

NEPAL: POLITICAL AND ECONOMIC UPDATE

This note is an update of the situation in Nepal provided in the board information paper (BIP) of 4 August 2006¹ and Nepal Country Operations Business Plan (2007 – 2009) submitted on 5 October 2006.

A. Recent Political and Security Developments

1. The coalition Government of the seven-party alliance (SPA) and the Communist Party of Nepal/Maoist (CPN/M) signed an historic Peace Accord on 21 November 2006, which ended the violent 11-year long insurgency and opened a pathway towards lasting peace and sustainable development in Nepal. The peace process subsequently achieved a remarkable milestone with the formation of the new House of Representatives (HOR) on 15 January 2007, which included representatives of the CPN/M. On the same day, the eight party HOR passed a new Interim Constitution, reflecting the aspirations of a 'new Nepal' which would be peaceful, inclusive, and prosperous. Of particular significance was the commitment to working toward the social and economic transformation of the country, which is essential for supporting the peace process and addressing the root causes of the conflict.

2. However, the Interim Constitution drew immediate criticism from the *Madeshi* (traditional residents of *Terai* – lowlands) and *Janjati* groups (indigenous nationalities) for not being inclusive, followed by violent protests in the eastern *Terai* region and demonstrations with some blockades by the *Janjati* groups. When the violence failed to subside, the Government agreed to amend the Interim Constitution, including changes to ensure the (i) establishment of a federal system through constituent assembly (CA) elections, (ii) addition of electoral constituencies on the basis of population, and (iii) formation of a commission to delimit the constituencies and proportional inclusion of indigenous and underprivileged groups in all state organs. The amendment was endorsed by the Cabinet on 9 March 2007 and subsequently passed by the HOR.

3. The disaffected parties remain dissatisfied with the amendments and are keeping pressure on the Government through strikes and other actions. For example, the *Janjati* group led by the Nepal Federation of Indigenous Nationalities (NFIN) unleashed further agitation to press their demands for an ethnicity-based federal state structure, including the right to self determination. As part of its protests, the Janatantrik Terai Mukti Morcha (JTMM) declared the *Terai* region a Democratic Independent Terai State, and some JTMM factions called for a boycott of the CA elections. A third *Terai* group, the Madhesi People's Rights Forum (MPRF), has also declared fresh programs of agitation through *Terai* closures (*bandhs*) to press for their demands for a separate *Terai* state. The disturbances and *bandhs*, which in a few instances have turned violent, have intensified in recent weeks and in some isolated cases have affected development work and Government staff.² The more recent deterioration in conditions in the

¹ ADB. 2006. Nepal: *Political and Economic Update*. Manila (IN. 215-06)

² On the evening of 16 April, a faction of the JTMM abducted and killed a government servant working as a trainer at an education training center funded under Loan 1840-NEP: Teacher Education Project. The JTMM-G has taken responsibility for the killing without giving any reason; however it is believed that the action is part of an earlier warning to government employees of 'hill' origin to leave the *Terai*. The Government is investigating the incident, and following ADB's expression of concern, provided assurance that it will take full responsibility for the security of development operations in the *Terai*. Separately, the Government is pursuing talks with the various movements to end violence in the region.

Terai is mainly due to clashes between opposing factions and increasing ethnic-cum-regional issues relating to problems of exclusion and power sharing mechanisms.

4. An Interim Government was formed on 1 April 2007. This marked another fundamental and long awaited milestone in the peace process. With the inclusion of the CPN/M in Government, including leadership of several key ministries responsible for development activities (e.g., the Ministries of Physical Planning and Works, and Local Development), it is expected that the development space for donor partners will be increased considerably. Although the interim government was formed on the basis of the underlying commitment to hold the CA elections on 20 June 2007 (as agreed by the eight parties), the Election Commission (EC) has officially informed the Government that holding a free and fair election would not be possible on that date. The EC has informed the Government that it needs at least 110 days after all election-related legal procedures are concluded to conduct a free and fair election. Therefore, it is very unlikely that the CA elections will be held as currently scheduled. Prospective postponement of CA elections has increased tensions between the larger political parties; hence the Government has not yet made any official announcement about a new date for CA elections.

5. In response to the rising violence in the *Terai*, the Interim Government has also formed a Committee to negotiate with the disaffected groups. The Committee formally made a request to all agitating groups to come to the negotiating table to find a political solution to their grievances. In response, NFIN decided on 15 April 2007 to withdraw its indefinite valley blockade, and the MPRF and JTMM have welcomed the Government's invitation for talks, but both groups have said a "conducive environment" should be created for the talks to take place.

6. In the meantime, the United Nations (UN) Arms Monitors have completed the registration of CPN/M combatants and their arms in the seven cantonments including registration of weapons held by CPN/M outside camps for the security of their leaders. As per the tripartite agreement (Government-CPN/M-UN) on management of arms and armies, the Nepalese Army has also completed locking up their weapons in a number equivalent to the CPN/M. A Nepal Peace Trust Fund has been established by the Government to cover costs of: (i) management of the camps and reintegration of ex-combatants; (ii) rehabilitation of internally displaced people; (iii) elections to the constituent assembly; (iv) strengthening of the law and order situation and police administration; and (v) support to the overall peace process. The UN has also established a Peace Fund to complement the Government's Trust Fund and facilitate coordinated support from donors for urgent peace process tasks.

B. Recent Economic Developments

7. Nepal's economic performance during the first six months of FY2007 (mid-July 2006 to mid-January 2007) were characterized by slow growth, rising inflation, and weak export performance. The Government has therefore revised its gross domestic product (GDP) growth forecast for FY2007 from 5% to 3.8%, mainly due to a significant decline in agricultural production resulting from unfavorable weather. The economic performance indicates that the expectations of a quick economic turnaround following the Comprehensive Peace Agreement signed between the Government and the CPN/M in November 2006 has not yet materialized.

8. Government revenues grew by 19.7% (NRs37.8 billion) in the first six months of FY2007 (mid-July 2006 to mid-January 2007) compared to 5.9% in the same period in FY2006. Total government expenditure stood at NRs44.7 billion during the first six months in FY2007 as against the original estimate of NRs71.9 billion, which is only about 62% of the target. The

underspending was mainly attributed to low development expenditures due to the absence of people's representatives in local bodies, resulting in weak investment in infrastructure. As a result of a higher growth of revenue and lower expenditures, the Government recorded a budget surplus of NRs2.65 billion (around 8.5% of GDP at mid-January 2007) in the first six months of FY2007 in contrast to a deficit of NRs2.50 billion in the same period last year. The trade deficit – estimated at 19% of GDP in FY2006 – is expected to rise to over 20% of GDP during FY2007.

9. With the Tenth Five-Year Plan (FY2002 – FY2007) ending in mid-July, the Government is in the process of preparing a three-year Interim Development Plan (IDP), instead of the Eleventh Plan, to address development challenges during the transitional period. The IDP preliminarily aims to target annual growth of 5.5%, which would be a significant acceleration over past performance. The main objectives of the IDP are to tackle poverty and unemployment, and promote good governance, focusing on reconstruction, rehabilitation and reintegration.

C. Response of the International Community

10. The international community has welcomed the recent positive political developments, such as the formation of Interim Parliament, Interim Constitution and amendments, and Interim Government with the participation of CPN/M. However, the donor community remains cautious given the risks in the current political situation and the difficult challenges ahead. In particular, it has raised concerns on the delay of CA elections and the need to find a peaceful solution to the *Terai* unrest, and has emphasized the urgency of moving the peace process forward.

11. The international community nevertheless recognizes the need to remain engaged and continue providing assistance to Nepal at this critical juncture. Given the significant uncertainty and fluidity associated with the current political situation, the international community has adopted a flexible and shorter term approach to its development support. Realizing the importance of maintaining a close dialogue with the international community, the Government has been organizing regular government-donor meetings to update on its development initiatives and priorities, which has been positively received.

D. Status of ADB's Operations in Nepal

12. With the formation of the Interim Government with CPN/M participation and the completion of the registration of CPN/M combatants and their weapons, the country's security situation has improved, expanding the development space. While the recent protests and demonstrations in the *Terai* have posed some disruptions and increased risks for ADB's operations in that region, these activities have not significantly affected ADB operations.

13. ADB's portfolio performance showed significant improvement in 2006. The contract award ratio increased sharply to 22% in 2006 from 15% in 2005, while the disbursement ratio improved to 20% in 2006 from 7.7% in 2005. This helped the net resource transfer to reach \$62 million in 2006 from \$2.9 million in 2005. Further, the number of projects at risk decreased to 17% in March 2007 from 30% in 2005. This was possible due to the improved project implementation environment after the April 2006 peace accord and ceasefire, and a number of specific actions undertaken as outlined in the Portfolio Management Strategy Paper, including (i) improving project readiness, (ii) donor harmonization for procurement, (iii) intensive engagement with Government, (iv) improved financial management, (v) closer monitoring and supervision, and (vi) spring cleaning exercises.

14. There are currently 23 ongoing loans, four grants, and 38 ongoing TAs, including two JFPR grants. Contract award and disbursement targets for 2007 for the ongoing loans are \$100 million and \$87 million, respectively. In the first quarter, contract awards and disbursement achievements were 109% (\$28 million) and 103% (\$25 million), respectively, against their quarterly targets. NRM's assessment in April 2007 of the impact of the security situation on the current portfolio revealed that 20 projects (80%) were not seriously affected, four projects (16%) projects were moderately affected, and one project (4%) was quite affected. A similar assessment done in June 2006 indicated 13 projects (57%) not seriously affected and 10 projects (43%) moderately affected.

E. ADB's Future Assistance in Nepal

15. ADB is processing the 2007 program as confirmed with the Government in December 2006. Three firm loans amounting to \$131.35 million have been programmed for 2007: (i) Education Sector Cluster Program (subprogram 2, \$8 million), (ii) Improving ICT Accessibility for Public Service Delivery (\$25 million), and (iii) Rural Reconstruction and Rehabilitation Sector Development Program (\$98.35 million). The 2007 Country Programming Mission (CPM) was undertaken during 17 – 29 April and discussed and confirmed with the Government the lending and nonlending assistance program for 2008 – 2009, with the latter year's program being tentative at this stage. The political process requires the time horizon for programming to be no more than one-two years. The regular three-year horizon for programming can be expected to be reinstated once the constituent assembly elections are held and a new constitution is established and a democratically elected representative government is in place. The Mission also met with development partners to share ADB's proposed assistance and explore possible cofinancing opportunities.

16. A comprehensive Country Operations Business Plan (COBP, 2007 – 2009) was prepared in October 2006, which confirmed that the Country Strategy and Program (CSP, 2005 – 2009) remains relevant in this transition period as the core reasons for poverty and conflict have not changed. In addition, the conflict-sensitive implementation approach of the CSP continues to facilitate effective implementation of ADB's assistance, as evidenced by the improvement in portfolio performance. The mid term review of the CSP will be postponed until next year and another comprehensive COBP will be prepared in 2007.

17. In the meantime, the processing of projects that address the underlying causes of the conflict and support the peace and rehabilitation process will continue in close coordination with the development partners. ADB will have to maintain a flexible approach given the fluid and rapidly evolving political and security situation. In view of the challenging political and economic context, ADB will maintain its cautious and conflict sensitive approach to ensure effective implementation of assistance.