

NEPAL: POLITICAL AND ECONOMIC UPDATE

This note is an update on the situation in Nepal provided in the board information paper (BIP) of 29 May 2006.¹

A. Recent Political and Security Developments in Nepal

1. The peace process sparked by the historic political developments in Nepal in April 2006—the resignation of the King's government, reinstatement of the dissolved Parliament, and initiation of peace negotiations with the Communist Party of Nepal, Maoist (CPN/M), including a ceasefire—is continuing. Negotiating teams of the Seven-Party Alliance (SPA) and CPN/M have held two rounds of formal peace talks so far since April 2006. However, informal talks are taking place continually. The first round of talks on 26 May agreed on a 25-point ceasefire code of conduct, under which both sides agreed to refrain from armed hostilities, facilitate public service delivery and development activities, and seek international monitoring of the ceasefire. Significantly, the second round of peace talks on 16 June was a summit meeting led by Prime Minister G. P. Koirala and Chairman P. K. Dahal alias 'Prachanda' representing the SPA and CPN/M, respectively. An eight-point agreement was signed at the summit, stipulating the drafting of an interim constitution, formation of an interim government with CPN/M's participation, dissolution of the reinstated Parliament, dismantling CPN/M's parallel local administration structures, requesting the UN to manage and monitor weapons, and declaring the dates for constituent assembly elections soon.

2. While there is no formal mechanism in place yet, the Government has formally requested the UN's support for monitoring the ceasefire and weapons management. Drafting of an interim constitution has been initiated by a committee comprising representatives of the SPA, CPN/M and civil society. The interim constitution will also stipulate provisions for holding elections to the constituent assembly, CPN/M's participation in the government, and their inclusion in mainstream politics, possibly including an 'interim' parliament which would include CPN/M representatives. The interim constitution is also expected to address other fundamental issues such as the monarchy's role.

3. The peace process has been somewhat slower relative to expectations, but significant understandings have been reached and are being implemented as noted above. The ceasefire also has been effective, the security situation has improved substantially and the economy is picking up. Overall the country is headed in the right direction and, if sustained, could lead to a negotiated settlement of the conflict and lasting peace. However, the path ahead remains complex and poses significant risks. Central to success of the peace process is the issue of disarmament, demobilization and reintegration of the rebel forces. Significantly the CPN/M have not yet made an unequivocal statement on renouncing violence to achieve their political ends. Without it and demobilization of the rebel army, a conducive environment for free and fair elections to the constituent assembly cannot be created. Given the complex history of the present conflict, it is to be expected that the process for achieving a lasting peace will be very challenging and could involve 'twists and turns'. Although there is anxiety in Nepal about the eventual outcome of the peace talks, most analysts feel that the chances of ending the conflict this time are significantly higher. Aspirations of the country for peace, democracy and

¹ ADB. 2006. *Nepal: Political and Economic Update*. Manila (IN. 118-06).

development remain strong, and this appears to be keeping the major political forces including CPN/M under pressure to achieve peace through dialog.

B. Recent Economic Developments

4. The Finance Minister presented the budget for FY2007² to the Parliament on 12 July 2006. The macroeconomic framework of the budget targets a GDP growth rate of 5% in FY2007, compared with an average of 2.7% in the past three years. Inflation is forecast at about 6%, compared with an average of 5.3% in the past three years and 8% in FY2006. Other macroeconomic indicators are generally sound and are projected to strengthen in FY2007. The budget reflects the Government's commitment to initiate post-conflict reconstruction, rehabilitation and reintegration of rebel forces into Nepal's mainstream politics and development process if the peace talks succeed. The Government is committed to effect large resource transfers to support major social and economic transformation to address rural poverty. The moderately expansionary budget will support the peace process which is still at an early stage. The FY2007 budget targets are ambitious, and its achievements will depend critically on continuation of the peace process, and effective implementation of development activities. The IMF has responded favorably to the FY2007 budget.

5. The total expenditure outlay is 32% higher than the annual average increase of less than 10% in the past 3 years. Domestic revenue is targeted to increase by 18% over the achievement in FY2006. The target is ambitious given an actual average growth of only 10% in the past 3 years. Foreign assistance is expected to increase sharply by 72%, compared with an average growth of 23% in the past 3 years. The budget deficit is also projected to increase sharply to 3% of GDP from 1.8% in FY2006, and will be financed by increased domestic and external borrowings.

6. Recurrent expenditures are estimated to increase by over 20%, compared with an increase of 12% in FY2006, despite a significant reduction in the allocations for security and royal palace expenditures. This is mainly due to higher debt service payments, allowances to civil servants, and allocation for the constituent assembly elections expected to be held by April 2007. More significantly, the capital budget increased sharply by 56%, compared with an increase of only 5% in FY2006, reflecting improvement in the outlook for accelerated development activities. The bulk of the capital budget has been allocated for rural development, including social sectors (education, health, and rural water supply and sanitation), rural infrastructure (mainly rural roads), and a doubling of block grants to Village Development Committees. The allocation for pro-poor expenditures in FY2007 is about 40%, an increase of 6 percentage points over last year.

C. Response of the International Community

7. The international community has welcomed the political developments and the improvement in the security situation following the people's movement of April 2006, and continues to closely monitor the evolving situation in the country. Nepal's donor community is pleased with both parties' commitment to the ceasefire and the improved environment for implementing development activities. Most donors are eager to scale up assistance to Nepal to support the peace process³ but are keenly aware of the risks and challenges in the unfolding

² FY2007 begins from mid-July 2006.

³ This is reflected in the large increase in external resources targeted in the budget, which is to be sourced from foreign loans and grants noted above.

peace process. Several donor working groups have been formed to support the peace process, assist in the constituent assembly elections, advise on transitional justice, and assist in issues related to the management of weapons and demobilization of rebel armed forces.

8. The monthly meeting of donors is continuing and provides an excellent forum to exchange views, experience, and coordinate and harmonize development assistance in the rapidly evolving new political context. Among key concerns of donors is how effectively the national level commitments of the CPN/M are being translated at the ground level. For instance, CPN/M in several places is still pushing for local control of development. Issues relating to a possible post-conflict assistance package to Nepal are also under active discussion among the donors. However, concrete agreements on such package are not feasible at this stage due to the uncertainties associated with the peace process. Development activities are being implemented more effectively. ADB is actively coordinating and maintaining dialogue with the development partners. It is also an active participant in the regular Basic Operating Guidelines Group meetings.

D. Status of ADB's Operations in Nepal

9. The ceasefire, the code of conduct and continuation of peace talks have significantly facilitated development activities. The activities are expected to expand further with the government's expansionary fiscal stance in FY2007, and if the peace process progress well. Decommissioning and disarmament as well as the dismantling of CPN/M's parallel local administrative structures with the ceasefire holding and peace talks continuing, will be the key to restoring a 'normal' environment for project implementation.

10. ADB's portfolio performance has improved due to the favorable political and security developments and effective engagement with the Government to address project implementation constraints. During the first half of 2006, the contract award achievement was \$21.6 million and disbursement achievement was \$25.4 million. These are 72% and 99% of the respective semi-annual targets. NRM's latest assessment⁴ of the impact of the security situation on the 23 ongoing ADB-assisted projects suggests an overall improvement in the project implementation environment: 13 (57%) projects were not seriously affected, 10 (43%) moderately affected, and none highly affected. A similar assessment in mid-March 2006 showed 13 projects (57%) were not seriously affected, 8 (35%) moderately affected, and 2 (8%) quite affected. Further improvement is expected in the months ahead as progress is made to restore peace.

11. In view of the risks involved in the peace process, ADB will continue to adopt a conflict-sensitive approach to ensure that its assistance is implemented safely and effectively. ADB will also continue to conduct regular conflict impact assessments and undertake annual spring-cleaning of its active portfolio in Nepal.

E. ADB's Future Assistance to Nepal

12. ADB Nepal CSP (2005 – 2009) focuses on promoting pro-poor and broad-based economic growth, supporting inclusive social and human development, and promoting good governance. While the political context in Nepal has changed considerably since the preparation of the CSP, the underlying causes of the conflict and poverty in Nepal remain unchanged. The CSP was built on a thorough assessment of the conflict, the structural constraints and their

⁴ The latest assessment was conducted on 20 July 2006.

implications for development and poverty reduction. The assessment suggested that the root causes of the conflict lie in deep-seated social exclusion, large social, economic and regional inequalities, as well as weak governance.

13. The strategy and objectives of the CSP are well served by its conflict-sensitive approach to operations which address the issues and constraints stated above. The CSP recognizes the need for effective delivery of development assistance even in the conflict environment, and includes operations that indirectly support the attainment of peace. A review of the CSP in light of the political changes since April 2006, shows that the overall strategic direction, and priorities and operational approach of the CSP for Nepal remain valid in the current political and development context. This is mainly due to the CSP's emphasis on addressing the root causes of the conflict and its conflict-sensitive approach to project design and flexible implementation modalities. However, the assistance pipeline may need adjustments particularly if the peace talks succeed.

14. ADB is processing the country program for 2006 in close consultation with development partners. Considering the risks associated with the peace process, ADB continues to adopt a cautious approach in its operations. This entails assessment of the political and security situation at every major project processing milestone, continuing the conflict-sensitive approach proposed in the CSP and coordinating operations closely with other development partners.

15. A comprehensive Board Information Paper (BIP) was circulated to the Board in December 2005 in lieu of the CSPU, while the last BIP was circulated in May 2006 in the wake of the historic political changes in April. While the CSPU process in 2006 was initiated in March, it had to be postponed due to the political changes in April 2006 and the new Government's request to defer further processing of the CSPU till the Budget for FY2007 was presented to Parliament. Since this was done on 12 July, the CSPU process has resumed. It may be recalled that except for few TAs no new assistance was committed to Nepal in 2005. Some of these projects have been carried over to 2006. Processing of relevant/appropriate projects, which contribute to addressing underlying causes of conflict and supporting the peace process, is continuing, in close coordination and in step with international development partners. Necessary adjustments to the country program in 2006 due to the carry over projects from 2005 have been discussed with the Government during the Country Programming Mission (CPM) from 24 July to 02 August. However, the program will be processed cautiously and prudently keeping in view of the country's complex situation. Also, in view of the uncertainties facing the country, only a near term program, i.e., for 2006 and 2007 is being considered during the CPM.