

NEPAL: POLITICAL AND ECONOMIC UPDATE

This note is an update on the situation in Nepal provided in the board information paper (BIP) of 30 January 2006.¹

A. Political and Security Situation

1. The political situation remains complex, with growing confrontation between the Government, and the seven mainstream political parties and the insurgents, who forged a 12-point accord² in November 2005. Consequently, the political parties have taken a more radical stance against the monarchy, demanding nationwide elections to a constituent assembly—a long-standing demand of the Communist Party of Nepal, Maoists (CPN/M)—and establishment of “absolute” democracy. The uncompromising stance of all sides suggests that the conflict could linger.

2. Municipal elections were held on 8 February 2006 as scheduled. The agitating political parties and CPN/M boycotted the polls and threatened to disrupt them. The polls were generally peaceful, but voter turnout was low—an average of 20%. Nepali civil society, political parties, and the international community were very critical of the elections held without broad political participation.

3. Following the end of CPN/M’s unilateral ceasefire on 2 January 2006, hostilities resumed. In the past month, CPN/M stepped up attacks on security posts and other government installations in several district headquarters and urban areas in its strongholds in the mid-western and eastern regions, causing casualties on both sides. CPN/M also resumed the disruptive *bandhs* and strikes. However, the blockade of district headquarters from 14 March 2006 and the proposed nationwide indefinite strike from 3 April 2006 were withdrawn at the political parties’ request, based on an understanding that they would continue to intensify their agitation against the Government to press for their demands. On the positive side, for the first time, CPN/M has formally agreed with the United Nations (UN) to honor the Basic Operating Guidelines,³ and committed to the UN High Commissioner for Human Rights that it will limit attacks on the security forces and their logistic support infrastructure. However, violations on both counts by both sides in the conflict are reported from time to time.

B. Recent Developments

4. The Government has reinvigorated the reform process in the past few months. In particular, an ADB-supported amendment to the Civil Service Act and several other long-pending ordinances aimed at strengthening corporate and financial governance and improving management of Kathmandu Valley’s water supply have been promulgated, and restructuring of the Agriculture Development Bank is well under way. A new Labor Ordinance has been promulgated, a new Governance Ordinance and a Procurement Ordinance have been endorsed by the cabinet, and oil prices and distribution have been deregulated, substantially fulfilling the outstanding reform conditions under World Bank’s Poverty Reduction Support Credit II and the International Monetary Fund’s (IMF’s) Poverty Reduction Growth Facility.

¹ ADB. 2006. *Nepal: Recent Political and Economic Update*. Manila (IN. 20-06).

² Under the 12-point accord, the political parties and CPN/M have agreed to intensify their campaign against the current regime and restore peace and democracy through elections to a constituent assembly that will reframe the Constitution. However, while CPN/M is pressing for an all-party convention and an interim government to oversee the elections to the constituent assembly, the political parties prefer to initiate the constituent assembly process by first having the dissolved Parliament reinstated.

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

5. The state minister of finance convened a meeting of Nepal's local donor group on 6 March 2006, signifying resumption of the Government–donor dialog after a long gap and allaying donors' concerns.⁴ The minister briefed the donors on the Government's recent economic reform initiatives, the implementation progress of its poverty reduction strategy, and its commitment to strengthen partnership with donors. The donors appreciated the Government's initiative and urged more regular dialog and more responsive engagement with the donor community.

6. In a landmark ruling on a writ petition, the Supreme Court declared the Royal Commission for Corruption Control (RCCC) unconstitutional and abolished it on 13 February 2006, and invalidated all its rulings, including the corruption charges against former Prime Minister Sher Bahadur Deuba and five others regarding the award of a civil works contract under the Melamchi Water Supply Project. Consequently, Mr. Deuba and former Physical Planning and Works Minister Prakash Man Singh, under detention since April 2005, were released the same day. The RCCC stands dissolved. The international community views the Supreme Court's ruling as a positive development, given its serious concerns about RCCC's establishment and conduct.

7. The director general of South Asia Regional Department (DG SARD) visited Nepal on 22–26 March 2006 for high-level consultations with the Government on ADB's operations in Nepal. He was granted an audience by His Majesty King Gyanendra Bir Bikram Shah Dev. He expressed to His Majesty and the Government ADB's deep concern about the conflict and growing political confrontation, and hoped that Nepal would find a peaceful and lasting solution soon. The DG SARD noted the reinvigoration of the reform process by the Government in the past few months resulting in actions on some long-pending and complex reforms under very difficult circumstances. He urged stronger focus on the reform and development agenda, and stressed the need for the Government to continue to engage with Nepal's donors to address their concerns. He expressed hope that ADB would be able to continue assisting Nepal in close coordination with donor partners but that it would depend on whether the assistance can be provided effectively and safely.

8. The Government expressed deep gratitude for ADB's assistance over the past three decades, and reiterated that ADB's assistance remains vital to achieving Nepal's development and poverty reduction objectives. Stating that Nepal was passing through extremely trying times, His Majesty explained that his Government was trying its utmost to find a lasting solution to the crisis. His Majesty expressed the view that Nepal's security situation has been long underestimated and that restoration of peace, stability, and democracy are key priorities of the Government. He emphasized that the crisis presents an opportunity to undertake major reforms and indicated a strong commitment to deepen reforms to open up Nepal's economy, promote foreign investment, and benefit from regional cooperation and integration.

C. Donors' Approach to Development Assistance in Nepal

9. ADB's Nepal Resident Mission (NRM) has been in regular and close contact with the local donor group to assess the political and security situation in Nepal, share experience in field operations, and discuss operational approaches. The DG SARD also interacted with key donors during his consultation mission. The donors remain concerned about the growing political confrontation, resumption of conflict, and the lack of progress toward restoring peace and

⁴ This meeting was followed by a meeting organized by the Ministry of Finance on 16 March to discuss policy and operational issues in education and health.

democracy, and urge the government and the political parties to reconcile and seek a lasting solution to the political crisis and conflict.

10. Donors still recognize that they need to remain engaged in Nepal despite the difficult operating environment and that the poor and vulnerable will be hit harder if development assistance is reduced sharply. They urge the Government to respect the Basic Operating Guidelines and cooperate on the “fragile states principles for good international engagement”. Donors continue to provide assistance where it is possible to do so effectively and safely under existing multi-year agreements with the Government, without significant reduction in assistance levels. The Government has indicated that since 1 February 2005, it has signed loan or grant agreements with 13 donors for 29 projects totaling \$334 million. Some donors, however, are not making new commitments, which would “dry up” their assistance from 2010 onward. World Bank continues to follow its “base-case” lending scenario of \$120 million–\$200 million per annum. It is in the advanced stages of processing two loans—poverty reduction fund and higher education—for \$110 million, which are expected to be approved by June 2006.

D. Status of ADB’s Operations in Nepal

11. ADB’s portfolio in Nepal comprises 23 loans and 27 technical assistance (TA) projects, covering all 75 districts. NRM’s latest assessment (15 March 2006) of the impact of the conflict on the implementation of these projects suggests that 3 (13%) of the 23 ongoing loans are quite affected by the security situation, while the remaining 20 are moderately or not seriously affected. This is mainly because the disruptions are time and location specific, and most project activities are participatory and community-based and, hence, able to continue effectively and safely in the current environment. Frequent general strikes and blockades continue to pose difficult challenges for project implementation.

12. ADB’s assistance in 2005 included three TA grants for \$2.16 million. Four of the five pending loans approved in 2003 and 2004 were declared effective in phases from October 2005 to February 2006, preceded by close consultation with relevant donors and ADB’s own assessment of the political, security, and institutional risks pertaining to each project.⁵

13. ADB’s portfolio performance improved significantly in 2005 compared with the past 3 years despite the conflict. Contract awards increased to \$70 million in 2005 from \$38 million in 2004, while the disbursement increased to \$43 million in 2005 from \$22 million in 2004. Similarly, the contract award ratio increased sharply to 15% in 2005 from 7% in 2004, while the disbursement ratio increased to 7.7% in 2005 from 4.4% in 2004. Further, net resource transfer to Nepal turned positive in 2005 for the first time in 4 years.

14. ADB continues to take a cautious approach to processing ADB’s assistance program to Nepal in 2006. Loan and TA processing is continuing based on close consultation with other donor partners and careful assessment of the political, security, and institutional risks in implementing these projects effectively and safely.

⁵ The four loans declared effective: Decentralized Rural Infrastructure Development (26 October 2005), Community Livestock Development (2 December 2005), Community Managed Irrigated Agriculture Sector Development (13 January 2006), and Skills for Employment (28 February 2006). Signing and effectiveness of the remaining loan—Gender Equality and Women Empowerment Project—is still on hold, pending promulgation of important legislation to end discriminatory provisions against women in Nepal’s laws.