

NEPAL: POLITICAL AND ECONOMIC UPDATE

This note is an update of developments in Nepal provided in the Board Information Paper (BIP) of 23 July 2009.¹

A. Recent Political Developments

1. Nepal's peace process is continuing, but remains challenging and complex with frequent controversies and political differences. The Communist Party of Nepal, Maoist (UCPNM)-led Government resigned in early May 2009 over the issue of establishing a new leadership in the Nepal Army. As a key opposition party in the legislature Constituent Assembly, UCPNM has been continuing to disrupt its proceedings, demanding correction to the President's decision to reinstate the Army Chief dismissed by the UCPNM-led Government in early May 2009.

2. The current coalition Government that took office on 23 May 2009 and led by Prime Minister Madhav K. Nepal of the United Marxist-Leninist party includes all key political parties except UCPNM. Through a series of expansions the Cabinet now comprises 44 members from nine parties. The Government faces a range of challenging tasks including facilitating the protracted constitution drafting process, the long-pending rehabilitation and integration of former UCPNM combatants, and addressing the continuing *Terai* (low lands in the south) movement seeking ethnic autonomy and the right to self determination. The Government has also been weakened by constant inter and intra-party disputes on power sharing and the disruption of Parliamentary proceedings. This has so far prevented approval of the national budget for FY2010 (ending mid-July 2010).

3. Despite these setbacks, all political parties remain committed to advancing the peace process. Although challenging, the political transition has been peaceful and the political disruptions have been managed within the spirit of the Comprehensive Peace Agreement and the framework of the Interim Constitution. Drafting of the new constitution is also continuing, although the process has been slower than expected. Thematic constitutional committees are currently engaged in debating and drafting their respective concepts for the new constitution. Although the CA has revised the schedule for completing certain milestones of the constitution drafting process, the deadline for completing the overall draft constitution remains unchanged, on May 2010. UCPNM is also now participating in key committees set up under the peace process.

4. For these reasons, there is cautious optimism that the peace process, which underpins the country's transition to a new political order, could again move forward and eventually usher in an era of peace, stability and economic prosperity. The international community remains engaged with the Government as well as other key stakeholders in support of the country's peace and development process.

B. Recent Economic Developments and Outlook

5. Due to a severe drought during the past winter, agriculture growth slowed to 2.2% in FY2009 from 4.7% in FY2008. Industrial growth remained stagnant at 1.8% due to the political disturbances, power cuts, and labor tensions. While services expanded more rapidly by 5.8%, the growth rate was slower than 7.0% achieved in FY2008. The slowdown in services was caused mainly by the wholesale and retail trade and financial subsectors, also affected by the

¹ ADB. 2008. *Nepal: Political and Economic Update*. Manila (IN. 192-09).

domestic disturbances. Given the delayed monsoon and based on the assumption of no further impact of the global crisis, the GDP can be expected to grow by 4.0% in FY2010.

6. Overall macroeconomic stability has been preserved despite the disruptive political transition, mainly supported by strong revenue growth, sustained remittance inflows, and generally prudent economic policies. However, inflation is on the rise reaching 13.2% in FY2009 (annual average) from 7.7% a year ago. The Government is taking measures to tame it with increased supervision to ensure smoother supply of essential food items. The Nepal Rastra Bank has also adopted a tighter monetary policy to address the excess liquidity in the market mostly contributed by remittance inflows. Fiscal stability is also being maintained and efforts are being made to limit domestic borrowing from the banking system.

7. The new coalition Government presented a somewhat ambitious budget for FY2010. Revenue is expected to grow by almost 33%, and the expenditure outlay is 37% higher than the estimated expenditure in FY2009. Although fiscal deficit (including foreign grants) is estimated to rise to 3.3% of GDP in FY2010 from nearly 2.0% in FY2009, a likely shortfall in the expenditure target should help stabilize the fiscal deficit to about 2.5% of the GDP. Given the Government's strong commitment and continued efforts at revenue mobilization by improving tax administration and broadening the tax base, the revenue target can be expected to be broadly achieved.

8. The impact of the global financial crisis on Nepal has been limited so far given the limited exposure of Nepal's financial sector to global financial markets. Despite some anticipated impacts on remittances, exports and tourism receipts, their performance has held up, although there has been some decline in tourist arrivals in the recent months. There are, however, signs that the decline may be transitory.

9. Nepal's balance of payments position remains stable. The current account was in surplus at about 4.0% of GDP in FY2009, mainly supported by the sustained inflow of remittances which has helped to offset the widening trade deficit. Foreign exchange reserves have also remained comfortable with an import cover of approximately 8 months. Unless the global economic downturn becomes prolonged, Nepal's external position can be expected to remain stable in FY2010.

C. Status and Implications for ADB Operations in Nepal

10. ADB's new Country Partnership Strategy (CPS) for Nepal is at an advanced stage of formulation with the Management Review Meeting held on 16 September 2009. The new CPS is scheduled for Board consideration in November 2009. The CPS formulation process involved extensive consultations with a broad spectrum of stakeholders including the Government, civil society, private sector and the development partners. In the spirit of the Paris Declaration on aid effectiveness, the Government, ADB, the Department for International Development of the United Kingdom and the World Bank partnered closely in undertaking the stakeholder consultations and a number of background studies and sector assessments. ADB has made special efforts to closely align the new CPS with the Government's development strategy and priorities. ADB's CPS formulation process has also benefited from the lessons and recommendations of the Independent Evaluation Department's 2009 Country Assistance Program Evaluation and Sector Assistance Program Evaluation (on agriculture and natural resources).

11. In view of the prolonged political transition, the time horizon of the new CPS will be three years, to coincide with the expected duration of transition and the government's own plans to prepare a new three-year interim plan. The evolving political transition and the governance and law and order situation pose a significant challenge in formulating the new CPS and defining the nature and focus of ADB's future reform and development assistance to Nepal. However, continuous and rigorous assessment of the country context and monitoring of ADB's operations suggest that Nepal's fundamental development priorities remain unchanged. The still widespread poverty, rising inequality and deep-seated social exclusion—the root causes of the conflict identified by the 2005 Country Strategy and Program—remain the country's key development challenges. While some significant progress has been achieved on these fronts in the past decade, continued assistance and efforts are needed to help Nepal sustain these hard-won gains. Failure to sustain and scale up these gains would risk sliding back into conflict.

12. A governance risk assessment as part of the CPS formulation process has identified risks relating to public financial management, public procurement and corruption in the prevailing situation. A risk management strategy has been developed under the new CPS to mitigate these risks by strengthening the capacity and accountability systems of key central and local-level public institutions and enhancing ADB's own monitoring of the overall governance situation and public procurement activities to ensure efficient and effective utilization of public resources, including external assistance.

13. At the operational level, ADB's portfolio performance as of 31 August of 2009 held up satisfactorily—contract awards stood at \$115.45 million (70% of the annual target), while disbursements reached \$72.64 million (62% of the annual target) despite the difficult operating environment. It is expected that the program will meet its projected annual targets. Overall portfolio performance has also improved with the reduction of the proportion of projects “at risk” to 0%, compared to 6% at the end of December 2008. Although the project implementation environment has improved since the restoration of peace in April 2006 with the proportion of projects significantly affected by political/security factors reducing to 4% in August 2009 (from 8% in October 2008), the overall implementation environment remains challenging due to the frequent political disruption in the *Terai* districts. ADB's Nepal Resident Mission continues to engage with the political leadership, key Government line agencies and other development partners to facilitate safe and effective operations.