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INTERIM STRATEGY NOTE

FOR

NEPAL

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Nepal Country Management Unit
South Asia Region

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The last Country Assistance Strategy for Nepal (Report No. 26509-NEP) was discussed on November 18, 2003.

Currency and Equivalents
 Currency Unit = Nepali Rupee (NRs.)
 US\$1 = NRs. 70.0 (as of December 31, 2006)

Fiscal Year

Nepal: July 15–July 14 (fiscal year starting on July 15, 2005 is designated as FY05/06)
 The World Bank: July 1–June 30 (fiscal year starting on July 1, 2005 is designated as FY06)

Abbreviations and Acronyms

AAA	Analytical and Advisory Activities	MTEF	Medium Term Expenditure Framework
ADB	Asian Development Bank	NAR	Net Attendance Rate
AG	Auditor General	NBL	Nepal Bank Limited
APP	Agricultural Perspective Plan	NC(D)	Nepali Congress (Democratic) (Party)
ASYCUDA	Automated System for Customs Data	NDF	Nepal Development Forum
AUSAID	Australian Agency for International Development	NEA	National Electricity Authority
CAS	Country Assistance Strategy	NER	Net Enrolment Rate
CBO(s)	Community-Based Organization(s)	NGO(s)	Non-Governmental Organization(s)
CBS	Central Bureau of Statistics	NLSS	Nepal Living Standards Survey
CDD	Community-Driven development	NOC	Nepal Oil Corporation
CFAA	Country Financial Accountability Assessment	NPA(s)	Non-Performing Asset(s)
CIAA	Commission for the Investigation of the Abuse of Authority	NPC	National Planning Commission
CPAR	Country Procurement Assessment Review	NRB	Nepal Rastra Bank
CPN-M	Communist Party of Nepal-Maoists	NTA/C	Nepal Telecommunications Authority/Corp.
CPN-UML	Communist Party of Nepal-Unified Marxist Leninist	OECD/DAC	Organization for Economic Cooperation & Development/Devel. Cooperation Division
DDC(s)	District Development Committee(s)	P1	High Priority Project (in MTEF framework)
DfID	United Kingdom's Department for International Development	PAC	Public Accounts Committee
DHS	Demographic and Household Survey	PAF	Poverty Alleviation Fund
DME	Department of Monitoring and Evaluation	PDF	Power Development Fund
DPC	Development Policy Credit	PERC	Public Expenditure Reform Committee
DRT	Debt Recovery Tribunal	PETS	Public Expenditure Tracking Surveys
EFA	Education for All	PFM	Public Financial Management
EMIS	Education Management Information System	PMAS	Poverty Monitoring & Analysis System
ERTA	Economic Reform Technical Assistance	PRGF	Poverty Reduction and Growth Facility
FAP	Foreign Aid Policy	PRS(C)	Poverty Reduction Strategy (Support Credit)
FSRP	Financial Sector Restructuring Program	RAIDP	Rural Access Improvement & Decentralization Project
FY	Fiscal Year	RBB	Rastriya Banijya Bank
GDP	Gross Domestic Product	RPP	Rashtriya Prajatantra Party
GON	Government of Nepal	RWSSP II	Second Rural Water Supply & Sanitation Project
GTZ	Gesellschaft für Technische Zusammenarbeit (German Agency for Technical Cooperation)	SDC	Swiss Agency for Development & Cooperation
HIPC	Highly Indebted Poor Country	SEDF	SouthAsia Enterprise Development Facility
HMGN	His Majesty's Government of Nepal	SMC(s)	School Management Committee(s)
HMIS	Health Management Information System	SME	Small and Medium-sized Enterprise
IAP	Immediate Action Plan	SNV	Netherlands Social Development Organization
ICD	Inland Container Depot	SOE	State-Owned Enterprise
IDA	International Development Association	SPA	Seven Party Alliance
IDU(s)	Intravenous Drug User(s)	SWAp(s)	Sector Wide Approach(es)
IFC	International Finance Corporation	TA	Technical Assistance
ILO	International Labor Organization	TB	Tuberculosis
IMF	International Monetary Fund	UN	United Nations
ISN	Interim Strategy Note	UNCITRAL	UN Commission on International Trade Law
JSAN	Joint Staff Advisory Note	UNDP	United Nations Development Programme
LIC DSA	Low Income Country Debt Sustainability Analysis	UNFPA	UN Population Fund
LPG	Liquefied Petroleum Gas	UNHCR	UN High Commissioner for Human Rights
MDG(s)	Millennium Development Goal(s)	UNICEF	UN Children's Fund
MFA	Multi-Fibre Agreement	VAT	Value Added Tax
MIGA	Multilateral Investment Guarantee Agency	VDC(s)	Village Development Committee(s)
MOF	Ministry of Finance	VRS	Voluntary Retirement Scheme
MOGA	Ministry of General Administration	WHO	World Health Organization

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NEPAL

INTERIM STRATEGY NOTE

TABLE OF CONTENTS

Executive Summary

I.	Introduction.....	1
A.	Context.....	1
B.	Recent Developments	1
C.	Possible Scenarios and Strategic Response	2
II.	The Country Context.....	4
A.	Social Context.....	4
B.	Political Context	7
C.	Economic Context: Recent Economic Development and Prospects.....	9
D.	Progress towards Implementing the Poverty Reduction Strategy.....	11
E.	Progress towards Implementing the Reform Agenda	12
	Broad-Based Economic Growth	12
	Social Sector Development.....	14
	Social Inclusion and Targeted Programs	15
	Good Governance	15
	Immediate Action Program.....	17
	Donor Coordination/Harmonization	17
III.	Lessons Learned from the Recent Past.....	18
IV.	The Way Forward.....	19
A.	Introduction.....	19
B.	Possible Scenarios.....	20
C.	The Bank's Assistance Strategy.....	20
D.	Risks	24
	Immediate Risks	24
	Fiduciary Risks	25
E.	Concluding Remarks.....	26

TABLES

Table 1	Poverty in Nepal, FY95/96-FY03/04.....	4
Table 2	Progress towards Achieving the Millennium Development Goals	6
Table 3	Selected Macroeconomic Indicators, FY01/02-FY05/06	9
Table 4	Indicative Lending Program	22

BOXES

Box 1	How Has Poverty Been Reduced in Nepal?.....	5
Box 2	Poverty Monitoring and Analysis System	12
Box 3	Some Experience from CDD Projects in Nepal.....	19

APPENDICES

Appendix I	Progress to Date on CAS Implementation
Appendix II	CAS Outcomes, Milestones and Interventions: FY04-FY06
Appendix III	Evaluation of CAS Triggers
Appendix IV	Debt Sustainability Analysis
Appendix V	Update on the Immediate Action Plan
Appendix VI	Community Driven-Development: Evidence of Success
Appendix VII	Expenditure Eligibility

ANNEXES

Annex A1	Key Economic and Program Indicators—Change from Last CAS
Annex A2	At A Glance
Annex B2	Selected Indicators of Bank Portfolio Performance and Management
Annex B3	Bank Group Program Summary
Annex B4	Non-Lending Activities
Annex B5	Social Indicators
Annex B6	Key Economic Indicators
Annex B7	Key Exposure Indicators
Annex B8	Status of Bank Group Operations

Map (IBRD 33455)

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NEPAL Interim Strategy Note

Executive Summary

i. The political transition in April 2006 has opened a new chapter in the history of Nepal. The signing of a comprehensive peace agreement between the Government of Nepal (GON) and the Communist Party of Nepal-Maoists (CPN-M) in November lays out a roadmap to a lasting peace and the construction of a new governance structure. Nepali citizens feel that they can now put their country on a firm path towards a ‘New Nepal,’ which is peaceful, inclusive, just, and prosperous. But, the road ahead is not without serious pitfalls. In the short run, the political situation will remain fluid and potentially unstable until successful constituent assembly elections are held and all sides accept the results. The differences between the CPN-M and other political parties in political and economic philosophies remain unresolved and are the fundamental source of the uncertainty.

ii. The recent conflict is a stark reminder of two important realities in Nepal. First, the state has been gravely short on legitimacy. The sustained armed insurgency is the most obvious proof of this. Second, that a group of citizens took up arms and found a significant base of support indicates that some segments of the population felt profoundly excluded from the established system. The grievances were political and social, as well as economic. Moving forward then, Nepal must focus on the two central issues: state building and inclusion.

iii. Nepal’s endeavor to build a new future must also be put in the context of the long term transformation from a country that was feudal and closed in many respects to a country that is ‘liberal’ (in the basic sense of respecting the equal rights and freedoms of individuals) and open. Improvements in education and broad progress in economic development—key drivers of this process—will inevitably take several generations. In the meantime, reforms may be uneven, public service delivery may remain weak and old-style politics may continue. It will be important for the Bank to maintain a historical perspective and provide steady support to the country’s long term development, especially in education, basic infrastructure and state institution building. Without forming these broader developmental foundations, Nepal will not complete this journey.

iv. In meeting this challenge, Nepal is not without some significant assets. It has shown great strength in mobilizing community level energy to implement development programs. When the government needs to respond to rising expectations of the people in service delivery and build the credibility of the state as a developmental institution, it would only be sensible for it to work with the strength of the communities. Successful community-based programs can and should be scaled up.

v. Given the significant uncertainty and fluidity associated with the political situation, three broad scenarios cover the range of possibilities under which the Bank’s assistance strategy should be considered.

- ***Steady transition*** to a New Nepal, with the country moving steadily along the agreed political roadmap toward a new Constitution and government, and development accelerates.
- ***Stalled transition*** in which the political process hits some obstacles and stalls. Or as Nepal finds itself now, even though the peace process is intact, the reform and development side is moving slowly. This, however, is not a sustainable long-term scenario, for fundamental tensions remain unresolved.

- **Deterioration** with the political process failing, possibly resulting in a widespread conflict and a breakdown in the key functions of the state.

vi. Since a new political order will not emerge for at least 12-18 months, the Bank's strategy will have to be flexible in the near term, while not losing sight of Nepal's overall development needs. Therefore, while this is an Interim Strategy Note (ISN), it continues to focus on a longer term developmental agenda for Nepal.

vii. In general, the Bank's strategy will focus on protecting the past reform gains and helping the government prepare for the important post-conflict work. The Bank would continue to enter into new commitments for a number of projects, many built on robust community engagement and others strengthening the foundations for faster growth. Strong dialogue, backed by analytical work carried out with not just the government but also a broad range of stakeholders, will continue, especially on the issues of inclusion, state building and growth. The Bank will also provide support to the formulation of a new national vision—which is essential to give a unified direction to the social energies mobilized by the political change—and development of a major post-conflict economic program. As opportunities emerge—whether related to implementation of the peace process, implementation of reforms, or implementation of the post-conflict program—and there is movement towards the positive end of the scenario spectrum, additional Bank assistance could be provided, including budget support. Such opportunities will provide important entries into building state capacity and donor harmonization. In addition to inclusion, the Bank's strategy will also focus on assisting Nepal to accelerate growth and create employment. Should the situation worsen, the Bank's support would need to become more selective, but would continue to assist community-based initiatives that have proven fairly resilient even in conflict.

viii. Even in the best scenario, there is a considerable risk that Nepal's leadership will be preoccupied with the political agenda. Ignoring the development agenda could prove damaging not only for the long term needs of the country, but also for the near term political goal of achieving a lasting peace. Unless the government is able to demonstrate that economic conditions and public services are improving, the population could lose patience and narrow the space necessary to resolve the political issues. As political competition heats up—especially as the constituent assembly elections draw closer—there are also risks of abuse of public resources for campaign purposes and undermining of sound policies to pander to certain groups. Collective efforts by the development partners to help Nepal maintain emphasis on the development and reform agenda will be a key risk mitigation measure.

ix. Executive Directors may wish to discuss the following issues.

- Do they agree with the basic analysis of the long term context of Nepal's development challenges, and the near term outlook that underpins the proposed strategy?
- Do they agree with a strategy that advocates strong and continued engagement despite the considerable political uncertainty?
- Do they agree with the range of lending and non-lending support envisioned by the ISN, including possible budget support?

NEPAL

Interim Strategy Note

I. Introduction

A. *Context*

1. The 2003 Country Assistance Strategy (CAS) for Nepal—covering FY04-FY07—was discussed by the Board in November 2003.¹ Because of the volatile political situation over the last few years, a formal update has been delayed. Instead, management has provided oral briefings on the country situation to the Board of Directors in March 2005, December 2005 and August 2006. In the context of the continuing fragile political environment, this Interim Strategy Note (ISN) is meant to: (i) provide an update on the country context; and (ii) in the context of recent lessons learned, lay out the Bank’s strategy in the face of the anticipated continuing uncertainty. It is expected that greater clarity will emerge on the political front only in the next 12-18 months and with it the new development strategy of the Government of Nepal (GON).² This report is intended to guide the Bank’s assistance program for Nepal until that time.³

B. *Recent Developments*

2. A large-scale protest movement in April 2006 led to the end of King Gyanendra’s direct rule,⁴ reinstatement of the House of Representatives and formation of a “Seven Party Alliance” (SPA) government. More recently in November 2006, the signing of a comprehensive peace agreement between the SPA and the Communist Party of Nepal-Maoists (CPN-M) marked a major political breakthrough in the country, raising prospects for a lasting peace. An important milestone will be constituent assembly elections—agreed to be held by mid-June 2007—and until that time, the situation will likely remain fluid.

3. The events of April 2006 created an ‘open moment’ in Nepal.⁵ The enormous popular energy that was mobilized against the old order also lifted many social and political constraints, and the Nepali people have come to feel that a peaceful, inclusive and prosperous Nepal is within their grasp. Unless expanded with a vision and sustained action, however, this open moment will likely shut quickly. Without a unifying path, the huge energy mobilized in April can pull the country in different directions in

¹ See Report No. 26509-NEP, dated October 20, 2003. For an update on progress implementing the CAS, see Appendix I.

² Following the events of April 2006 the official name of the government was changed from His Majesty’s Government of Nepal (HMGN) to Government of Nepal (GON). For purposes of consistency, throughout this document the new name is used.

³ Corresponding with the time envisioned for political clarity and a new development strategy to emerge in Nepal, it is anticipated that a new Bank strategy would be prepared in the next 12-18 months. Until that time, management would continue to update the Board as warranted.

⁴ Direct rule by the King began on February 1, 2005 when a coalition government was dismissed and a new council of ministers was formed under the chairmanship of the King. However, the intense political instability really began with the dissolution of Parliament in May 2002 and the subsequent sacking of the elected cabinet in October 2002 on account of its inability to hold Parliamentary elections.

⁵ Professor Ashraf Ghani, in his May 2006 report for the Bank, was the first to use the term ‘open moment’ to describe Nepal’s socio-political situation.

pursuit of self interests by narrower groups. Already there are signs of such—e.g., excessive demands being made by organized labor, temporary teachers, the contractors' association and even bank defaulters. In the tenuous balance of power between the SPA and CPN-M, both sides seem inclined to engage in competitive populism, rather than astute management of unrealistic expectations. If such myopic politics continues, Nepal could well spiral back into renewed violence or chaos.

C. Possible Scenarios and Strategic Response

4. The November peace agreement between the SPA and CPN-M sets out a broad political roadmap for the future.⁶ While there is good reason for optimism, the path ahead for Nepal is still fraught with possible pitfalls and a wide range of scenarios are conceivable. For the purposes of strategic planning, this document considers three scenarios:

- In the best case scenario—'**steady transition**' toward a New Nepal—the country will continue to move forward toward lasting peace (based on the agreed roadmap) and a well functioning democracy and accelerated development.⁷
- In the worst case scenario—'**deterioration**'—the state would cease to be able to perform its basic functions and the country could slide into a widespread civil war.
- Between these two extremes, there are many scenarios that would maintain a modicum of stability, but not make progress on the development agenda or in resolving the underlying issues, especially when the peace process hits contentious issues. If history is any guide, a '**stalled transition**' is possible for prolonged periods, but is fundamentally not sustainable in the long run, as sooner or later the country will be forced to deal with the basic issues underlying the conflict.

5. These possibilities make for an uncertain environment in which to contemplate development assistance to Nepal. Yet, regardless of the political developments, there are certain invariant points that are likely to define the development agenda and hence help guide the Bank's strategy formulation. Specifically:

- First, a fundamental challenge that the government—even with the CPN-M—will face is one of establishing credibility for the state as an institution, or at least taking concrete steps toward that goal. Without doing so, the basic governability of the country will be threatened in the short run, and any endeavor to achieve significant development will be futile in the long run. Nepal must begin to reorient the state apparatus, which in the past has been more geared toward dispensing patronage to a privileged few at the expense of the rest. The state must become an instrument of collective action by the people. Related to this, Nepal needs to articulate a long term vision to give clear direction to the aspirations of the population and the social energies for change.
- Second, Nepal must sustain focus on development. The King's unsuccessful attempt to address the complex political and development problems through direct rule demonstrated that there are no shortcuts to solving them. The social, political and economic challenges of the country must

⁶ The details of this roadmap are spelled out in paragraph 16.

⁷ Until free and fair constituent assembly elections are completed and the results are widely accepted, the peace process could easily be derailed. Therefore, the elections will be an important milestone in this scenario. This milestone will also be significant for development assistance, for it will put the government in a strong position to seek additional assistance from the development partners to accelerate implementation of an economic package to help cement peace.

be viewed in the context of the long term transformation—of the kind that can take several generations—that Nepal is going through. The shortcomings of the state and democratic political processes are linked to the generally low levels of economic security and education of the citizens. Without addressing these basic problems, it is unlikely that a ‘New Nepal’ would become a reality. While there is a tendency among some to think that Nepal should first address the political agenda and then the development agenda, such a sequential approach is problematic, as there are no guarantees that the political issues will be settled within a short period. ‘Stop and go’ development efforts would only compound the damage to the longer term process. A more immediate reason for keeping a focus on development is that if it is neglected the population could easily lose patience, making it impossible for the political process to run its course. Finally, it will be essential that Nepal’s development partners—including the Bank—provide as much assistance as possible—financial, technical and other—to support the peace process to help ensure its success.

- Third, the evidence is compelling that the strength behind development in Nepal is highly concentrated at the community level. Success stories abound, from forestry user groups and women’s groups, to community-based programs in rural drinking water, rural roads, micro-hydropower generation, community management of schools and the Poverty Alleviation Fund (PAF). Many of the truly community-owned efforts have shown great viability even in conflict-affected areas. Where a supportive framework has been created for communities to undertake such activities, there have been impressive development successes. Therefore, much of Nepal’s development effort—especially in the politically charged environment—should be built on community leadership.
- Fourth, among the many problems that Nepal has to address, focus on the inclusion agenda will be particularly important, especially given that greater inclusion was a central demand of the April “Second People’s Movement.” Coining of a new word for democracy (‘loktantra’ in lieu of ‘prajatantra’) reflects the recognition that democracy as practiced after the first People’s Movement in 1990 was not truly inclusive. Without taking adequate steps to ensure that Nepal is becoming more inclusive socially, politically and economically, the underlying tensions will not be resolved. In this regard, creating more equal opportunities in education—including access to higher education—will be especially important, for that is central to effective inclusion in other dimensions.

6. While the political situation is being sorted out and less emphasis is likely to be placed on implementing reform and development activities, it is critical to retain focus on the fundamentally long term nature of the challenges that the Bank is trying to help address. In such a situation, financial assistance should continue to concentrate on community-based projects and be complemented by opportunistic support to good governance-enhancing initiatives, especially strengthening key public sector institutions. As a consensus on the development agenda emerges, it is likely that the focus on public investments for the remoter areas and the under-served will increase and the inclusion agenda will gain broader support—both themes that are prominent within the current Poverty Reduction Strategy (PRS). Therefore, for the time being, it is important to recognize that the PRS fundamentally remains a robust framework for guiding the country’s development. By extension, the broad framework in the existing CAS also retains considerable relevance. Nonetheless, in recognition of the fluid context, there is a need to modify the implementation approach.

7. Without a doubt, the Bank needs to remain engaged and continue to support Nepal’s development process, as well as the peace building and state building efforts in as steady a manner as practicable. At the same time, the Bank needs to remain flexible and able to quickly respond as the situation changes. As mentioned previously, it is particularly important for the Bank and other development partners to be able

to respond rapidly to help reinforce the nascent peace, as a failure to do so may lead to the loss of a crucial opportunity. Following a discussion of the country context and lessons learned in the implementation of the Bank Group's support since the 2003 CAS, the last section of this document contains a more detailed description of the Bank's proposed approach to assisting Nepal at this critical juncture.

II. The Country Context

A. Social Context

8. With average per capita Gross Domestic Product (GDP) of US\$270 (2005), Nepal remains the poorest country in South Asia and ranks as the twelfth poorest country in the world. However, over the last decade Nepal has made considerable progress toward reducing poverty, with the headcount poverty rate falling dramatically—from 42 percent to 31 percent—between FY95/96 and FY03/04 (see Table 1).⁸ Declining from 22 percent to 10 percent, the incidence of poverty in urban areas has more than halved, while poverty in rural areas has also declined notably (from 43 percent to 35 percent), although it remains higher than in urban areas. Poverty rates have also declined across all of Nepal's development regions and ecological belts.

	Poverty Headcount Rate	
	FY95/96	FY03/04
Nepal	41.8	30.8
Urban	21.6	9.6
Rural	43.3	34.6
Development Regions		
Eastern	38.9	29.3
Central	32.5	27.1
Western	38.6	27.1
Mid-western	59.9	44.8
Far-western	63.9	41.0
Ecological Belts		
Mountains	57.0	32.6
Hills	40.7	34.5
Terai	40.3	27.6
Source: CBS, 2004		

9. Evidence of improvements in the standard of living between FY95/96 and FY03/04 is confirmed by other indicators, including: (i) an increase in agricultural wages and ownership of durables; (ii) an increase in the actual consumption of 'luxury' foods; (iii) a decline in the proportion of households reporting inadequacy in their food consumption; and (iv) improvements in the self-assessments of adequacy of housing, clothing, health care and children's schooling. The decline in poverty has been accompanied by an increase in inequality, as evidenced by an increase in the Gini coefficient from 34.2 to 41.1. This pattern was driven by the increasing returns to human and physical assets, especially higher education and occupational skills such as professional employment and self-employment in manufacturing and services. Since low income groups lacked these assets, income inequality worsened. Most of the increase in inequality, however, occurred because the gap between the "middle class" and the "rich" grew.⁹ Inequality remains greater in urban areas—i.e., Gini coefficient of 43.6—than in rural areas—i.e., Gini coefficient of 34.9. While there

⁸ This is based on the FY95/96 and FY03/04 Nepal Living Standards Surveys (NLSS-I and NLSS-II) and analysis carried out jointly by the Central Bureau of Statistics (CBS) and the Bank. CBS has published these results that are also analyzed in the World Bank Poverty Assessment—*Resilience amidst Conflict: an Assessment of Poverty in Nepal, FY95-96 and FY03-04* (Report No. 34834-NP, June 26, 2006).

⁹ Specifically, between FY95/96 and FY03/04, the per capita expenditure ratio between expenditure groups:

- (i) Declined 2 percent for the ratio p25/p10—i.e., "poor" and "very poor";
- (ii) Rose 6 percent for ratio p50/p25—i.e., "middle class" to "poor";
- (iii) Rose 8 percent for the ratio p75/p50—i.e., "upper middle class" to "middle class"; and
- (iv) Rose 27 percent for the ratio of p90/p50—i.e., "rich" and "middle class".

was little change in inequality in urban areas over time, inequality in rural areas grew as did the inequality between urban and rural areas.

10. In terms of the profile of poverty, households of agricultural wage earners, those who are landless or have small land holdings, those with illiterate household heads, and those living in large households (seven or more members) tend to remain poor. Poverty rates are also higher for people living in the remote Mid- and Far-West regions—areas where the population has limited access to paved roads, health facilities and market centers. While the population living below the poverty line has declined significantly since FY95/96, progress for different groups has been uneven. In terms of caste and ethnic groups, Dalits represent the poorest segment of the population, despite an appreciable decline in poverty (from 58 percent to 46 percent). While the greatest depth of poverty has shifted from being for Dalits to the Hill Janajatis, consumption patterns reveal that all groups are better off in urban areas. A number of structural economic changes have been suggested to explain poverty reduction in Nepal, most importantly a significant increase in remittances (see Box 1).¹⁰

Box 1: How Has Poverty Been Reduced in Nepal?

The decline in poverty in Nepal has been driven by growth in per capita consumption expenditure and income which, in turn, have been driven by five main factors:

(i) **Increased remittances**—with an estimated 1 million workers abroad in 2004 (primarily in India, the Gulf and East Asia), remittance inflows soared from 3% of GDP to 12%. The share of households receiving remittances has also increased from 24% in FY95/96 to 32% in FY03/04. The increase in remittances is responsible for more than one-half (6.2 percentage points) of the overall reduction in headcount poverty rate between FY95/96 and FY03/04.

(ii) **Higher agricultural wages**—agricultural wages rose 25%, non-agricultural unskilled wages rose 20% and skilled wages more than doubled. Increased aggregate demand, improved connectivity and better access to markets stimulated entrepreneurial activities and allowed non-agricultural incomes to increase. Out-migration and availability of jobs outside the agricultural sector tightened local labor markets and stimulated agricultural wages, improving the welfare of the agricultural laborers who tend to be the poorest. Agricultural incomes stagnated because of the weak performance of the crop sector, but the decline in real prices of major staples (rice and wheat) benefited poor consumers.

(iii) **Increased connectivity**—Nepal's road network annually increased by 6.7% between FY95/95 and FY03/04, with the largest expansion occurring in roads classified as "district or rural roads", which grew annually by 11%. This pro-poor expansion, as well as improved modes of transportation increased access to shops, markets, schools and hospitals. Improvements in rural connectivity helped raise non-agricultural employment and incomes.

(iv) **Urbanization**—was a powerful driver of poverty reduction, moving workers from low productivity jobs in rural areas to higher productivity activities in urban areas. Changes in the population shares across urban and rural areas and across regions accounted for about one-fifth of the overall reduction in the poverty headcount rate. Urbanization was also important for changing social relations between advantaged and disadvantaged ethnic population groups, as discrimination is less entrenched in urban areas.

(v) A **decline in the dependency ratio**—the number of non-working people per working adult fell between FY95/96 and FY03/04 as a result of the decline in fertility that began in the 1980s. In urban areas, the number of working males per household increased the most.

11. In addition to consumption and income gains, there also have been some improvements in human development indicators. As a result of significant increases in a number of education-related indicators—including net enrolment and youth literacy—the country is likely to meet the primary enrollment and gender-related Millennium Development Goals (MDGs; see Table 2). Similarly, there have been substantial gains with regard to child (and less so with infant) mortality, albeit with large regional variations. However, child malnutrition and maternal mortality remain high and the prospects of achieving these MDGs are unclear. Despite the progress, there remain issues on many fronts, and conditions vary throughout the country and among different social groups.

¹⁰

The effect of remittances on reducing headcount poverty was estimated using established analytical methodologies (see World Bank Poverty Assessment). The overall effect of remittances on trends in inequality is not clear. While ex ante better-off households are less likely to receive remittances, the remittances they receive are larger on average than the remittances received by ex ante poor households. It could be that households receiving the largest remittances had been receiving them for a long time and this is reflected in the value of their assets.

Table 2: Progress towards Achieving the Millennium Development Goals (MDGs)

MDG	Nepal's Current Position	Prospects and Issues
Halve, between 1990 and 2015, the proportion of people living in extreme poverty.	The poverty headcount rate declined dramatically from 42% in FY95/96 to 31% in FY03/04. Some progress in reducing malnutrition with prevalence of stunting among children 3 years of age or younger dropping by 11% between 1996 and 2001.	Nepal needs to improve the developmental impact of remittances and 'jump start' improvements in agriculture. The prevalence of stunting is still high at 43%, and the problem of underweight and wasting prevalence has not improved, as rates hover at 45-55% and 10-15%, respectively.
Achieve universal primary education by 2015.	Net attendance rate (NAR) of primary-aged children rose from 57% (FY95/96) to 72% (FY03/04), net enrolment ratio (NER) rose from 69% to 84% and youth literacy from 56% to 73%. These are significant gains that bode well for meeting the primary enrolment MDG. Universal primary education also entails completion of primary school, for which rates have only risen marginally since 1995. Primary completion rate of under 60% is still low.	Quality of primary education remains a concern, as the system is characterized by high repetition rates, high dropout rates and low completion rates. Given the current level of achievements, attainment of universal primary education remains a challenge, but if the momentum of recent improvements is maintained, it may be achievable. Although equity in education has improved, wide disparities remain across socio-economic groups.
Progress towards gender equity and empowering women by eliminating gender disparity in primary/secondary education by 2005.	Access of girls to education has improved as the gender parity index (ratio of NER of girls to boys) increased from 70 in FY95/96 to 86 in FY03/04. Females have been the biggest beneficiaries of the increase in literacy rates.	Growth in completion rates by girls has outpaced that for boys. If the trend continues, gender parity in primary education will be reached by 2010.
Reduce infant and child mortality rates by two-thirds between 1990 and 2015.	The infant mortality rate has been declining at 3.7% per year since the mid-1980s, with a drop from 79 per 1,000 live births in FY95/96 to 51 in FY05/06. Child mortality fell more sharply from 118 to 65 in the same period mainly due to greater coverage in immunization, and disease prevention and treatment.	Given current trends, good chance of attaining the child mortality target. Progress in reducing infant mortality has been slow and the rate will have to accelerate to meet the MDG. Progress in reducing child and infant mortality in Eastern and Far-Western regions has been slow and will not meet the target.
Reduce maternal mortality rate by three-quarters between 1990 and 2015.	Maternal mortality remains high (394 per 100,000 live births in 2006). More than 6 out of every 10 deliveries are not assisted by skilled attendants.	Prospects of achieving the maternal mortality MDG are unclear due to lack of comparable data over time.
Have halted by 2015 and begin to reverse the spread of HIV/AIDS, incidence of malaria and other major diseases.	TB-related deaths have fallen from 15,000-18,000 (1994) to 8,000-11,000 annually, and TB cases have been declining (301 per 100,000 in 2000 to 258 in 2003). The prevalence rate of HIV/AIDS in the general population is unknown, although it has been estimated that 62,000 are living with HIV infection (2003). Prevalence rates among high risk groups—especially IDUs and street-based female sex workers—are increasing and concerted action is needed.	Prospects for curbing TB are positive but there are two challenges: (i) co-infection with HIV and TB cases could render detection and treatment more difficult; and (ii) an increase in incidence of multi-drug resistant forms of TB. Data gathering and estimation of HIV/AIDS rates are still at an infancy stage, and the HIV/AIDS program lacks an appropriate institutional mechanism, with inter-sectoral involvement.
Integrate the principles of sustainable development into country policies and programs, and reverse the loss of environmental resources.	There are issues—e.g., depletion of soil nutrients and arsenic contamination in the Terai—that show environmental sustainability remains a problem, but other initiatives—in drinking water and forestry—show positive progress. A national sustainable development strategy is under preparation.	Deforestation remains a serious local problem in many mountain and hill areas. There are also increasing commercial pressures on biodiversity resources. Community forestry has been successful, with limited impact on fuelwood extraction. There are also increasing commercial pressures on biodiversity resources.
Develop a global partnership for development.	Exports/GDP have stagnated at around 16% since FY01/02 due to weakening external demand/competitiveness. Nepal is dependent on foreign assistance to meet its investment needs. As the fiscal deficit is financed mostly by grants and concessional aid, public external debt stands at 43% of GDP. Unemployment has declined over time and access to telecommunication services remains limited.	Nepal's medium term growth and poverty reduction prospects hinge on its ability to restore stability under which development can proceed and the country can undertake structural reforms and appropriate investments to raise its competitiveness and productivity as well as confront the issues of the lagging regions, and disadvantaged ethnic and caste groups.

Sources: "Nepal Living Standards Survey FY03/04", Volumes I and II, Central Bureau of Statistics; 2006 World Bank Poverty Assessment "Resilience amidst Conflict: An Assessment of Poverty in Nepal, FY95-96 and FY03-04"; "Nepal Demographic and Health Survey 2001" and "Family Health Survey 1996", Ministry of Health, New Era, ORG Marg.; Nepal: MDG Progress Report 2005, National Planning Commission and United Nations.

12. Key to equity, recent work—*Unequal Citizens: Gender, Caste and Ethnic Exclusion in Nepal* conducted by the Bank in collaboration with the National Planning Commission (NPC), Central Bureau of Statistics (CBS) and the United Kingdom’s Department for International Development (DfID) with contributions from the Asian Development Bank (ADB)—has documented the persistence of gender, caste and ethnicity-based discrimination in Nepal. A review of the legal system has revealed gender disparities in citizenship, and property and employment rights, as well as a disturbing ambiguity in the constitution and legal code that has permitted the continuation of discrimination against Dalits (former ‘untouchables’) by protecting peoples’ right to “traditional practices that have been operating throughout history.” This latter clause has been interpreted by a conservative judiciary as justifying the ban of Dalit entry into certain temples or their use of public water taps frequented by the privileged castes.

13. The report finds that average real per capita consumption in Dalit, Janajati (indigenous groups) and Muslim households remains significantly lower than that of ‘high caste’ households even after accounting for the effects of household size, number of children, occupation and education level of household head, land ownership, receipt of remittances, and residential and geographic characteristics. This unexplained residual difference in household consumption can be interpreted as an additional ‘penalty’ faced by certain caste or ethnic groups. In the case of Dalit households, this penalty means that their real per capita consumption will be approximately one-quarter less than that of a similarly situated Brahman/Chhetri household. As such, gender, caste and ethnic dimensions remain important considerations with regard to Nepal’s overall development agenda.

14. To sustain poverty reduction, Nepal faces the dual challenges of accelerating domestic growth and sharing this growth more broadly across the population. Policies to achieve these ends will help all citizens of Nepal—including groups that have been traditionally excluded—but such policies will not be sufficient to improve the well-being of disadvantaged groups. Building human and social capital of excluded groups is the single-most important way to bring prosperity to them. In addition to increasing quality of education and improving the pro-poor impact of patterns of health spending that will benefit all Nepalese, various targeted policies that are also needed to build human capital of disadvantaged groups and help reduce social exclusion.

B. Political Context

15. In April 2006—approximately fourteen months after King Gyanendra took direct control of executive powers on February 1, 2005—a large-scale protest movement arose across Nepal.¹¹ Having entered into an agreement in November 2005 to collaborate in opposition to the King’s authoritarianism, the SPA¹² and CPN-M were able to mobilize wide-spread street protests. Following 19 days of increasingly intense demonstrations across the country that resulted in 21 fatalities, on April 24 the King yielded to the protestors’ demands to reinstate the erstwhile House of Representatives and hand over executive powers to a government formed by the SPA and led by veteran politician G. P. Koirala of the

¹¹ This has come to be known as “*Jana Andolan II*” or the Second People’s Movement. The first *Jana Andolan*—between February and April 1990—toppled the erstwhile party-less *Panchayat* regime and restored the multi-party parliamentary polity disbanded in 1961 by King Mahendra, father of the present King.

¹² The SPA brings together the seven main parliamentary parties: (i) the centrist Nepali Congress; (ii) the breakaway Nepali Congress Democratic (NCD); (iii) the Terai-based Nepal Sadbhawana Party (Anandi Devi faction); (iv) the left of center Communist Party of Nepal-United Marxist Leninist (CPN-UML); (v) the Nepal Workers and Peasants Party; (vi) Jana Morcha Nepal and (vii) Left Front Nepal. The Rashtriya Prajatantra Party (RPP) and the breakaway Rashtriya Janashakti Party—both previously labeled as ‘royalist’ before the King’s takeover—are not formally part of the SPA, although both parties remain critical of the takeover.

Nepali Congress (NC) party.¹³ A key priority of the SPA government was to secure a solution to the decade old Maoist insurgency.

16. Following six months of intermittent peace talks, on November 21, 2006 the SPA and the CPN-M signed a Comprehensive Peace Agreement declaring an end to the insurgency which claimed some 14,000 lives. To reach permanent peace and a new Constitution, the two sides have broadly agreed on the following roadmap: (i) containment of Maoist troops in camps and separation of their arms, and confinement of Nepal Army personnel and weapons in barracks, except for essential security duties (following start-up delays, the process began in earnest in mid-January); (ii) an interim Constitution that was agreed to on December 18 and was promulgated on January 15; (iii) formation of an interim Parliament—completed on January 15, following which the CPN-M leadership announced the dissolution of parallel structures—and government (to include CPN-M participation) to assume power soon thereafter; (iv) constituent assembly elections by mid-June 2007 (however, this is looking increasingly unlikely due to slippages in the originally agreed timetable); and (v) eventually a new permanent government under a new Constitution (likely two to three years down the road).

17. Both parties sent identical letters to the UN Secretary General on August 9, 2006, seeking UN assistance in monitoring the management of arms and armies of both sides. The two parties have concluded an agreement to this regard, witnessed by the UN. The Comprehensive Peace Agreement expands the UN role to include human rights monitoring and election supervision. On December 1, 2006, the UN Security Council endorsed the Secretary General's proposal to send a technical assessment mission to Nepal with a view to establish a UN political mission. The mission's primary objective would involve assistance to the peace process in order to secure a peaceful transition toward elections.

18. The original reinstated House of Representatives: (i) declared itself a 'supreme body' above the 1990 Constitution; (ii) severely restricted the King's authority, including the extraordinary powers 'to remove difficulties in the implementation of the Constitution' invoked by the King to justify a number of his actions since October 2002; (iii) abolished the King's position as supreme commander of the army and amended the Military Act to curtail his formal control over the armed forces; and (iv) declared royal income and assets taxable. The House of Representatives also renamed the government from His Majesty's Government of Nepal to the Government of Nepal (GON), which in turn, has resulted in a change of the country's official name from the 'Kingdom of Nepal' to simply 'Nepal'.

19. Ten months after the April uprising, the euphoria appears to have subsided in Kathmandu and a sense of routine has returned. Nevertheless, this is accompanied by an underlying disquiet punctured by frequent tests of authority between the SPA government and the CPN-M leadership. While no serious fighting has taken place, the CPN-M—even by their own admission—have continued wide-spread extortion from individuals, private businesses and other organizations against the terms of an agreed code of conduct governing the cease-fire. Meanwhile, the terai districts continue to simmer with various factions claiming to represent the 'Madhesi' community (including breakaway groups from the CPN-M) outbidding one another in their demands. The understanding that the Maoists will soon join an interim government has kept many observers optimistic that Nepal is making steady progress toward peace and a new Constitution. Others, however, are more cautious, amid concerns that the planned constituent assembly elections will be far from free and fair. Given the popular desperation for peace, all sides will

¹³ The House of Representatives—the lower house of the legislature—was dissolved in May 2002 on the recommendation of the then Prime Minister Sher Bahadur Deuba, in anticipation of fresh Parliamentary elections. Those polls were subsequently postponed on grounds of the adverse security situation. Restoration of the erstwhile Parliament was Prime Minister Koirala's singular political assertion during the 14 months of protest against royal rule which was accepted by the Maoist leadership as a provisional compromise.

be hesitant to delay the elections, thereby creating a flashpoint around the elections. With the balance of power remaining tenuous, the risk of Nepal reverting to an armed conflict cannot be entirely dismissed.

C. Economic Context: Recent Economic Developments and Prospects

20. **Recent Economic Developments.** Preliminary growth estimates for FY05/06¹⁴ are around 1.9 percent owing largely to slower growth in the agriculture, transport, finance and real estate sectors (see Table 3). Construction (4.2 percent) and trade, restaurant and hotels (3.9 percent) were the key drivers of growth over the past year.

21. On the fiscal front, the deficit (after grants) declined from 4.0 percent of GDP in FY01/02 to 1.7 percent in FY05/06 for two reasons. First, on account of tax policy and administrative reforms, Nepal's revenue effort has been respectable in recent years, increasing from 11.5 percent of GDP in FY01/02 to 12.2 percent of GDP in FY05/06. Second, the intensification in the conflict and

	FY01/02	FY02/03	FY03/04	FY04/05	FY05/06
Growth (percent change)					
Real GDP at market prices	-0.6	3.4	3.7	2.7	1.9
CPI (period average)	2.9	4.7	4.0	4.5	8.0
Government finances (percent of GDP)					
Total revenue	11.5	12.3	12.2	12.9	12.2
Total expenditure	16.9	16.0	15.5	16.5	16.2
Current expenditure	11.5	11.4	11.2	11.6	11.4
Capital expenditure	5.4	4.6	4.3	4.9	4.8
Overall deficit (before grants)	5.4	3.7	3.3	3.5	3.9
Overall deficit (after grants)	4.0	1.6	1.0	0.8	1.7
Net domestic borrowing	2.9	0.9	0.6	0.2	1.4
Public debt	69.5	66.5	65.2	59.0	56.2
Broad money growth (end of period)	4.4	9.8	12.8	8.3	15.6
91-day T-bill (end of period; percent)	3.8	3.0	1.5	3.9	3.3
Balance of payments (percent of GDP)					
Current account balance (excluding grants)	1.9	0.3	0.9	-0.3	0.6
Trade balance	-12.6	-15.4	-15.6	-16.1	-19.1
External debt	53.4	52.6	51.2	45.8	43.0
Debt service	4.9	5.0	4.5	4.5	4.2
Gross official reserves (end of period) (months of imports of goods and services)	7.0	6.6	7.3	6.2	6.5

IMF staff estimates. FY05/06 is provisional.

deterioration in the security situation—particularly in rural areas—have affected the public sector's ability to spend on development activities. These implementation difficulties have translated into a decline in capital spending from 5.4 percent of GDP in FY01/02 to 4.8 percent in FY04/05. This decline notwithstanding, the public sector has managed to shield expenditures earmarked for pro-poor community-driven projects through the effective implementation of a number of expenditure management reforms introduced in the Medium Term Expenditure Framework (MTEF). The FY06/07 budget—presented in July 2006—projects 28 percent growth in public spending (compared to the estimated FY05/06 outturn), much of which is directed towards pro-poor expenditures and community-based activities. First quarter FY06/07 data show that compared to the same period last year, capital expenditure has increased almost eight-fold. Related to the positive developments on the political/security fronts, this reflects the significantly better implementation environment and the fact that resources were made available within a week of the budget announcement.

22. The Central Bank of Nepal (Nepal Rastra Bank; NRB) has maintained a cautious monetary policy over the past few years. By keeping broad money growth at reasonable levels, it has been able to contain inflation between 4 and 5 percent through FY04/05. However, the cascading effects of increases in the value added tax (VAT) rate (10 percent to 13 percent) and the price of petroleum products, together with blockades and supply disruptions, led to inflation rising to around 8 percent in FY05/06.

¹⁴ The Nepali fiscal year is based on the lunar calendar and starts in mid-July. The fiscal year starting in mid 2005 is designated as FY05/06.

23. Nepal's external sector—mainly international trade—has suffered severe setbacks in recent years. Exports have stagnated at an average of around 16 percent of GDP since FY01/02 when Nepal suffered the first and the biggest blow in what has unfolded as a series of terms of trade shocks.¹⁵ On the other hand, imports have regained their pre-FY01/02 levels with signs of some pickup in economic activity. In FY05/06, export value growth was around 4 percent while import value growth was over 18 percent. Despite the persistent trade deficit, Nepal's current account balance remained positive in FY05/06, largely due to the offsetting effect of remittances that have registered phenomenal growth in recent years and are now about 12 percent of GDP. Total international reserves at the end of FY05/06 were sufficient to cover about six and one half months of imports of goods and services.

24. Nepal's public sector debt situation was reviewed for the 2005 Highly Indebted Poor Country (HIPC) Initiative implementation status report. This analysis indicates that Nepal is likely to be eligible for HIPC debt relief. Based on estimated end December 2004 debt indicators, Nepal's net present value of debt to exports is 198 percent. Furthermore, based on the Low Income Country Debt Sustainability Analysis (LIC DSA) framework—an exercise conducted jointly by the International Monetary Fund (IMF) and the World Bank in January 2006—Nepal's external debt dynamics are subject to a high risk of debt distress (see Appendix IV).¹⁶

25. **Economic Prospects.** Nepal's macroeconomic outlook for the medium term rests heavily on the prospects for sustained peace and political stability. A lasting improvement in the security situation, a return to normalcy on the political front and concurrent acceleration of key economic reforms, ought to lead to a gradual return to growth rates of 5 percent.¹⁷ Growth would be driven by marked rebounds in the manufacturing and services sectors, and would be enhanced by contributions from public sector investment and increased tourism earnings. Long run growth prospects are also dependent on improvements in the stock of human capital, improvements in governance and a deeper financial sector. However, if there is a resumption of the conflict, much lower growth rates—i.e., 2 to 3 percent—could be expected.

26. The fiscal framework—with a deficit (before grants) of around 3.5 percent of GDP—is an indicative one, given the possible shifts in public expenditures following a likely peace dividend. The cessation of the armed conflict will be instrumental in containing security spending pressures, and crucial in bolstering the revenue effort and the public sector's ability to scale up capital investments. At the same time, election-related and immediate post-conflict expenses will need to be factored in.

27. The current account balance is likely to remain positive as remittances are projected to grow faster than the deficit in the trade account. The growth of remittances has thus far not resulted in a Dutch disease effect as the real exchange rate has not appreciated by more than 5 percent over the FY06 medium run average. Nevertheless given the projected increase in aid due to the peace dividend, the real exchange

¹⁵ Initially Nepali exports were affected by the dampened external demand following the world-wide economic downturn after September 11. Nepali exports were then hurt by the unfavorable terms of the 2002 Trade and Transit Treaty with India through which India imposed quantitative restrictions on four key Nepali goods. Subsequently, Nepali goods have been losing out in the international marketplace due to increased competition, and more recently, the phasing out of the Multi-Fibre Agreement (MFA).

¹⁶ The DSA contained in Appendix IV was released in the IMF's Staff Report on the 2005 Article IV Consultations (February 2006), and since that time Nepal has continued to be current on its debt service. It is noteworthy that a revised DSA is currently under preparation and will be finalized in the context of the IMF Staff Report on the next review of the Poverty Reduction and Growth Facility (PRGF).

¹⁷ These projections are based on a macro-modeling framework developed by the Nepal country team—i.e., the "1-2-3 PRSP model" (see Guimbert and Tiwari 2006 mimeo)—and are in line with IMF estimates.

rate will need to be monitored carefully to ensure Nepal's competitiveness. Given the currency peg with India, price movements will broadly mirror India's except for temporary spikes owing to exogenous shocks (e.g., pass-through of international petroleum prices) and inflation is projected at around 5 percent in the medium term.

D. Progress towards Implementing the Poverty Reduction Strategy

28. In June 2006, the third Tenth Plan/PRS Progress Report was released and a Joint Staff Advisory Note (JSAN) was prepared.¹⁸ The report presents a comprehensive analysis of progress during FY04/05 (i.e., mid-July 2004 to mid-July 2005) in implementing the strategy towards achieving the PRS targets. A number of points from this report deserve highlighting, specifically:

- Poverty reduction between FY95/96 and FY03/04 was significant, although for reasons largely outside the scope of the PRS (i.e., remittances).
- Between FY02/03 and FY04/05, there was some progress with regard to social indicators, including an increase in the net enrollment rate (from 82 percent to 87 percent), an increase in the number of women receiving ante-natal care and a sharp increase in the proportion of households with sanitation facilities (from 26 percent to 46 percent). However, immunization coverage appears to have slightly dropped.
- After negative growth in FY01/02 (the base year of the Tenth Plan), economic growth has rebounded, but remains low and has been disappointing in certain sectors (e.g., industry).
- The MTEF is in place and there has been progress prioritizing projects, most notably with an increase in budget releases for high priority ("P1") projects. However, reporting on outputs/outcomes remains weak.
- While progress has slowed with regards to privatizing/liquidating and reducing non-performing assets (NPAs), financial sector reform is moving forward and the two main banks—Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB)—have generated operating profits over the past three years. Furthermore, the process has been initiated to hire a Sales Advisor to help with their privatization.
- Important legislation strengthening the environment for private sector development has been passed, including a Companies Ordinance and a Secured Transactions Ordinance.
- While some progress has been made in agriculture—i.e., increases in the areas under irrigation and rural electrification, public market collection centers and transfers of irrigation schemes to water users associations—growth has remained weak. Also, the total area under community forestry rose by around 10 percent between FY02/03 and FY04/05.
- Decentralization has moved forward some, including the creation of more than 400 forestry user groups, preparation of citizen charters in 54 districts, an increase in conditional grants, an increase in the number of schools transferred to community management, decentralization of the management of health posts and the creation of PAF.

¹⁸ See Report No. 37887-NP, November 28, 2006. The original PRS was presented to the Board along with the CAS in November 2003.

- Finally, there has been good progress related to poverty monitoring and evaluation (see Box 2).

29. While a tempered conclusion is reached that progress has been made on many agendas, the report acknowledges that there is a gap between what has been planned and achievements on the ground. Nevertheless, the report supports a continuation of the agreed development strategy with a greater emphasis on community-led development and notes the immense challenges of achieving higher growth—a PRS cornerstone.

E. Progress towards Implementing the Reform Agenda

30. Nepal's performance in reform implementation in recent years has been mixed. While in some areas, the reforms have taken deep root and have led to further reforms, on other fronts there has been limited progress. The following sections evaluate progress in implementing the reforms contained in each of the four PRS pillars—broad-based economic growth, social sector development, social inclusion and targeted programs, and good governance—along with the Immediate Action Program and donor coordination/harmonization efforts.

Broad-Based Economic Growth¹⁹

31. Macroeconomic Management.

Overall Nepal's fiscal and monetary management has been remarkably prudent despite the steadily deteriorating security situation. Significant progress has been made on streamlining tax policy and improving tax administration, particularly through: (i) the expansion of ASYCUDA usage at major custom points; (ii) an increase in VAT rates; (iii) institution of a Large Taxpayer's Unit within the Inland

Box 2: Poverty Monitoring and Analysis System (PMAS)

Poverty is being monitored by a dedicated unit—the Division of Monitoring and Evaluation (DME)—in the NPC. There are many aspects of poverty monitoring—from expenditure/input to output, tracking and measuring income poverty, human development/social indicators, environmental and gender issues, accountability and vulnerability—all of which are linked. GON officially unveiled PMAS in December 2004 to bring focus and clarity to the country's poverty monitoring efforts. Past efforts—limited to expenditure monitoring, release of funds based on satisfactory performance implementation, progress on priority activities reviews, and conducting a variety of surveys, including NLSS, Demographic and Household Survey (DHS), Education Management Information System (EMIS), Health Management Information System (HMIS)—lacked focus in tracking development outcomes and were often donor-driven. Furthermore, monitoring conducted in isolation weakened the link to policy formulation. Recently launched initiatives are helping to strengthen capacity and monitor not only financial and physical progress, but also outcomes. The initiatives include: (i) household/facility level poverty-related surveys (NLSS and DHS) to be alternatively sequenced every 2.5 years; (ii) EMIS and HMIS to be conducted annually; (iii) CBS to clear all survey questionnaires; (iv) strengthening the Project Performance Information System to monitor the performance of all P1 projects; (v) implementing the Integrated Budget Preparation Guidelines to facilitate annual budget preparation linked to outputs; (vi) changing the Financial Management Information System to capture outputs of all P1 projects to implement performance-based budget release; and (vii) conducting of Public Expenditure Tracking Surveys (PETS) in health, education and transport.

Cognizant of the need to align the integrated financial management system with PRS monitoring, the Bank is working closely with GON to develop the capacity of DME and strengthen the statistical capacity of CBS. Although these efforts are limited to monitoring and evaluation and are by no means complete, collaboration is on-going to: (i) improve the process of digitization of EMIS and HMIS codes to enable linking these surveys to household surveys; (ii) develop alpha-numeric matching programs to match schools (inclusive of schools transferred to SMCs) to EMIS for evaluation purposes; (iii) undertake technical discussions to modify DHS to make it locally relevant to health policy imperatives; and (iv) institutionalize PETS in key sectors.

¹⁹

A PRGF was approved by the Board of the IMF in November 2003. The first review of the PRGF was completed in October 2004 and Article IV Consultations were concluded in January 2006. More recently (November 2006), the second and third reviews of the PRGF were completed (although with some waivers for performance criteria) and the arrangement was extended by one year to November 2007.

Revenue Department; (iv) assignment and registration of permanent account numbers; and (v) sweeping customs administration reforms.

32. Similarly, on the expenditure side, the authorities have continued efforts to re-orient spending priorities towards pro-poor activities. A move towards program-based budgeting is being facilitated by the existence of sector wide approaches (SWAs) in primary education and health. Together these have enabled maintenance of a tighter output/outcome focus, improved realism and protected pro-poor spending in the budget.

33. **Financial sector** reforms are progressing satisfactorily on several fronts, although the overall reform momentum has slowed considerably over the last two years and recovering funds from large defaulters is proving especially difficult. The foreign management teams brought in to restructure NBL and RBB were entrusted with the task of right-sizing the banks, computerizing banking operations and strengthening the commercial banking culture to lead toward re-capitalization and privatization of the banks to ‘fit and proper’ investors. Both RBB and NBL made operating profits in FY03/04-FY05/06, demonstrating that the first stages of the reform are well underway. Significant staff cutbacks have taken place in both banks to achieve efficiency gains. However, the pursuit of large defaulters—and hence, the reduction of NPAs—has been difficult despite the establishment of a Debt Recovery Tribunal (DRT), as defaulters continue to capitalize on loopholes in the legal system. Given the relatively limited progress on these tougher issues over the past years, it is natural to question the level of real political commitment to this reform effort.

34. **Infrastructure.** To harness resources from the private sector to invest in the development of key infrastructure services, attempts have begun to dismantle public monopolies and establish a number of public-private initiatives. Nepal Telecommunications Corporation (NTC) was converted into a public company (Nepal Telecom) and under the regulatory oversight of the Nepal Telecommunications Authority (NTA): (i) a joint-venture private operator has been licensed to provide basic telephone services in the Kathmandu Valley; (ii) a rural telecom operator (Sanchar) has been licensed to provide services to roughly 534 Village Development Committees (VDCs) in the Eastern Region; and (iii) another private company has started to roll out mobile services throughout the country. An important outcome of these reforms is that the number of VDCs with telephones has increased by 16 percent over the last three years.

35. To curtail leakages and increase efficiency in the power sector, Nepal Electricity Authority (NEA) has unbundled its operations into generation, transmission and distribution. Furthermore, in line with the policy of allowing communities and cooperatives to participate in the sale and distribution of electricity in their respective areas, NEA has decentralized some of these functions. The Power Development Fund (PDF) has also been established to mobilize investments in small and medium power development projects, although to date no transactions have been finalized.

36. High transport costs and the lack of connectivity are major impediments to Nepal’s development. Over the 2003-05 period an additional 575 kms of roads (equivalent to 3.5 percent of the existing length) were built, focusing on connecting district headquarters with the national network and improving access between rural areas and market centers. An autonomous Roads Board—funded mainly by a fuel levy to oversee road maintenance—was established. While this institutional structure initially faced teething and coordination problems, they are now largely resolved. Another important measure related to reducing transit costs was making the Birgunj Inland Container Depot (ICD) operational. This was finally achieved in 2005 through a bilateral agreement between India and Nepal, and the appointment of a private terminal manager. Six months following the ICD becoming operational, container traffic increased from an initial 150 containers/month to 800/month. Additionally, figures collected over the initial six month period of operation showed that the ICD reduced the transport and transit cost by around 37 percent.

37. The state-owned enterprise (SOE) posing the biggest threat to fiscal stability is the Nepal Oil Corporation (NOC), with current annual losses standing at about 1 percent of GDP. Petroleum prices have increased by 25-60 percent (depending on the fuel) since December 2003, but adjustments continue to be made in an ad hoc manner.²⁰ The implementation of an automatic pricing formula is proving elusive and the authorities are now studying the recommendations of a high level committee on petroleum reforms.²¹ The liquefied petroleum gas (LPG) market has been liberalized allowing dealers to directly source from suppliers of their choice. Liberalization is also planned for other petroleum products and a law for a petroleum regulatory framework has been drafted.

38. A draft new labor law that seeks to relax labor market rigidities—through provisions that allow needs-based contractual hiring and retrenchment upon either amalgamation or rationalization of a business—is under consideration. This follows extensive dialogue and consultations among the government, employers and unions. However, ambiguities surrounding the design of the proposed “social security fund” mechanism and its financing still need to be clarified and it is unclear when the draft law would be discussed by Cabinet.

Social Sector Development

39. A number of innovative service delivery mechanisms have been implemented in Nepal to counter the difficulties of providing social services through traditional public sector channels in the conflict environment. At the core of this lies devolution of service provision responsibility to autonomous community groups. Even if the cease-fire continues, it is likely that this strategic direction will remain given its proven effectiveness.

40. **Education.** The transfer of primary schools to School Management Committees (SMCs) started in 2003 and has had considerable success. As of August 2006, about 2,350 primary schools (out of a total of about 21,000) in 59 of 75 of Nepal’s districts had been handed over to SMCs. To provide greater autonomy to SMCs in the area of teacher recruitment, the Eighth Amendment to the Education Act stops central recruitment of teachers and the education regulations were amended to clarify SMCs’ authority. While it is too early to present a rigorous evaluation of the performance of SMC-managed schools, a July 2004 quick evaluation of a sample of 63 such schools is encouraging—i.e., overall enrolment, as well as enrolment of Dalit and other excluded students, has increased and teacher absenteeism has decreased in the schools in the sample. Nevertheless, there had been reports of Maoist interference at the local level in the sector and more recently, under pressure primarily from the teachers’ unions, there have been some signals of weakening government commitment to this program.

41. **Health.** Similarly, devolution of health posts and hospitals to local management groups is also in progress, although there are institutional issues and the sector is considerably behind education in understanding and implementing a sector-wide approach. As of March 2006, 1,317 sub-health posts (out of 3,100), 19 health posts (out of 751) and 25 primary health care centers (out of 189) in 28 districts had been transferred to local bodies. The management of one district hospital has also been contracted to local management. An initial evaluation of this experience suggests that there have been some positive changes from the users’ perspective, but that a number of issues need to be sorted out, primarily related to coordination and awareness of the new roles and responsibilities. Other ambitious reforms have also been initiated emphasizing essential health care services, output-based planning and budgeting, increased

²⁰ A rise in petroleum product prices in August 2006 was rolled back following violent street protests.

²¹ These recommendations include: (i) timely price increases and de-politicization of price increases through the introduction of an automatic pricing mechanism; (ii) improving NOC’s operational efficiency; and (iii) greater private sector participation in the sector.

public-private partnerships, and strengthened sector management. For significant progress, however, strong coordination and regular implementation monitoring will be necessary. With regards to HIV/AIDS, despite a well-defined national framework and considerable resources committed by external development partners, implementation progress has been slow in the absence of strong institutional arrangements.

42. **Water and Sanitation.** The rural water and sanitation component of the National Water Supply and Sanitation Policy was revised in 2004. In both the revised policy and the PRS, there is a clear framework that aims to increase coverage of safe drinking water services from 71 percent to 85 percent and sanitation facilities from 25 percent to 50 percent of the population by FY07/08. Regulations are in place granting operational autonomy to the Rural Water Supply and Sanitation Fund Board and the Board's performance remains satisfactory. Access to safe water has increased to 77 percent (2005), while sanitation coverage has risen significantly to 46 percent.

Social Inclusion and Targeted Programs

43. Reforms to increase social inclusion cut across most of the on-going sectoral reforms, particularly in the social sectors. In education, scholarships for Dalits and children from other marginalized groups are in place and mechanisms for social audits of these schemes are being introduced to improve targeting. The number of female students receiving scholarships at the primary level increased from around 150,000 in FY01/02 to 635,000 in FY04/05. On health management committees, seats are reserved for Dalits and women. In addition, the Ministry of General Administration (MOGA) is developing an affirmative action plan.

44. NLSS-II reveals that certain caste, ethnic and religious groups—most notably, Dalits and Muslims—have poverty levels well above the national average. In order to reverse the vicious circle of poverty among these marginalized groups, PAF has been established as an independent body to channel and target resources directly to poor communities. PAF—fully operational for the last two years—is governed by an autonomous board and operates through 65 partner organizations in six pilot districts. As of mid-July, the PAF Board had approved funding of 2,480 community-based sub-projects covering 334 VDCs. As of that date, US\$10.3 million had been disbursed into community bank accounts. The nature of approved PAF sub-projects reflects a shift in the delivery modality from the standard welfare-driven approaches of the past towards those based on community mobilization and self-help (see Box 3 and Appendix VI).

Good Governance

45. In establishing this pillar in the PRS, the government has begun to recognize that good governance—reflected most acutely in weak implementation of reforms, poor service delivery and corruption—is a central obstacle to development.²² In addition to the advances on the reform and service delivery agendas, over the past few years there has been progress towards: (i) improving civil service

²² For the past decade, governance issues have been at the core of the Bank's program, with the financial sector reforms being the 'litmus test' for moving to a base case lending scenario. While steady progress is being made on a number of fronts and the overall governance strategy is sound, there are still many challenges that are reflected in variety of ways—e.g., limited progress on the large defaulter issue—and in various quantitative governance measures. More specifically: (i) based on the 2005 Transparency International Corruption Perceptions Index, Nepal scores 2.5 and is ranked 117th (out of 159 countries); and (ii) based on the six aggregate worldwide governance indicators (i.e., the "KKM" indicators), Nepal's percentile rankings range from 1.9 for political stability/no violence to 29.1 for control of corruption, with three indicators—government effectiveness, voice and accountability, and political stability—scoring at the 15 percentile rank or below.

effectiveness; (ii) improving financial management and accountability, including implementation of anti-corruption measures; and (iii) decentralization. Specifically, some recommendations of the Public Expenditure Reform Committee (PERC) have been implemented, including merging a number of ministries, abolishing vacancies and instituting a freeze on new hiring. Several actions have also been taken to improve the efficiency and accountability of the civil service, and there has been some progress in rationalizing the processes for transfers, tenures and promotions—e.g., the number of transfers decreased from 6,560 in FY99/00 to 3,335 in FY03/04 and 1,900 in FY04/05—allowing for greater tenure stability and policy coherence. This policy has been underpinned by the development of a comprehensive Personnel Information System linked to payroll information, enabling greater accuracy in civil service records and allowing for the management of postings and transfers. However, the draft Governance Act, that clarifies the responsibilities between the executive and the civil service, has not been enacted despite several years of discussion surrounding this.

46. While an institutional framework exists to ensure sound financial management and accountability, it needs to be strengthened. Measures to improve budgeting, expenditure management and monitoring systems have begun to be implemented, with the joint government/Bank Country Financial Accountability Assessment (CFAA) laying out an action plan for reform. A Joint Financial Accountability Review carried out by the authorities/DfID/Bank (May 2005) revised the agreed CFAA action plan to further improve financial accountability and transparency. Additionally, the Government has completed necessary consultations with stakeholders and recently approved a new Procurement Act. This Act follows from the recommendations of the 2002 Country Procurement Assessment Report (CPAR), and will provide and codify the legislative underpinning for a more transparent and competitive public procurement and tendering process for goods, civil works and services based on the UNCITRAL model law. Related to this, the Nepal Administrative Staff College is building its capacity to deliver procurement-related training.

47. Related to corruption, significant steps—at both the levels of enforcement and prevention—have been taken to strengthen institutions with the mandate to tackle corruption. To give continuity to the progress made so far and to institutionalize the reforms, since 2004 a five-year forward looking anti-corruption strategy has been under implementation. In addition, a National Vigilance Center was established, and the Commission for the Investigation of Abuse of Authority (CIAA)—which has initiated various legal proceedings against politicians and senior officials—has been strengthened. Going forward, the overall accountability environment would benefit from enhanced disclosure and oversight, in support of demands for greater transparency and access to information (e.g., more timely and reliable interim financial reports, more focused and timely audits and strengthened capacity of the legislative oversight).

48. Related to decentralization, in continuing the policy to empower and strengthen local participation in enhancing service delivery at the district level, total devolution of primary education, essential health care, extension services in agriculture and livestock, feeder roads, and small and micro-hydropower activities is being piloted in fourteen districts, covering one district from each zone. To implement this, line ministry staff at the district level will be seconded to the District Development Committees (DDCs) until the Local Service Commission Act is promulgated. Both conditional and non-conditional funds will be deposited in the District Development Fund to implement district development activities and the treasury monitoring system will be improved to capture local financial flow. While these efforts are commendable, this rather ambitious plan—especially in a context lacking elected local governments—needs to be implemented carefully.

Immediate Action Program

49. Since June 2002, real institutional capacity constraints related to reform implementation have been explicitly recognized in an innovative annual action plan, known as the Immediate Action Plan (IAP). The IAP—a selective set of “must do” activities—is derived from the PRS reform agenda, and has been used to hold relevant Ministries and Departments accountable for promised actions. The first IAP (FY02/03) contained 19 actions covering the four PRS pillars, all of which were implemented. Buoyed by this success, the second IAP (FY03/04) encompassed 22 actions, again which were largely completed on time. The third IAP (FY04/05) expanded the number of actions to 24, but with a completion rate of only 82 percent raised the need to complete outstanding actions in the subsequent year. The fourth year FY05/06 IAP was limited to 20 actions (including the incomplete FY04/05 IAP measures) and guided by the principles of realism, inclusion of the needs of conflict-affect areas and close alignment of the actions to the immediate reform agenda. Despite the success associated with the earlier IAPs, the process lost some momentum during more recently with waivering political focus on reform implementation. The fifth year FY06/07 IAP was released in mid-December 2006 following its approval by the Cabinet, and shows a further reduction to 17 actions. A summary of achievements under the IAP program is provided in Appendix V.

Donor Coordination/Harmonization

50. Recognizing that real donor coordination can only happen under the strong leadership of the Ministry of Finance (MOF), Nepal unveiled its Foreign Aid Policy (FAP) in 2002. The basic principle of the FAP is to ensure that development partners respect Nepal’s own development strategy and expenditure priorities as the framework in which to provide aid. In line with this, the local donor coordination group—that had been traditionally co-chaired by UNDP and the Bank—has been chaired by MOF since August 2003.

51. At the 2004 Nepal Development Forum (NDF), the authorities took the process a step further and proposed a significant ‘aid integration’ process. The main purpose of this is to improve aid effectiveness, by among other measures, reducing the transactions costs of aid delivery and better aligning aid with national strategies and priorities. At the overall program level, the process tries to incorporate all major aid decisions (i.e., which projects to finance) into the annual MTEF cycle which in turn supports the priorities identified in the PRS. At the individual program/sector level, donors are encouraged to provide financing through a programmatic approach in sectors in which a well thought-out sectoral strategy and policy exist. Finally, at the financial modality level, aid should be aligned with the public sector financing system. While donors endorsed the idea at the time, because of the political turmoil most donors felt that it was not the right time to implement the approach fully.²³ In addition, while Nepal had been involved in the process of piloting the draft principles on good international engagement—i.e., resulting from the OECD/DAC “Fragile States” initiative—the pilot was suspended in April/May 2006 (linked to ‘do no harm’) to encourage the government to focus on the peace process, while continuing to include the principles within donor thinking. Despite the political turbulence of recent years, a number of measures have been taken to continue strengthening the foundation to make the larger aid integration

²³ If successfully implemented, such a program would have moved Nepal to the forefront of donor harmonization and made the MTEF the truly medium term, comprehensive framework that it was meant to be. However, following February 1, 2005 some partners felt that the government had little legitimacy and were not inclined to channel large portions of their assistance through public sector institutions, but needed to keep some distance. On the other hand, some partners—including the Bank, IMF and ADB—stressed the need to keep actively engaged, despite the change in the nature of government. This difference in position created significant tensions within the development community, at least temporarily seriously undermining the harmonization efforts.

process a reality; specifically: (i) coherent sector strategies have been adopted in several key sector—e.g., primary education and health; (ii) the process to manage budget resources has been improved (e.g., the MTEF, Procurement Act, etc.); and (iii) the output/outcomes focus of the monitoring system has been strengthened.

52. In moving forward on the aid harmonization agenda, it is important to learn from past experience.²⁴ It has been widely recognized that one of the causes of Nepal's political instability—including the armed insurgency—has been the failure of the state as a truly democratic institution to provide effective services to all its citizens and promote inclusive development. Because of the weaknesses in state institutions, many donors have unwittingly contributed to the situation by creating parallel institutions to deliver services and implement investment projects, thereby stifling improvement in state capacity. When a foundation for permanent peace has been reached, there will be a need for the government to initiate a special reconstruction and accelerated development program (see paragraph 60). To reinforce the foundations of peace, within a short period the government will have to deliver visible development benefits to all Nepalis, in particular to those who have been left out in the past. Establishing an effective state that delivers inclusive development is at the heart of the challenge facing Nepal. To meet this challenge it is critical that the results are seen as being delivered by the state and a post-conflict economic program implemented by the development partners would seriously undermine this process. As such, in the coming months there is a tremendous opportunity to take the harmonization agenda several steps forward, but the government must be seen as firmly in the driver's seat.

III. Lessons Learned from the Recent Past

53. Given the worsening country situation—especially after February 2005—staff have made considerable efforts on a continuous basis to monitor portfolio performance, drawing lessons on how to more effectively engage in the challenging environment.

54. Despite the insurgency, institutional weaknesses, and lack of strong and development-focused political leadership that have made development work extremely challenging in Nepal, it has been possible to continue with successful project implementation. To cope with the greater difficulties faced in direct supervision from time to time, the Bank and government have put in place additional means for tracking progress through the use of third parties that have easier access to insecure areas. A number of key lessons and observations have emerged from our recent engagement that help to underpin the strategic choices going forward. Specifically:

- The environment in the field in Nepal is characterized by greater logistical challenges that have tended to slow the pace of implementation in many areas and increase uncertainty in implementation timetables. Work of a recurrent nature has for the most part continued and in some cases has continued to improve because of greater community involvement (e.g., community managed schools).

²⁴ Using a common framework across some 60 countries, including Nepal, the Bank (OPCS) is currently in the process of conducting an Aid Effectiveness Review as a follow up to the March 2005 Paris Declaration on Aid Effectiveness. The objective of the review is to help client countries, Bank teams and other development agencies share a common evaluation of progress and jointly direct action and resources to strengthen ownership, alignment, harmonization, results and mutual accountability. The recently completed Nepal Aid Effectiveness Profile (www.worldbank.org/aer) details Nepal's status and progress on these fronts.

- At the central level the various administrations have been more focused on political and security issues than on development, a risk that persists in the current environment.
- In conflict-affected areas, truly community-owned—i.e., CDD—projects have proven considerably more resilient than projects implemented by traditional public sector agencies and even those implemented by Non-Governmental Organizations (NGOs; see Box 3 and Appendix VI).²⁵
- From the ‘fragile state’ pilot, donors have come to recognize that the ‘do no harm’ principle, applied in the context of a non-democratic regime, could lead to inadequate support for state capacity building which demands sustained efforts. While this tension may never be entirely resolved among donors, the Bank’s tendency to focus on long-term engagement now receives greater understanding from other donors.

Box 3: Some Experience from CDD Projects in Nepal

Two Nepal CDD projects—Poverty Alleviation Fund (PAF) and the Second Rural Water Supply and Sanitation (RWSSP II)—have shown considerable success, even in the challenging environment. PAF—that focuses on income generation and small infrastructure sub-projects—has reached over 314,000 people in 334 VDCs in six conflict-affected districts in the space of two years. It has made significant strides in targeting and empowering disenfranchised groups (i.e., janajatis, dalits and women), reaching Nepal’s most vulnerable poor. The rate of the return on many PAF sub-projects is quite high—e.g., anecdotal evidence on income generating sub-projects shows a sustained increase in household income of 10-12 percent and high returns—on the order of 70 percent—have been shown for infrastructure sub-projects due to the resulting time and labor savings.

Also under implementation for two years, RWSSP II—that focuses on community-managed water and sanitation projects and follows a successful first project—has brought water to about 450,000 beneficiaries and provided latrines for about half that number. By switching the service delivery approach from central supply-driven to demand-driven in which communities are empowered to make decisions about their own schemes: (i) sub-project sustainability has increased—i.e., over 80 percent are considered sustainable compared to less than 50 percent of traditional projects; and (ii) communities have benefited from the time savings—averaging three hours a day—that can now be used toward more productive economic activity or furthering education.

IV. The Way Forward

A. Introduction

55. As mentioned, three wide-ranging political scenarios have been defined for Nepal in the medium term: (i) steady transition to a New Nepal; (ii) stalled transition; and (iii) deterioration. While the actual evolution of events will undoubtedly be more complex than these simple scenarios, having a clear strategy in place for each scenario should help the Bank respond to all situations. Except in the case of deterioration, the four key points that are central to Nepal’s future—i.e., state building, sustained focus on development, community-based approaches and inclusion—help to formulate an appropriate Bank

²⁵ This is not to suggest that CDD approaches were immune to Maoist interference, as there was evidence of the Maoists seeking to exercise control over development activities and reports of them questioning the hand-over of public schools to community management. However, at the same time over the past few years, there were periods where decision-making at the central government level seemed to have become increasingly centralized and exceedingly slow. Given the current political fluidity, this is something that could continue. While it has had relatively few repercussions for the IDA portfolio, it had more serious impacts for those development partners whose portfolios are dominated by large traditional investment projects with big procurement packages.

response. With the events of November 2006, Nepal faces a tremendous opportunity. However, keeping on track with the highly demanding peace process—along with accelerating the development agenda—will require treading on the razor’s edge. It would not be surprising if the process suffers setbacks from time to time, thereby pushing the country back and forth along the continuum of possible scenarios. The Bank’s approach will be to carefully monitor the situation and flexibly provide support in response to the emerging opportunities.

B. Possible Scenarios

56. **Stalled Transition.** In this scenario, politics will remain the focus for the short term. As such, the initiation of new reform initiatives will be very difficult if not impossible, and past reforms may continue to come under threat of reversal. Thus, a top priority will be helping Nepal to protect the past reforms and move forward with some reforms on which there has already been considerable preparation. Since this scenario is inherently unstable in the long run, it also presents an opportunity to assist Nepal to prepare for the steady transition scenario and minimize the risk of moving toward deterioration.

57. **Steady Transition.** In this best case scenario, the country would continue to move toward reasonably free and fair constituent assembly elections, at which time both the SPA and CPN-M would accept the results. With that, the peace process would reach a significant milestone and Nepal would have moved firmly into a transition phase. At that stage, it would become important for the authorities to be able to demonstrate that a post-conflict economic program is ready. Such a program should be designed to accelerate development activities and rapidly generate employment opportunities to minimize the risk of reverting back to conflict. To enable sustained and effective development efforts thereafter, the issues of state building, national vision and inclusiveness become particularly important. A failure of the political elite in this regard could lead to a serious loss of popular confidence in the political process. In this scenario, development activities would accelerate, although the initiation of new reforms would remain difficult and become increasingly so as the date of the constituent assembly elections draws nearer. In addition, with the entry of the CPN-M into the government, there will be a need to bring them up to speed on the key elements of the reform and development agenda.²⁶ Nevertheless, in various stages of the transition scenario, there is a window of opportunity to move the reform agenda forward.

58. **Deterioration.** In the worst case scenario, the political process would fail, possibly resulting in a widespread conflict and a breakdown in the key functions of the state

C. The Bank’s Assistance Strategy

59. **Protecting the Reforms.** With regard to protecting the reform initiatives, the focus will be on four areas:

- **Community management of schools.** Despite strong obstruction—primarily from teachers’ unions—about 2,350 schools have been transferred to community management with quite impressive early results. This has been the pivotal driver of a far-reaching education reform that is central to the inclusion agenda as well as poverty reduction more broadly. If the principle of community management is lost, the education sector is bound to suffer a major setback. The Bank will continue to strongly support the stakeholder groups working to further this reform.

²⁶ It is important to note that the CPN-M has formed an ‘economic team’ and that a number of meetings have been held between this team and the Bank’s team to discuss various reform and development-related issues. In general these meetings have been constructive.

- **The set of governance reforms designed to improve public expenditure management**, including MTEF, the Procurement Act and the Governance Act. Preserving and furthering progress in this area is critical to protect the system to ensure that fiscal discipline is maintained in times of political instability and the state can establish credibility as an institution.
- **Financial sector reforms**, in particular the issue of defaulters. If pressure is not maintained on this issue, significant damage will be done to the credibility of the government's commitment to creating an equitable market system and tackling the broader governance issues.
- **The inclusion agenda**, where some progress has been made in expanding access to primary education and developing an affirmative action in the civil service. As previously mentioned, this is critical to defend given its importance in inciting the recent People's Movement.

60. **Preparing a Post-Conflict Economic Program.** In collaboration with the ADB, in late 2005 the Bank started to provide support for preparation of a post-conflict economic program. For Nepal to move toward a steady transition, it is important that this work be accelerated. Four important elements should be woven into the program: (i) state building (i.e., implementation through existing public sector institutions as much as possible); (ii) inclusion; (iii) genuine partnerships between the public sector and the private sector/communities; and (iv) rapid impact through improved public services as well as economic growth and employment creation. Equally important in this effort is to continue to strengthen the public sector financial management and outcome monitoring systems. While such a package should be comprehensive—including significant investments in infrastructure—it is also critical to build on the strength of community-based programs and to ensure that the overall program pays careful attention to the inclusion agenda. The aim would be to have a program ready by the middle of 2007.

61. **Carrying out a National Visioning Process.** Viewed as a way of counter-balancing the national preoccupation with the political agenda and providing a coherent direction to the popular aspirations for change, some leaders in the government as well as leaders outside government have recognized the need for developing a national vision.²⁷ While the Bank has been providing ideas about such a process and will continue to offer support as appropriate, clearly such a process requires national ownership. A visioning exercise may in fact help Nepal move toward the best case scenario.

62. **Lending Support.** Throughout the period, the Bank has consistently maintained the position that Nepal's development requires sustained support for the home-grown change efforts. It is clear that many of the efforts in the social sectors and infrastructure investments will continue to require external resources. In this spirit, as long as positive outcomes can be expected, the Bank will continue with new lending. If political developments remain toward the more favorable end of the scenario, the US\$120-200 million range envisioned in the original CAS seems to offer appropriate parameters. The specific lending decisions and aggregate level will be guided by the assessment of the overall situation, carefully taking into account the collective sense of the international community on the need for external assistance to support the transition to peace. An indicative lending program is presented in Table 4. Certain types of programs deserve particular attention, specifically:

- **Community-based projects.** With the exception of a serious deterioration in the political conditions—especially one in which projects executed through public sector agencies will be

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The purpose of a national visioning process is for Nepali citizens to develop a broadly shared vision of the future, in terms of not only the political structure of the country, but also the basic framework for development, economic management and social change. Such a vision—of what Nepal might look like in 20-25 years and what the country might have to do to get there—would not be a detailed blueprint, but more of a broad framework to guide development of more detailed plans of action, including the next PRS.

approached with great caution—expanding community-based development activities will continue to be a high priority.²⁸ Even in the best case scenario, given Nepal’s geographic challenges, CDD projects will continue to be critical in delivering broad benefits quickly. Therefore, the Bank will expand its support for such initiatives, especially scaling up what is already working. The Bank will pay special attention to PAF, which is being expanded with unprecedented speed.²⁹ Similarly, the Bank would be prepared to help scale up other on-going community-based programs, including in rural drinking water, irrigation, rural electrification and rural roads.

Type ¹	FY07	FY08
		145.0
A, B	PAF Additional Financing	25.0
A, B	Second Higher Education	60.0
A, C	Irrigation	40.0
B, C	Avian Influenza Control Project	20.0
C	Economic Reform TA Additional Financing	5.0 (S) ²
B, C	Development Policy Credit (DPC)	30-70 (S) ³
		210.0
A, B, C	Agriculture Sector Operation	40.0
A, B	PAF II	100.0
A, B, C	Infrastructure Development	30.0
A, B, C	Education For All Supplement	40.0
A, B, C	Community Electrification	30.0 (S)
B, C	DPC	30-70 (S) ³

Notes: (1) Types are defined as: (A) community-based; (B) inclusion; and (C) strengthening public institutions; (2) ‘S’ denotes stand-by operations that are not included in the annual sub-totals, but envisioned in an improving transition scenario; and (3) the actual DPC amounts would depend on the circumstances as described in paragraph 64.

- **Inclusion.** The primary education SWAp—Education for All (EFA)—will continue to be the central instrument to promote broad inclusion. To the extent that any additional financing may be needed, the Bank would be prepared to consider such support as long as the reforms stay on track. In moving toward a more inclusive Nepal, however, it is also important to ensure that in addition to receiving basic education every diligent child has a decent chance of receiving good quality higher education. The lack of such options has been an important contributing factor to both the discontent that underlies the insurgency and the recent People’s Movement. Recognizing the need to reform the tertiary education system to meet these challenges, a decision has been made to allow far greater autonomy to the campuses of the public sector university system and to support independent universities. In effect, this reform taps into the energies that autonomous campuses, acting as ‘communities,’ can mobilize through greater empowerment. This reform is equally important for the long term state building process, which requires well-trained university graduates. Despite the political uncertainties, a number of campuses are eager to move ahead with reforms and the Bank proposes to support this critical effort through a Second Higher Education Project. In addition, all interventions—but primarily those using a CDD modality—will continue to place a strong focus on inclusion issues.

63. **Supporting a Post-Conflict Meeting of the Development Partners.** If the political process secures what is broadly viewed as a foundation for lasting peace (e.g., successful constituent assembly elections), the government can be expected to organize a donor meeting to discuss and seek support from

²⁸ As mentioned in the discussion on CAS implementation (see Appendix I), over the past few years the Bank has shifted toward supporting community-based projects and hence, has gained considerable experience and expertise. As also highlighted before, such activities have proven far more viable in the conflict situation.

²⁹ In recognition of this, in November 2006 the Board approved additional IDA grant financing (US\$25 million) for PAF. Together with other donors, the Bank will consider a significantly larger follow-on project.

the development partners for its post-conflict economic program. The Bank would work closely with other partners in supporting such a process.

64. Should there be positive movement along the scenario continuum, it is possible to envision a number of different types of opportunities for the Bank to scale up its program by providing additional financing, most likely in the form of **budget support**.³⁰ In all cases, taking advantage of lessons learned from other successful budget support operations in fragile environments, the Bank would explore the possibility of a multi-donor budget support program.³¹ Budget support could be envisioned to:

- **Support reform implementation.** Despite the political turmoil, the dialogue on reforms has continued since approval of PRSC I (November 2003). To be able to implement the ambitious FY06/07 budget fully, additional funding will be needed. Or alternatively, in the absence of budget support, development activities that are essential for reinforcing the peace process could end up being scaled back. Hence, the authorities have expressed strong commitment to implementing significant reforms to underpin a prospective budget support operation. Reform actions are envisioned in four key areas: (i) progress against defaulters; (ii) adjustment of fuel prices; (iii) introduction of a more flexible labor law; and (iv) passage of the Governance Act. Given the political situation, however, the government is likely to have to use more incremental approaches to some of these reforms than earlier envisioned. The Bank will continue to carry on an active dialogue with the authorities on defining a realistic reform program that is nevertheless strong enough to sufficiently improve the development framework. If such a package can be actually implemented, the Bank remains committed to providing budget support.³²
- **Finance a post-conflict program.** Once a more lasting political basis for peace is secured, it would be reasonable to assume a fairly large post-conflict economic program will be proposed for a three to five year period, above and beyond the on-going assistance. In such a scheme, the Bank would naturally be expected to contribute significant amounts.³³ Working with other partners,

³⁰ A concern with provision of budget support could be a sudden and unexpected political change that could take place after the release of such support and lead to questionable uses of highly fungible resources. Some financial mechanism to minimize such a risk will be considered should the Bank decide to move forward with this manner of support. For instance, as suggested in Table 4, the support could be provided in smaller slices.

³¹ DfID has already expressed interest in joining such multi-donor support.

³² Technical assistance funds might also be needed to support implementation of the reform agenda. In FY05, the Bank provided US\$3 million for the Economic Reform Technical Assistance (ERTA) project. With the funds managed by a steering committee within GON, this transparent source of grant financing—which any public sector agency can access on a competitive basis to promote reforms—has been much appreciated by the reform-minded leaders. To continue the efforts to protect, and deepen where possible, the past and present reforms, and support the peace process, more funds may be needed. The Bank would consider providing additional funding for this purpose and encourage other donors to contribute. This would also help move the aid harmonization agenda forward in a critical area where much aid money has been spent without due scrutiny or accountability.

³³ Under IDA14, Nepal's indicative FY06-FY08 IDA allocation is about US\$460 million. Given no new commitments in FY06, and limited new commitments so far in FY07, the Bank is likely to have significant flexibility to increase its financial assistance up to the indicative three year allocation if called on. In addition, Nepal's IDA allocation could increase over time with improvements in country policy and institutional performance, especially with regards to the governance situation. However, the exact IDA allocation would depend not only on Nepal's performance, but also on: (i) the performance of all other IDA

the Bank would try to maximize the extent to which the programs will be implemented through or under clear auspices of the government. This is important in terms of the critical goal of establishing the credibility of the state. To meet an equally important goal of rapid implementation and broad reach, the Bank would encourage continued support to community-driven initiatives and public-private partnerships of all kinds. Much of the additional assistance from the Bank should take the form of budget support to allow the greatest degree of flexibility and speed.

- **Support the transition to a more stable environment.** The intricate transition process is already creating demands for resources to sustain the process itself. Containing the CPN-M combatants in camps during the cease-fire period, providing immediate relief to the victims of the conflict and conducting the constituent assembly elections all require resources. While several bilateral donors are providing support in limited ways in this regard, significant resources may have to be provided out of the budget. This in turn could crowd out much needed development spending. Whether there will be a real fiscal crunch is uncertain at this time. Should such an eventuality materialize that either jeopardizes the peace process or threatens development efforts, Bank support could be envisioned.

65. **Formulating a New Development Strategy.** In a more stable environment, the new long term vision will need to be translated into a more concrete, medium term development plan (i.e., a new PRS). Many of the ideas may be reflected in the post-conflict package, but the full scope of the new vision is unlikely to be completely incorporated. The Bank would assist Nepal in articulating a new plan that would likely include strong focus on state building, inclusion and decentralization.

66. History has shown that it is impossible to rule out a deteriorating situation. To the extent possible, the Bank will remain engaged through dialogue, analytical work and potentially limited financial support. If the situation is not so extreme (e.g., the conflict resumes but the government retains control over the basic state apparatus), the Bank will continue to support community-level activities as long as they remain viable. As mentioned, the track record of a few such projects—including in particular the PAF—is encouraging in this regard.

C. *Risks*

Immediate Risks

67. As elaborated in the 2003 CAS, the most important risk for Nepal is that of severe deterioration or collapse. The CAS identified acceleration of reform and development as the key antidote to this danger. Unfortunately, the reform process did suffer a two-year period of slowing down, and hence, this fundamental risk to Nepal has increased. In this high risk environment, however, there are two kinds of more immediate risks to Nepal and implementation of the Bank's strategy.

68. **Risk of Reform Reversal.** Although many of the reforms initiated in the last few years have taken firm root, the risk of reversal remains significant. Most of the reforms have promoted more 'liberal' principles in the broad governance arena—e.g., respect for every Nepali as an equal citizen and accountability of the public sector as a provider of public services to all citizens. This has pushed back the feudal attitudes that favored patronage-based governance and concentration of power in a privileged group. These more traditional forces are likely to continue to find ways to undermine and even roll back the progress made in public expenditure management, financial sector reform, public sector

borrowers; (ii) the total size of the IDA resource envelope; and (iii) any adjustments arising from the IDA grant component and possible assistance under the Multilateral Debt Relief Initiative.

accountability, decentralization and the fight against corruption. In the post-April 2006 environment, there is also a sense of entitlement among many stakeholder groups, each demanding some immediate ‘payoff’ for their participation in the April movement. Such pressures are already threatening some reforms, including for instance the new Procurement Act and community management of schools. However, these reforms have proven that there are also strong forces within Nepali society promoting change. To mitigate such a risk, the Bank will continue to provide support to such stakeholders and promote policy debate on those reforms.

69. **Risk of Political Inattention to the Development Agenda.** As mentioned, there is a real risk that the political elite will continue to focus primarily on the political agenda to the neglect of development agenda. As noted, this can lead to not only a long-term problem, but also a more immediate problem of narrowing the space of the political process itself. As such, the Bank—along with other donors—will need to make every effort to keep at least some focus on critical aspects of the development agenda. Nonetheless, this risk should be considered very high.

Fiduciary Risks

70. Given the decade-long strategic focus on better governance, the Bank has placed considerable emphasis and effort on improving the quality of resource management in Nepal. This starts from the efficiency of the overall allocation of budgetary resources, introduction of better service delivery mechanisms and finally strengthening the more traditional financial management systems. With sustained support from the Bank, significant reforms are being implemented at all three levels. At the macro level, the MTEF was introduced, thereby improving allocative efficiency and bringing greater poverty focus to the budget. In regard to service delivery modalities, community management of schools and sub-health posts has been introduced, and reliance on autonomous bodies for service delivery (e.g., PAF, the rural water ‘Fund Board’) has been expanded. At the more technical level, based on the joint FY02 GON/Bank CFAA, the Financial Administration Regulations were revised, as was the Procurement Act to introduce international standards into public sector procurement. Procurement monitoring indicators (based on OECD/DAC Guidelines) are also being prepared to measure progress in performance. Related to auditing, the Bank has supported the Auditor General’s (AG’s) Office in its effort to: (i) upgrade auditing practices toward international standards; and (ii) develop staff skills. On oversight, the Bank has placed a high priority on working with legislative and administrative oversight bodies, including the Public Accounts Committee (PAC), the AG’s Office and other relevant anti-corruption agencies. Related to general budget management, as mentioned, the Bank has supported the introduction of the MTEF thereby improving the allocation efficiency and bringing greater poverty focus to the budget. Finally, the on-going Public Financial Management (PFM) Review and the establishment of PFM benchmarks will provide new opportunities for further strengthening public financial management and procurement systems. The PFM review—jointly being carried out by the authorities and Bank in close collaboration with other development partners—forms part of a comprehensive approach to supporting PFM reforms emphasizing country-led reform, donor harmonization and alignment around the PRS with focus on monitoring and results.

71. Despite the progress made, it is important to note that the dissolution of Parliament and the expiration of the terms of elected local governments in 2002 significantly weakened the electoral oversight system. Furthermore, heightened security tensions throughout the country restricted movement and to some degree concentrated power in the hands of security forces at the district level (at least for a time) on the one hand and increased Maoist interference in development activities on the other hand, raising the risk of resource misuse. Also, as mentioned previously, the security situation had made site inspections/supervision more challenging. These developments posed additional risks and could again become issues if the situation deteriorates. In that case, to mitigate these risks the government and Bank

would revert to auxiliary means of verifying program/project implementation on the ground, including third party verification and in-depth monitoring of sample sites by independent teams.

D. Concluding Remarks

72. The development landscape in Nepal will remain challenging for the foreseeable future. The reform process initiated in the early 2000s demonstrated that many reforms were possible even within an unstable political environment. In fact, the political turmoil at times seemed to create space for the technocratic leaders to carry the reforms forward. The events since February 1, 2005 have narrowed this space and made it more difficult to anticipate major reforms prior to some resolution of the political issues. Development activities led by communities, however, do seem to be resilient and are making a real difference in the lives of the most vulnerable. Therefore, in the near term the Bank will focus on supporting community-led activities wherever they are successfully being implemented, while working with the reform forces to protect the gains and prepare for further reforms that should become possible when national attention is refocused on development. In addition, all Bank assistance—both financial and otherwise—will to the extent possible support the peace process to help ensure its success. While the challenges are many, today Nepal continues to face a real ‘open moment’. Continued assistance from the Bank, provided with a reasonable degree of flexibility, will be critical in helping Nepal take advantage of this unique opportunity.

Appendix I Progress to Date on CAS Implementation

A. Introduction

The Bank’s strategy was designed to support key elements under the four pillars of Nepal’s PRS: (i) broad-based economic growth; (ii) social sector development; (iii) social inclusion and targeted programs; and (iv) good governance. The strategy was backed by the successful process of supporting the reform dynamics that had been gaining strength in Nepal and continued the Bank’s focus on improving governance—by bringing resources to grassroots levels and improving development effectiveness—with increased emphasis on growth and inclusion.

The CAS identifies 15 PRS areas that are central to poverty reduction and consistent with the Bank’s relative strengths vis-à-vis Nepal’s other development partners. In each of these areas, broad development results or ‘outcomes’ were identified and translated into 26 intermediate outcomes deemed to be specific and meaningful for the FY04-FY07 period. Annually, the Nepal Country Team goes through a process in which the outcomes are reviewed, the milestones for the previous year are evaluated and new milestones are established for the forthcoming year. With progress being monitored continuously, this process has helped to establish a shared sense of accountability by the whole Country Team for the overall country outcomes.

B. Outcomes

The CAS recognizes that each outcome is expected to have less than 100 percent probability of happening, even with the best efforts on the part of the Bank.¹ Furthermore, the matrix of outcomes is seen as a ‘portfolio’ in its entirety—i.e., consisting of some high-probability, but relatively low-impact outcomes and some low-probability, but high-impact outcomes. To avoid extremes, each year the portfolio of annual milestones is constructed with an expected overall success rate of around 60-70 percent.²

FY	Planned (beginning of FY)		Achieved (end of FY)	
	Number	Probability ¹	Number	Ratio ²
FY03	13	66%	9	69%
FY04	25	62%	15	60%
FY05	23	65%	11	48%
FY06	23	68%	9	39%

Notes: (1) Initial expected annual overall success rate.
(2) Ratio of number achieved to total.

Table 1 shows the achievements since FY03 with regard to the CAS milestones.³ Two things are noteworthy from this table: (i) the number of milestones monitored by the team increased sharply after FY03, as the new CAS spelled out a relatively ambitious set of outcome goals; and (ii) while 69 percent of the milestones were achieved in FY03, performance has declined over time, with only 48 percent of the

¹ In practice, the probabilities of 20, 40 [i.e., ‘low probability’], 60 [‘medium probability’] or 80 [‘high probability’] percent are assigned to each of annual milestones, recognizing the relatively crude nature of the probability assessments.

² This does not imply that for outcomes/milestones that are not fully achieved, there will be no progress. In many cases, it is likely that some progress toward the ultimate outcome will have been made.

³ The CAS outcomes, milestones and interventions are presented in more detail in Appendix II. For an evaluation of progress toward meeting the CAS triggers, see Appendix III.

milestones achieved in FY05 and even fewer achieved in FY06 (i.e., 39 percent).⁴ This is consistent with the judgment that the overall reform program slowed with the May 2004 change in government and even more with the political uncertainty following February 2005. Furthermore, the team has concluded that with an increase in the number of milestones, the program has lost some of the focus achieved earlier, along with the ability to respond effectively when opportunities arise. In part, however, this reflects the more uncertain reform environment in which it has become necessary to support a larger number of possible initiatives to deal with the risk of many initiatives faltering.

Table 2 presents another summary of progress towards achieving the CAS outcomes. This demonstrates the cumulative effects of meeting the annual milestones and suggests that the overall success rate towards achieving the CAS outcomes is about 65 percent to date. In all three categories of outcomes—i.e., those with high, medium and low probabilities—approximately two-thirds of the CAS outcomes are on track or have recorded significant progress. Looking at the achievement of outcomes from the perspective of the PRS pillars, the social sector development pillar has had a relatively high success rate (83 percent). On the other hand, the broad-based growth pillar has been the least successful (57 percent), in part reflecting the slowdown of the reform momentum and the worsening country environment for the growth agenda. Both the social inclusion and good governance pillars are registering progress towards achieving two out of three outcomes, despite their relatively low probabilities and the limited number of direct Bank interventions in these areas. The focus in these areas has been more on establishing the analytical foundations for change and engaging in the early stages of policy dialogue, a strategy that appears to be starting to pay off. Together these provide some evidence that despite the challenging country circumstances, it is still possible to achieve positive development results in Nepal.

Table 2: Progress towards Achieving the CAS Outcomes

Initial Assessment	Outcomes ‘on-track’ and/or with significant progress	Outcomes ‘off-track’ and/or with little progress
High Probability	BBG: Outcome-focused budget and monitoring in place BBG: Population with close access to roads increased BBG: Private operator introduced for rural telecom in East BBG: Additional rural houses served by micro-hydro power SS: Efficient and timely textbook distribution system in place SS: Essential health care services implemented in 25 districts SS: Extend rural water supply to additional 10% of pop. SS: Extend coverage of sanitation to additional rural pop. SI: Increased public funds used by disadvantaged rural groups for services	BBG: Magnitude of SOE problems recognized and strategy developed BBG: Lowered costs of doing business by liberalizing business support services BBG: Improved efficiency of NEA
Medium Probability	BBG: NRB performing regulatory and supervisory functions effectively BBG: Reform labor laws to allow greater flexibility in employment BBG: RBB/NBL privatized or liquidated BBG: Reduced share of main road network in poor condition SS: 25% of public schools under community management GG: Improved accountability and transparency	BBG: Improved enabling environment for factor and output markets BBG: Increased agricultural productivity and farm incomes SS: Progress towards financial sustainability of public universities GG: Decentralization advanced substantially SI: Affirmative action policy/system in place in civil service
Low Probability	SI: Reduced out of school primary-aged children GG: Clear delineation of responsibilities between Ministers and civil servants	BBG: Increased institutional capacity for trade policy implementation
Total	17 (65 percent)	9 (35 percent)

Key: **BBG:** broad-based economic growth; **SS:** social sector development; **SI:** social inclusion; and **GG:** good governance

⁴ It should be noted that there has been noticeable progress with many of the ‘unmet’ FY06 milestones and it is anticipated that many of them will be achieved albeit with delays.

C. IDA Program

Lending

Since FY03, Nepal has been in the ‘base case’ lending scenario, defined as a scenario in which the reforms continued to move forward and development work remained possible despite the hostilities. This envisaged an average annual lending program of about US\$190 million, but in noting the uncertainty associated with the ability of the authorities both to maintain a rapid pace of project implementation and sustain a strong enough reform process to justify annual Poverty Reduction Support Credits (PRSCs), a range for new commitments—US\$120-200 million—was defined.

Mindful of the steadily worsening situation, to improve development effectiveness over the past few years, the Bank has been shifting its focus, which in turn has shaped a more “conflict-resilient” portfolio. Moving away from conventional large-scale projects implemented by public sector agencies, but at the same time continuing the emphasis on governance, IDA has shifted towards projects that: (i) are based on significant community participation—so called ‘community-driven development’ or CDD projects⁵—or private sector participation; (ii) support reforms at the central level that enjoy strong ownership; and (iii) support the core service delivery functions of the central government where well-developed sector wide programs emerge. Exclusively in these three categories, since November 2003 eight projects and additional financing for one project have been approved for a total of US\$345.8 million in IDA credits and grants. Reflecting the slowdown in reform implementation, together with the worsening country situation, there has been a declining annual trend in lending volumes over the period—i.e., (i) FY04: US\$185.8 million; (ii) FY05: US\$135 million; (iii) FY06: no new commitments; and (v) FY07 to date: US\$25 million. The specific lending activities carried out during the period are presented in more detail below and summarized in Table 3.

- The first **Poverty Reduction Support Credit** (PRSC, Cr. 3830-NEP) provided US\$70 million to support implementation of the reforms in the PRS. Approved in November 2003, the reforms supported by the credit emphasized creating fiscal space for, and improving the effectiveness of growth-enhancing investments and the investment climate. The program also supported further consolidation of reforms intended to improve service delivery and efforts to promote social inclusion by improving the effectiveness of targeted programs and access to schooling for excluded groups. With regard to governance, emphasis was placed on improving the effectiveness of the civil service, strengthening anti-corruption and accounting institutions, and improving the functioning of key agencies and public sector financial management. The program was successfully implemented with the credit closing in November 2004. For more details on program implementation see the Implementation Completion Report (ICR).⁶
- The **Financial Sector Restructuring Project** (FSRP, Cr. 3864-NEP/H074-NEP) supports the ongoing efforts to develop a healthier financial sector in Nepal that is able to intermediate funds more efficiently and effectively to the benefit of all segments of society and in a manner that supports private

⁵ This emphasis on CDD has reshaped Nepal’s own development approach and is reflected in a significant increase in the share of budget resources that are controlled directly by communities or expended under close community oversight. This shift has begun to improve the quality of critical public services (e.g., education and health care) and because of this shift in modality of service delivery such services continue to be provided in many parts of the country even as the conflict has intensified. This change has also improved the ability to continue implementing the PRS in spite of the conflict. In addition, there is, of course, an important role for local governments to play with regard to the overall development agenda and improving service delivery, especially when it comes to scaling up and sustaining community efforts.

⁶ Report Number 31959, dated April 27, 2005.

sector development, increased investment and faster growth. This partial grant (US\$7 million)/partial credit (US\$68.5 million) was approved in March 2004, and provides support along a two pronged approach towards: (i) further strengthening NRB through a program of bank supervision strengthening, accounting and auditing development, human resource engineering, information technology upgrading and other support; and (ii) deepening the process of reform in the two large banks (NBL and RBB) so as to improve their operational capacity and ensure that they operate in a more commercially-oriented fashion and to move them as swiftly as possible into the private sector.

Table 3: Lending Activities, FY04-FY06

Pillar/ Category ¹	Credit/ Grant No. ²	Name	Approval Date	Amount (US\$ M)
Broad-Based Economic Growth				
(ii)	3830	First Poverty Reduction Support Credit (PRSC I)	11/18/03	70.0
(ii)	3684/H074	Financial Sector Restructuring Project (FSRP)	3/9/04	75.5
(i)	H171	Rural Access Improvement & Decentralization Project (RAIDP)	3/31/05	32.0
(ii)	H173	Economic Reform Technical Assistance Project (ERTA)	6/28/05	3.0
Sub-total Broad-Based Economic Growth				180.5
Social Sector Development				
(i)	3911	Second Rural Water Supply and Sanitation Project (RWSSP II)	6/1/04	25.3
(iii)	3956	Education for All (EFA)	7/8/04	50.0
(iii)	3980/H125	Nepal Health Sector Program	9/9/04	50.0
Sub-total Social Sector Development				125.3
Targeted Programs and Social Inclusion				
(i)	H091	Poverty Alleviation Fund (PAF)	6/1/04	15.0
(i)	H258	PAF Additional Financing	11/14/06	25.0
Sub-total Targeted Programs and Social Inclusion				40.0
Total				345.8
Notes: (1) Categories are defined as above—i.e., (i) CDD projects; (ii) support reforms at the central level with strong ownership; and (iii) support core service delivery functions and backed by well-developed sector wide programs.				
(2) Items beginning with 'H' are IDA grants; others are IDA credits.				

- The **Second Rural Water Supply and Sanitation Project** (RWSSP II, Cr. 3911-NEP)—a credit for US\$25.3 million approved in June 2004—has two primary objectives, to: (i) improve institutional performance of the rural water supply and sanitation sector, and mainstream the Fund Board approach; and (ii) support communities to form inclusive local water supply and sanitation user groups that can plan, implement, and operate drinking water and sanitation infrastructure that delivers sustainable health, hygiene and productivity benefits to rural households. DfID is a partner in this project that is being implemented in close coordination with some other development partners active in the sector, most notably the ADB.

- The **Poverty Alleviation Fund** (PAF, H091-NEP)—a grant for US\$15 million approved in June 2004—supports marginalized groups in Nepal through community-based sub-projects for small-scale infrastructure, social services and income generation. Through a variety of support methods, the project also assists in the process of strengthening local bodies. PAF was established by the authorities as an autonomous body and is initially operating in six districts of Nepal, four of which are in the west, which is generally considered to be underserved in terms of public services and investment. **Additional financing** (H258-NEP)—a grant for US\$25 million—was approved for PAF in November 2006 supporting the same activities although in an expanded area that includes Nepal's 25 poorest districts.

- The **Education for All** (EFA, Cr. 3956-NEP) project contributes to the long-term development objective of strengthening Nepal's human resource base to support economic growth and reduce poverty. The project—a SWAp approved in July 2004 for US\$50 million—contributes to improved delivery of

public services to the rural poor, with more effective targeting of females and other vulnerable groups, and hence, indirectly to social cohesion and stability. A number of development partners—IDA, DfID, Denmark, Finland and Norway—are pooling resources with the public sector to finance the EFA program, which intends to improve access to and benefit from basic and primary education for all children, especially girls and children from disadvantaged groups, and from literacy programs for poor adults.

- The development objective of the **Nepal Health Sector Program** (Cr. 3980-NEP/H125-NEP) is to expand access to, and increase the use of, essential health care services, especially by underserved populations. This partial grant (US\$40 million)/partial credit (US\$10 million) was approved in September 2004 and is supporting implementation of Nepal's health sector program that is comprised of two broad components: (i) strengthening service delivery; and (ii) developing institutional capacity and management. This SWAp—for which the IDA credit/grant is providing 10 percent of the financing over a five year period—is being co-financed by DfID, with several other development partners—including WHO, UNICEF, USAID, UNFPA, AUSAID, SDC, GTZ and ILO—providing parallel financing.
- The **Rural Access Improvement and Decentralization Project** (RAIDP, H171-NEP)—a grant for US\$32 million—was approved in June 2005. Through decentralized implementation arrangements and a capacity development program, the project will help to improve governance and service delivery for rural infrastructure, while at the same time promoting agricultural and rural economic growth, and generating employment through direct project investments in rural transport infrastructure. SDC is providing parallel financing, the institutional strengthening efforts will be implemented in collaboration with ADB, and implementation of the entire program is being closely coordinated through the Nepal Rural Roads Forum with other donors active in the sector, including DfID, GTZ, WFP and SNV.
- The **Economic Reform Technical Assistance Project** (ERTA, H173-NEP)—a grant for US\$3 million approved in June 2005—aims to support the implementation of key short term measures in the PRS/reform agenda. To achieve the objective of strengthening public sector capacity to implement economic reform, the project focuses on providing technical assistance in four key areas: (i) improving governance and public sector management; (ii) accelerating privatization; (iii) improving service delivery; and (iv) implementing a strategic communications program.

As mentioned in the main text, the shift in the focus of the IDA portfolio that has been taking place over the last five years—placing more emphasis on CDD—appears to have paid off, as projects continue to be successfully implemented in many areas even in the challenging environment. Nevertheless, this is not to suggest that CDD approaches are immune to Maoist interference, as there had been evidence of the Maoists seeking to exercise control over development activities and reports of them questioning the hand-over of public schools to community management. At the same time, over the past few years there were periods where decision-making at the central government level seemed to have become increasingly centralized and exceedingly slow. While this had relatively few repercussions for the IDA portfolio, it had more serious impacts for those development partners whose portfolios are dominated by large traditional investment projects with big procurement packages.

Analytical and Advisory Activities

As envisioned in the CAS, Analytical and Advisory Activities (AAA) have continued to play an important role in engaging Nepali authorities in policy dialogue and helping to evoke change. The *Nepal Development Policy Review: Restarting Growth and Poverty Reduction* (June 2004) was a key piece in this regard, summarizing Nepal's development constraints and challenges, along with fostering debate on the development agenda for re-starting inclusive economic growth. *Unequal Citizens: Caste and Ethnic Exclusion in Nepal* (June 2005) provides a rich documentation of gender, caste and ethnicity-based

discrimination in Nepal, and for years to come, promises to offer a strong analytical foundation for active public discourse on the inclusion agenda. Related to decentralization and the essential role played by local organizations, the report *Nepal Decentralized Organizations* (March 2004) documents the roles and relationships between local organizations operating in five sectors in rural Nepal, and will be a useful guide for helping to ensure success of decentralized planning, governance and implementation of programs. A complementary piece focusing on urban issues—*Urbanization and Service Delivery in the Context of Decentralization: A Review of the Issues for the Kathmandu Valley* (December 2004)—highlights specific issues facing urban local bodies and how these issues relate to plans for further decentralization. Continuing the Bank’s strong emphasis on the financial sector reform agenda, the report *Legal and Judiciary Environment for Financial Sector Development* (February 2005) reviews the larger setting of financial sector reform and development in Nepal, and suggests measures to strengthen the enabling environment. It has formed a basis for an active reform discussion with the Supreme Court that could result in grant financing from the Institutional Development Fund (IDF) to initiate reforms. The strategy note on *North South Transport Corridor Options* (August 2004) provides analysis and recommendations on how to improve Nepal’s north south transport corridors to enhance the accessibility of remote hill districts, and improve market integration and trade facilitation. Most recently (September 2006), the poverty assessment—*Resilience Amidst Conflict: An Assessment of Poverty, FY95/96 and FY03/04*—was launched in Kathmandu. Providing a cogent explanation for the impressive 11 percent drop in the poverty rate in a span of eight years, this report has helped to deepen the understanding of the complex process of changes in poverty and human development in Nepal, and contributed to a more sophisticated policy debate.

Capacity Building

Recognizing the institutional weaknesses and lack of capacity in Nepal, capacity building—i.e., facilitating country-led change—has been an essential component of the IDA program. Largely through the efforts of the staff based in Kathmandu, close policy dialogues have been forged with public sector counterparts in many sectors, which have motivated reform efforts and helped to develop comprehensive sectoral strategies/plans. The approval of SWAps in primary education and health is evidence of the success of these efforts, as is the enhanced dialogue in a number of other sectors, including higher education, water and sanitation, irrigation, agriculture, and various rural infrastructure sub-sectors. In addition, intensive technical assistance (TA) provided by IDA in key areas—including the carrying out of NLSS-II and poverty analysis, the implementation of MTEF, the strengthening of monitoring and evaluation capacity, fiscal decentralization, and affirmative action programs in the civil service—has also helped to solidify the foundation for the reforms.

Portfolio Management

As of December 31, 2006 the IDA portfolio in Nepal consists of twelve credits/grants, with total commitments of about US\$450 million and an undisbursed balance of about US\$260 million. The portfolio is relatively young (an average project age of three years), with seven of the projects and the additional financing (62 percent of outstanding commitments) approved since the last CAS, and only two projects (16 percent of outstanding commitments) older than four years. With regard to overall portfolio performance, the picture has been mixed. In terms of riskiness, there has been some deterioration in portfolio performance over the period with projects-at-risk and commitments-at-risk increasing due to long-standing implementation delays in three projects and country-related risks in all projects.⁷ However, in a recent country portfolio review it was noted that many of these problems are on the way to being

⁷ Under the Bank’s project risk rating system, Nepal has one “risk flag”—i.e., country environment—which is non-project specific. Therefore, as the entire portfolio is considered risky from the country standpoint, to be considered “at risk”, an individual project requires two more project-specific risk flags.

resolved and the number of projects-at-risk is expected to decline in the coming months. In terms of disbursements, after sluggish performance in FY04 (a disbursement ratio of about 15), disbursements increased significantly in FY05 (a disbursement ratio of nearly 30 percent) and dropped in FY06 (a disbursement ratio of about 21 percent).⁸ Although project implementation—as measured by disbursements—has fluctuated a bit in the volatile country environment, it has remained very respectable even when compared to overall Bank-wide averages.⁹

To mitigate the portfolio risks, the Bank has been proactively monitoring project implementation. The approach taken includes close monitoring of the country situation, continuous dialogue with the authorities and other key stakeholders, and timely supervision—although perhaps with limited field visits depending upon the security situation—to help keep portfolio performance stable and detect potential risks. The policy dialogue with senior officials helps to mitigate external risks that are beyond project control. The portfolio implementation strategy focuses on providing responsive and cost-effective, continuous implementation support, along with streamlining/harmonizing some of internal processes. This requires more frequent reviews with project implementation agencies, hands-on TA and continued training of project staff in issues related to the Bank’s fiduciary and safeguard policies. Safeguard issues—including financial management and other fiduciary obligations—continue to receive priority attention during project identification, preparation and implementation to ensure effective compliance. On the preparation side, project readiness filters have been developed and are applied to all projects to ensure the alignment of quality-at-entry of new projects/programs with the MTEF process, thus precluding the need for effectiveness conditions in new projects/programs. Finally, given the outcomes-focus of the program, outcome-based monitoring is also an integral focal area during project supervision.

⁸ About 60 percent of disbursements in FY05 were from the two financial sector reform projects, with a significant share being payments for the voluntary retirement scheme (VRS) programs in NBL and RBB. While the use of IDA funds for this purpose was questioned by a number of chairs at the Bank’s Board, “right-sizing” is an important action from the standpoint of restructuring NBL and RBB, and hence, for the overall financial sector reform program. However, even excluding the amount disbursed from these two projects, disbursements in FY05 were higher than in the two previous fiscal years.

⁹ Specifically, the overall Bank-wide disbursement ratio was 24 percent in FY06. Nepal’s performance is also quite favorable when compared to a number of FY06 average regional disbursement ratios—i.e., East Asia and Pacific: 20 percent; Middle East and North Africa: 18 percent; and Europe and Central Asia: 17 percent.

Appendix II
CAS Outcomes, Milestones and Interventions: FY04-FY06

CAS Pillar/PRS Outcome	CAS Outcomes	FY04 Milestones ¹	FY05 Milestones ¹	FY06 Milestones ¹	IDA and Partner Interventions
BROAD-BASED ECONOMIC GROWTH					
<ul style="list-style-type: none"> Improved pro-poor budget allocation Improved efficiency of public spending 	<ul style="list-style-type: none"> Outcome focused budgeting and monitoring in place Magnitude of SOE financial problems recognized by the authorities and strategy/action plan developed 	<ul style="list-style-type: none"> MTEF applied to all expenditures; Deferred to FY04/05 Completion of audits of all SOEs; Some remain incomplete 	<ul style="list-style-type: none"> Aid integration process implemented for FY05/06 budget Completion of audits of all major SOEs (including NEA, RNAC, NTC, NOC) 	<ul style="list-style-type: none"> Aid integration process implemented for FY06/07 budget; Some progress, but not achieved given set backs on donor coordination following 2/1/05 	<p>IDA Policy dialogue, PRCS I, ERTA Key partners IMF, UK</p>
<ul style="list-style-type: none"> Labor productivity enhanced Rights of labor protected 	<ul style="list-style-type: none"> Reform labor laws to allow greater flexibility in employment 		<ul style="list-style-type: none"> Flexible employment and retrenchment laws allowed on a pilot basis 	<ul style="list-style-type: none"> Flexible employment and retrenchment laws allowed on a pilot basis; Under discussion among the SPA and other stakeholders 	<p>IDA Policy dialogue, PRSCI I, ERTA Key partners ILO</p>
<ul style="list-style-type: none"> Increased private sector investment 	<ul style="list-style-type: none"> Lowered costs of doing business by liberalizing business support services Improved urban development and special economic zones Increased remittance transfers 	<ul style="list-style-type: none"> Amend investment and trade policy to liberalize the business support services market by allowing Foreign Direct Investment (FDI) in these sectors; Liberalization in marginal areas only 			<p>IDA Policy dialogue, ERTA Key partners IMF, UK, UNDP, ILO</p>
<ul style="list-style-type: none"> Increased export/GDP ratio 	<ul style="list-style-type: none"> Increased institutional capacity for trade policy formulation and implementation 	<ul style="list-style-type: none"> Adoption of Nepal Trade and Competitiveness Study as country policy (A) 	<ul style="list-style-type: none"> Establishment of apex foreign trade policy body 	<ul style="list-style-type: none"> Establishment of apex foreign trade policy body; Has not happened, in part due to lack of leadership at the Ministry of Industry and Supplies 	<p>IDA Policy dialogue Key partners IF partners, UK</p>
<ul style="list-style-type: none"> Central Bank's supervisory and regulatory capacity improved Efficiency of the financial system service delivery improved 	<ul style="list-style-type: none"> NRB performing regulatory and supervision functions effectively 	<ul style="list-style-type: none"> Comprehensive Bank and Financial Institutions Act (A) 	<ul style="list-style-type: none"> Article 86 of NRB Act amended (A) Prompt/ corrective action taken against troubled banks or those not in compliance with NRB guidelines (A) At least two major defaulter cases each resolved in NBL/RBB 	<ul style="list-style-type: none"> Prompt corrective action taken against [large] troubled banks (A) International bank examiners (on-site & off-site) hired/started work in mid-March 2006; one private bank has been asked to take corrective measures 	<p>IDA FSTA, FSRP Key partners IMF, UK</p>

¹ (A) denotes Achieved. Additional details on the progress towards meeting various milestones are provided in **Bold**.

CAS Outcomes, Milestones and Interventions: FY04-FY06

CAS Pillar/PRS Outcome	CAS Outcomes	FY04 Milestones ¹	FY05 Milestones ¹	FY06 Milestones ¹	IDA and Partner Interventions
<ul style="list-style-type: none"> Confidence in the financial system augmented Efficiency of the financial system service delivery improved 	<ul style="list-style-type: none"> RBB/NBL privatized or liquidated 	<ul style="list-style-type: none"> Restructuring plans agreed (A) 		<ul style="list-style-type: none"> Process initiated to take 100% ownership of NBL; Various options under consideration, including enforcement of Article 86 of NRB Act to resolve NBL ownership issues Sales Advisors hired to prepare a credible Information Memorandum to help guide the tendering process (A) 16 international firms submitted expressions of interest; NRB short-listing candidates 	<p>IDA FSTA, FRSP Key partners IMF, UK</p>
<ul style="list-style-type: none"> Enhanced agricultural productivity Overall agricultural growth by 4.1%; crops production increased by 4.1% 	<ul style="list-style-type: none"> Improved enabling environment for factor and output markets Increased agricultural productivity and farm incomes 		<ul style="list-style-type: none"> Agreed framework for promoting agricultural diversification (A) 	<ul style="list-style-type: none"> An action plan to implement new agriculture policy (with focus on agricultural commercialization, diversification and on-farm irrigation) 	<p>IDA Policy dialogue Key partners ADB, FAO, Germany, Japan, UK</p>
<ul style="list-style-type: none"> Sustainable road maintenance fund available in accordance with annual maintenance plan 	<ul style="list-style-type: none"> Percentage of main road network in poor condition reduced to 10% 	<ul style="list-style-type: none"> Roads Board operational (A) 		<ul style="list-style-type: none"> 80% of secondary road network in good and fair condition (A) 86% of the SRN is in good/fair condition as of FY06 	<p>IDA RMDP, RAIDP Key partners ADB, UK, Japan</p>
<ul style="list-style-type: none"> Road access increased to 70 District headquarters Increased investment in agricultural road and electrification 	<ul style="list-style-type: none"> Share of population with close access to roads (i.e., ½ day walk) increased by 4% 		<ul style="list-style-type: none"> Decentralize responsibility for rural roads in 10 competent Districts 	<ul style="list-style-type: none"> 10 Districts to have full ownership and management responsibility for district roads (A) 14 DDCs were identified as fully devolved districts in FY05; 64 districts (out of 75) have District Transport Master Plans to increase road access and connectivity 	<p>IDA RMDP, RAIDP Key partners ADB, Japan, Germany, SDC, UK</p>
<ul style="list-style-type: none"> Access of telecom services to all VDCs At least two telephone lines in all VDCs 	<ul style="list-style-type: none"> Private operator introduced for rural telephone service in Eastern Region 	<ul style="list-style-type: none"> Private rural operator contracted (A) 	<ul style="list-style-type: none"> All VDCs in Eastern Region provided telephone connection 	<ul style="list-style-type: none"> Amendments to Telecommunications Act approved; Delays continue in amending the Act 	<p>IDA Telecom</p>
<ul style="list-style-type: none"> Increase in percentage of population with access to electricity from 40 to 55% 	<ul style="list-style-type: none"> Improved efficiency of NEA (as measured by a reduction in system losses to 20%), combined with greater private sector participation 30,000 additional households in remote areas served by micro-hydropower 	<ul style="list-style-type: none"> Internal unbundling of NEA (A) Adopt subsidy policy for rural electrification (A) Increased number of sustainable community-based micro-hydro schemes; Effectiveness of PDP delayed 	<ul style="list-style-type: none"> Power Development Fund (PDF) making at least one lending decision 	<ul style="list-style-type: none"> 10,000 additional households served by micro-hydropower; Significant progress has been made with implementing micro hydro village electrification projects, but served about 3,000 additional households by end of the FY 	<p>IDA PDP Key partners Denmark, UNDP</p>
SOCIAL SECTOR DEVELOPMENT					

CAS Outcomes, Milestones and Interventions: FY04-FY06

CAS Pillar/PRS Outcome	CAS Outcomes	FY04 Milestones ¹	FY05 Milestones ¹	FY06 Milestones ¹	IDA and Partner Interventions
<ul style="list-style-type: none"> Net primary enrolment increased from 82% to 90% Increased percentage of pupils completing primary level Decline in percentage of primary school repeaters Decline in drop out rates at the primary level 	<ul style="list-style-type: none"> 25% of public schools under community management providing socially inclusive and higher quality education Efficient and timely textbook distribution system in place, as measured by all primary school children having books at the beginning of the school year 	<ul style="list-style-type: none"> 1,000 primary schools transferred to community management (A) Free textbook policy effectively implemented; Postponed by a year All community funded primary schools receiving block grants (A) 	<ul style="list-style-type: none"> Number of primary schools transferred to communities reach 2,500 (A) Private sector participation in distribution of textbooks initiated (A) 	<ul style="list-style-type: none"> Number of primary schools transferred to communities reaches 4,500; about 2,350 schools transferred in 62 out of 75 districts as of August. Process slowed down owing to agitation against community schools using coercive means Private sector participation in production of textbooks initiated; (A) Production and distribution of textbooks—up to grade 5—in all 16 districts of the Eastern region have been privatized on a pilot basis 	<p>IDA Community Schools LIL, EFA Key partners ADB, Denmark, EU, Finland, Japan, Norway, UNICEF</p>
	<ul style="list-style-type: none"> Progress towards financial sustainability of public universities 	<ul style="list-style-type: none"> Agreement on policy framework for higher education, including plans for cost sharing and separation of 10+ grades from universities 	<ul style="list-style-type: none"> Agreement on policy framework for higher education, including plans for separation of 10+ grades from universities (A) 	<ul style="list-style-type: none"> University accreditation system in place; Although there has been significant progress on this front, it is premature to say that the system is in place 	<p>IDA Policy dialogue</p>
<ul style="list-style-type: none"> Reduction in infant mortality rate from 64 to 45% Reduction in child mortality rate from 91 to 72% Reduction in maternal mortality from 415 to 300 (per 100,000) 	<ul style="list-style-type: none"> Essential health care services implemented in 25 districts, at least half with low health indicators 	<ul style="list-style-type: none"> Implementation of essential health care packages started Health facilities at DDC/VDC levels handed over to community or private/NGO management in 1/3 of Districts (A) 	<ul style="list-style-type: none"> Essential healthcare package rolled out in 15 Districts (A) Autonomous HIV/AIDS Trust Fund operational 	<ul style="list-style-type: none"> Essential health care package implemented fully in 15 Districts (A) All EHC interventions have been classified as P1 and are being implemented in various degrees in all 75 districts Institutional/legal framework established for autonomous HIV/AIDS Trust Fund; Committee established to draft the structure of such an entity, but the framework was not completed by end of the FY 	<p>IDA Sector policy dialogue, Health Sector Program Key partners EU, Germany, Japan, Norway, UK, US, UN agencies</p>
<ul style="list-style-type: none"> Consistent community driven approach operational sector wide Health and hygiene improved About 3.8 million people have access to safe and sustainable drinking water services 	<ul style="list-style-type: none"> Extend rural water supply to an additional 10% of the population Extend coverage of sanitation services to an additional 5% of the rural population 	<ul style="list-style-type: none"> Rural Water Fund Board made independent (A) 	<ul style="list-style-type: none"> Sector M&E system with clear indicators field tested and established 	<ul style="list-style-type: none"> A fully tested sector M&E system established; While the Fund Board approach is being replicated widely, progress in establishing a fully tested M&E system is delayed. There has been good progress, but will only be completed in late 2006 	<p>IDA RWSSP II Key partners ADB, UK, Water Aid</p>

CAS Outcomes, Milestones and Interventions: FY04-FY06

CAS Pillar/PRS Outcome	CAS Outcomes	FY04 Milestones ¹	FY05 Milestones ¹	FY06 Milestones ¹	IDA and Partner Interventions
<ul style="list-style-type: none"> Enrolment rate of girls and disadvantaged children increase Improvement in the ratio of girls enrolment rate to that of boys 	<ul style="list-style-type: none"> Reduce out of school primary aged children (primarily Dalits, girls and disadvantaged Janajati groups) by 50% 	<ul style="list-style-type: none"> Establish scholarship programs to support the target population Establish systems for monitoring educational attainments, including inclusion of girls and Dalits, at community-managed schools (A) 	<ul style="list-style-type: none"> Establish systems for monitoring the educational attainments, including the inclusion of girls and Dalits, at community managed schools (A) 	<ul style="list-style-type: none"> Clarification and revision of classification for support to Dalits and disadvantaged Janajatis passed by Cabinet; Has not been done, but is a high priority 	<p>IDA Follow up of Gender & Social Exclusion Analysis Community Schools LIL, EFA Key partners ADB, Denmark, EU, Japan, Norway, UNESCO</p>
SOCIAL INCLUSION AND TARGETTED PROGRAMS					
<ul style="list-style-type: none"> HDI index of far-western and mid-western provinces to increase by 8% per year Proportion of deprived communities below poverty line declines significantly 	<ul style="list-style-type: none"> Increased public funds used by disadvantaged rural groups for services 	<ul style="list-style-type: none"> Autonomous PAF established and operational (A) VDCs that do well in improving poverty and social inclusion outcomes are rewarded with additional funding from PAF 		<ul style="list-style-type: none"> PAF approves at least 200 grants (A); As of 7/06, PAF has provided benefits to 2,450 community organizations covering over 62,000 households in 334 VDCs 	<p>IDA PAF, PAF Additional Financing Key partners Denmark, UK</p>
<ul style="list-style-type: none"> Success rates of female, ethnic and disadvantaged groups in civil service increased 	<ul style="list-style-type: none"> Affirmative action policy and implementation system for improving the diversity of the civil service in place and working 	<ul style="list-style-type: none"> Workshop in collaboration with MOGA and other donors on various approaches to affirmative action to help develop Nepal's policy (A) 	<ul style="list-style-type: none"> An affirmative action program for Civil Service agreed (A) A serious report produced by a serious high-level affirmative action committee 	<ul style="list-style-type: none"> Affirmative action program for Civil Service passed by Cabinet; Although there has been solid progress, the process is not yet in place and has not yet been implemented 	<p>IDA Policy dialogue/TA Key partners UK</p>
GOOD GOVERNANCE					
<ul style="list-style-type: none"> Central grants allocated to local bodies based on poverty Functioning of fiscal decentralization based on road map drawn by fiscal commission 	<ul style="list-style-type: none"> Decentralization (as per the Local Self Governance Act-LSGA) advanced substantially, with good monitoring systems in place 	<ul style="list-style-type: none"> Fiscal decentralization framework designed 	<ul style="list-style-type: none"> Pilot decentralization scheme designed for selected DDCs and municipalities 		<p>IDA Policy dialogue/TA Key partners Denmark, UK, UNDP</p>
<ul style="list-style-type: none"> Enhance civil service efficiency and accountability 	<ul style="list-style-type: none"> Clear delineation of responsibilities between Ministers and civil service to ensure autonomy/accountability 		<ul style="list-style-type: none"> Governance Act approved (A) 	<ul style="list-style-type: none"> Implementation of new Governance Act; Act under discussion within the cabinet sub-committee 	<p>IDA Policy dialogue, ERTA Key Partners ADB</p>
<ul style="list-style-type: none"> Transparency and accountability improved Citizen's charter in all DDCs and municipalities prepared 	<ul style="list-style-type: none"> Improved accountability and transparency 	<ul style="list-style-type: none"> Institutionalization of expenditure tracking survey in the public sector (A) 	<ul style="list-style-type: none"> Procurement Act approved by cabinet (A) 	<ul style="list-style-type: none"> 25% reduction in qualified expenditures reported in 2003 AG's report (A) 2006 AG's reports reduction of irregularities by about 37% of total irregularities reported as of FY02/03 Implementation of Procurement Act (A) Act approved by the Parliament 	<p>IDA Policy Dialogue/TA, IDF grants Key partners Denmark, UK, US</p>
Total number of milestones:		25	23	23	
Number of milestones achieved:		15	11	9	
Percent of total milestones achieved:		60%	48%	39%	

Appendix III
Evaluation of CAS Triggers

Area	Low Case Triggers	High Case Triggers	Progress to Date	Evaluation
Immediate Action Plan (IAP)	<ul style="list-style-type: none"> • Implementation of annual IAP falls significantly short of targets (less than half attained) 	<ul style="list-style-type: none"> • Annual IAP implementation is complete and the process is deepened 	<ul style="list-style-type: none"> • FY02/03 (first) IAP contained 19 actions, all of which were implemented. • FY03/04 IAP contained 22 actions, all of which were largely completed on time. • FY04/05 IAP contained 24 actions, completion rate of 82%. • FY05/06 IAP contains 20 actions, including those not completed in FY04/05; with unstable political situation completion rate decreased. • FY06/07 IAP contains 17 actions. 	Base Case
Decentralization of Service Delivery	<ul style="list-style-type: none"> • Decentralization of basic services delivery—especially in education and health—stalls 	<ul style="list-style-type: none"> • Decentralization of basic services accelerates • Fiscal decentralization accelerates, with full decentralization implemented in some districts 	<ul style="list-style-type: none"> • Since 2003, about 2,350 primary schools (in 59 districts) have been transferred to SMCs. • 1,317 sub-health posts (out of 3,100), 19 health posts (out of 751) and 25 primary health care centers (out of 189) in 28 districts have been transferred to local bodies. • FY05/06 budget devolves activities in primary health, primary education, agriculture/livestock extension services, and rural infrastructure to local bodies and CBOs in 14 districts; however, not clear how this will work given the absence of elected local bodies. 	Base Case
Financial Sector Reform	<ul style="list-style-type: none"> • Banking reform stalls—i.e., restructuring by FY05 not in sight 	<ul style="list-style-type: none"> • NRB/RBB restructuring plans agreed and implementation initiated 	<ul style="list-style-type: none"> • External management teams in place since 7/03 (NBL) and 2/04 (RBB), with both contracts extended. • NBL/RBB generated operating profits in FY03/04 through FY05/06. • Disclosure policies brought to international standards and workforces restructured. • Debt recovery process continues to face resistance, especially from high profile and large willful defaulters. • Little progress towards resolving the private shareholdings of NBL in preparation for privatization. • Privatization of at least one of the two (i.e., NBL and RBB) not envisioned until FY08 at the earliest, however, the process has commenced to acquire sales advisors for the process. 	Low Case
Public Expenditure Management	<ul style="list-style-type: none"> • Management of public expenditures weakens—i.e., weakened application of MTEF/project prioritization system/similar mechanisms. 		<ul style="list-style-type: none"> • The MTEF has been put in place and there has been progress with regard to prioritizing projects, most notably with an increase in budget releases for P1 projects. • FY06/07 budget is the fourth in a row that maintains aggregate fiscal discipline anchored within the PRS. • Reporting on outputs/outcomes remains weak, but efforts (including PMAS) are on-going. • The share of pro-poor spending in total public sector expenditures increased from 27% in FY02/03 to 31% in FY04/05. 	Low Base Case

Evaluation of CAS Triggers

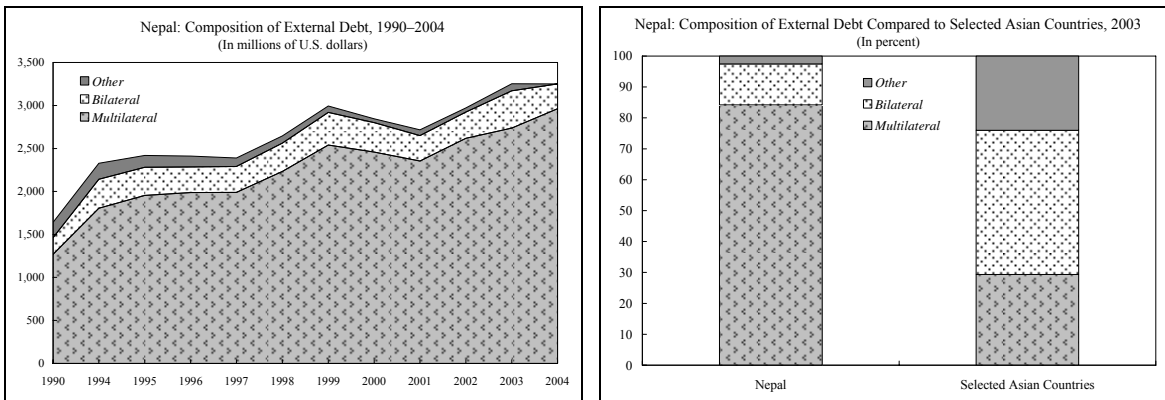
Area	Low Case Triggers	High Case Triggers	Progress to Date	Evaluation
			<ul style="list-style-type: none"> • Share of social sector spending increased (from 7% to 7.6% of GDP) in FY05/06 budget. • Aid integration proposals not integrated into budget cycle, in part due to setbacks in donor coordination following 2/1/05. 	
Governance	<ul style="list-style-type: none"> • Anti-corruption drive loses momentum 		<ul style="list-style-type: none"> • CIAA has been strengthened, and a highly visible anti-corruption drive had been started. • Since 2005, a five-year forward looking anti-corruption strategy has been under implementation. 	Low Case
Inclusion		<ul style="list-style-type: none"> • Strong measures implemented to improve access to basic education for disadvantaged children 	<ul style="list-style-type: none"> • In primary education, scholarships for Dalits and children from other marginalized groups are in place and mechanisms for social audit of these schemes are being introduced to improve targeting. 	Low Base Case
Portfolio		<ul style="list-style-type: none"> • Continued satisfactory portfolio performance to confirm absorptive capacity 	<ul style="list-style-type: none"> • With regard to overall portfolio performance, the picture has been mixed over FY04/FY05. In terms of riskiness, portfolio performance has deteriorated (over FY04) with projects-at-risk and commitments-at-risk increasing due to long-standing implementation delays in one project and primarily country-related risks in another project. • In terms of disbursements, after sluggish performance in FY04 (i.e., a disbursement ratio of 15 percent), disbursements increased significantly in FY05 (i.e., a disbursement ratio of nearly 30 percent). Disbursements in FY06—amounting to about US\$67 million or a disbursement ratio of 21%—are lower than in FY05, but still respectable when compared to the overall Bank-wide disbursement ratio and that of many regions (i.e., East Asia and Pacific: 20%; Middle East and North Africa: 18%; and Europe and Central Asia: 17%). As such, even in the increasingly volatile environment, project implementation—as measured by disbursements—has remained strong. 	Base Case
			OVERALL EVALUATION	LOW to LOW BASE CASE

Appendix IV Debt Sustainability Analysis¹

I. LOW INCOME COUNTRY-DEBT SUSTAINABILITY ANALYSIS (LIC-DSA)²

A. Size and Composition of Public and Publicly Guaranteed (PPG) Debt

1. Nepal's total public debt is estimated at 61 percent of GDP at end-2004, of which roughly 75 percent is external debt. External debt doubled between 1990 and 2004, reflecting budget support and project finance from multilateral institutions, mostly IDA and the ADB. At end-2004, nominal external debt stood at around US\$3¼ billion, of which 90 percent was owed to multilateral institutions. By comparison, multilateral debt accounted for 29 percent of total external debt in selected Asian economies. The composition of Nepal's debt implies a high degree of concessionality, with an average grant element of close to 50 percent.



B. Assumptions

2. **Baseline projections of PPG debt are based on the following key assumptions:**

- **Real sector:** Real GDP growth is projected to rise gradually from 3 percent in FY05/06 and stabilize at 5½ percent after FY09/10, in line with growth rates observed in the early 1990s. Inflation is projected at 5 percent. The nominal interest rate on domestic debt is expected to average 7 percent during FY05/06–FY09/10, and 6 percent thereafter. The exchange rate is projected to depreciate against the dollar, in line with movements in the Indian rupee to which the Nepalese rupee is pegged.
- **Fiscal sector:** The revenue-to-GDP ratio is projected to rise from 13 percent in FY04/05 to 13¾ percent by FY07/08, assuming some increase in the VAT rate and improved tax collection. The

¹ Public debt dynamics are assessed using the Low Income Country Debt Sustainability Analysis (LIC-DSA) framework. This DSA was conducted jointly between the World Bank and the International Monetary Fund (IMF), finalized in January 2006 and released in the IMF's Staff Report on the 2005 Article IV Consultations (February 2006). Based on the external LIC-DSA, Nepal's external debt dynamics are subject to a high risk of debt distress. Since then, Nepal has remained current on its debt service. A revised DSA is currently under preparation and will be finalized in the context of the IMF Staff Report on the next PRGF review.

² The LIC-DSA produces different results from calculations under the enhanced HIPC Initiative because of different methodologies.

expenditure-to-GDP ratio rises from 16 percent in FY04/05 to 18½ percent in FY07/08 as development spending picks up, and stabilizes thereafter. Growth of real primary spending averages 7 percent in FY05/06–FY09/10 (5¼ percent in FY10/11–FY24/25).

- **External sector:** Exports of goods and services are projected to average 6¾ percent over the projection period. Imports of goods and services are expected to rebound in line with economic activity following the decline in FY04/05, averaging 7¼ percent. The non-interest current account balance is projected to deteriorate from a surplus of 6 percent of GDP in FY04/05 to a deficit of 1¼ percent of GDP by FY24/25. Scheduled debt service on existing external debt increases from around US\$120 million in FY04/05 to US\$125 million in FY24/25. New financing is assumed to be moderate during the next three years, but rising gradually from US\$170 million in FY05/06 to US\$370 million by FY09/10. The grant element of new borrowing is assumed to average around 45 percent during FY04/05–FY09/10 and 40 percent thereafter.

C. Baseline

PPG External Debt

3. **A key feature of the LIC–DSA framework is that it compares debt burden indicators to indicative policy-based thresholds.** The thresholds are based on the empirical finding that low-income countries with stronger policies and institutions tend to have a higher debt carrying capacity. At end-2004, Nepal's NPV of debt-to-exports ratio is estimated at 172 percent (the relevant policy-based indicative threshold is 150 percent). The ratio is projected to fall to 148 percent by FY09/10 and 83 percent by FY24/25. Other relevant indicators remain below the thresholds throughout the projection period.

4. **In the baseline scenario, debt burden ratios are projected to fall between FY04/05 and FY24/25** (Table II.1). The NPV of external public debt-to-GDP (28 percent to 15 percent) NPV of external public debt-to-exports (172 percent to 83 percent); external public debt service-to-exports ratio (10 percent to 8 percent); and external public debt service to revenues (213 percent to 109 percent).³

	Indicative Thresholds 1/	Nepal 2004/05
NPV of debt, in percent of		
Exports	150	172
GDP	40	28
Revenues	250	213
Debt service, in percent of		
Exports	20	9
Revenues	30	12

1/ Shows indicative policy dependent thresholds under the joint IMF-World Bank low-income country debt sustainability framework for a medium policy performer.

Total Public Debt

5. Domestic debt accounts for about 25 percent of total public debt. Under the baseline scenario, the NPV of public debt-to-GDP ratio declines from 44 percent at end-FY04/05 to 30 percent by FY24/25 (Table II.4; Figure II.2). Over the same period, the NPV of public debt-to-revenue ratio falls from 292 percent to 190 percent, and the public debt service-to revenue ratio decreases from 23 percent to 16 percent.

D. Sensitivity Analysis

6. Stress tests suggest that Nepal's debt profile is susceptible to shocks.
- Total public debt: Following an extreme shock—a one-time 30 percent real depreciation in FY05/06 which leads to the highest level of NPV of debt-to-GDP 10 years after the shock—the NPV ratio

³ Given the high concessionality of external debt, the debt service-to-exports ratio is low, and at levels similar to most HIPC's after full HIPC debt relief. The ratio reflects debt service on existing debt and debt service on projected disbursements.

peaks at around 54 percent in FY05/06 and falls to about 33 percent in FY24/25. The debt service to revenue ratio peaks in FY08/09 at 28 percent converging to the baseline level of 16 percent in FY24/25.

- **External debt:** Following an export shock—defined as export value growth at historical levels minus one standard deviation in the first two years of the shock—the NPV of debt-to-exports ratio increases significantly, peaking at 333 percent in the last year of the shock. The debt service-to-exports ratio peaks at 19 percent in FY14/15. These results are driven by Nepal's recent volatile export performance. The combined shocks scenario has a similar effect, primarily based on the export component of the shock. Under a low growth scenario (3 percent), the NPV of external debt-to-GDP ratio would be higher by 7 percent of GDP by FY24/25 relative to the baseline.

E. Staff Assessment

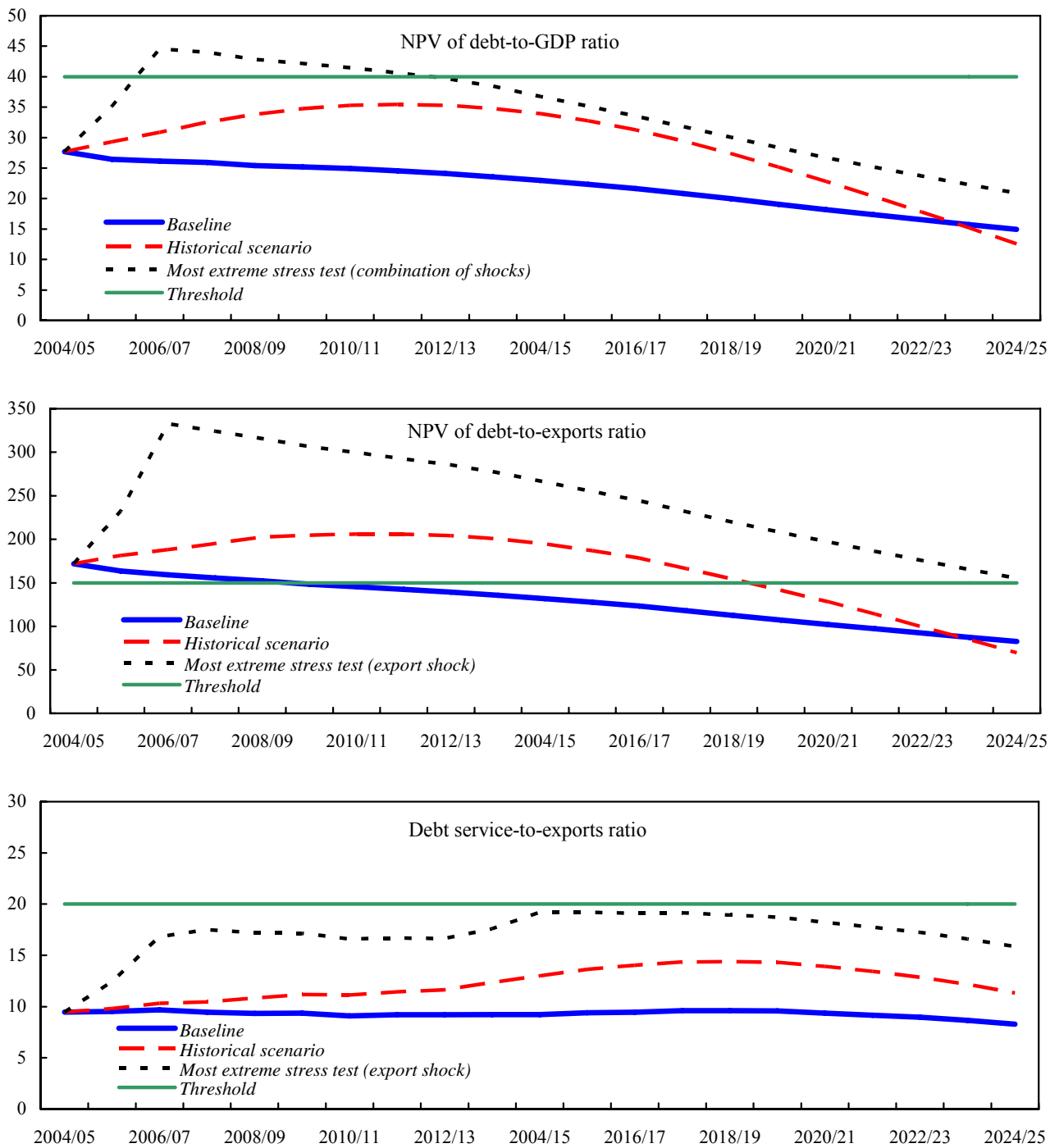
7. **Based on the LIC-DSA, staffs conclude that Nepal's external debt dynamics are subject to a high risk of distress.** The sensitivity analyses underscore the need to implement sound macroeconomic policies and reforms, including toward achieving higher export growth, while maintaining efforts to raise revenue. Those factors combined with foreign financing at favorable terms—preferably through grants—would help Nepal make progress toward achieving its MDG targets while containing risks to debt sustainability.

II. ENHANCED HIPC AND MULTILATERAL DEBT RELIEF (MDR) INITIATIVES

8. **Nepal was recently deemed to be potentially eligible—on a preliminary basis—for HIPC relief under the extended sunset clause.** This determination was based on an estimated end-2004 NPV of debt-to-exports ratio (around 200 percent after traditional debt relief; the enhanced HIPC threshold is 150 percent). If Nepal's eligibility is confirmed in early 2006, it could receive relief under the enhanced HIPC Initiative and MDRI.

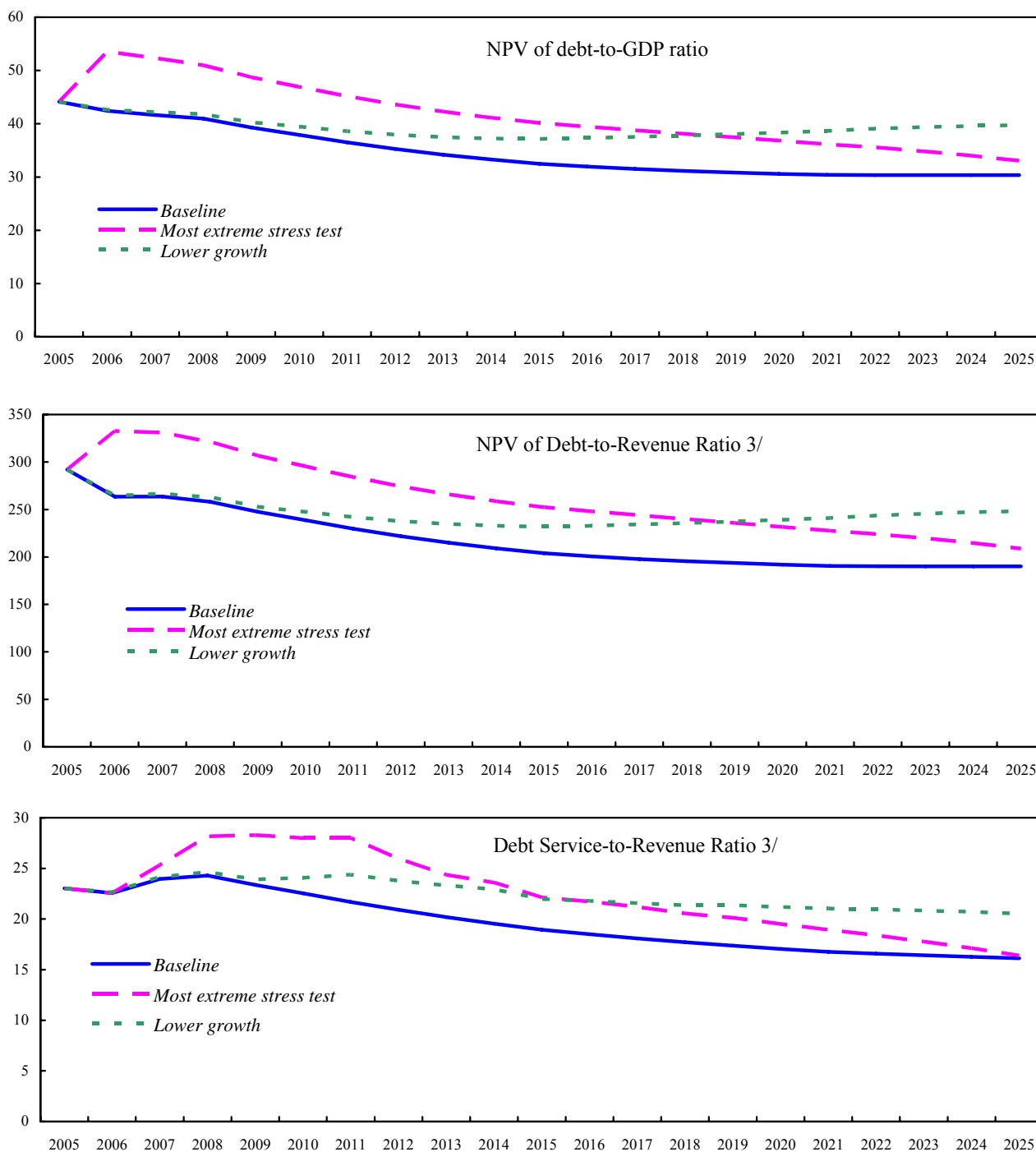
Figure II.1. Nepal: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2005–2025

(In percent)



Source: Staff projections and simulations.

Figure II.2. Nepal: Indicators of Public Debt Under Alternative Scenarios, 2005–2025 1/ 2/
(In percent)



Source: Staff projections and simulations.

1/ Most extreme stress test is test that yields highest ratio in 2015.

2/ 2005 refers to fiscal year 2004/05.

3/ Revenue including grants.

Table II.1. Nepal: External Debt Sustainability Framework, Baseline Scenario, 2001/02–2024/25 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Estimate 2004/05	Projections						2010/11-2024/25 Average	
	2001/02	2002/03	2003/04				2005/06	2006/07	2007/08	2008/09	2009/10	2004/05-2009/10 Average		2014/15	2024/25
External debt (nominal) 1/	52.7	52.6	51.0			47.1	44.5	43.6	43.1	42.0	41.4		36.6	24.5
<i>Of which</i> : public and publicly guaranteed (PPG)	50.5	49.3	48.1			44.4	41.8	40.8	40.2	39.1	38.4		33.5	21.3
Change in external debt	3.0	-0.2	-1.6			-3.9	-2.5	-0.9	-0.5	-1.1	-0.6		-1.1	-1.1
Identified net debt-creating flows	-4.2	-5.5	-9.9			-6.7	-6.1	-5.8	-5.8	-5.4	-4.9		-3.1	-0.4
Non-interest current account deficit	-4.9	-3.0	-3.4	-1.8	3.3	-5.9	-5.0	-4.7	-4.4	-3.8	-3.1	-4.5	-1.2	1.1
Deficit in balance of goods and services	13.8	13.8	13.7			13.2	13.7	16.4	16.7	16.8	16.6		14.8	11.7
Exports	16.8	16.9	18.0			16.1	16.1	16.4	16.7	16.7	17.0		17.4	18.1
Imports	30.6	30.7	31.7			29.3	29.9	32.8	33.3	33.5	33.6		32.2	29.8
Net current transfers (negative = inflow)	-15.9	-16.5	-17.0	-12.4	4.0	-18.4	-18.0	-17.9	-17.8	-17.4	-16.7	-17.7	-13.3	-8.6
Other current account flows (negative = net inflow)	-2.7	-0.3	-0.1			-0.8	-0.7	-3.2	-3.2	-3.1	-3.1		-2.7	-2.0
Net FDI (negative = inflow)	0.1	-0.2	0.0	-0.1	0.2	0.0	-0.2	-0.2	-0.2	-0.2	-0.3	-0.2	-0.4	-0.5
Endogenous debt dynamics 2/	0.7	-2.3	-6.4			-0.8	-0.9	-0.9	-1.2	-1.4	-1.5		-1.5	-1.0
Contribution from nominal interest rate	0.4	0.4	0.5			0.4	0.4	0.4	0.4	0.4	0.4		0.4	0.3
Contribution from real GDP growth	0.3	-1.7	-1.5			-1.2	-1.3	-1.3	-1.6	-1.8	-2.0		-1.9	-1.3
Contribution from price and exchange rate changes	-0.1	-1.0	-5.3			...	...	...	...	...	...		...	...
Residual (3-4) 3/	7.1	5.3	8.3			2.8	3.6	4.9	5.3	4.3	4.3		1.9	-0.7
<i>Of which</i> : exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
NPV of external debt 4/	...	...	32.5			30.4	29.1	28.9	28.8	28.4	28.2		26.1	18.1
In percent of exports	...	...	180.8			188.8	180.5	176.4	173.0	169.8	166.2		149.6	100.2
NPV of PPG external debt	...	...	29.6			27.7	26.4	26.1	25.9	25.4	25.2		23.0	15.0
In percent of exports	...	...	164.8			172.0	163.7	159.3	155.7	152.1	148.4		131.7	82.8
Debt service-to-exports ratio (in percent)	9.4	9.6	9.7			9.5	9.5	9.7	9.5	9.3	9.4		9.2	8.3
PPG debt service-to-exports ratio (in percent)	9.4	9.6	9.7			9.5	9.5	9.7	9.5	9.3	9.4		9.2	8.3
Total gross financing need (in billions of U.S. dollars)	-0.2	-0.1	-0.1			-0.3	-0.3	-0.3	-0.3	-0.2	-0.2		0.0	0.6
Non-interest current account deficit that stabilizes debt ratio	-7.8	-2.8	-1.9			-2.0	-2.5	-3.8	-3.8	-2.7	-2.5		-0.1	2.2
Key macroeconomic assumptions														
Real GDP growth (in percent)	-0.6	3.4	3.4	3.9	2.0	2.5	3.0	3.0	4.0	4.5	5.0	3.7	5.5	5.5
GDP deflator in U.S. dollar terms (change in percent)	0.1	2.0	11.3	1.4	4.7	6.2	5.4	2.4	2.3	3.5	2.0	3.6	1.7	0.7
Effective interest rate (in percent) 5/	0.8	0.9	1.0	1.1	0.3	0.9	0.9	1.0	1.0	1.0	1.1	1.0	1.3	1.3
Growth of exports of G&S (U.S. dollar terms, in percent)	-19.4	6.0	22.2	6.2	22.6	-2.4	8.8	7.2	8.1	8.4	8.8	6.5	7.7	6.7
Growth of imports of goods and services (U.S. dollar terms, in percent)	-14.4	6.0	18.7	6.1	15.1	0.8	10.5	15.9	8.1	8.6	7.5	8.6	6.1	5.6
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	48.4	42.7	41.3	42.9	40.8	38.9	42.5	36.8	35.1
Memorandum item:														
Nominal GDP (in billions of U.S. dollars)	5.6	5.9	6.8			7.4	8.0	8.4	9.0	9.7	10.4		14.7	27.7

Source: Staff simulations.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - \rho(1+g)] / (1+g+\rho+g\rho)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that NPV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table II.2. Nepal: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2004/05–2024/25
(In percent)

	Estimate 2004/05	Projections						
		2005/06	2006/07	2007/08	2008/09	2009/10	2014/15	2024/25
NPV of Debt-to-GDP Ratio								
Baseline	28	26	26	26	25	25	23	15
A. Alternative scenarios								
A1. Key variables at their historical averages in 2005/06–2024/25 1/	28	29	31	33	34	35	34	13
A2. New public sector loans on less favorable terms in 2005/06–2024/25 2/	28	27	27	28	28	28	29	24
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2005/06–2006/07	28	27	27	26	26	26	23	15
B2. Export value growth at historical average minus one standard deviation in 2005/06–2006/07 3/	28	29	33	32	32	31	28	17
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2005/06–2006/07	28	29	30	30	29	29	27	17
B4. Net nondebt creating flows at historical average minus one standard deviation in 2005/06–2006/07 4/	28	33	39	38	37	37	32	18
B5. Combination of B1-B4 using one-half standard deviation shocks	28	35	45	44	43	42	37	21
B6. One-time 30 percent nominal depreciation relative to the baseline in 2005/06 5/	28	37	37	36	36	35	32	21
NPV of Debt-to-Exports Ratio								
Baseline	172	164	159	156	152	148	132	83
A. Alternative scenarios								
A1. Key variables at their historical averages in 2005/06–2024/25 1/	172	182	188	195	203	205	195	70
A2. New public sector loans on less favorable terms in 2005/06–2024/25 2/	172	167	166	167	168	168	166	131
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2005/06–2006/07	172	164	159	156	152	148	132	83
B2. Export value growth at historical average minus one standard deviation in 2005/06–2006/07 3/	172	232	333	324	316	307	266	155
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2005/06–2006/07	172	164	159	156	152	148	132	83
B4. Net nondebt creating flows at historical average minus one standard deviation in 2005/06–2006/07 4/	172	203	236	229	222	216	184	102
B5. Combination of B1-B4 using one-half standard deviation shocks	172	235	320	311	302	292	248	136
B6. One-time 30 percent nominal depreciation relative to the baseline in 2005/06 5/	172	164	159	156	152	148	132	83
Debt Service Ratio								
Baseline	9	10	10	9	9	9	9	8
A. Alternative scenarios								
A1. Key variables at their historical averages in 2005/06–2024/25 1/	9	10	10	10	11	11	13	11
A2. New public sector loans on less favorable terms in 2005/06–2024/25 2/	9	10	10	10	10	10	10	11
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2005/06–2006/07	9	10	10	9	9	9	9	8
B2. Export value growth at historical average minus one standard deviation in 2005/06–2006/07 3/	9	12	17	18	17	17	19	16
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2005/06–2006/07	9	10	10	9	9	9	9	8
B4. Net nondebt creating flows at historical average minus one standard deviation in 2005/06–2006/07 4/	9	10	11	11	11	11	14	11
B5. Combination of B1-B4 using one-half standard deviation shocks	9	11	14	15	15	15	18	14
B6. One-time 30 percent nominal depreciation relative to the baseline in 2005/06 5/	9	10	10	9	9	9	9	8
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	36	36	36	36	36	36	36	36

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and nondebt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table II.3. Nepal: Public Sector Debt Sustainability Framework, Baseline Scenario, 2001/02–2024/25

(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 2/	Standard Deviation 2/	Estimate 2004/05	Projections								
	2001/02	2002/03	2003/04				2005/06	2006/07	2007/08	2008/09	2009/10	2005/06- 09/10 Average	2014/15	2024/25	2010/11- 2024/25 Average
Public sector debt 1/	67.9	67.2	65.2			60.8	57.8	56.4	55.3	53.0	51.1		43.0	36.7	
<i>Of which</i> : foreign-currency denominated	50.5	49.3	48.1			44.4	41.8	40.8	40.2	39.1	38.4		33.5	21.3	
Change in public sector debt	6.3	-0.7	-2.0			-4.4	-3.0	-1.4	-1.1	-2.3	-1.9		-1.3	-0.3	
Identified debt-creating flows	4.2	-2.3	-6.9			-4.2	-3.5	-1.3	-1.2	-1.8	-1.1		-0.6	-0.2	
Primary deficit	2.9	0.1	-0.3	2.4	1.5	-0.3	-0.1	0.8	1.2	1.3	1.3	0.7	1.5	1.7	1.6
Revenue and grants	12.9	14.4	14.5			15.1	16.1	15.8	15.9	15.9	15.9		15.9	16.0	
<i>Of which</i> : grants	1.4	2.1	2.3			2.1	2.5	2.2	2.2	2.2	2.2		2.2	2.2	
Primary (noninterest) expenditure	15.8	14.5	14.2			14.8	16.0	16.6	17.1	17.1	17.2		17.4	17.7	
Automatic debt dynamics	1.2	-2.5	-6.6			-3.8	-3.4	-2.1	-2.4	-3.0	-2.5		-2.1	-1.9	
Contribution from interest rate/growth differential	0.4	-2.5	-2.9			-1.5	-1.6	-1.6	-1.9	-2.1	-2.1		-1.9	-1.8	
<i>Of which</i> : contribution from average real interest rate	0.1	-0.2	-0.7			0.1	0.1	0.1	0.3	0.3	0.4		0.4	0.2	
<i>Of which</i> : contribution from real GDP growth	0.4	-2.2	-2.2			-1.6	-1.8	-1.7	-2.2	-2.4	-2.5		-2.3	-1.9	
Contribution from real exchange rate depreciation	0.8	0.0	-3.7			-2.3	-1.8	-0.6	-0.5	-0.9	-0.4		-2.2	-0.1	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	2.2	1.6	4.9			-0.3	0.5	-0.1	0.1	-0.5	-0.7		-0.7	-0.1	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	-0.6	3.4	3.4	3.9	2.0	2.5	3.0	3.0	4.0	4.5	5.0	3.9	5.5	5.5	5.5
Average nominal interest rate on forex debt (in percent)	0.9	0.9	1.0	1.1	0.3	0.9	1.0	1.1	1.1	0.0	1.2	0.9	1.4	1.5	1.4
Average real interest rate on domestic currency debt (in percent)	3.2	1.8	0.1	0.7	1.9	0.6	0.8	0.7	1.6	4.4	2.6	2.0	3.0	0.4	2.1
Real exchange rate depreciation (in percent, + indicates depreciation)	1.6	0.0	-7.8	0.7	4.4	-4.9	-4.2	-1.4	-1.3	-2.4	-1.0	-2.0	-0.7	-0.7	-0.7
Inflation rate (GDP deflator, in percent)	3.4	4.5	5.0	5.4	2.0	4.1	5.0	5.5	5.0	5.0	4.0	4.9	4.0	4.0	4.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-4.2	-5.0	0.9	4.5	8.7	7.0	11.5	6.8	7.0	4.8	5.3	7.1	5.8	4.6	5.2

Sources: Nepalese authorities; and Fund staff estimates and projections.

1/ Public and publicly guaranteed debt.

2/ Historical averages and standard deviations are derived over the past 10 years.

Table II.4. Nepal: Sensitivity Analysis for Key Indicators of Public Debt, 2005–2025

	Estimate	Projections										
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2025
NPV of Debt-to-GDP Ratio												
Baseline	44	42	42	41	39	38	36	35	34	33	32	30
A. Alternative scenarios												
A1. Real GDP growth and primary balance are at historical averages	44	44	45	45	44	44	44	44	44	44	44	44
A2. Primary balance is unchanged from 2004	44	42	40	38	35	33	30	27	25	23	21	6
A3. Permanently lower GDP growth 1/	44	43	42	42	40	39	39	38	38	37	37	40
B. Bound tests												
B1. Real GDP growth is at historical average minus one standard deviations in 2006/07	44	43	43	42	41	40	39	38	37	36	36	32
B2. Primary balance is at historical average minus one standard deviations in 2006/07	44	46	48	47	45	44	42	41	40	39	38	31
B3. Combination of B1-B2 using one half standard deviation shocks	44	45	47	46	44	42	41	40	39	38	37	30
B4. One-time 30 percent real depreciation in 2006	44	54	52	51	49	47	45	44	42	41	40	33
B5. 10 percent of GDP increase in other debt-creating flows in 2006	44	42	42	41	39	38	37	36	35	34	33	32
NPV of Debt-to-Revenue Ratio 2/												
Baseline	292	263	264	258	247	239	230	222	215	209	204	190
A. Alternative scenarios												
A1. Real GDP growth and primary balance are at historical averages	292	275	282	283	280	280	279	278	276	275	273	269
A2. Primary balance is unchanged from 2004	292	262	256	242	221	205	188	173	158	144	131	40
A3. Permanently lower GDP growth 1/	292	265	266	263	253	248	242	238	235	233	232	248
B. Bound tests												
B1. Real GDP growth is at historical average minus one standard deviations in 2006/07	292	266	271	267	256	249	242	237	232	228	224	201
B2. Primary balance is at historical average minus one standard deviations in 2006/07	292	285	303	297	284	275	266	258	251	244	239	198
B3. Combination of B1-B2 using one half standard deviation shocks	292	281	295	289	276	267	258	250	244	238	232	192
B4. One-time 30 percent real depreciation in 2006	292	333	331	321	307	295	284	274	266	259	252	209
B5. 10 percent of GDP increase in other debt-creating flows in 2006	292	263	264	258	248	241	232	225	219	214	209	200
Debt Service-to-Revenue Ratio 2/												
Baseline	23	23	24	24	23	23	22	21	20	20	19	16
A. Alternative scenarios												
A1. Real GDP growth and primary balance are at historical averages	23	22	24	26	26	26	26	24	22	21	19	16
A2. Primary balance is unchanged from 2004	23	23	24	24	22	21	20	18	16	15	13	3
A3. Permanently lower GDP growth 1/	23	23	24	25	24	24	24	24	23	23	22	21
B. Bound tests												
B1. Real GDP growth is at historical average minus one standard deviations in 2006/07	23	23	24	25	24	24	25	24	23	23	21	17
B2. Primary balance is at historical average minus one standard deviations in 2006/07	23	23	25	28	28	28	28	26	24	24	22	16
B3. Combination of B1-B2 using one half standard deviation shocks	23	23	25	27	27	27	27	25	24	23	22	16
B4. One-time 30 percent real depreciation in 2006	23	23	25	26	27	25	25	25	24	23	22	16
B5. 10 percent of GDP increase in other debt-creating flows in 2006	23	23	24	24	26	23	24	23	22	21	20	16

Sources: Country authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).

2/ Revenues are defined inclusive of grants.

Appendix V

Update on the Immediate Action Plan

The government has been trying to provide impetus to its reform initiatives through among other means, the adoption of the Immediate Action Plan (IAP). The IAP represents the continuing efforts to bolster the country's track record for implementing reforms.

The first IAP was adopted by the Council of Ministers in June 2002. Building on the successful implementation of the first IAP, the authorities proceeded to develop an annual IAP in succeeding years to bridge capacity gaps and expedite key reforms. With the second IAP (i.e., prepared in 2003), a joint government-donor task force, called the Reform and Development Group, was convened and charged with developing the IAP. This group enhanced the IAP process by identifying lead Ministries and donor agencies ('Lead Agencies') responsible for carrying out detailed assessments of the respective actions. These assessments included an explanation of the impact or importance of the actions, specific outcomes, monitoring indicators, timeframe for implementation and the key implementing agencies on both the government and donor sides.

The first IAP (2002) was developed primarily to establish a track record for implementing the reforms promised by the authorities. It focused on expediting reforms in three areas—prioritizing public expenditures, improving service delivery and fighting corruption, as well as improving accountability. All 19 actions were successfully implemented and a common understanding was established on the essential need to carry out all the actions stated in the plan. Moreover, thorough implementation helped establish the authority's credibility with undertaking reforms.

The second IAP (2003) contained a set of measures that were critical for the successful implementation of the Poverty Reduction Strategy (PRS). The 2003 IAP consisted of 24 reform actions, representing an increase from the number of actions in the first IAP. The measures were directly linked to the four pillars of the PRS. In addition to the three areas covered under the first IAP, the 2003 plan included reforms in agriculture, private sector development, rationalization of SOEs, infrastructure development, targeted programs, decentralization, as well as measures to address human rights.

The third IAP (2004) built upon the lessons of the earlier reform initiatives in which it was realized that institutionalizing reforms is essential to achieve a lasting impact. Hence, greater focus was placed on governance—one of the PRS pillars. Out of the 22 actions identified for the 2004 IAP, ten were directly related to governance. The achievement rate, however, fell to 82 percent resulting in the need to complete the outstanding actions in the following year under the 2005 IAP.

The fourth year FY05/06 IAP was limited to 20 actions (including the incomplete FY04/05 IAP measures) and guided by the principles of realism, inclusion of the needs of conflict-affect areas and close alignment of the actions to the immediate reform agenda. Despite the success associated with the earlier IAPs, the process has lost some momentum during this period with wavering political focus on reform implementation.

Matrices on the actions and the achievements under the IAPs of 2002, 2003, 2004, and 2005 are presented below.

The 2002 Immediate Action Plan	
Area/Action	Achievement
Prioritizing Public Expenditures	
<p>Prioritization of all expenditures—especially development activities—to make the budget more realistic and reflect increased security requirements.</p>	<ul style="list-style-type: none"> • FY03 budget preparation guided by MTEF and 10th Plan/PRS processes. • “Fungibility” issue addressed by allocation of full funding for security needs. • Number of projects reduced to 470 from 626; 156 projects dropped based on criteria of relevance and exclusion. • For the first time, a separate annex was included in FY03 budget (“Red Book¹”) covering seven sectors (education, water, health, agriculture, irrigation, roads and power) with 100 high priority (P1) projects. • Prioritizing exercise completed in all ministries. • In August, NPC revised/updated MTEF which was discussed in a workshop with participants from civil society, media, government and donors. NPC/MOF further revised MTEF, with final version to be issued in mid-November. • Arrangements made to ensure necessary and timely budget to P1 projects. MOF monitored release of funds. Assessment of the arrangement in November concluded that P1 projects are now more assured of the resource availability.
<p>Resource allocations to be made consistent with decentralization by:</p> <ul style="list-style-type: none"> • Allocating block grants to local bodies in FY03 in an amount not less than FY02 allocations. • Channeling funds to agricultural extension, sub-health posts and basic and primary education through local bodies. • Developing poverty-based formula for block grant allocations to local bodies and implementing in FY04 budget. 	<ul style="list-style-type: none"> • FY03 budget allocations for DDCs, VDCs, and municipalities remained identical to FY02 allocations despite severe resource constraints. • Since some revenue collection functions were devolved to local bodies, NPC/MOF started to explore the possibility of matching FY04 allocations with the revenue potentials of the districts. • Resource flows to local bodies/institutions increased due to additional grants for agriculture extension, sub-health posts and education. Government explored possibility of transferring resources to grassroots level. • Report of Expenditure Management Committee submitted. Guidelines prepared for bringing uniformity in resource channeling to local bodies. • Uniform guidelines to further smoothen release of grants to local bodies/ institutions were developed and discussed. • Poverty-based allocation formula developed.
<p>P1 projects to be assured of full funding, with release of funds to be tied to meeting agreed performance indicators.</p>	<ul style="list-style-type: none"> • Development projects/programs classified into three categories—P1, P2 and P3. • P1s allocated 52% of development expenditures in seven sectors and received 1/3 of budget allocation at the beginning of FY03. • Annual and trimester work programs of P1s approved by NPC. • Changes in resources allocated to P1s not permitted without prior approval from NPC. • Project indicators developed as a basis for budget release to reconcile allocations and expenditure for P1s. Release mechanism, especially to local bodies, was streamlined. • Budget release to projects tied to trimester performance. Reports/ procedures developed to monitor physical progress and tie funds release to performance. • Indicators/benchmarks for monitoring outcomes developed by Ministries in close coordination with NPC.
Measures for Improving Service Delivery	

¹ The Red Book is the budget’s appropriation book.

The 2002 Immediate Action Plan	
<p>Education</p> <ul style="list-style-type: none"> • Formulation of procedures for transferring management of primary schools to communities. • Begin the initial phase of transferring public primary schools to community management and block grants to SMCs. • Recruitment of primary school teachers handed over to SMCs. • Freeze on recruitment of primary school teachers by central Government. 	<ul style="list-style-type: none"> • Guidelines/procedures (relating to school selection criteria, authority of SMCs, role and responsibilities of concerned agencies and auditing/accounting) for handover of primary schools agreed, made public and widely distributed. • Amendment to Education Act drafted to facilitate school transfer within the existing legal framework. • 112 schools in 8 districts were transferred. • Provision of block grants to SMCs made through income and expenditure statement. • Recruitment of primary school teachers frozen; not one teacher was recruited centrally since the announcement of IAP. • Communication strategy (to encourage communities to take over primary schools) under design to facilitate transfer program.

The 2003 Immediate Action Plan		
Action	Lead Agency	Achievement
PILLAR 1: BROAD BASED ECONOMIC GROWTH		
P1-A. Macroeconomic stability		
Full implementation of MTEF to improve the outcomes focus and prioritization of the budget system. Extension of MTEF to all ministries, and use of recurrent and capital expenditure concepts.	NPC/ MOF & WB/DFID	<ul style="list-style-type: none"> • MTEF extended to all ministries and the allocation to the P1 projects in development budget increased to 72.5 % compared to the target of at least to 65%. • Aggregate budget figure presented using recurrent and capital classification and produced as an annex to the Red Book.
Annual Plans of all P1 projects (FY2003/04) published in the Red Book (as the basis for performance-based funds release) to bring transparency to high-priority investment activities.	NPC/ MOF & WB/DFID	<ul style="list-style-type: none"> • All P1 projects published in the Red Book. • Annual plans of all P1 projects made public.
P1-B. Agriculture		
Fifty season-long farmer field schools (FFSs) on “integrated pest management (IPM)” organized in appropriate areas within Mid- and Far-Western districts in collaboration with and/or by contracting out to NGOs/CBOs.	MOA & ADB	<ul style="list-style-type: none"> • 34 out of targeted 35 officers trained in IPM approach. • 1,250 farmers as targeted trained on IPM. • 50 year round FFS as targeted carried out.
Farmer’s Agricultural Funds established in 6 districts, at least 4 of which are in Mid and Far Western Region.	MOA & DFID	<ul style="list-style-type: none"> • Guidelines for implementing Local Initiative Fund (LIF) and District Extension Fund (DEF) developed and approved in 6 districts. • District Agriculture Development Fund and institutional framework established. • Representatives of 20 farmer groups selected by District Agricultural Development Committee (DADC) given orientation training on the use of LIF; 6 training courses completed. • 10 CBOs/NGOs/ private sector organizations given orientation training on the use of DEF as planned. • 25% of staff of DDCs and concerned line agencies given training on LIF and DEF as planned. • Call for LIF proposals in 5 of 6 districts and initial selection announced. • Call for DEF proposals in each district to implement activities was not conducted. • Call for proposals for participatory M&E of LIF and DEF implementation announced.
P1-C. Irrigation		
On-farm water management program scaled up from the current 9 districts to 20 districts.	DOI/DOA & ADB	<ul style="list-style-type: none"> • 58 officers compared to a target of 30 were trained. • 4,858 out of 5,400 farmers involved in FFS. • On-farm water management programs scaled up to 20

The 2003 Immediate Action Plan		
Action	Lead Agency	Achievement
		districts as targeted.
Legal authority provided to water user associations (WUAs) through revision to the Irrigation Regulations, 2000 for collection of irrigation services fees (ISF) from water users.	DOI & ADB	<ul style="list-style-type: none"> The 2000 Irrigation Regulations were revised and shared within DOI's division offices and WUAs through their national federation. Water User Association empowered to charge and collect user charges.
P1-D. Public enterprise rationalization		
Boards of all public enterprises (PEs) with majority Government shareholding reconstituted in line with the Cabinet decision of December 17, 2002.	MOF & WB	<ul style="list-style-type: none"> Boards of 19 PEs listed in the Yellow Book² reconstituted such that no more than 5 members in each board (chairman, general manager, representatives of MOF and line ministry, and an expert in the concerned sector), and the chairman and General Manager (GM) selected as per the procedure established by the Cabinet. In the rest of the PEs, respective acts provided for the number of board members.
P1-E. Financial system		
Passage/issuance of Bank and Financial Institutions Act/Ordinance to protect depositors from fraudulent or irresponsible banking practice, and safeguard the integrity of the financial system.	NRB & IMF	<ul style="list-style-type: none"> Act/Ordinance promulgated.
P1-F. Infrastructure development		
Roads Board operationalized and funded with a special fuel levy as authorized in the previous annual budgets. Annual maintenance plan received from Road agencies and reviewed by the Roads Board.	DOR/MOF & WB	<ul style="list-style-type: none"> Annual maintenance plan prepared. First maintenance installment released to road agencies. Fuel tax levied. Road Board constituted and recruitment of professional staff completed.
P1-G. Public expenditure management		
Responsibility for distribution of electricity to local consumers handed over from NEA to 25 cooperatives/user groups/private entities.	NEA & ADB	<ul style="list-style-type: none"> NEA Board approval of NEA by-laws for bulk electricity distribution. Proposals from 26 institutions (for handover) approved, and 18 institutions were certified.
PILLAR 2: SOCIAL SECTOR DEVELOPMENT		
P2-A. Health		
Essential health services package (EHSP) implemented. <ul style="list-style-type: none"> Upgrade mother and child health workers (MCHWs) to auxiliary nurse midwives (ANMs). Sub-health posts (SHPs) building construction. Program for control and prevention of Japanese encephalitis. SHPs handed over. 	MOH & WB	<ul style="list-style-type: none"> Training initiated for 466 MCHWs out of target 500 upgraded to ANM. Budget for vaccination not availed. 626 SHPs out of a targeted 500 were handed over.
Scheme to hand over sub-health posts to Local Health Management Committees (LHMCs) supported by VDCs/DDCs. Scheme expanded in existing 'IAP 2002' Districts and scaled up to include 10 new (conflict affected) Districts.	MOH & WB	<ul style="list-style-type: none"> Handing over of sub-health posts fully completed in 21 districts and partially in 2 districts.
P2-B. Education		
Transfer of 600 schools to community management. (It is expected that a majority of the schools will be at the primary level but those at the lower secondary and secondary levels may also be included.)	MOE & DANIDA	<ul style="list-style-type: none"> 775 schools (out of a targeted 600) handed over to school management committees and these schools receiving regular public sector block grants.
Provision of 25% of the cost of teacher salaries to 3,150 community primary schools (CPS) for a number of teacher positions calculated on the basis of Education Regulations (1 teacher per 55 pupils	MOE & DANIDA	<ul style="list-style-type: none"> Funds released to 2,221 schools in 67 districts in cost-effective manner.

The 2003 Immediate Action Plan		
Action	Lead Agency	Achievement
in Terai, 1:45 in the hills and 1:35 in the mountains.		
Responsibility for school feeding transferred from the primary schools (PSNFP) to the District Education Officers in 21 districts. School feeding for 450,000 children made an integral part of school management in primary schools in these districts.	MOE & DANIDA	<ul style="list-style-type: none"> 342,418 students in 2,782 schools out of targeted 450,000 school children received daylight meals.
PILLAR 3: TARGETED PROGRAMS AND SOCIAL INCLUSION		
A fully functioning autonomous and accountable PAF.	NPC & WB	<ul style="list-style-type: none"> PAF Act promulgated and autonomous PAF created. Draft regulation submitted to Council of Ministers/Prime Minister. Operational manual proved; draft manual for financial and environmental management prepared and under consultation. Organizational structure of PAF Secretariat approved. Executive Director appointed and other professional staff to be selected.
Approval and implementation of affirmative action policies and programs to promote the participation of women as well as Janajati and Dalit groups in the civil service, including the upper layers.	MOGA & ADB	<ul style="list-style-type: none"> Preparatory course for 82 women (of which 8 were Janajati) out of target 250 attended training for Section Officers (SOs) examinations. 51 out of target 500 participants (women/Dalit/Janajati) graduates trained for final exams of SOs. Training provided to 209 out of target 500 undergraduate women/Dalit/Janajati.
Public spending in Mid and Far Western increased on the basis of needs assessment. Appropriate monitoring systems set up.	NPC & WB/DFID	<ul style="list-style-type: none"> Development budget allocation increased by 32.3% compared to previous fiscal year.
PILLAR 4: GOOD GOVERNANCE		
P4-A. Anti-corruption and transparency		
Legal action initiated against major bank defaulters (at RBB and NBL) and parties responsible for the major irregularities identified in the AG's report.	AG & NORAD/IMF/CIAA	<ul style="list-style-type: none"> List of major defaulters published in Gorkhapatra. Legal action initiated against those involved in the major cases of embezzlement as reported in the AG report. AG reports were made public even in the absence of the Parliament.
Police reform towards creating a professional, modernized police force and establishment of an independent Police Commission.	MOHA & DFID	<ul style="list-style-type: none"> Draft Ordinance to constitute Police Service Commission sent to Ministry of Justice Law and Parliamentary Affairs for legal consultation.
P4-B. Decentralization		
Fiscal decentralization framework developed and implementation initiated in FY2003/04, including release of conditional or unconditional grants to local governments for poverty alleviating activities. Local Body Fiscal Commission (LBFC) capacity developed in the process.	MOLD/MOF/NPC & DANIDA	<ul style="list-style-type: none"> Framework developed and implemented. Poverty-sensitive DDC grant formula based on poverty was prepared. LBFC secretariat functioning. Expenditure assignment study completed and stakeholders being consulted. Feasibility study on resource mobilization of 5 municipalities completed.
Tourism fees shared with concerned DDCs as provided in the Local Self Governance Regulation (LSGR).	MLD/MOT & DANIDA/MOWR	<ul style="list-style-type: none"> Sharing of tourism fees announced in FY04 budget. 30% of mountaineering fees deposited in separate account since the start of fiscal year. Manual for procedure for sharing tourism fees being prepared.
Local civil service system established and implementation initiated in FY2003/04.	MLD & DANIDA	<ul style="list-style-type: none"> Draft bill prepared and distributed to stakeholders for comments/suggestions.
P4-C. Human rights		
The government's human rights record improved with respect to its handling of the conflict. Action	MOF/NHRC & NORAD/ MOHA	<ul style="list-style-type: none"> National Human Rights Action Plan approved by Cabinet.

The 2003 Immediate Action Plan		
Action	Lead Agency	Achievement
includes provision of sufficient funds to National Human Rights Commission (NHRC) to fulfill its mandate.		

The 2004 Immediate Action Plan		
Action	Lead Agency	Achievement
PILLAR 1: BROAD BASED ECONOMIC GROWTH		
P1-A. Macroeconomic stability		
Expand MTEF to cover both recurrent and capital budget.	NPC/MOF	<ul style="list-style-type: none"> Budget classified into recurrent and capital. MTEF expanded to cover both recurrent and capital expenditure.
Publish annual plans of P1 projects with each trimester's budget allocation and output indicators.	NPC/MOF/line ministries	<ul style="list-style-type: none"> Trimester division of annual programs of P1 projects along with output indicators posted on NPC's website.
P1-B. Agriculture		
Establish District Agriculture Extension Fund (DEF) in additional 14 districts.	MOAC	<ul style="list-style-type: none"> District Support Units established in 14 districts. 217 DEF contracts issued against the target of 142 1,281 LIF contracts issued with farmers' group against the target of 1,142.
Formulate implementation plan of the APP in coordination and consultation with services like roads, forest, irrigation, electricity and rural infrastructure backed by a framework to set priorities among districts.	NPC/MOAC	<ul style="list-style-type: none"> Task force created under the chairmanship of member of the NPC (Agriculture). Draft report pertaining to status of APP implementation in 6 APPSP districts prepared. Draft APP implementation action plan prepared.
P1-D. Trade		
Implement time bound customs reforms plan.	MOF	<ul style="list-style-type: none"> Draft of performance based incentive system prepared and discussed. Performance based incentive system applied in selected customs offices (Sirsiya (Parsa district) office selected as a model). Biratnagar Customs selected for ASYCUDA Selectivity Module and work commenced in July. Nepalgunj and Sirsiya Customs Offices selected for extension of ASYCUDA and preparations underway.
P1-E. Labor		
Introduce legislation to make labor employment and retrenchment laws more flexible in Export Processing Zones and Special Economic Zones.	MOICS/MOLTP	<ul style="list-style-type: none"> Draft Special Economic Zone Act prepared and principally approved by the Cabinet.
P1-F. Infrastructure Development		
Classify ongoing roads to central and local level ones and hand over responsibility of construction, operation and maintenance of local level roads to local bodies.	MPPW/MOLD	<ul style="list-style-type: none"> Roads classified into central and local roads and 67 roads classified as central level roads. 510 roads devolved to local bodies. NRs. 26 3.4 million transferred from MPPW and sent to 54 districts and 23 municipalities through MOLD.
P1-G. Power Sector		
Design and implement a mechanism to make, at a minimum, quarterly adjustments to end-user prices for petroleum products at par with international market prices, using a transparent automatic price formula.	MOICS	<ul style="list-style-type: none"> Automatic price adjustment formula prepared and cabinet approval obtained to adopt the formula.
P1-J. Industry		
Establish legal framework for creating enabling environment for private sector development.	MOICS/MOF	<ul style="list-style-type: none"> Cabinet approval obtained for the following acts/ordinances: (i) secured transaction act/ordinance; (ii) insolvency act/ordinance; and (iii) company act/ordinance.
P1-K. Food Security		
Ensure food security (food supply) to the food	MOICS	<ul style="list-style-type: none"> Increase of NRs. 22.3 million in the budget compared

The 2004 Immediate Action Plan		
Action	Lead Agency	Achievement
deficit areas.		to previous year. <ul style="list-style-type: none"> Time bound action plan prepared to avoid food shortage in the conflict-affected Karnali Zone; 48,803 quintal of food distributed to 30 food deficit districts.³
PILLAR 2: SOCIAL SECTOR DEVELOPMENT		
P2-A. Health		
Implement the first year work plan of the Nepal Health Sector Program Implementation Plan (NHSP-IP).	MOH	<ul style="list-style-type: none"> MCHW target revised downward from original of 750 to 550 and required MCHW selected. Dang, Banke and Kailali Districts identified as prone to Japanese Encephalitis and tender process for immunization program underway; target 250,000 persons not yet immunized. Additional 1,202 health posts handed over to communities. Procurement order of Comprehensive Emergency Obstetric Care (CEOC) kits issued and kits distributed to 500 ANM s by mid June. Abortion Training sites identified for 2 hospitals, Gandaki Regional Hospital and Lumbini Zonal Hospital and trainer's training completed.
P2-B. Education		
Increase accessibility of disadvantaged children to primary and secondary level education.	MOES	<ul style="list-style-type: none"> Total of NRs. 58,341,000 of funds for booster scholarships (with accompanying directives) provided to 116,682 children against the target of 116,000. Total of NRs. 139,916,000 in maintenance scholarships provided to 559,668 (more than targeted) Dalit students in all districts. Total of NRs. 159,569,000 in maintenance scholarships provided to 635,380 girls against target of 317,000. Total of NRs. 37,320,000 in maintenance scholarships provided to 31,070 secondary school children against target of 31,000.
PILLAR 3: TARGETED PROGRAMS AND SOCIAL INCLUSION		
Provide block grants (through PAF) to innovative but cash-constrained community-led initiatives that promise to significantly improve service delivery in conflict-affected areas.	OPMCM/NPC	<ul style="list-style-type: none"> Criteria for block grants developed. 106 proposals collected. Agreements with 15 partner organizations signed totaling an amount of NRs. 16,385,616.
Implement Poverty Monitoring and Analysis System (PMAS).	NPC	<ul style="list-style-type: none"> Mechanism for monitoring targeted programs areas/regions in draft form prepared and comments from stakeholders to be incorporated. Household and facility survey system adopted/ streamlined. Second progress report of PRS prepared and published. Preliminary consultations held on mechanism/ instruments for participatory poverty monitoring.
PILLAR 4: GOOD GOVERNANCE		
P4-A. Anti-Corruption and Transparency		
Publicly release audit reports of the AG.	OPMCM/MOF/ MOLJPA	<ul style="list-style-type: none"> Consultation with regard to the constitutional/legal aspects of release completed. Reports made public.
Professionalize and modernize police force supported by an independent police commission.	MOHA	<ul style="list-style-type: none"> Draft ordinance forwarded to the Cabinet and sent back for further refinement.

³ The increase in the allocated amount has been taken as proxy for increase in food supply in food deficit districts.

The 2004 Immediate Action Plan		
Action	Lead Agency	Achievement
		<ul style="list-style-type: none"> • Police Service Commission formed.⁴
P4-B. Civil Service Reform		
Delineate responsibilities between ministers and civil service.	OPMCM/MOGA	<ul style="list-style-type: none"> • Draft Governance Act/Ordinance prepared (not enacted).
Implement affirmative action policies and programs to promote the participation of women, Janajati and Dalit groups in civil service.	MOGA	<ul style="list-style-type: none"> • Draft amendment on affirmative action plan/policies forwarded to Cabinet. • Coaching classes for class I and II officers conducted for target 50 women, Janjatis and Dalits. • Coaching classes for 308 (out of targeted 250) women, Janjati and Dalit participants for the gazetted class III officers completed. • Preparations underway to conduct coaching classes for 403 (out of targeted 500) women, Janjati and Dalit participants for entrance examination for non-gazetted officers.
P4-B. Decentralization		
Operationalize Local Bodies Service System.	MOLD/MOGA	<ul style="list-style-type: none"> • Draft Local Bodies Service Act/Ordinance prepared and discussed with MOGA. • Towards making Local Bodies Service Commission operational, work is underway to project total human resource requirements of the local bodies. Also, directives issued to those districts where human resource requirements have been projected to provisionally approve staffing of positions.
Implement Local Bodies Fiscal Commission's recommendations including expenditure assignment.	NPC/MOLD/ Sectoral ministries	<ul style="list-style-type: none"> • Guidelines for conditional grant prepared but not yet in place. • rural roads, rural drinking water and small irrigation devolved to local bodies. • Expenditure Assignment Implementation Plan under preparation and still to be made operational.
P4-C. Human Rights		
Implement the Human Rights Action Plan of the Government and sign MOU with the Office of the High Commissioner for Human Rights (OHCHR).	OPMCM/MOFA/ concerned ministries	<ul style="list-style-type: none"> • Action plan prepared by MOES for task force to formulate policy and transparent manual regarding free and compulsory education and to ensure the right to education but not yet implemented. • Human Rights monitoring committee formed in MOLJPA. • Jail law amended with the provision of community service and open jail. • Conflict Management Unit established in MOHA. • Task force created to prepare reports according to the Economic, Social and Cultural Charter. • MOU to strengthen the Human Rights Commission of Nepal signed.
DONOR HARMONIZATION		
Prepare aid integration framework.	NPC/MOF	<ul style="list-style-type: none"> • Consultation among line agencies and donor partners with respect to aid integration framework underway. • Business plan for education sector in its final stage while business plans for health, drinking water, irrigation, agriculture, roads and rural electrification drafted and under discussions. • Donor provision of indicative multi-year plans is underway.

The 2005 Immediate Action Plan		
Action	Lead Agency	Status as of July 2006
PILLAR 1: BROAD BASED ECONOMIC GROWTH		
P1-A. Macroeconomic stability		
Promulgate following ordinances in order to simplify the public transactions and to manage future liability of the government: (i) Procurement Ordinance; and (ii) Pension Fund Ordinance.	MOF/MOGA/ OPMCM	<ul style="list-style-type: none"> Procurement Ordinance approved by Cabinet on February 16, 2006. A firm selected to draft related act and regulation. Call for proposals for the study on pension funds announced.
Initiate the process of e-filing in tax administration.	MOF	<ul style="list-style-type: none"> Study to examine practices in neighboring countries completed.
P1-E. Financial system		
Promulgate/amend following ordinances /acts: (i) Secured Transaction Ordinance (ii) Insolvency Ordinance (iii) Company Ordinance (iv) Rastriya Beema Sansthan Act	MOF/MOICS/ OPMCM	<ul style="list-style-type: none"> First 3 ordinances promulgated. Rastriya Beema Sansthan Act not amended.
P1-E. Labor		
Introduce legislation to make labor employment and retrenchment laws more flexible in Export Processing Zones and Special Economic Zones.	MOICS/MOLTP	<ul style="list-style-type: none"> Labor Act modified by the ordinance but now void. Draft of Special Economic Zone prepared and consultation underway.
P1-G. Power Sector		
Implement a mechanism to make adjustments to end-user prices for petroleum products at par with international market prices using a transparent automatic price formula.	MOICS	<ul style="list-style-type: none"> Report by Committee formed by NPC submitted.
Introduce legislation to allow the private sector to compete in import and distribution of petroleum products.	MOICS/OPMCM	<ul style="list-style-type: none"> Draft Act prepared allowing private sector to import, store, transport and distribute petroleum products.
PILLAR 2: SOCIAL SECTOR DEVELOPMENT		
P2-A. Health		
Upgrade those Maternal and Child Health Workers (MCHWs) to Assistant Nurse Midwives (ANMs) in their respective places who have obtained required qualifications.	MOHP/MOGA	<ul style="list-style-type: none"> First draft to amend the Health Services Act prepared and forwarded to Congress..
Establish a more effective institutional arrangement for financing, managing and coordinating HIV/AIDS epidemic.	MOHP/NPC/MOF	<ul style="list-style-type: none"> Process underway.
P2-B. Education		
Initiate the process of integrating +2 education with the higher secondary education.	MOES	<ul style="list-style-type: none"> Relevant acts drafted and forwarded to the Cabinet Studies being carried out about technical aspects of the integration.
PILLAR 3: TARGETED PROGRAMS AND SOCIAL INCLUSION		
Prepare an action plan for the internally displaced persons (IDPs).	MOH/PS/MOF	<ul style="list-style-type: none"> Policy to provide relief for internally displaced persons (IDPs) and associated annual work plan sent to stakeholders for comments.
Amend discriminatory laws against women	MWCSW/ MOLJPA	<ul style="list-style-type: none"> Laws identified by the MWCSW and being forwarded to the Cabinet.
Initiate the formulation of affirmative action policies for women, <i>Dalit</i> and disadvantaged <i>Janajatis</i> in selected areas.	MOLD/MOWCSW /NPC	<ul style="list-style-type: none"> A resolution passed by the House of Representatives to reserve 33% of seats for women in different areas.
Formulate and implement micro credit policy.	MOF	<ul style="list-style-type: none"> Final draft prepared and consultation underway.
PILLAR 4: GOOD GOVERNANCE		
P4-B. Civil Service Reform		
Delineate responsibilities between political officials and civil service.	MOGA/OPMCM	<ul style="list-style-type: none"> Draft Ordinance approved by Cabinet on February 23, 2006.
Expand the computerized civil service personnel information system (PIS) from MOGA to MOHP.	MOGA/MOHP	<ul style="list-style-type: none"> Virtual Private Network established at the MOHP. Arrangements made at the MOHP to share

The 2005 Immediate Action Plan		
Action	Lead Agency	Status as of July 2006
		information from the PIS. <ul style="list-style-type: none"> • Works underway to make the PIS and the Human Resource Center information compatible.
Formulate affirmative action policies in civil service.	MOGA	<ul style="list-style-type: none"> • A resolution passed by the House of Representatives to reserve 33% of seats for women in different areas. • Draft amendment to the Civil Service Act prepared with 45% reservations to women, Dalits and Janajatis.
P4-B. Decentralization		
Implement full devolution plan in selected districts.	NPC/MOLD/MOF	<ul style="list-style-type: none"> • Full devolution plan under consideration by the government. • Draft guideline prepared.
Empower local bodies (where full devolution has been adopted) with the authority to hire personnel in vacant positions within their respective jurisdiction on contract basis.	NPC/MOLD/MOF	<ul style="list-style-type: none"> • Progress linked to above actions.
Conduct study as to how to adjust the civil servants in local bodies within the context of full devolution.	MOGA/MOLD/related ministries	<ul style="list-style-type: none"> • Draft Local Service Act prepared.
POVERTY MONITORING		
Institutionalize the Poverty Monitoring and Analysis System (PMAS).	NPC/MOES/MOHP	<ul style="list-style-type: none"> • Final draft of participatory poverty monitoring framework developed. • District Education Offices equipped to prepare and publish flash reports at district levels.
DONOR HARMONIZATION		
Implement the aid integration process.	NPC/MOF/line ministries	<ul style="list-style-type: none"> • Business plans for education, health, and agriculture finalized, and those for, drinking water, irrigation, roads and rural electrification are being finalized.

Appendix VI

Community Driven-Development: Evidence of Success

Even in the challenging political and security situation that Nepal has faced over the last few years, the implementation of community driven-development (“CDD”) type projects—i.e., demand driven, with community participation and empowerment in which communities procure and manage resources, emphasizing transparency—have continued with remarkable success. Below are more details elaborating some successes of two of the CDD projects that the Bank has supported in Nepal.

A. *Poverty Alleviation Fund*

The Poverty Alleviation Fund (PAF) provides funding for small sub-projects that create infrastructure, employment and income-generating opportunities in poor communities, particularly for socially excluded groups. Within the space of two years, the PAF has impacted over 62,000 households, or over 314,000 people in 334 VDCs in six conflict-affected districts. PAF has been successful on several fronts for achieving its objective of providing direct and indirect benefits to the poorest people who have been excluded for reasons of gender (women), ethnicity (janajatis), or caste (dalits).

First, targeting of the disenfranchised has been quite successful. Of the PAF beneficiaries, 43 percent are dalits and 35 percent are janajatis, although these groups only account for 15 percent and 23 percent of the population in the targeted districts. Moreover, whereas a sampling of one-quarter of the community-based organizations (CBOs) and their respective settlements found that about one-half of the population were hard core poor and two-thirds of the CBO members were classified as hard core poor, indicating that the PAF has been quite successful in avoiding elite capture.

Second, empowerment of these groups and women is also evident in their high participation rates as members and leaders of the community organizations. For example, women account for one-third of Chairpersons, 43 percent of Secretaries, and 60 percent of Treasurers of the CBOs.

Third, the sub-projects themselves have demonstrated evidence of high returns. Livestock purchase—the most common sub-project selected by CBOs—is estimated to have lead to sustained increases in household income of 10-12 percent, translating to a 20-25 percent rate of return. Given that informal credit markets charge 30-40 percent, these sub-projects have given the poor access to highly productive investments. Other more anecdotal evidence shows that infrastructure sub-projects can also lead to substantial rates of return. For example, a water project in Murma—a very remote village—saved the village women several hours daily spent collecting water, time that is now being spent on farming. Based on the average women’s agricultural wage, this suggests a sub-project rate of return well above 70 percent. In another example in the remote district of Darchula, electricity sub-projects provided households with electricity at a cost far lower than GON standards. Moreover, they also opened the way for irrigation and increased food availability and security.

Demand for funding from PAF has been high. As resources from the original IDA grant of US\$15 million (effective December 2004) were about to be fully committed two years ahead of schedule, in November 2006, additional financing of US\$25 million was approved by the Board to ensure continuity of PAF activities. In addition, a follow-on project for US\$100 million is planned for FY08.

B. *Rural Water Supply and Sanitation Fund*

Two Rural Water Supply and Sanitation projects (RWSSP I and II) provided financing via the Rural Water Supply and Sanitation Fund Board (the “Fund Board”) for the improvement of water and

sanitation services in participating communities. As of November 2006, the program has impacted nearly 4.7 million beneficiaries, and another 6.0 million are expected to be reached in subsequent phases.

The success of this approach to the rural water supply and sanitation sub-sector has been widely acknowledged, as it has helped to define a demand-driven approach to service delivery through an inclusive, participatory process in which the communities are empowered to make informed decisions about their schemes.

The approach has brought about much greater sustainability and strong community mobilization to a sector where sustainability of conventional schemes was a serious problem. Community ownership is proving to yield much more sustainable water supply and sanitation services as they are also operated and maintained by the communities who play the lead role in the planning, designing and implementation. The results of sustainability—carried out three years after installation of the schemes—found that around 85 percent of the schemes were institutionally, socially, financially and technically sustainable. This is in stark contrast to the sustainability of traditional schemes, where 10 percent of the completed schemes require rehabilitation and 50 percent require major repairs.

The participating communities have not only benefited from improved water supply, but also from time savings (averaging three hours per day) from fetching water as it is brought closer to their houses. In addition, with the project supporting the women's technical support services, women are able to put the time saved to productive use—e.g., income generating activities, such as poultry farming, vegetable gardening, goat raising etc., and/or being able to devote more time childcare, personal hygiene and even attending non-formal education classes. With health, hygiene and sanitation education, and the availability of a community-managed Sanitation Revolving Loan Fund to provide funding for buying materials needed to construct latrines, sanitation coverage is also increasing.

After successfully completing the initial RWSSP, the Bank is currently financing the Second Rural Water Supply and Sanitation Project (US\$25 million).

Appendix VII
Expenditure Eligibility

Item	Parameter	Remarks/Explanation
Cost sharing. Limit on the proportion of individual project costs that the Bank may finance	Up to 100%	Nepal's ownership of Bank-supported projects is demonstrated by the strong policy and institutional reforms they have carried out to create an enabling environment for poverty reduction and project implementation. Bank financing of projects is fully integrated into the budget. Nepal has been increasing its efforts to improve overall expenditure management, including progressively moving towards securing flexible financing of sector-wide reform programs.
Recurrent cost financing. Any limits that would apply to the overall amount of recurrent expenditures that the Bank may finance	No country-level limit	Bank financing of projects is fully integrated into the budget and thus subject to Nepal's fiscal management regime anchored in the Medium Term Expenditure Framework (MTEF). The application of the new policy is consistent with the country's prudent fiscal stance and efforts to integrate public spending and donor resources into the MTEF process.
Local cost financing. Are the requirements for Bank financing of local expenditures met, namely that: (i) financing requirements for the country's development program would exceed the public sector's own resources (e.g., from taxation and other revenues) and expected domestic borrowing; and (ii) the financing of foreign expenditures alone would not enable the Bank to assist in the financing of individual projects	Yes	The two requirements are met. At the project level, the Bank expects to finance local costs as required by the project's development objectives.
Taxes and duties. Are there any taxes and duties that the Bank would not finance?	None	The Bank may finance the costs of taxes and duties as long as they are reasonable and non-discriminatory. As of June 2004, no taxes are identified as unreasonable or discriminatory vis-à-vis Bank-financed projects.