-term funding. Moreover, Appendix 1, para 24 points out that "the low interest rates attached to the ADB funds ... may have negatively affected deposit mobilization and provided a strong incentive for AgriBank's branches and PCFs to borrow from the ADB line of credit." Considering these facts, we are concerned about the effectiveness of the provision of a long-term credit line as a strategy to develop the rural finance sector, or provide long-term credit to households.

4. While many of ADB credit lines in the past have been rationalized mainly by references to a lack of access to long-term funds (or a mismatch between short-term funding and long-term credit needs), it would be necessary to examine more deeply other reasons such as the level of "core deposits" of the financial institution, the risks of long-term lending, distortionary policies such as interest

rate ceilings, land tenure arrangements, and operational inefficiencies. The PPER mentions many of these issues in Vietnam, including the distortionary policy environment, interest rate controls, and inefficient land markets; and it mentions many of the distortionary effects of subsidized credit lines, including crowding out of deposits. But, the PPER continues to encourage the perception that the key constraint is a shortage of long-term funding and recommends future credit lines as an appropriate solution. Management would argue against this recommendation. Instead, we would propose that future projects/programs be focused on policy improvement, institutional reforms, and capacity building to enable these PFIs to operate more commercially and sustainably, without subsidies, and to rely more on commercial sources of funds, including deposits, commercial borrowing, and/or private equity.

5. The PPER (para 49 and elsewhere) recommends legalizing moneylenders. We agree. However, the Report is silent on microfinance institutions (MFIs) as an alternative source of financial services. Work under TA 3741-VIE demonstrated that Government policies discourage the establishment and operation of MFIs, and that subsidized credit from the AgriBank and PCFs contribute to crowding out MFIs. ADB's Mekong Department has been working with the State Bank of Viet Nam and others to seek improvements in the policy and regulatory environment for microfinance, and the PPER should also recommend such improvements.

6. Finally, the Executive Summary states that "The Project was, and still is consistent with the ... operational strategies of ADB at the time of project design and of post evaluation." It should be noted that the Project would no longer be consistent with current policies as detailed in the ADB's Operations Manual (D6, paras 6, 8, 9, 17, and 18) and ADB's Microfinance Development Strategy ("Financing Modalities" on page 35). Based on these policies, as well as ADB's operational strategy for financial sector development in the region, we would not support a similar project today.