

NEPAL: POLITICAL AND ECONOMIC UPDATE

This note is an update on the situation in Nepal provided in the board information paper (BIP) of 4 April 2006.¹

A. Recent Political and Security Developments in Nepal

1. Nepal underwent dramatic political changes in April 2006, nearly 15 months after King Gyanendra dismissed former Prime Minister Deuba and assumed direct rule on 1 February 2005. In the wake of growing confrontation with the King and his Government on the issue of restoring democracy and peace negotiations with the Communist Party of Nepal/Maoist (CPN/M), the alliance of seven political parties (SPA), backed by CPN/M, launched a nationwide general strike and protests during 6–9 April 2006 to press for reinstatement of the dissolved Parliament, restoration of democracy, and elections to a constituent assembly. As the Government imposed repressive security measures—arrests of political leaders, banning of public demonstrations, curfews, and even shooting at demonstrators—the movement snowballed into a mass uprising throughout the country, defying the Government's prohibitions and demonstrating popular will. The prolonged and intense mass agitation, in which over 20 people were killed by security forces, led to proclamations by the King on 21 and 24 April 2006, relinquishing the state powers he assumed on 1 February 2005 and reinstating the dissolved Lower House of Parliament.

2. Parliament held its first session on 28 April 2006, and a new interim coalition Government was formed on 2 May 2006, headed by G.P. Koirala (former Prime Minister), president of the Nepali Congress Party (NCP), and represented by four key political parties in the SPA—NCP; Communist Party of Nepal, United Marxist-Leninist; Nepali Congress (Democratic); and United People's Front.² Parliament passed a major resolution on 30 April 2006 to hold elections to a constituent assembly, a long-standing demand of CPN/M and a key demand of the 12-point understanding reached between CPN/M and SPA in November 2005. This was followed by another historic proclamation by Parliament on 18 May 2006, declaring itself as Nepal's sovereign authority. The nine-point proclamation significantly curtails the powers and privileges of the monarchy, brings the Army under Parliament's control, and declared the country a secular state. There has been widespread support for the proclamation, including by CPN/M.

3. CPN/M declared a unilateral ceasefire for 3 months on 26 April 2006, and the new Government swiftly reciprocated by declaring an indefinite ceasefire, removing the terrorist tag on CPN/M and releasing several CPN/M leaders under detention. The Government's indefinite ceasefire reflects its willingness to peacefully resolve the conflict. This has significantly improved security and paved the way for peace dialog. Preparations are under way for peace talks—a code of conduct to be observed by both sides is being negotiated, CPN/M has constituted a peace negotiation team headed by its supreme leader himself, and the Government has appointed the Home Minister to lead its team. Other members of the government team were also recently appointed. The two sides had an initial round of talks on Friday, 26 May 2006 that focused on a range of confidence building measures, including the creation of a code of conduct.

¹ ADB. 2006. *Nepal: Political and Economic Update*. Manila (IN. 74-06).

² Prime Minister Koirala was appointed on 27 April 2006, followed by appointment of six other Cabinet members on 2 May 2006. The Cabinet was further expanded to 18 members on 22 May 2006.

4. These developments present an unprecedented opportunity to all political forces to address the fundamental sources of political instability, and are promising for restoring lasting peace and democracy. Unlike in the past, CPN/M's demand for a constituent assembly has been accepted, the Government has declared an indefinite ceasefire, the SPA represents almost all democratic political forces, the SPA and CPN/M have a 12-point understanding leading up to peace negotiations, and Nepali society is much more open to discussing all political issues. The chances of a successful peace negotiation thus appear higher than at any time in the past.

5. However, the situation is still fragile and the political process for restoring peace and democracy will be challenging and carries significant risks. Parliament has endorsed elections to a constituent assembly but there are no established mechanisms for holding them under the constitution and agreeing on and ratifying a new one will be difficult. Holding free and fair constituent assembly elections presents yet another challenge given that CPN/M is still armed and has not yet abjured violence, controls large parts of Nepal's territory, and played a major role in the popular upsurge, significantly strengthening its mass base. Disarming and demobilizing CPN/M's armed force will be a serious challenge. However, the unprecedented people's movement suggests that the people's aspiration for peace and democracy is strong. Significantly, the popular pressure on all parties in the conflict to achieve a lasting peace is continuing. Arguably, for the first time in half a century, not just since the beginning of the conflict in 1996, there is a real opportunity to resolve fundamental political issues and to achieve a lasting peace.

B. Recent Economic Developments

6. Nepal has maintained macroeconomic stability despite the conflict. However, it has come under stress in recent months. GDP growth in FY2006 is expected to dip below 2%—well under the Government's target of 4%—because of weaker performance of agriculture and poor performance of industry and services as the conflict and political unrest escalated. The fiscal situation has also come under severe stress, with an expected revenue shortfall of more than 10% against the FY2006 budget target and sharply higher recurrent expenditures. While low development spending should prevent a large budget deficit, the Government is experiencing a cash-flow crisis, which could increase domestic borrowing sharply. Inflation has increased sharply in recent months and is expected to reach 8.0% from 4.5% in FY2005, mainly because of higher recurrent expenditure, lower agricultural output, and high international oil prices. The finance minister presented a white paper to the Parliament on 15 May 2006, describing these macroeconomic risks and proposing some short-term measures to address these through more effective expenditure management, strong revenue administration, and an interim economic program aimed at improved public service delivery.

7. The new Government, reflecting popular sentiment, has announced a review of all ordinances promulgated since October 2002, when the King dismissed the elected Government. The review intends to repeal ordinances that are politically controversial and undemocratic. Notably, some ordinances include reforms supported by international financial institutions (IFIs) and other donors. Some ordinances embodying major reforms supported by ADB-funded projects or programs since 2001 risk repeal. ADB, International Monetary Fund (IMF), World Bank, and other donor partners have initiated policy dialogue with the new Government to ensure continuity of the reform process while addressing specific provisions which are considered undemocratic. The Government has assured that it will not back-track on major IFI-supported reforms, which were initiated during the previous tenures of the present finance minister and Prime Minister. It has assured ADB that if the repeal of some ordinances affects

reforms supported by ADB, Parliament will quickly pass revised ordinances to maintain the continuity of reforms. ADB needs to stay engaged with the Government to avoid major rollback of reforms for populist reasons.

8. The Ministry of Finance convened a local donor group meeting on 17 May 2006, the first since the new Government took office. Chairing the meeting, the finance minister indicated that the Government will adopt a two-track approach in the present context—the political process for establishing peace and democracy as the primary agenda while remaining focused on reforms and development, in view of the high popular expectations. However, he explained that given the charged political environment, it will be difficult for the Government to undertake major fundamental reforms and ambitious development programs at this time. The priority of the present Government is to improve governance and public service delivery. In this connection, an interim economic program is being prepared and will be announced shortly, outlining the Government's key policies and priorities. He sought the donor community's support and flexibility in helping the Government implement its priority reform and development program and meet the popular expectations.

C. International Community's Response

9. The international community has unequivocally welcomed recent developments as a way to seek a peaceful solution to the conflict, ushering in lasting peace and stability in Nepal. Many countries—India, United States, European Union, Norway, Finland, United Kingdom, Denmark, and Japan—have indicated their readiness to continue and normalize their assistance, and to increase their assistance as the situation permits. The local donor group agrees on the need to respond quickly and positively, but carefully to the new developments by normalizing donor assistance, which has been disrupted in varying degrees since 1 February 2005. The donors believe that a fully harmonized and coordinated approach must be adopted in providing assistance to peace-building, reform, and development, and that mixed signals must not be sent to the parties in the conflict. They feel this is essential to support Nepal's quest for peace, democracy, and development.

10. However, the donors also recognize the difficult challenges ahead. Although the ceasefire is expected to expand the "development space" and ease the effective and safe delivery of donor assistance as during the previous ceasefires, the donors urged the Government to address the issue of development space as part of the peace process. They also sought the Government's support for the Basic Operating Guidelines³, which will continue to guide donor operations. There is general agreement that it would be difficult to expand development activities to the desired level or to fully normalize them given the significant risks (para. 5). While Nepal tries to meet the daunting political challenges over the next 1 or 2 years, donors will do well to continue their operations at 2003–2004 levels (before the royal takeover of 1 February 2005).

11. The donor community sympathizes with the new Government, given the daunting challenges it faces. The donors have agreed to take steps to normalize their assistance programs. They also agree that assistance to rural development, power, water supply and sanitation, education and health, and infrastructure should continue. However, most donors also feel that this is not the time to insist on strong conditionalities associated with structural reform. Even if the Government can take strong reform actions, it should wait for a democratically elected government to take the more fundamental reform actions—such as amendment or

³ Basic Operating Guidelines consist of 14 specific guidelines stating how development agencies operate in Nepal.

enactment of laws and major restructuring of public utilities—to reduce the risk of reversal. Most donors therefore feel that the international community should show flexibility: the political environment is conducive to continuing development assistance but may not be ready to implement major reforms. The donors also agree to wait for the Government to indicate its immediate and short-term priorities. While several donors have indicated their willingness to respond to the Government's request for additional assistance, there is general agreement that it may be difficult to upscale development assistance at this time given the challenges the Government faces.

D. Implications for ADB's Operations in Nepal

12. The recent political changes have positive implications for ADB's operations. The announcement of ceasefire by both parties to the conflict and their focus on moving toward peace talks have significantly improved security. This could expand the development space substantially. As a result, the project implementation environment—which is beginning to improve, with virtually no disruptions to the movement of people and goods and significantly reduced tensions across the entire country—can be expected to improve as the peace talks get under way and the ceasefire takes root.

13. ADB's Nepal Resident Mission's latest assessment (15 May 2006) of the impact of the security situation on the 23 ongoing ADB-assisted projects in Nepal suggests that it has improved: 13 (57%) projects are not seriously affected, 10 (43%) moderately affected, and none highly affected. More improvement is expected as the parties in the conflict show genuine commitment to peace. A similar assessment in mid-March 2006 showed 13 projects (57%) were not seriously affected, 8 (35%) moderately or not seriously affected, and 2 (8%) quite affected.

E. ADB's Operational Approach in the Current Context

14. ADB must continue its cautious, conflict-sensitive approach and close monitoring of the evolving situation in collaboration with other development partners, and routinely assess the implications for ADB operations. Effective and safe implementation must continue to be the criteria for continuing ADB operations in Nepal.

15. ADB must move in step with other development partners, be responsive to the changed context, and support the Government's peace-building efforts and development priorities. ADB is therefore processing the 2006 country program for Nepal based on an urgent request by the Government in close consultation with other development partners and using a cautious and conflict-sensitive approach. The political, security, and institutional risks will be continuously and carefully assessed for all projects to ensure that they will be implemented effectively and safely. ADB will examine the actions taken in the ordinances to be reviewed, which include reforms supported by ADB-funded projects and programs. ADB should strike a proper balance between the need to continuing engagement with the Government and the prudent operational intervention on a case-by-case basis. In this respect, ADB will work closely with the World Bank and IMF.

16. The 2005–2009 country strategy and program (CSP) for Nepal is based on a thorough assessment of the conflict and on a conflict-scenario approach—deterioration, base case, and improvement of the conflict situation. It also has a conflict-sensitive implementation strategy embedded in it. This has permitted ADB's operations to be implemented effectively and safely in most cases. However, the ongoing CSP update should review the basic approach and operational priorities of the CSP in the present context. While there will be some changes, two

proposed projects—Rural Finance Sector Development Cluster Program I and the Road Connectivity Sector I Project—are being processed since they are still relevant to delivering expected development results. South Asia Regional Department proposes to carry out an interim review of the Nepal CSP over the next 3 months. The findings will be reported to the Board through a BIP. A CSP update will also be prepared for Board consideration later this year.