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MEMORANDUM OF THE PRESIDENT
OF THE
THE INTERNATIONAL DEVELOPMENT ASSOCIATION
TO THE
EXECUTIVE DIRECTORS
ON A
COUNTRY ASSISTANCE STRATEGY PROGRESS REPORT
OF THE
WORLD BANK GROUP
FOR
THE KINGDOM OF NEPAL

November 18, 2002

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The last Country Assistance Strategy for Nepal (Report No. 18578-NEP) was discussed on December 13, 1998.

Currency and Equivalents

Currency Unit = Nepali Rupee (NRs.)

US\$1 = NRs. 76.733 (as of November 18, 2002)

Fiscal Year

July 15 – July 14

(FY03 is from July 15, 2002 to July 14, 2003)

Abbreviations and Acronyms

AAA	Analytical and Advisory Activities	LIL	Learning and Innovation Loan
ACS	Anti-Corruption Strategy	LSG (A)	Local Self-Governance (Act)
ADB	Asian Development Bank	MDGs	Millennium Development Goals
ADB/N	Agricultural Development Bank of Nepal	MFA	Multi-Fiber Agreement
AML	Anti-Money Laundering	MIGA	Multilateral Investment Guarantee Agency
APL	Adaptable Program Loan	MoF	Ministry of Finance
BPEP	Basic and Primary Education Project	MTEF	Medium-Term Expenditure Framework
CAN	Country Assistance Note	NBL	Nepal Bank Limited
CAS (PR)	Country Assistance Strategy (Progress Report)	NDF	Nepal Development Forum
CBOs	Community Based Organizations	NGOs	Non-Governmental Organizations
CEO	Chief Executive Officer	NIDC	Nepal Industrial Development Corporation
CFAA	Country Financial Accountability Assessment	NLSS	Nepal Living Standards Survey
CIAA	Commission for the Investigation of the Abuse of Authority	NPA	Non Performing Assets
CPAR	Country Procurement Assessment Report	NPC	National Planning Commission
DDC	District Development Committee	NRB	Nepal Rastra Bank
DfID	UK Department for International Development	NTC	Nepal Telecommunications Corporation
DHO(s)	District Health Office(s)	OECD/DAC	Organization for Economic Corporation and Development/Development Assistance Committee Operations Evaluations Department
DIMC	Decentralization Implementation Monitoring Committee	OED	
DPR	Development Policy Review	PAC	Public Accounts Committee
DTT	Deloitte Touche Tohmatsu, USA	PAF	Poverty Alleviation Fund
FAP	Foreign Aid Policy	PERC	Public Expenditure Reform Commission
FCGO	Financial Comptroller General's Office	PRGF	Poverty Reduction and Growth Facility
FSSS	Financial Sector Strategy Statement	PRS (P)	Poverty Reduction Strategy (Paper)
FSTA	Financial Sector Technical Assistance (Credit)	PWGs	Public Works Guidelines
FY	Fiscal Year	RBB	Rastriya Banijya Bank
GDP	Gross Domestic Product	RMC	Reform Monitoring Committee
GTZ	Gesellschaft für Technische Zusammenarbeit (German Agency for Technical Cooperation)	RWSSP	Rural Water Supply and Sanitation Project
HMGN	His Majesty's Government of Nepal	SAC	Structural Adjustment Credit
IAP	Immediate Action Plan	SHP(s)	Sub-Health Post(s)
IDA	International Development Association	SLC	School Learning Certificate
IDF	Institutional Development Fund	SMC(s)	School Management Committee(s)
IF	Integrated Framework	TA	Technical Assistance
IFC	International Finance Corporation	UML	United Marxist Leninist (Party)
IMF	International Monetary Fund	UNDP	United Nations Development Program
INGOs	International Non-Governmental Organizations	USAID	United States Agency for International Development
JBIC	Japan Bank for International Cooperation	VDC	Village Development Committee
LGs	Local Governments	WTO	World Trade Organization

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NEPAL
Country Assistance Strategy Progress Report

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NEPAL
Country Assistance Strategy Progress Report
November 18, 2002

Summary. The last Country Assistance Strategy (CAS)—discussed at the Board in December 1998—put forth a strategy aimed at helping Nepal overcome some major constraints to development—poor governance and economic weaknesses, including poor public expenditure management, ineffective public service delivery, and a weak financial sector. Although Nepal has remained in the “Low Case” through much of the period, the disciplined approach by the Bank to link its lending level to improvements in governance has contributed to bringing this issue to the center of the policy dialogue. The 1998 CAS fundamentals remain valid and will continue to guide the Bank’s work program. A full Bank Group CAS is planned in FY04, following the Poverty Reduction Strategy Paper (PRSP) currently under preparation.

In the May 1999 general elections, the Nepali Congress Party secured a comfortable majority. Contrary to expectations, the ruling party’s parliamentary majority did not translate into political stability or consistent reform efforts. The instability and paralysis that plagued a series of coalitions during 1994-99 persisted, and continued factional in-fighting led to the dissolution of the lower house in May 2002. As it became clear that national elections could not be held as scheduled because of the security situation, Prime Minister Sher Bahadur Deuba recommended a one-year postponement. In response, King Gyanendra invoked Article 127 of the Constitution to dismiss the Deuba cabinet on October 4th and temporarily took over executive powers. Mr. Lokendra Bahadur Chand was appointed Prime Minister by the King on October 11th and heads an interim Government charged with restoring peace and holding the suspended elections.

The Maoist insurgency began in 1996 as a low intensity and mainly rural campaign to replace the present polity with a “people’s republic.” In November 2001, the Maoists escalated violence by attacking army installations for the first time. A state of emergency was declared and the army was mobilized. The conflict has claimed over 7,000 lives, more than half of them during the last year. While the deployment of the army could contain the insurgency, lasting peace will remain elusive unless the root causes are addressed, including improved service delivery and social inclusion.

Since the last CAS, Nepal’s economy has gone through a cycle of accelerated growth and relatively strong macroeconomic position to rapid deceleration and increasing fragility. The worsened security situation has hurt the tourism industry and business confidence in general. The ability of Nepal to export to a highly competitive global market is being questioned. Serious reforms will be needed to protect macro balances and improve general economic competitiveness. As threat of the insurgency intensified and fiscal pressures built, the Government has become increasingly more serious about reform implementation. Over the past year or so, despite the continued political turmoil, the reform efforts—largely led by technocrats—seem to have gained momentum and resolve. Significant progress has been already made in several areas, including the financial sector, public expenditure management, service delivery, the fight against corruption and donor coordination. To integrate and push forward these reforms, an Immediate Action Plan (IAP) has been under implementation with uncommon vigor and seriousness. A quiet governance revolution seems to have begun in Nepal. These changes have been met with strong public support and merit the fullest support of the Bank Group.

Given the broad-based, cross-cutting nature of on-going reforms, promoted by the emerging coalition of key reformers, the Bank will move to a Base Case scenario and start to develop a programmatic approach to financial assistance. In moving toward such an approach—to be fully developed in the next CAS in line with the PRSP—the proposed program could be anchored by a Structural Adjustment Credit (SAC) cast in the context of a medium-term reform program. Such an operation would be contingent upon a satisfactory macroeconomic framework and the continued implementation of a coherent set of reforms. These reforms—contained in the IAP—are designed to further improve public expenditure management, enhance the transparency and accountability of the public sector and strengthen implementation of poverty programs. Provided that the current reform process continues, such an operation would be an effective way to recognize the important progress that has been already made. By financing the fiscal cost of reforms, it would also help the Government sustain and deepen the process by financing the fiscal cost of carrying forward the changes to create more accountable and effective public institutions. The program also envisions some innovative project interventions and a substantive non-lending program reflecting a shift toward the Bank’s role as a change facilitator.

NEPAL
Country Assistance Strategy Progress Report (CAS PR)
November 18, 2002

A. The Bank Group's Assistance Strategy

Introduction

1. With a late start to economic development, Nepal has seen vast improvements since the 1950s. Access to basic social services—including primary education and health care—has increased greatly, as has access to other services such as drinking water, electricity, telecommunications and rural infrastructure. Nevertheless, Nepal remains one of the world's poorest countries, with an annual per capita income of about US\$250 with many indicators showing a bleak quality of life.

2. Progress in the fight against poverty has been hampered by a number of factors, including successive ineffective and unstable Governments. More recently, the challenge has intensified with the escalation of the Maoist insurgency, the imposition of a nine-month state of emergency and lingering instability in the Government, including dismissal of the Deuba Government by King Gyanendra and the formation of an interim Government in October 2002. Security concerns are heightened and there is a fear of wider civil disturbance. Together with the global economic slowdown that has affected Nepal's trade-dependant economy harshly, these domestic events—along with the June 2001 tragedy in the Royal family—have led to a sharp downturn in economic activities. Related to these is a potential fiscal crisis in which development expenditures could be severely affected, as public spending is up on account of the security needs, while revenue collections are low. In reality the crisis is even deeper, as it represents a questioning of the legitimacy of the state as an institution of public policy-making and a provider of public services. There is widespread belief that the Maoist insurgency is fundamentally a challenge to a state that has not been effective.

3. Nonetheless, this picture of instability and uncertainty is incomplete without noting that amidst all the turbulence, His Majesty's Government of Nepal (HMGN) has been implementing a wide range of reforms over the last year or so. Those reforms are being pushed by a persistent core group of committed technocrats and are gaining momentum. The growing political turmoil over the last several months seems to have given these technocrats more space to push forward with the reform agenda and their position appears to have been strengthened further under the interim Government. In fact, with the growing demand for a more accountable and transparent Government, the roll-back of the undue political interference by ministers in administrative functions is likely to be lasting, thereby giving the technocrat-led reform process some durability. Notable progress has been made in developing the country's Poverty Reduction Strategy (PRS, see Box 3) and in implementing reforms in the financial sector (see paragraph 29), public expenditures (see paragraph 23), fight against corruption (see paragraph 25), infrastructure regulatory environment (see paragraph 28) and the Immediate Action Plan (IAP, see Appendix I).

4. The last Country Assistance Strategy (CAS) for Nepal¹—discussed at the Board on December 13, 1998—was prepared in a relatively uncertain and unstable environment. There had been numerous changes in Government—five since 1994—along with internal dissension in all three major political parties. In addition, it was widely believed that corruption was pervasive, leading to misallocation of public resources, delays in project implementation, difficulties in launching private investments and rapid turnover and perverse incentives for public servants. Despite generally acceptable macroeconomic

¹ Report Number 18578-NEP, dated November 17, 1998.

management, the economy suffered from a number of factors—including poor public expenditure management and a weak financial sector—and Nepal had been unable to exploit its assets—fertile land in the Terai, access to greater donor aid, strong tourism appeal and enormous water resources and hydropower export potential.

5. The CAS identified poor governance as the fundamental constraint restricting Nepal's development. Evidence supporting this diagnosis included the observations that: (i) many public sector institutions are viewed as ineffective, wasteful and corrupt; (ii) public services in general do not reach the poor; (iii) political commitment to reform is weak; and (iv) leakages from the public expenditure system are high². To address these constraints, the CAS proposed a two-pronged approach, specifically: (i) bringing resources to the grassroots levels through mobilization of social capital; and (ii) improving the effectiveness of the Government's development program.

6. The strategy contained three elements to effect this approach. First, supporting HMGN's own policy of greater decentralization, the Bank would provide funding for projects designed to bring more resources to grassroots levels. Second, the Bank would encourage reforms at the central level of Government by linking the overall lending level to progress in improving Government effectiveness. Third, the Bank would strengthen donor coordination so that the strategic focus would be shared more widely, and hence, become more powerful.

7. As will be discussed in more detail below, although Nepal remained in the "Low Case" scenario during much of the period, consistent implementation of the strategy has helped to highlight the importance of governance issues. The fundamentals of the CAS remain valid today and will continue to guide the Bank's work program until a new CAS is prepared. The basis for the next CAS will be HMGN's Poverty Reduction Strategy Paper (PRSP), currently under preparation.

B. The Evolution of the Setting for the Bank Group's Assistance Strategy

Social Context

8. During the 1990s, Nepal's economic performance improved with per capita income growth increasing to about 2.5 percent as the economy responded to macroeconomic stability, the first round of liberalization and falling population growth rates. Nevertheless, economic growth has not been sufficient to bring about a substantial reduction in poverty and about 42 percent of the population lives below the poverty line³. Progress towards attaining most of the Millennium Development Goals (MDGs) in Nepal has remained slow and the country faces many challenges towards achieving them (see Box 1). Not only are social indicators low, but they are alarmingly low for the very poor. There are also wide disparities across income/consumption groups, between urban and rural areas and within jurisdictions, and across

² The Public Expenditure Review (Report No. 20211-NEP, April 11, 2000) subsequently elaborated on many of these themes, especially on the failure of public spending to deliver services. The constraints identified included: (i) a dysfunctional budget system; (ii) lack of ownership of donor-assisted projects both by the Government and population at large; (iii) institutional weaknesses in implementation; (iv) poor governance; (v) poor resource allocation patterns; and (vi) poor performance of public enterprises.

³ This is based on the 1995/1996 Household Survey. A Nepal Living Standards Survey (NLSS) will be launched in early-2003 to update household level information on trends in consumption, poverty and their determinants. It should be noted that HMGN's official estimate of poverty is 38 percent (as cited in Box 3), which is based on an extrapolation carried out by the National Planning Commission (NPC).

Box 1: Achieving the Millennium Development Goals (MDGs)—Nepal's Progress in the 1990s	
Key Targets	Current Levels and Recent Trends
Halve, between 1990 and 2015, the proportion of people whose income is less than US\$1/day.	It is estimated that 42% of the Nepali population are below the poverty line. As comparable estimates are lacking—until finalization of the soon to be initiated NLSS II—it is impossible to know the trend, but given recent low levels of economic growth it is unlikely that there have been noticeable improvements.
Enroll all children in primary school by 2015.	There is evidence that the enrolment rate of primary-aged children rose in the 1990s reportedly to 80%. Nevertheless, if recent improvement rates are not accelerated, it will be difficult to meet the goal.
Make progress towards gender equity & empowering women by eliminating gender disparities in primary/secondary education by 2005 and all levels by 2015.	1999 ratios for different levels show significant improvements in the relative access of girls to school education. While it is unlikely that the targets will be reached by 2005, the girls to boys gross enrolment ratios for both primary and lower secondary should reach close to 90%.
Reduce infant and child mortality rates by two-thirds between 1990 and 2015.	There have been considerable reductions in infant and under-5 mortality within the last decades, with the former declining to 64 (per 1,000 live births) and the latter to 91. Nevertheless, there are large regional variations, with rates higher in rural areas.
Reduce maternal mortality ratios by three-quarters between 1990 and 2015.	Maternal mortality was estimated at 539 (per 100,000 live births) in 1996, however, previous estimates are not comparable. There has been a slight improvement in deliveries attended by health care providers, but it will be difficult to meet the goal.
Have halted by 2015 & begun to reverse the spread of HIV/AIDs, incidence of malaria & other major diseases.	Due to a lack of updated, reliable data, it is impossible to obtain an accurate assessment of the HIV/AIDs situation; however, it has been suggested that the HIV rate is rising rapidly.
Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources.	There are issues—i.e., depletion of soil nutrients and arsenic contamination in the Terai—that show environmental sustainability remains a problem. However, other initiatives—in drinking water and forestry—indicate that problems associated with sustainable development can be solved. A national strategy for sustainable development will be formulated by 2005.
Halve by 2015 the proportion of people without sustainable access to safe drinking water.	Access to drinking water has increased rapidly and data (although with problems) suggest that Nepal will reach near-universal access to drinking water by 2015. Nevertheless, while there is access, the safety of drinking water is a concern.

Sources: Nepal Country MDG Progress Report, UN Country Team, February 2002; and staff estimates.

different socio-ethnic groups. More specifically, growth has been concentrated in urban areas, leaving behind 86 percent of the population who live in rural areas, where per capita agricultural production has grown minimally and the overall level of economic activity has been sluggish. Compounding the situation is the virtual absence of a poverty monitoring system; hence, hampering policy formulation and evaluation of outcomes.

Political Developments

9. Shortly after the presentation of the last CAS, the Nepali Congress Party secured a comfortable majority in the May 1999 general elections. Contrary to expectations, however, the ruling party's parliamentary majority did not translate into political stability nor a consistent effort at addressing Nepal's development problems. Rather, the instability and paralysis that plagued a series of coalitions ruling Nepal between 1994-1999 persisted and in the last nine months the political landscape in Nepal has been extraordinarily unstable. Following the dissolution of the Parliament on May 22, 2002, Prime Minister Sher Bahadur Deuba continued as caretaker prime minister and announced general elections for November 13, 2002—two years ahead of schedule.

10. Around the same time, factional in-fighting in the ruling party climaxed and resulted in a split in the top leadership. Subsequently, the Election Commission recognized the faction led by former Prime Minister G.P. Koirala as the "official" Nepali Congress Party, leading Mr. Deuba to form a new party. During an all-party meeting convened by Mr. Deuba in late-September, it was concluded that the Maoist

insurgency was too big a security threat to ensure free and fair elections. Just prior to this, insurgents had stepped up their campaign to prevent the elections, often targeting potential candidates—e.g., reportedly 60 United Marxist Leninist (UML) party workers had been killed or abducted by insurgents. Hence, in late-September Mr. Deuba recommended deferment of the election by over a year. Determining that Mr. Deuba's actions amounted to dereliction of duty, the King dismissed Mr. Deuba and temporarily took over all executive powers. In the search for a new Government, the King was clear that it should be headed by and composed of individuals of “clean image” who would not run for office in the forthcoming elections—the dates of which are still unannounced.

11. On October 11, 2002, veteran politician Mr. Lokendra Bahadur Chand was appointed by King Gyanendra as the new Prime Minister—Nepal's eleventh in the last seven years and the fourth since the 1999 elections. Mr. Chand, who has previously served as Prime Minister—briefly in a coalition Government in 1998 and in 1990 as the last Prime Minister in the party-less Panchayat regime—heads a nine member cabinet which appears to have fair regional and ethnic representation. The broad responsibilities given to the interim Government include: (i) restoring peace; (ii) holding the suspended elections; (iii) controlling official corruption; (iv) maintaining friendly relations with all countries; and (v) running the day-to-day affairs of the country effectively and efficiently to serve the people.

12. The Maoist insurgency—previously a low intensity and mainly rural campaign to replace the present polity with a “people's republic”—has claimed more than 7,000 lives by official accounts and has escalated into Nepal's longest and bloodiest conflict since the mid-1700s unification campaign. In mid-2001 a truce was reached with the insurgents and the Government embarked on a process of negotiations, hoping to assimilate the Maoists into the political mainstream. But in November 2001, the Maoists broke off talks with the administration, ostensibly over the Government's refusal to call a constituent assembly to examine the nation's political future. This was accompanied by a wave of attacks on security forces and public installations, provoking the Deuba Government to brand the insurgents as “terrorists” and declare a state of emergency on November 26, 2001 which for the first time pitted the army (as opposed to the police and paramilitaries) against the insurgents. According to some official accounts, casualties during the first year of the military action have topped 4,300. The emergency order, which also curtailed press freedoms and many fundamental rights, was first ratified by Parliament in late-February 2002 and subsequently extended through an Ordinance, remaining in effect until late-August when it was allowed to expire.

13. The conflict is effectively a battle for control of governance in the rural areas. Since the restoration of Parliamentary democracy in 1990, chronically weak governments have patronized the urban elite, bred corruption and delivered very little in the impoverished rural areas where poverty has been exacerbated by ethnic and social tensions. The insurgents have exploited this vacuum. The deployment of the army could force the insurgents to abandon most of their territorial gains but, as with all guerilla wars, a lasting peace will remain elusive unless governance is improved and earnest efforts are made to address the poverty and exclusion that drive the conflict.

Economic Developments

14. On the economic front, since the last CAS Nepal's economy has gone through a cycle of accelerated growth and relatively strong macroeconomic position to rapid deceleration and increasing fragility. Aggregate GDP grew on average by 5.2 percent per annum between FY99 and FY01, but growth in FY02 sharply dropped to 0.8 percent (see Table 1). The recent slowdown is pervasive, but principally led by contractions in manufacturing and tourism, a deceleration in agricultural growth and a steep drop in exports. Increasing fiscal stress also challenges economic management. Revenue collections have slowed sharply due to the economic slowdown and at the same time security-related

expenditures have increased causing a sharp increase in domestic borrowing. These features of the economy persist into the current fiscal year and the medium-term outlook is challenging.

15. From FY98 to FY00, economic growth accelerated primarily due to booming exports and non-agricultural growth, but also because of improved agriculture sector performance. The economy responded well to macroeconomic stability and the liberalization of the investment and trade regimes of the early-1990s. The economy became more open with rapidly growing trade—especially exports, which grew more than 15 percent per year (in US\$ terms) to OECD countries and India. Growth also became more broad-based as agriculture grew due to a number of factors, including an increase in the use of fertilizer, diversification of cropping patterns to cash crops, improvement in rural infrastructure and availability of agricultural credits.

16. Starting in the last quarter of FY01, a combination of factors has led to a rapid economic slowdown. The global economic slowdown whose effects worsened in the aftermath of September 11th particularly affected trade within the region and demand for exports from Nepal. These adverse factors were compounded by the Royal family tragedy, political instability—including the in-fighting within the Nepali Congress Party and frequent cabinet changes—and investor uncertainty caused by the escalation of the conflict. These have collectively contributed to the contraction of manufacturing and tourism (airline arrivals declined by 38 percent in FY02), and halted the growth of the non-agricultural sector. Growth in agriculture—which accounts for more than one-third of the economy—also declined (to 1.5 percent in FY02) due to untimely rains.

Table 1. Nepal: Selected Economic Indicators, FY98–FY03

Nominal GDP (FY01): US\$5,562 million Population (FY01): 23.6 million						
	FY98	FY99	FY00	FY01 Estimate	FY02 Projections	FY03 Projections
Growth (percent change) ^{1/}						
Real GDP at market prices	2.9	4.5	6.2	4.8	0.8	3.8
Savings and investment (percent of GDP)						
Gross investment	24.8	20.5	24.2	24.3	23.6	25.4
National savings	22.1	21.0	24.7	25.4	24.6	25.6
<i>Of which: Public savings</i>	1.3	0.9	1.1	0.2	-1.0	-0.9
Prices (percent change)						
Consumer prices (end-of-period/12-month)	12.0	9.0	0.6	3.4	3.5	4.3
CPI (average)	3.3	12.8	3.4	2.4	2.9	4.0
GDP deflator	4.2	8.8	4.4	3.1	3.5	4.3
Government budget (percent of GDP)						
Total revenue	10.5	10.2	10.7	11.4	11.4	11.6
Total expenditure	16.8	15.4	15.7	17.6	17.4	17.5
Current expenditure	9.2	9.4	9.6	11.2	12.4	12.6
Capital expenditure and net lending	7.6	6.1	6.1	6.4	5.0	5.0
Overall deficit after grants	4.5	3.9	3.5	4.5	4.0	3.6
Overall deficit before grants	6.3	5.2	5.0	6.2	6.0	6.0
Domestic financing (net)	0.6	1.4	0.9	2.7	2.6	2.3

^{1/} Growth projections are as of July 2002 and expected to be revised downwards. Fiscal projections are based on authorities preliminary estimates.

17. Exports—the engine of economic growth in the 1990s along with tourism—have been particularly severely affected. In US\$ terms, the growth of exports was 18 percent in FY99 and 27 percent in FY00 with the exports of three items—garments, carpets and pashmina—accounting for 50 percent of total export earnings. During FY02, exports to countries other than India declined by 37 percent (compared to 4 percent growth in FY01) and export growth to India decelerated from 23 percent to 11 percent. Correspondingly, imports fell by 9.5 percent in FY02 (compared to 3.5 percent growth in FY01), indicating an economic slowdown. While the renewal of the Indo-Nepal Trade Agreement in March 2002 helped to ameliorate uncertainty about trade with India, the new agreement has imposed

considerably more stringent value-added requirements and quotas to restrict Nepali exports, thereby raising obstacles to the recovery of trade and the economy.

18. Despite the slowdown in exports, the balance of payments position (with reserves of about eight months of imports of goods) and current account balance remain relatively sound due to off-setting factors—i.e., a doubling of labor remittances in FY02 compared to FY99 and the slowdown in imports. The danger is that the on-going instability in the country could reduce the flow of remittances, in which case the macroeconomic position would be less secure.

19. Since the last quarter of FY01 fiscal stress has been growing. In FY99 and FY00, the deficits were about 5 percent of GDP and revenue increased by 35 percent due to tax policy reforms and improvements in administration. But the economic slowdown has led revenue increases of only 3.3 percent in FY02 in spite of introducing mid-year tax measures. The recent trend in the rise of regular expenditures to meet security expenses and lack of growth of revenues resulted in an estimated fiscal deficit of 6.0 percent of GDP in FY02. Equally significant has been the rise of domestic financing of the deficit from 0.9 percent of GDP in FY00 to 2.6 percent of GDP in FY02. While most—i.e., more than 80 percent—comes from commercial banks and non-bank purchases of treasury bills (with insurance companies and pension funds being the major buyers among the latter group), its effect on interest rates have been muted by the slow economy. Nepal's financial regulations—limiting Central Bank deficit financing (less than 20 percent of domestic financing in FY02) to 5 percent of revenue collections of the previous year—have also helped to dampen inflationary pressures.

20. Several factors contribute to rather gloomy medium-term prospects for the non-agricultural sector. First, security concerns and attacks on economic targets have worsened the business climate and increased investor uncertainty aside from directly adversely affecting tourism. Second, the prospects for Nepal's exports to OECD countries are weakened both by the on-going global slowdown and the phasing out of Multi-Fibre Arrangement (MFA) quotas. Third, the growing fiscal imbalance could threaten macroeconomic stability. To counter these negative developments and shocks, there is a need to: (i) restore security and confidence of the private sector; (ii) maintain macroeconomic and fiscal stability to create an enabling environment for the private sector; and (iii) take urgent measures to increase productivity and reduce the costs of doing business in the face of increasing global competition.

C. The Reform Program—The Government's Response

Introduction

21. While Nepal's planning objective shifted explicitly to poverty reduction after the 6th Five Year Plan (1980-1985), with the launching of the 9th Five Year Plan (1997-2002) Nepal expressed a strong commitment to poverty alleviation, along with setting long-term targets for poverty-related indicators. Implementation of reforms and poverty-oriented programs had been slow, and by the time of the Nepal Development Forum (NDF) held in Paris in April 2000, there was a growing recognition in HMG that poor governance was undermining the whole Government system, including its ability to address poverty issues effectively. With a renewed sense of urgency, HMG designed and unveiled a comprehensive reform program for poverty reduction at the 2000 NDF. The announced reform program focused on the key constraints hampering economic growth and poverty reduction, including: (i) fiscal policy and economic management; (ii) governance, including civil service reform and decentralization; (iii) private sector development and the financial sector reform; and (iv) improving aid effectiveness. These reforms were placed in the context of: (i) the human development agenda; and (ii) environmental management. Recognizing the urgency of initiating the financial sector reforms in particular—especially resolving the deteriorating situation in the two largest banks (discussed below)—the Ministry of Finance (MoF) made

this sector the “rallying point” for reform. This was also seen as a major step in changing the “old ways” of doing business that breed corruption. HMGN provided a progress report on reform implementation at the 2002 NDF (see Box 2).

22. The implementation of reforms has been uneven and much slower than expected for some time, in large part due to the continuing lack of strong political leadership. As the economy started to slow in the second half of FY01 and continued into FY02, the threat of the insurgency intensified and fiscal pressures built, HMGN has become increasingly serious about reform implementation. While many

political leaders continue to show a lack of commitment to real reform, some reform-minded leaders—a core group of technocrats—are acting with a sense of urgency. In recent months, the reform efforts have intensified in several areas—especially the financial sector, fighting corruption, public expenditures and the development and with implementation of the Immediate Action Plan (IAP, see Appendix I). As a fundamental response, HMGN has announced that it will make the 10th Five Year Plan its Poverty Reduction Strategy (PRS, see Box 3) and will back it up with a Medium-Term Expenditure Framework (MTEF).

Fiscal Policy and Economic Management

23. With regard to fiscal policy, Nepal has a relatively efficient tax system for its income level based on low income tax rates and a VAT. Nevertheless, with the increased security spending and economic slowdown, there is a need to raise revenues and streamline spending. In the case of public expenditures, an important development started with the work of the Public Expenditure Reform Commission (PERC), whose March 2001 report made a number of far-reaching recommendations to reform public expenditures. This has led to the preparation of the MTEF that provides the fiscal underpinnings of the 10th Plan/PRSP. In the FY02 and FY03 budgets, PERC recommendations have been incorporated, including prioritizing the development budget, introducing the MTEF, initiating pension reform and expanding decentralization. The first drafts of the MTEF for five key line ministries were presented at the 2002 NDF and preparation of the MTEF in all ministries has been completed.

24. For all ministries, the MTEF spells out: (i) sector visions, (ii) national sectoral goals based on the 10th Five Year Plan approach paper; (iii) mission statements; (iv) sectoral objectives; (v) outputs and activities to achieve the objectives; (vi) strategies to achieve sectoral objectives; (vii) prioritization of existing projects staying within the three-year resource ceiling; and (viii) a list of projects that would be undertaken if additional resources were made available. To sharpen prioritization, the FY02/FY03 budgets increased the share of overall expenditures on important public goods and services, including education, health, local development and agriculture. At a more disaggregated level, the budgets contained more intra-sectoral prioritization and provide higher allocations (relative to FY01 expenditures)

Box 2: The 2002 NDF

Amidst tremendous challenges, the 2002 NDF—fully prepared and managed by HMGN—was held in Kathmandu and Pokhara on February 4-7. An impressive process preceded the NDF in which background papers were made widely available—including being posted on a Government website—and discussed by civil society. Nearly 1,000 persons—from all facets of Nepali society—participated in the opening session, with about 200—including NGOs and private sector representatives—participating in subsequent sessions.

In addition to providing an update on reform implementation, the meeting focused on the substance and process for the 10th Five Year Plan/PRSP/MTEF exercises. While the development partners expressed general support to HMGN, the key message delivered at the meeting was the need to focus on implementation on the ground through improved service delivery to the poor and a demonstration that development programs are having an impact on poverty.

HMGN actively sought programmatic support/budget assistance from the development partners. While a number of donors indicated that they would favorably consider such an approach, it was indicated that this would only be possible with effective implementation—including evidence of better service delivery to the poor—and strict monitoring and controlling corruption.

to a number of important pro-poor programs. In priority sectors, the budget is the first year of a rolling MTEF.

Box 3: The Process and Substance of the Draft 10th Plan/PRSP

HMGN intends the 10th Five Year Plan (2002-2007) to be the country's Poverty Reduction Strategy (PRS). The preparation process is underway and as part of the "pre-NDF" consultations, an approach paper for the PRSP/10th Plan was prepared and widely discussed. The Vice Chairman of the National Planning Commission (NPC) heads a Steering Committee providing the strategic leadership for the exercise and various sub-committees have coordinated the background studies and reports. Technical teams headed by Ministry Secretaries had primary responsibility for sector strategy formulation leading to strong inter-agency participation and ownership. The first draft was discussed in five regional workshops along with special consultations organized with key segments of civil society (i.e., women, dalits, migrant workers, trade unions, etc.). Recommendations emerging from the public consultations included the need to: empower/strengthen local government institutions; modernize/commercialize agriculture; promote basic/technical education; provide more facilities for basic health and drinking water; and implement strong measures for improving bureaucracy and reducing corruption. Furthermore, in June 2002 DfID sponsored a workshop to examine environmental aspects of the PRSP, that will be followed up on during the preparation of the Bank/IMF Joint Staff Assessment.

HMGN released the Nepali language draft of the 10th Plan/PRSP in late-September and a national seminar was held to discuss the draft. The PRSP has the following features:

- As indicated, the process has been very participatory and wholly country-driven.
- The strategy is results-oriented with a clear target—i.e., to reduce the poverty rate from 38% to 30% by FY07. Explicit targets have been set for 13 social goals—including most of the MDGs—and economic management goals have been clearly defined and benchmarked.
- Emphasizing the importance of the private sector and export-led growth, the strategy has four pillars: (i) high, sustainable and broad-based growth; (ii) development of social sectors and infrastructure; (iii) targeted programs for the poor and excluded; and (iv) good governance.
- The development budget allocation associated with the PRSP is well-prioritized, emphasizing social sectors (39%), physical and rural infrastructure (37%) and agriculture and forestry (24%).

However, the draft PRSP is still relatively weak in a number of areas, including: (i) sectoral policies and strategies are not adequately prioritized, specified or mapped to targets; (ii) monitoring and evaluation arrangements (see Box 7); and (iii) there are major omissions, such as a lack of analysis on the Maoist conflict and its implications. Nevertheless, HMGN is working to address these issues.

Governance, including Civil Service and Decentralization

25. Although poor governance remains the fundamental challenge in Nepal, the country has made good progress in developing accountability and financial management institutions, but the effectiveness of many of these institutions still suffers from capacity constraints. Prior to dissolution of the lower house of Parliament, the country had an active Public Accounts Committee (PAC). It also has an independent Auditor General, a Financial Comptroller General's Office (FCGO) with generally good accounting procedures, an increasingly active independent Commission for the Investigation of the Abuse of Authority (CIAA) and a newly-created Special Court for corruption cases. Recently, CIAA has taken actions against 22 civil servants in the MoF and has also initiated actions against the Executive Chairman of the national airline and a Joint Secretary of the Ministry of Physical Planning on suspicion of amassing wealth beyond normal circumstances. Two former ministers and two other officials of the Ministry of Water Resources have been arrested and placed under judicial remand for 25 days on corruption charges. This is the first time that the Special Court has acted against ministerial-level personnel (though to date no prominent figure has been successfully prosecuted). While financial management and accountability issues persist—including a widespread perception of corruption—the recent efforts are commendable and in the right direction. In addition, the PERC made several recommendations pertaining to financial management and a national steering committee has been created to implement the recommendations of the recently-concluded Country Financial Accountability Assessment (CFAA—see paragraph 41).

HMGN has taken steps to address the issue of anti-money laundering (AML), primarily through the drafting of an AML Act—currently being discussed by the Central Bank Board—that includes the establishment of a Financial Intelligence Unit. Furthermore, by contributing to future greater trade policy transparency, Nepal’s efforts to join the World Trade Organization (WTO) have the potential to create irreversible steps to improve governance. Nevertheless, progress in implementing civil service reforms has been slow and there have been few accomplishments, other than the elimination of some vacant civil service positions.

26. *Decentralization.* Recognizing the potential for more efficient service delivery through decentralization, Nepal has one of the more advanced legislative frameworks for decentralization in South Asia, but implementation of decentralization has been slow. The 1999 Local Self-Governance Act (LSGA) set ambitious decentralization targets and despite some accomplishments (see Box 4), much remains to be done to achieve results on the ground—including addressing capacity constraints at the local levels. At the 2002 NDF, HMGN presented a three-pronged decentralization strategy that includes: (i) fiscal devolution; (ii) capacity building; and (iii) monitoring and evaluation. While the Decentralization Implementation Monitoring Committee (DIMC) has approved the fiscal decentralization framework, it is yet to be operationalized. The overlap between local Government functions and those of the de-concentrated units of the sectoral line agencies of the central Government also needs to be resolved. Complementing decentralization, the Government has decided to provide direct support to community-based development schemes. To this end, an autonomous and transparent Poverty Alleviation Fund (PAF) is being explored to finance human resource development, small-scale infrastructure schemes demanded by communities and support for income generating activities. If a credible, transparent and cost-effective PAF is established, it could expand to a broader scope, replacing many of the existing HMGN-financed programs and becoming the implementation vehicle for many donor-funded programs.

Box 4: Progress in Decentralization

The 9th Five Year Plan aimed to achieve the poverty reduction targets by enhancing public services through decentralization. To this end, the following initiatives have been taken:

- The Local Self-Governance Act (LSGA, passed in 1999) lays the foundation for a local self-governance system recognizing the role of local self-governance and devolution to Local Governments (LGs);
- Parliament approved the LSGA Regulations and Financial Regulations in 2000;
- A high level Decentralization Implementation Monitoring Committee (DIMC) chaired by the Prime Minister was formed;
- DIMC approved a comprehensive (with more than 60 activities) time-bound decentralization implementation plan and instructed all ministries to start implementation;
- The FY02 budget devolved basic and primary education, primary health, agriculture and other services to LGs. Under the IAP, transfer of primary schools and sub-health posts to LGs has been initiated;
- Bills to amend 10 sectoral acts that conflict with the LSGA were presented to Parliament; and
- A Fiscal Decentralization Commission was established to oversee the gradual implement of the recommendations made in the report of the Local Bodies Finance Commission.

27. In mid-July 2002, the decentralization process suffered a set-back when the terms of locally-elected bodies—both at the village/municipality and district levels—were allowed to expire. The Government had already exercised the constitutional option to extend the tenure of the local bodies for one year and felt that it could not grant a further extension, leading to the current situation in which local bodies—Village Development Committees (VDCs), municipalities and District Development Committees (DDCs)—are being run by Government bureaucrats. While local plans for FY03 were mostly completed before the suspension, it is unclear how the planning process for FY04 will be accomplished without elected officials in place. As such, to minimize the disruption in the work of local Governments, there is a need to hold local elections as soon as possible.

Private Sector Development and Financial Sector Reform

28. Nepal has made significant progress in implementing regulatory reforms to expand infrastructure provision with private sector participation. A number of regulatory bodies have been set up—in power and telecommunication—and private sector operators have been issued licenses to provide services in these sectors. In general, there is a lack of restrictions in the investment climate and recently announced initiatives will help to make the labor market more flexible. Public enterprises—dominant in utilities and airlines and to a lesser degree in construction and agriculture distribution—have normally not been loss-making or a large drain on the budget. Although there have been some efforts in the last year, little progress has been made in privatization. A number of factors continue to hinder the process, including: (i) labor problems; (ii) environmental issues; and (iii) failure of bids to meet technical qualifications.

29. The *financial sector reforms* are elaborated in the Government's Financial Sector Strategy Statement (FSSS: adopted in December 2000) and include reforming the Central Bank (Nepal Rastra Bank: NRB) to strengthen its autonomy and authority, and strengthen supervision and management of commercial banks⁴. The NRB Act (revised January 2002) increases the independence and authority of NRB, establishes transparent rules governing hiring and firing of its Governor and gives NRB greater authority to supervise commercial banks, including taking over the management of troubled banks and severely punishing irregularities by bank officials. In addition, the Deposit Taking Institutions Act will tighten regulatory rules governing all financial bodies, including other non-banking deposit-taking financial institutions.

30. Other important reforms include reducing the role of the Government in the financial sector as a direct owner of financial institutions, beginning with the two largest banks—Rastriya Banijya Bank and Nepal Bank Limited (see Box 5). After considerable delay, an external management team has taken over the management of NBL to help address its deep-rooted management and financial problems. On March 8, 2002 NRB removed the NBL Board on account of failure to manage NBL properly and replaced it with an NRB-appointed Board. At the same time, ICC Bank (Ireland)/Bank of Scotland was invited to Kathmandu to negotiate a management contract. Negotiations took place in April

Box 5: Rastriya Banijya Bank and Nepal Bank Limited

The two largest banks in Nepal—Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL)—account for around 50 percent of total banking system assets. With IDA support, a comprehensive assessment of these two banks (carried out under the direction of NRB in 1999/2000) found serious shortfalls in all aspects of their governance, management and operations. The report concluded that the banks' loan assets are highly overstated and extremely risky and that, as a consequence, the banks are technically insolvent. It was estimated that these two banks had losses (as of mid-1998) of as much as US\$450 million—equivalent to around 46 percent of the Government budget or 8.6 percent of GDP. Inevitable deterioration since mid-1998 implies that these losses would have increased significantly since then.

The assessment confirmed that: (i) the management of the banks is basically dysfunctional; (ii) there is no reliable data on loan portfolios; (iii) financial accounting is primitive and not according to international standards; (iv) business strategies are not in place; (v) human resource policy is weak and counterproductive; (vi) management information systems and record keeping are basic; and (vii) governance and management are highly politically driven and lack a commercial focus. To begin tackling these issues, in September 2000 NRB advertised internationally to recruit professional management teams to take over RBB and NBL.

and management control was turned over to the new team in mid-July. The team has moved swiftly and decisively to stir up NBL and the banking system; however, the long-term restructuring plan for the institution remains to be determined. While commitment to undertake similar actions in RBB is strong,

⁴ Financial sector reforms and institutions are discussed in length in “Nepal: Financial Sector Study”, Report No. 24959-NEP, October 16, 2002.

new management is not yet in place. Following the broken contract with Deloitte Touche Tohmatsu⁵, an expatriate CEO has been selected and is expected to be in place by the end of the year. Seven additional support positions (for treasury management, credit, accounting, internal audit, information technology, loan recovery and human resources), as well as for an accounting firm to provide support were advertised in the international press and are expected to be selected and in place in early-2003. HMGN has also initiated reforms—with support from ADB—to improve the viability/sustainability of the Agricultural Development Bank of Nepal (ADB/N) and the Nepal Industrial Development Corporation (NIDC).

Improving Aid Effectiveness

31. The Government has made impressive efforts—through an extensive participatory process—to prepare its Foreign Aid Policy (FAP). The main objectives of the FAP are to: (i) increase convergence of development priorities; (ii) improve quality, effectiveness and efficiency of operation; (iii) enhance economic growth for poverty reduction and human development; and (iv) facilitate equitable participation of donor institutions and Nepal. The FAP outlines HMGN's steps to achieve these objectives, including the formulation of new guidelines, strategies and policies aimed at influencing/regulating the flow and composition of aid and for ensuring better utilization of such assistance. In addition, the FAP proposes adjustments to the development partners' assistance programs and policies in order to strengthen their support to Nepal's development effort. In late-2001 the development partners themselves undertook a review of their practices, which reached similar conclusions and recommendations (see Box 6).

Box 6: Review of Development Partnerships in Nepal*

In late-2001, a multi-donor team (headed by OECD/DAC) carried out a review of development partnerships in Nepal with the objective of helping donors reflect on their past assistance efforts, particularly the ways in which they worked with the process of Nepal's own development efforts and to make suggestions on how to improve effectiveness. The findings of the review are consistent with the issues raised in the FAP, with a key message being that the present relationship between donors and Nepal is far from ideal. From a quantitative perspective, Nepal is heavily dependent on donor assistance because of the extent of poverty, few internal resources, huge needs and the low level of national and local revenues. By tending to supplant Nepali efforts with aid money and by diverting the attention of Nepalis in positions of power towards securing new aid commitments, donors have inadvertently and indirectly contributed to the failure of Nepal to resolve its own problems. In addition, a general concern was expressed that donors are too dominant and that the impact of aid and overall development efforts are not generating satisfactory and sustainable results on the ground.

On their part, donors have felt that they have responded to the ineffectiveness and lack of direction of HMGN by taking more responsibility for designing and implementing programs and projects. As such, some donors have reduced their aid levels and formulated strong conditions in their aid programs, while others have reduced their efforts to work through the central Government and instead work more directly with local Governments, NGOs and communities or engage their own implementing agencies and consulting companies. Aid has provided important contributions to the improvement in living standards in isolated valleys and hillsides and has resulted in some significant improvements in program implementation. Nevertheless, without a strong collaboration with national institutions, the sustainability and replicability of many programs remains uncertain. There is a general perception within Nepali civil society that in the past two decades the national institutional capacity for development has eroded partly due to increased donor activism. In order to reverse this situation, the national actors need to take charge of their program.

* From "Review of Development Partnership in Nepal: Review Team's Main Findings and Recommendations," January 21, 2002, paper presented at the 2002 NDF.

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A contract was signed on January 31, 2002 between NRB and Deloitte Touche Tohmatsu, USA (DTT) for the later to take over the management of RBB effective the first week of March. Given the prevailing security situation in March the DTT team was hesitant to travel to Nepal. In early-July DTT informed HMGN that they were not able to carry out the contract; hence, breaking it.

The Human Development Agenda

32. Although the impact on human development is not yet apparent, many recent changes are likely to begin improving education and health outcomes in Nepal materially in the coming years. As mentioned below (see paragraph 39), in education, the Basic and Primary Education Project (BPEP) is supporting the strengthening of institutional capacities at national, district and school levels to plan and deliver more efficient and better quality education services. In turn, this is expected to lead to increased levels of learning resulting from improved student retention (especially for girls and children from socially disadvantaged groups), more effective teacher performance and efficient teacher deployment practices. This program has been under implementation for over three years and modest, yet steady progress is being made (see Annex 9). Furthermore, BPEP has placed emphasis on improving education offered to working children. Through the Nepal Understanding Child Labor Project—a joint effort of the Bank, ILO and UNICEF—a report has been drafted and discussed with HMGN that attempts to analyze the issue of child labor more holistically by examining the determinants of child labor in Nepal, along with the policy environment and response.

33. In the health sector, a reform strategy has recently been developed by the Ministry of Health (in a participatory manner) to assure available, accessible and effective essential health care services. Currently, this strategy is being translated into a specific sector program—containing a detailed implementation plan—that will be supported in a programmatic manner by the development partners. Complementing these actions, through the implementation of the IAP, important initial steps are being taken in the decentralization of public primary schools and health posts (see Appendix I). Nevertheless, monitoring and analytical capacity for social indicators—including poverty—remain weak and need to be strengthened (see Box 7).

Environmental Management

34. Nepal's efforts to address environmental management began with the 6th Plan, since which time environmental conservation activities are to be carried out in parallel with sectoral programs. At all levels—including municipalities and VDCs—formulation of periodic plans has started to integrate environmental issues. More recently, emphasis has been placed on Environmental Impact Assessment capacity building in line with the newly implemented institutional and legislative framework contained in the Environmental Conservation Act and its regulations. Plans have been developed to implement the convention on Biological Diversity and a Sustainable Development Agenda for Nepal has been prepared. Nevertheless, implementation of environmental and natural resource conservation and policies have suffered due to a number of problems, including weak capacity and poor coordination. There are many active donors and NGOs in this area and funding does not appear to be a constraint.

Box 7: Monitoring Poverty

The draft 10th Plan/PRSP includes targets for a number of indicators, including the incidence of income poverty, illiteracy, infant mortality, maternal mortality and life expectancy. UNDP has supported work to identify key poverty monitoring indicators resulting in the establishment of a set of indicators that partially overlaps with the MDGs. While there is no shortage of indicators, there are serious weaknesses in tracking indicators—including the MDGs—in Nepal. Specifically: (i) on data collection, few tools are used systematically—i.e., a comprehensive strategy is lacking and surveys/studies are generally funded by donors on a “one-off” basis so that results are not comparable over time; and (ii) on data use, an institutional setup is lacking to track indicators over time, coordinate collection and analysis and provide data to policy-makers. These issues will continue to be addressed through the MTEF, PRSP and other vehicles. As an example, another round of the NLSS—comparable to the 1995/96 survey—will be launched shortly (with Bank support) and allow for poverty comparisons over time.

D. Progress in Implementing the Bank Group's Strategy

Background

35. The Operations Evaluation Department (OED) carried out a Country Assistance Note (CAN) for Nepal in November 1998⁶. Overall, the CAN painted a fairly dismal picture assigning the following ratings: (i) Outcome—unsatisfactory; (ii) Institutional development impact—modest; (iii) Sustainability—uncertain; (iv) Bank performance—unsatisfactory; and (v) Borrower performance—unsatisfactory. With regard to the unsatisfactory Bank performance, a number of factors—including a limited policy focus in a poor policy environment, a generally low level of activity, a narrow focus on agriculture, controversial performance under Arun III⁷, uncoordinated aid along with aid fatigue and sound but sparse economic and sector work—were cited as key problems. In retrospect, it suggested that the Bank should have done more to help address the fundamental institutional and policy constraints to create an enabling environment for: (i) cost-effective and sustainable public investment; and (ii) greater private sector activity. These considerations have been taken into account during CAS implementation and in many respects, this Progress Report further integrates them in the evolving country assistance program.

IDA Program

36. Since the Board discussion of the CAS, given the limited slow progress in implementing reforms Nepal has been in the “Low Case.” Unless there are substantial improvements in governance and public service delivery, more financial assistance from IDA will not be a solution to Nepal’s problems. The Government clearly recognizes poor governance—reflected most acutely in weak implementation of reforms, poor service delivery and corruption—as the central obstacle to development. The introduction of a MTEF and the IAP have been prompted by the Bank’s dialogue with HMGN. The rationale of the Bank’s position has been appreciated by the Nepali public in general and also has shown some results (see Appendix III). Today, there is a great realization within Nepal that the Bank is truly concerned with the well-being of the poor and that it is not possible to simply “negotiate” aid out of IDA.

37. In response to the program presented at the 2000 NDF and based on the growing realization of the urgency of financial sector reform—specifically, the possible risk of a financial sector crisis, the huge drain on public resources and an indication of HMGN’s willingness to do away with the “old way” of doing business—key steps in this area became the “litmus test” for moving into a “Base Case” scenario.

38. *Lending.* The Low Case lending program focused on community-based projects—to mobilize and leverage social capital at the grassroots level—and on supporting specific but modest reform efforts. Implicitly assuming a quick transition to the Base Case, the Bank continued to prepare a number of larger, “reform-heavy” projects and in retrospect may have missed an opportunity to develop and deliver a few more “Low Case appropriate” projects. This tactical error is being corrected.

39. Since the last CAS, four projects have been approved for a total of US\$94.6 million; specifically:

⁶ This was subsequently reclassified as a Country Assistance Evaluation (Report No. 19850) and released in November 1999.

⁷ Arun III—a two-phase 400 MW power project—was dropped in 1995. Doing so generated wide negative publicity for the Bank, strained relations with HMGN for a period thereafter and consumed substantial Bank administrative and human resources. Even in 2002 there is frequent mention of the Bank and this particular project in the Nepali press, confirming that it is far from forgotten.

- The **Second Basic and Primary Education Project** (BPEP, Cr. 3185-NEP) was approved in March 1999 (US\$12.5 million). Conceived as an Adaptable Program Loan (APL), the objectives of the first phase are to develop institutional capacity for qualitative and quantitative improvements in primary education. The project incorporates “basket funding” with a number of donors—including IDA, Denmark, the European Union, Finland, Norway, Japan, UNICEF and the ADB—providing joint support to a well-formulated ten-year sectoral program;
- The **Rural Infrastructure Project** (Cr. 3215-NEP) was approved in May 1999 (US\$5 million) to strengthen the institutional capacity of a decentralized governance system in its planning and managing capabilities to improve the quality, efficiency and sustainability of rural roads with active participation of the project beneficiaries. Given limited Bank experience implementing community-based road projects in Nepal, a Learning and Innovation Loan (LIL) was selected as the appropriate vehicle to test this fundamental shift in approach. Through this project a number of decentralization options are being tested, including working: (i) directly with the DDCs; (ii) with DDCs through contractors; (iii) with Community Based Organizations (CBOs); and (iv) through Non-Governmental Organizations (NGOs). The many implementation challenges associated with this project have made it a learning experience for all involved. Nevertheless, recent results are promising as confidence and experience are being accumulated to work more effectively at grassroots levels;
- The objective of the **Road Maintenance and Development Project** (Cr. 3293-NEP)—approved in November 1999 (US\$54.5 million)—is to help achieve sustainable maintenance, rehabilitation and construction of an economically justifiable strategic road network, while also promoting more sustainable funding and efficient public sector management of road maintenance. The project supports key sectoral policy reforms by establishing a Roads Board and Road Fund to assure a stable source of funding for maintenance expenditures, while at the same time providing motorable access to isolated districts in the Mid- and Far-West regions of the country (the heart of the insurgency area); and
- The **Telecommunications Sector Reform Project** (Cr. 3581-NEP) was approved in December 2001 (US\$22.6 million) and supports on-going sectoral reforms and increase rural access to telecommunications services through the licensing of a private operator (selected on a competitive basis) and establishing public telecommunications centers.

40. *Economic and Sector Work.* Consistent with the Low Case scenario, strong emphasis was placed on helping to build the agenda and needed consensus for reform. The *Public Expenditure Review* (April 2000) was very influential in this regard. As indicated previously, this work helped to shape the framework for the many of the public expenditure reforms that are currently under implementation or envisioned. This has been followed up with intensive technical assistance and dialogue—in collaboration with the UK Department for International Development (DfID)—which have helped (and will continue to help) HMGN develop and implement the MTEF. As important, the Bank’s continuing dialogue with the authorities on the topic of the financial sector reforms—including financing the RBB/NBL report and the *Nepal: Financial Sector Study* (October 2002)—have kept the process on track, although admittedly progress has at times been slow⁸. Other key pieces have also focused on reform agenda items, including: (i) *Priorities and Strategies for Education Sector Reform* (July 2001) which helps to identify and build consensus on a comprehensive reform agenda at all levels in this fundamental sector; (ii) *Proposed Power Sector Development Strategy* (March 2001) which identifies the key constraints and makes

⁸ DfID and the International Monetary Fund (IMF) have been important partners in these efforts. In addition, IMF has been providing technical assistance to NRB.

recommendations to expand Nepal's hydropower resource potential to service the electricity needs of the people and to generate export potential; and (iii) *The Business Environment and Manufacturing Performance in Nepal* (December 2000), the first investment climate survey carried out in the South Asia Region.

41. The other area of focus of our Analytical and Advisory Activities (AAA) has been on governance, decentralization and improving service delivery. The study *Poverty at the Turn of the Twenty-First Century* (May 1999) analyzed poverty trends and projections, the poverty profile and key elements for a poverty alleviation strategy. Related to service delivery, the *Terai Options Study* (October 2000) examines experience with various institutional arrangements for delivery of rural services in the Terai and makes recommendations for future development of cost-effective service delivery in the context of decentralization. A *Country Procurement Assessment Report* (CPAR) was finalized in FY01 and many of its recommendations are being implemented. A *Country Financial Accountability Assessment* (CFAA)—carried out with an extremely committed Government partner and other donors—was completed in FY02, also with an agreed action plan currently under implementation⁹. In the area of decentralization, three on-going studies—on fiscal decentralization, the proposed PAF¹⁰ and local institutions in the delivery of services in rural areas—are the first step of what is foreseen as an AAA-focus area for the coming years.

42. *Portfolio Management.* The current IDA portfolio in Nepal consists of seven active projects, of which five are due to close in the next nine months. Active operations as of October 2002 represented an aggregate IDA commitment of about US\$216 million (net of cancellations), of which US\$84 million (39 percent) remains undisbursed. The project implementation environment in Nepal is characterized by weak public management, a low skills base, political instability and challenges caused by the insurgency. Most of the projects—especially in the remote and less developed Mid- and Far-West regions—have been affected by the worsening security situation, with IDA stretched to undertake adequate supervision and project activities slowing or even coming to a halt in some instances. The Bank shares the experience with other donor agencies that truly community-owned projects tend to be largely unaffected by the insurgency. Project implementation has also suffered from political interference in implementation, in part seen through frequent changes of project staff and senior civil servants. Perceived or real corruption and lack of accountability in public institutions remain a problem affecting project performance. Despite notable improvements in the last two years, the shrinking portfolio remains at high risk and could be adversely affected by intensified insurgent activities. Although six of the seven projects in the portfolio had satisfactory performance ratings at the end of October 2002, half of these projects carry a high risk of unsatisfactory implementation performance and about one-fourth are at risk of not fully achieving their development objectives. As such, there is the possibility that portfolio restructuring and/or partial cancellations may be carried out.

43. To mitigate the risks, the Bank—primarily through the staff in the Nepal Country Office—has been proactively monitoring project implementation. In this effort, the Bank, together with the Government, the Asian Development Bank (ADB) and the Japan Bank for International Cooperation (JBIC) has been carrying out Joint Country Portfolio Performance Reviews since 2000. The main objective of these reviews is to discuss generic issues affecting portfolio management—such as security, passage of laws and regulations, procurement, financial management and safeguards—and agree on time-

⁹ Financing was obtained under two different Institutional Development Fund (IDF) Grants to assist in the efforts to implement certain recommendations/action plans of the CPAR (related to public procurement reform) and CFAA (related to public audit reform).

¹⁰ A draft of the PAF policy note “Towards a Sustainable Approach for Poverty Reduction and Decentralization in Nepal” was discussed in October 2002 and will be finalized before the end of the year.

bound action plans to resolve the identified issues. A memorandum of understanding is signed by all participating agencies and the agreed actions are closely monitored and reviewed semi-annually. During the most recent joint review—conducted in early-October 2002—HMGN expressed concerns about declining disbursement in the ADB and IDA portfolios and agreed to work with the partners to improve portfolio performance and the commitment volumes in the future. These joint reviews are complemented by quarterly reviews of the implementation progress of IDA projects, along with close supervision and monitoring. In addition to placing emphasis on quality at entry and quality of supervision during the portfolio reviews, Bank staff are active in identifying and resolving potential issues before they become problems.

IFC

44. In Nepal, the IFC aims to support the development of private infrastructure and financial markets and to invest in private projects that contribute to economic development and foreign exchange earnings. In view of the poor business environment, there have not been many opportunities for viable investments. As of October 31, 2002, IFC's held portfolio in Nepal was US\$91 million (US\$62 million from IFC's own account and US\$29 million in B-loans) in two power generation projects, one tourism project and one leasing company. The IFC has recently opened a regional multi-donor technical assistance facility for SME development—the Small Enterprise Development Facility—based in Dhaka, that will cover Nepal, as well as Bangladesh, Bhutan and the North-East states of India.

MIGA

45. MIGA has not underwritten any new projects in Nepal since 1996, when it issued \$32.8 million in guarantees to Statkraft SF, ABB Kraft AS, and Kvaerner Energy AS (all of Norway) for their investment in Himal Power Ltd.¹¹ Himal Power—a 60 MW “run-of-the-river” power plant—was the first foreign-owned and operated power project of its kind in Nepal. At issuance, it was expected to meet up to 25 percent of annual electricity needs. Currently, MIGA does not have any active definitive applications for projects in Nepal. Given the current political and security climate, however, it can be expected that foreign investors who do go forward with private sector investments in the country will choose to have political risk mitigants—potentially including MIGA's political risk guarantees—in place for their investments.

E. The Way Forward

The Current Situation—A “Twin Crisis”

46. The escalation of the Maoist threat has focused minds in Kathmandu on the perils of exclusion and the consequences of “mis-governance.” Many now accept that the insurgency may be temporarily stifled through military means, but unless the state demonstrates its ability to effectively deliver public services, it will continue to face challenges to its legitimacy. With its reach largely restricted to urban centers however, the Government in Kathmandu faces serious obstacles in its efforts to restore the people's confidence in it as an institution of public policy-making and a provider of public services. In the wake of the heightened security response, a second crisis has unfolded—economic prospects are bleak and public spending continues to rise on account of growing security needs as domestic revenues stagnate. This could be debilitating as limited resources would make the Government's response to the first crisis more difficult.

¹¹ In August 2001 MIGA issued a replacement contract for the project, reflecting a change in ownership, but not altering exposure.

47. Despite this rather difficult state of affairs, the current situation does present an opportunity for deeper reform. For one, the severe budget constraint combined with the urgent need to improve public services can help to clarify priorities. A clear view has emerged among reformers and donors that improving service delivery—and doing so urgently—is the highest priority. Consultations carried out in September 2002—a “pulse-taking” (see Appendix II)—confirm this, along with the governance crisis as the fundamental challenges facing the country. There is also consensus on what needs to happen—i.e., budget prioritization, change in delivery modalities and stronger accountability mechanisms. As indicated previously, the IAP announced in June 2002, the FY03 budget presented in mid-July and the Economic Reform Program 2002 announced in late-October reconfirm the Government’s resolve to move ahead with the reform program. In addition, the 10th Plan/PRSP, a MTEF providing an appropriate fiscal underpinning to the plan and the FAP all demonstrate progress and HMGN’s efforts to move in the right direction.

The Bank’s Assistance into FY04

48. There is emerging consensus in Nepal on what needs to be done and how to and how **not** to tackle the challenges. The fundamental constraint identified in the last CAS—governance—remains the major challenge and the two-pronged approach—bringing resources to the grassroots levels and improving development effectiveness—will continue to guide the Bank’s strategy into FY04 when a new CAS will be presented on the basis of HMGN’s PRSP. In the meantime, the Bank’s current strategy has been adapted to take into account the following:

- First, the work program will have an even greater focus on outputs/results. In late-2001, the country team developed a set of longer term outcomes, along with medium-term (FY03-05) outcomes associated with the CAS strategic objectives. Subsequently, work was been undertaken to identify strategies, means and instruments to ensure success towards meeting each of these outcomes and all activities will be focused towards achieving them;
- Second, the Bank will place greater emphasis on being “facilitators of change” in Nepal, as opposed to focusing on specific project interventions. Recognizing that the crises have created an environment to favor the reformers, the Bank will work closely with the change agents to ensure that irreversible steps are taken to improve public service delivery systems and governance. Such a focus will include carrying out more AAA, including developing and implementing dialogues and technical assistance programs with key reforming sectors and actors;
- Third, the Bank will begin to move gradually towards a more “programmatic” approach. Such an approach would be fully articulated within the next CAS following completion of the PRSP. Nevertheless, given the current fiscal pressures facing Nepal and the current reform efforts to improve service delivery and change the quality of public sector governance, the Bank would consider an adjustment credit under appropriate conditions (see paragraph 50).
- Fourth, traditional investment lending would continue to be used for: (i) piloting/testing new approaches (such as a possible Poverty Alleviation Fund LIL) to determine feasibility, ownership and assess the scope for replicability and scaling-up; (ii) support to well-defined “one-off” activities (e.g., certain institutional/sectoral reforms such as the proposed Financial Sector Technical Assistance and the proposed Power Sector Development); and (iii) community-based projects (such as the Second Rural Water Supply and Sanitation), especially in a Low Case environment in which adjustment lending would not be appropriate. In many cases, it is envisioned that a LIL would be the preferred

instrument, which once tested could be followed up by programmatic lending to support a demonstrated Government ownership and the incorporation of such programs into the budget; and

- Finally, the Bank will continue to strengthen the process of donor coordination and building partnerships¹². This will be especially important to ensure complementarity without duplication in all efforts, but especially in the provision of financial assistance. The positive lessons gained in the education and financial sectors provide valuable operational experiences in this respect. At a more macro level, the close coordination surrounding the IAP and following the “London Meeting”¹³ have strengthened donor partnerships in the last few months. Nevertheless, in pursuing these goals, it is important to leave sufficient space for Government leadership of the process, especially in the key areas.

49. As indicated, AAA will increase in importance as emphasis is shifted toward the Bank’s role as a change facilitator. Given the importance of decentralization and the lack of progress in implementing the decentralization agenda, the on-going work in this area will be expanded and continue to be a central theme in FY03 and beyond. This assistance has been requested by HMGN and while initially intended to help develop a broad design of a fiscal decentralization system, it will be followed up by creating and maintaining capacity to provide on-demand advice (with short policy notes and provision of technical assistance, etc.) to support implementation over the medium-term. Other important themes for AAA in the next 18 months will be those areas in which attacking the challenges and removing the bottlenecks will have the largest impact on poverty reduction. The key areas envisioned include growth and trade, social exclusion (including gender biases), child labor and poverty. Given the importance of trade for Nepal’s economic prospects, the *Trade and Competitiveness Study*—being carried out under the Integrated Framework (IF)—will help to identify key constraints to Nepal’s further integration into the multilateral trading system in a manner that is supportive of the PRS¹⁴. To better understand the institutional underpinnings of caste, ethnic and gender-based social and economic exclusion in Nepal and how these affect poverty outcomes—as well the options for policy and institutional reform—a *Social and Gender Analysis* is planned for FY03/04. The *Nepal Understanding Child Labor Project* will be continued, placing this important issue firmly within the program. In FY04, the Bank will also carry out a Development Policy Review (DPR) and initiate work on an updated Poverty Report. Given the completion of the CPAR and CFAA, all fiduciary requirements will have been met during FY04. In addition, intense policy dialogues—especially in sectors such as education, health, and agriculture/rural development—and technical assistance—including support to consolidating the MTEF and establishing a monitoring and evaluation framework for poverty—will continue to play a key role in the delivery of our assistance to Nepal by helping change agents in these sectors develop and implement credible reform programs.

¹² As alluded to previously, donor coordination efforts in Nepal have been very effective and there are numerous examples of strong Bank/donor cooperation, including: (i) DfID and the IMF in the financial sector; (ii) BPEP “basket funding” in the education sector (see paragraph 39); and (iii) implementation of the IAP in which various donors have been assigned lead responsibilities for supporting HMGN’s efforts in the different areas and implementation progress is monitored jointly.

¹³ An international meeting hosted by the UK Government in London on June 19-20, 2002 has helped to set an agenda for the development of an integrated strategy to tackle the developmental, political and security aspects of the conflict in Nepal.

¹⁴ Following the concept note discussion in September 2002, the study is currently on-going. The analysis will lead to a set of recommendations on policy reforms, institutional capacity strengthening and action plans to promote trade competitiveness.

50. The planned program of financial assistance under this Progress Report could be anchored with a Structural Adjustment Credit (SAC). Such support would be contingent on implementation of a selective, yet significant set of coherent reforms—contained in the IAP (see Appendix I)—and firmly rooted in a medium-term reform program (i.e., the PRSP) designed to further prioritize public expenditures, improve implementation of poverty programs and improve the accountability and transparency of the public sector, including measures to promote private sector development. Successful progress in implementing the reform program—including meeting the triggers defined in the 1998 CAS (see Annex 9)—would be essential for Nepal to remain in the Base Case and hence, a candidate for an adjustment credit.

51. Complementing the above mentioned support, examples of the types of investment/technical assistance (TA) credits being planned for the coming 18 months include:

- Financial Sector Technical Assistance (FSTA) to support: (i) reducing the role of the Government in the financial sector as a direct owner of financial institution, starting with the two large ailing commercial banks; and (ii) strengthening and developing the regulatory and supervisory framework of NRB. This project would support the financial sector reforms—discussed widely in this document—including the initial stages of restructuring RBB and NBL;
- Power Sector Development to: (i) support development of Nepal’s hydropower potential in an environmentally and socially sustainable manner so as to help meet domestic electricity demand; (ii) improve access of rural areas to electricity services; and (iii) promote private sector participation in the power sector as a way to improve sector efficiency and mobilize financing for sectoral investment requirements. In addition to supporting reforms in the power sector, this project would help improve access to electricity in rural areas using community-driven, bottom-up planning and decentralized implementation;
- A possible Poverty Alleviation Fund (PAF LIL) to help HMGN design, begin to implement and carry out an initial evaluation of a PAF-type instrument. A well-defined and well-functioning PAF has the potential to channel resources to grassroots levels, support decentralization and become an umbrella mechanism for promoting greater continuity and coordination of donor programs for poverty reduction; and
- Second Rural Water Supply and Sanitation (RWSSP II) to: (i) mainstream the “Fund Board¹⁵ approach” towards improving the performance of the entire rural water sector (i.e., scaling up successful pilot interventions); (ii) strengthen Government and non-government capacity to facilitate the delivery of rural water and sanitation services and undertake monitoring and effectiveness of such and strengthen community capacity to sustain the efforts; (iii) deliver sustainable health and hygiene benefits to the rural population through improvements in water and sanitation facilities; and (iv) improve rural real incomes by assisting women identify ways to earn income through time saved in carrying water. In addition to supporting reforms in the sector, the project would help improve access to water and sanitation services in rural areas, using a participatory community demand-driven methodology.

52. *Lending Triggers for Bank Assistance.* Given the progress made in implementing the reform agenda—particularly in the financial sector—at this point it is appropriate to move Nepal out of the Low

¹⁵ The Rural Water Supply and Sanitation Fund Development Board—i.e., “Fund Board”—was created in March 1996 with the objective of promoting sustainable, reliable and cost-effective demand-led rural water supply and sanitation services with emphasis on community approaches. The institution—which has been quite effective—is fairly autonomous, with a seven member board of directors containing private sector representatives, including at least one woman.

Case scenario. To remain in the Base Case—including a candidate for adjustment lending—will require Nepal to continue to meet the triggers presented in the 1998 CAS (see Appendix III for details on their performance). As such, Nepal will need to cement its track record on implementing reforms. A key condition would be fulfillment of the specific up-front actions contained in the IAP that are linked closely to the medium-term reform program contained in the PRSP. Progress would be jointly evaluated with HMG and other development partners. In addition, it is assumed that a satisfactory macroeconomic program would be in place, supported by a possible Poverty Reduction and Growth Facility (PRGF). As such, continued close coordination with the IMF is essential. Nevertheless, should the reform efforts falter, Nepal could again revert into a Low Case scenario.

Risks

53. Nepal faces serious challenges and major risks emanating from a variety of internal and external sources. First and foremost, is the risk imposed by the *worsening security situation*. As mentioned, the insurgency is challenging the legitimacy of the state, to which a military response will not be sufficient. The state must demonstrate its ability to achieve public purposes and address the poverty problem. The recent escalation of violence, including the rampage on infrastructure installations—in which over one-third of the country's 3,900 VDC buildings have been destroyed, 13 districts are without phones, five hydroelectric plants are out of action, 250 post offices have been destroyed and six airports have been closed, cutting off people in remote areas from the only means of transportation—is worrying and will have a lasting negative impact on Nepal's development.

54. Also linked to the worsening security situation is the strong possibility that the performance of the Bank's portfolio could significantly deteriorate, should the situation be prolonged. Since there is some evidence that community-based projects tend to be less affected, the Bank approach to shift toward more community-based interventions is appropriate. In addition, the current situation presents an opportunity for deeper reform—especially those reforms that improve governance and public service delivery—and the Bank will continue to provide strong support to the change agents, along with more actively disseminating positive reform experiences in improving service delivery. Improved public sector performance will be the most fundamental response to reducing the risk of insecurity.

55. A second set of risks arise from the potential to *return to entrenched, patronage-based politics*. While the recent acceleration in reforms—largely led by technocrats—has been impressive and encouraging, it will take some time before a more performance-oriented Government is created and politicians and civil servants come to accept a new set of norms for the conduct of their respective business. When the more technocratic interim Government makes way for an elected Government, there is a risk of old-style politics returning and with it tendencies for rent-seeking and slowing of reforms. The reform-minded leaders of the current Government are acutely aware of such risks. They see accelerating reforms and gaining popular support for the changes as the best safeguard against backsliding. Furthermore, it is evident that the Nepali people at large welcome and support many of the reforms that are underway (see Appendix I). Simply demonstrating that such changes are possible in Nepal will likely give the people greater confidence in demanding further changes. This in turn would make it that much harder to return to political “business as usual.” Therefore, the Bank's basic strategy is to support the reformers in accelerating the reform process. Close donor coordination to send consistent messages to the Government is a key element of the Bank's strategy in this regard. This is a high risk, but high return approach and well justified by the emerging track record on reforms.

56. The extraordinary steps taken by the King to remove an elected Government and appoint an interim caretaker Government have led to further deepening of political uncertainty. If this leads to serious political instability, even the reform-minded technocrats would find it difficult to get cabinet

decisions on further reforms and to keep the civil service focused on improving public services. The Bank can do little to mitigate such a risk, but it will monitor the situation closely.

57. Lastly, an additional risk is that the *economic situation will continue to deteriorate and Nepal will be even more vulnerable to the external environment*. Given Nepal's dependence on tourism and exports, unless there is a recovery in the global and domestic economic situations, Nepal's medium-term prospects are bleak. Again, implementing the reform agenda—specifically maintaining fiscal and macroeconomic stability and increasing economic productivity and competitiveness—provides the best chances for mitigating this risk.

James D. Wolfensohn
President

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Washington, D.C.
November 18, 2002

Appendix I Expediting the Reforms—The Immediate Action Plan

On June 3, 2002, the Council of Ministers endorsed an Immediate Action Plan (IAP) to expedite the reform process. The IAP was unveiled to the public two days later and contains three types of reforms: (i) prioritizing public expenditures; (ii) measures for improving service delivery; and (iii) measures for fighting corruption and improving accountability. As such, the IAP aims at effective management of public resources, prioritization of development projects/programs, enhancement of accountability and more effective delivery of public services. Equally important, the IAP is designed to break from the past tendency of HMGN to promise many actions and deliver few. Establishing a track record of good implementation is critical for not only gaining the confidence of the citizens, but also that of the development partners, especially as HMGN seeks to obtain budget support to cope with the current fiscal difficulties. The IAP was put into operation immediately and is being implemented with a considerable degree of success.

The IAP attempts to address a number of problems that have directly impacted HMGN's credibility. It proposes some far-reaching reforms, including:

- Prioritizing public expenditures and reforms to bring about realism and transparency in the annual budget;
- Channeling funds for local development through elected local bodies;
- Assuring funds for high priority programs with funds release tied to performance;
- Transferring public primary schools to community management, including the right to hire and fire teachers;
- Transferring management of primary health facilities to local authorities and make payments to health workers subject to verification of attendance by local bodies;
- Public posting of budget information and tracking of expenditures;
- Implementing public procurement and financial accountability reforms; and
- Developing and starting to implement an anti-corruption strategy.

The IAP is well-anchored in the PRSP (nearing finalization) and after the first set of immediate actions are implemented, a new IAP will be developed on an annual basis to expand the reforms. The Government has established a committee—the Reform Monitoring Committee (RMC) which contains representatives from Mof, NPC and the Office of the Prime Minister—to monitor implementation and review progress on a regular basis. In addition to elaborating specific actions, the IAP matrix defines the timeframe over which the actions are to be implemented, immediate indicators and expected outcomes. Periodic meetings are held with the development partners to discuss implementation progress.

Key actions of the IAP, along with implementation progress, are provided below.

Area/Action	Progress (As of October 31, 2002)
Prioritizing Public Expenditures	
Prioritization of all expenditures—especially development activities—to make the budget more realistic and reflect increased security requirements.	<ul style="list-style-type: none"> • FY03 budget preparation guided by MTEF and 10th Plan/PRSP 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 is included in FY03 budget (“Red Book”) covering seven sectors (education, water, health, agriculture, irrigation, roads

	<p>and power) with 100 high priority (P1) projects.</p> <ul style="list-style-type: none"> • 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 revising MTEF, with final version to be issued mid-November. • Arrangements made to ensure necessary and timely budget to P1 projects. MoF is monitoring release of funds. Detailed assessment of this arrangement to be made in mid- to late-November.
<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 implement in FY04 budget. 	<ul style="list-style-type: none"> • FY03 budget allocations for DDCs, VDCs, and municipalities remain identical to FY02 allocations despite severe resource constraints. • Since some revenue collection functions are devolved to local bodies, NPC/MoF have 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 is exploring 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 have been developed and under discussion. • Work initiated to develop poverty-based allocation formula.
<p>Priority projects (P1s) 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 receive 1/3 of budget allocation at the beginning of FY03. • Annual and trimester work programs of P1s being approved by NPC. • Changes in resources allocated to P1s not permitted without prior approval from NPC. • Project indicators being developed as a basis for budget release to reconcile allocations and expenditure for P1s. Work on-going to streamline release mechanism, especially to local bodies. • Budget release to projects to depend on 1st trimester performance. Reports/procedures developed to monitor physical progress and tie funds release to performance. • Ministries developing indicators/benchmarks for monitoring outcomes in close coordination with NPC.
<p>Measures for Improving Service Delivery</p>	
<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 School Management Committees (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 have been agreed, made public and widely distributed. • Amendment to Education Act drafted to facilitate school transfer within the existing legal framework. • 78 schools in 8 districts have been selected for transfer; 71 transfers approved and 26 schools actually transferred; 50 more schools being processed for handover. • Provision of block grants to SMCs made through income and expenditure statement. • Recruitment of primary school teachers frozen; not one teacher has been recruited centrally since the announcement of IAP. • Communication strategy (to encourage communities to take over primary schools) under design to facilitate transfer program.

<p>Health</p> <ul style="list-style-type: none"> • Management of sub-health posts (SHPs) by Local Health Management Committees. • VDC verification of staff attendance at SHPs before issuance of pay checks. • Compulsory public notices in SHPs stating the range of services, fees and hours of operation. 	<ul style="list-style-type: none"> • As of October 10, 68 SHPs have been handed over (32 in Chitwan and 36 in Jhapa), with 12 in Bhakapur being handed over in November. Altogether, about 500 SHPs in 11 districts have been identified to be taken over by end FY03. • An orientation package has been prepared by Ministry of Health to orient the VDCs, DDCs, District Health Offices (DHOs) and the SHPs to familiarize them with the changed roles in the management of the SHPs by local Health Management Committee. Training will start in mid-November and the main health donors (DfID, UNICEF, USAID/CARE International and GTZ) who have health care strengthening initiatives in the districts to be handed over will provide technical and financial support to carry out the program. • A letter with instructions to comply with arrangements for verifying attendance and salary payments has been made. Close monitoring of arrangements and reports being made public. • Instructions issued for public notification of SHP-related information and monitoring. For purposes of transparency, the newly designed training package includes formats for service and fees modalities to be posted at the SHP level. • The Local Health Management Committee under each VDC will have seven members, of which three will be Government nominees and four will be community members, including a local teacher, a female dalit representative, a local peer and the ward-based female community health volunteer.
<p>Civil Service Reform</p> <ul style="list-style-type: none"> • Gradual elimination of vacant civil service positions. 	<ul style="list-style-type: none"> • 7,500 vacant civil service positions eliminated. • Review of other positions expected to be completed by mid-November.
<p>Measures for Fighting Corruption and Improving Accountability</p>	
<p>Publish annual budget and report of actual expenditure (by local bodies and by line agencies). District analysis to be carried out at least quarterly.</p>	<ul style="list-style-type: none"> • MoF issued letter of authorization to all ministries containing instructions to carry this out; subsequently district offices have been notified. Sample survey being carried out to verify compliance.
<p>Make arrangements for posting budget allocations and expenditures at DDC/ VDC offices, SHPs and schools.</p>	<ul style="list-style-type: none"> • MoF issued letter of authorization containing instructions to carry this out.
<p>Carrying out expenditure tracking to establish extent to which public funds are actually reaching the points of service delivery.</p>	<ul style="list-style-type: none"> • Expenditure tracking initiated; 28 primary schools selected for 1st phase survey; expenditure utilization to be judged against the services provided/produced.
<p>No significant increase in the arrears of public utilities (electricity, telecommunications and drinking water).</p>	<ul style="list-style-type: none"> • Separate committees established to analyze Nepal Electricity Authority, Nepal Telecommunication Corporation and Nepal Water Supply Corporation. Reports to be submitted by mid-November.
<p>Adoption of time-bound action plan for implementing major recommendations of Country Procurement Assessment Review (CPPR).</p>	<ul style="list-style-type: none"> • Finalization of CPAR action plan. • Financial administration rules and regulations under review for potential amendments and improvements, particularly in procurement. • A draft Procurement Bill has been prepared for internal review; procurement training being designed.
<p>Public Works Guidelines (PWGs) to be made operational.</p>	<ul style="list-style-type: none"> • PWGs formally circulated. Ministerial committee established to monitor compliance. Responsibility for following guidelines assigned.
<p>Adoption of time-bound action plan for implementing major recommendations of Country Financial Accountability Assessment (CFAA).</p>	<ul style="list-style-type: none"> • CFAA action plan adopted and implementation initiated. • Development Action Plan monitoring sub-committee formed and operating under the Reform Monitoring Committee (RMC). • High level task force established to monitor implementation of action plan.
<p>Develop comprehensive Anti-Corruption Strategy (ACS) and make progress in its implementation.</p>	<ul style="list-style-type: none"> • ACS—prepared through consultative process—submitted for cabinet approval. Once approved, committee (chaired by Chief Secretary) to be established to formulate time-bound action plan that will be monitored and evaluated by the National Vigilance Center. • Key elements of ACS to include: (i) establishment of National Vigilance Center; (ii) citizen’s charter; (iii) time-bound service delivery mechanisms; (iv) public awareness campaign; (v) actions against bank defaulters; and (vi) actions against misuse of funds as reported by Office of the Auditor General.

Appendix II The CAS Consultations—A “Pulse-Taking”

A “pulse-taking” exercise was carried out as part of the preparation of this Progress Report. The aim of the exercise was to assess the possibility of improving service delivery at the district and village levels in the rather unsettled environment of Nepal in September 2002¹. Specifically, the main objective was to assess the impact that the insurgency and the response of the Government—through the recently expired state of emergency and the recent suspension of local elected bodies—has had on the delivery of services and supplies to various sections of the population outside the Kathmandu valley and the population’s ability to cope under the circumstances. The consultations were conducted by two multi-disciplinary teams—containing economists and social scientists with both Nepalis and non-Nepalis—over a period of two weeks. Field visits were arranged to ensure that both hill and Terai districts were represented in the sample in three of the five regions of Nepal. The prevailing security situation obviously played a major role in determining where the consultations could be carried out. Each of the teams took two field visits with team A visiting Morang, Sunsari Dhankuta and Rupandehi and team B visiting Banke, Kapilvastu, Kaski, Parbat, Baglung and Syangja.

In the towns and villages of the above districts, the teams consulted with a number of “user groups”—i.e., forest, savings/credit groups, women groups, landless, etc.—local NGOs, former local representatives of VDCs and DDCs, civil servants designated as members of the interim VDCs and DDCs, school teachers, students, trade unions and businessmen.

Before departing on the first set of field visits, the groups held a one day preparatory workshop. Between the field visits the teams returned to Kathmandu for a half-day to compare experiences and make adjustments in the respective approaches. At the end of the field visits, the teams held a final workshop during which they presented and discussed the findings and prepared a joint summary of the observations and suggestions. The main messages/observations of the consultations are presented below.

A crisis of governance is the main problem and the Maoist insurgency and the state of emergency have only aggravated the problem.

- People feel that HMGN is generally doing a poor job. National level politicians are considered corrupt and not trusted by many. “Good people cannot be politicians.”
- Local Governments (LGs) are perceived to have been useful with respect to issuing identity cards and when people need to get citizenship papers/passports to get jobs abroad. With the dissolution of LGs, there have been interruptions in these services; hence, a negative impact.
- Many people at the local level believed that corruption is institutionalized. Evidence was presented of the two main forms: (i) delivering products of poor quality; and (ii) spending money in unauthorized ways.
- Transparency is lacking—e.g., important Government documents such as the “Red Book” (annual budget) or district plans are difficult to obtain. The perception is that “information is power” and those in power are not willing to share information.

¹ The timing of the consultations—September 2002—must be taken into account when reviewing the results. Specifically, at that time the state of emergency had just ended and elections were anticipated for mid-November. Obviously, the situation has since changed. Nevertheless, many of the observations—reflecting bigger problems—are certainly valid. It is the intention of the country management unit to continue to undertake periodic consultations over the foreseeable future as the situation evolves to be better able to assess the changing “pulse” of the Nepali people outside the Kathmandu valley.

- Freedom of the press has been formally restored since the end of the state of emergency, however, fear persists and many people do not feel free to assemble and express their opinions. Many journalists were detained during the state of emergency and this has put a damper on investigative reporting that could have kept HMGN and LGs on their toes.
- User groups—which have proliferated—tend to be more participatory and successful in the delivery of services. They are by and large still dominated by local elites and hence not inclusive (of the poorest).
- NGOs—which have also proliferated—are viewed as successful in community mobilization and empowerment but, for the most part, not in the delivery of services. They use much of the money themselves and do not reach the poorest of the poor (except for some dalit NGOs).
- Donors lack coordination in their activities interfacing with LGs and there is little transparency in donor funding of NGOs. People felt that donors are also not targeting their programs to the poor.
- In the initial years of the movement, Maoists were generally perceived as supporting development activities that were pro-poor. But, this perception is eroding as they collect “taxes” and threaten or destroy development activities and infrastructure.
- The poorest of the poor are excluded. As a local official said “they (the poor) are not coming to us so we cannot help them and we have our hands full.”

Rural services have been disrupted in most of the hill districts, but much less so in Terai and the work of the LGs has been disrupted.

- In the areas held by the Maoists, or on the roads leading to these areas, the military are keeping a close watch on supplies entering these areas. Some items—such as food—are allowed in limited quantities, while others—such as a particular type of shoes, galvanized iron pipes, sockets, matches and instant noodles—are prohibited.
- There are worries that budget funds will not reach LGs soon (they are normally received by October) because of the political situation and the focus on the security situation.
- While plans for FY03 were mostly completed before the term of the LGs ended, it is not clear how the planning process for FY04 will be accomplished without elected officials in place.
- HMGN simply dissolved the LGs without giving instructions on what should be done. Even now many issues are not covered by recently issued instructions.

Elections can take place but most believe that they will not be “free and fair.” Hence, the legitimacy of elections at this point in time may be questioned.

- The military will not be able to provide the necessary security. They control “islands” of the territory, but not areas that are much more than one days walk from a main road.
- There are concerns about counting ballots in an election that is staggered/carried out in many phases.

A vision of the economic future is lacking.

- District officials do not seem to have well-formulated ideas of where the economies of their districts are heading or how they could develop a pro-business climate.

- School leavers, whether they manage to pass the school leaving certificate (SLC) or not, are staying in the villages and farming or taking menial jobs in the nearby towns, or emigrating to India, Malaysia or the Gulf.
- Villagers do not seem to be particularly motivated to think beyond self-sufficiency to produce cash crops or raise animals for sale on a regular basis.

There is a sense in the air that Nepal's situation will get worse before it will get better.

At the same time, people continue to hold hope and there are signs of long-term changes.

- Many people seem to have instinctive faith in democracy, especially the change that may come through locally-elected bodies.
- There may be a generational shift taking place, with higher education becoming much more prevalent and many children growing up with far greater awareness of the outside world.
- User and saving groups are everywhere, creating space for collective action and mutual support and increasing the socio-political and economic awareness of the people.

Appendix III
Performance on CAS Triggers

Base Case Performance Triggers	Results on the Ground (as of October 15, 2002)
Domestic revenue as share of GDP at or above 11%.	<ul style="list-style-type: none"> • FY00 revenue as percent of GDP was 10.7% and estimated to be 11.4% in FY01. • FY02 revenue projection is 11.4% of GDP and 11.6 percent in FY03.
Satisfactory implementation of VAT.	<ul style="list-style-type: none"> • Growth in collection of VAT revenue was 53% for FY99-FY01. • Legislation passed to strengthen VAT procedures. • Number of VAT registration increased by 339% (FY98-FY01) from 4,959 in FY98 to 21,758 in FY01. • Merger of Income Tax Department and VAT Department into Inland Revenue Department. • Real time data is available from all VAT branches.
Domestic borrowing below 2% of GDP.	<ul style="list-style-type: none"> • Domestic borrowing has climbed to more than 2% of GDP; (1.5% in FY00, 2.7% in FY01 and 3.2% in FY02).
No increase in the number of projects under public investment program.	<ul style="list-style-type: none"> • From 700 plus projects in the mid-1990s, the number of projects was reduced to 626 in FY02 and to 470 in FY03.
Three-year rolling investment program and full funding of priority projects and programs.	<ul style="list-style-type: none"> • Presentation of draft MTEF papers of five Ministries at NDF 2002 and MTEF preparation completed in remaining 16 ministries. • MTEF document to be finalized by mid-November.
Privatization of three enterprises, improvement of privatization procedures and introduction of competition in telecommunications.	<ul style="list-style-type: none"> • Private parties have been invited to negotiations for the privatization of the Butwal Power Company. • Bandwidth has been allotted for the operation of a private party cellular phone service. • Agreement on rural telecom. • Two SOEs have been closed. • MoF privatization cell is in the process of privatizing five more SOEs.
Good progress in RBB/NBL restructurings and preparation of divestiture.	<ul style="list-style-type: none"> • ICC Bank (Ireland)/Bank of Scotland assumed management control of NBL management in mid-July 2002 and has moved swiftly to start turning around the bank. • An expatriate CEO has been selected for RBB and is expected to be in place by end-2002. Seven additional support positions have been advertised internationally and will be filled in early-2003.
Tangible progress in	<ul style="list-style-type: none"> • Promulgation of 1999 Local Self-Governance Act.

Base Case Performance Triggers	Results on the Ground (as of October 15, 2002)
decentralization and local self-governance with greater local involvement in the management of development programs.	<ul style="list-style-type: none"> • Parliament approval of the Local Self-Governance Regulations and Financial Regulations (2002). • Decentralization Implementation Monitoring Committee's direction for the implementation of more than 60 time-bound activities under the Decentralization Implementation Plan. • Announcement in FY02 budget of devolution of basic and primary education, primary health, agriculture extension and retail level postal services to local bodies. • Undertaking measures to ensure District Plans approval at the district level.
Improved central Government administrative performance, e.g., stricter enforcement on rotation rules.	<ul style="list-style-type: none"> • Two Ministers resigned for premature transfer of officials. • A hiring freeze has been maintained. • 2,113 people took voluntary retirement during FY01. • Computerization of civil service payroll in progress. • FCGO has circulated quarterly expenditure reports to NPC and MoF. • By end-FY02, 45 districts connected to FCGO main office covering 99% of revenue, and 93% of expenditure.
New measures to reduce corruption.	<ul style="list-style-type: none"> • A high level Judicial Commission for investigation of ill-gotten property in the names of politicians and bureaucrats has been established. • HMGN is considering expanding the mandate of CIAA to the judicial system. • A Special Court created for corruption cases. • CIAA has taken action against 22 MoF civil servants, the Executive Director of the national airline and the Joint Secretary of the Ministry of Physical Planning on suspicion of amassing wealth beyond normal circumstances. • CIAA has interrogated five former ministers on suspicion of corruption, two of whom have been detained for corruption investigations.

CAS Program Matrix—Change From Last CAS

		<u>Performance Benchmarks</u>			Instruments & Other Donors	Progress/Current Status
Diagnosis	Strategy	Overall	IDA-Assisted Initiatives			
<p>Public Expenditure Poor prioritization and management of public expenditures; priority projects/programs often under-funded.</p>	<p>Improve prioritization and management of public funds.</p>	<p>Introduce three-year rolling expenditure & full funding of core projects/programs; reduce number of projects in Public Investment Program (PIP); eliminate unbudgeted expenditures.</p>	<p>Rational criteria for selection of core investment program; ensure priority funding for core investment and recurrent expenditures.</p>	<p>Public Expenditure Review (PER), MTEF, PRSP</p>	<p>A good start has been made in preparing MTEF with presentation at the 2002 NDF. Full incorporation of MTEF into the FY03 budget is taking place according to the timetable established in the IAP.</p>	
<p>Health/Family Planning High infant mortality (75 per thousand); low contraceptive prevalence rate (30%); high total fertility rate (4.6 children per woman); low life expectancy (55 years); low access to safe water (44%).</p>	<p>Provide essential health/family planning services & safe water supply through public/private/CBOs; improve peripheral health facilities—primary health centers/health posts/sub-health posts, district hospitals; enhance institutional capacity of and devolve adequate authority to district health offices for implementation of essential preventative & curative health services.</p>	<p>By 2004: lower infant mortality to 60 per thousand; reduce total fertility rate to 4.2; improve sustainable access to safe water by 15 percentage points.</p>	<p>Good supervision, training and career development for maternal and child health workers; increase contraceptive prevalence rate to 36% by 2004; 900 user group-managed rural water schemes by March 2002.</p>	<p>DfID (UK) Rural Water Supply Projects; possible Health Sector Project</p>	<p>As of 2001, the infant mortality rate declined to 64; the total fertility rate declined to 4.1; the contraceptive prevalence rate rose to 39% and life expectancy at birth rose to 59 years. These indicators are averages and hide the extremely poor health conditions, especially of the most vulnerable. Health indicators lag significantly behind the rest of South Asia. Progress is being made towards handing over of SPHs to communities as part of the IAP and a new Health Sector Reform Strategy has been developed by the Ministry of Health to assure available and accessible essential health care services with a minimum level of acceptable standards of quality of care and establish an effective health system to manage partnerships. A team is developing an implementation plan to implement the strategy and roll it into the FY04 annual health plan.</p>	
<p>Education Literacy at 48% for those over 6 years old; boys' net primary school enrollment of 80%, but girls only 58%; quality is low and repetition rates are high.</p>	<p>Increase quality of, and access to, education, especially for girls & women; introduce demand-driven vocational education where feasible; improve instructional delivery; improve educational facilities and, where quality can be maintained, increase accommodation to facilitate higher enrollment.</p>	<p>By 2004: increase primary cycle completion rate from 41% to 70%; decrease primary school completion from 11.8 years to 9.5 years; ensure at least one female teacher in each school; increase overall percentage of female teachers from 19% to 30%.</p>	<p>By 2004: increase net enrollment rate from 68% to 80%; increase literacy rate from 48% to 55%; 100% gross enrollment for girls and disadvantaged children in each district; increase average scores for grades 3 & 5 from 50% to 70%; increase pass rate for grades 4 & 5 from 70% to 80%.</p>	<p>WHO, UNICEF, UNFPA, UNDP, USAID, UK, EU, Japan, Norway, Germany, India, China, Switzerland, INGOs Basic & Primary Education II (BPEP II)</p>	<p>BPEP II is making modest steady progress in several areas. The primary cycle completion rate has risen to 54% and net enrollment rate is reported at 80%, with that of girls at 74%. Average learning achievements for grades 3 & 5 show mixed progress. Literacy rate of over 6 years of age has increased to 58%. Pass rates for grades 4 & 5 have increased to 82% and 76% respectively. The emergency situation could have an adverse impact on the nationwide program. Good progress in implementing</p>	

CAS Program Matrix—Change From Last CAS

		<u>Performance Benchmarks</u>				
Diagnosis	Strategy	Overall	IDA-Assisted Initiatives	Instruments & Other Donors	Progress/Current Status	
<p>Rural Development Agriculture yields lowest in South Asia; only 20% of arable land irrigated year-round; high levels of rural under-employment; localized deforestation and biodiversity loss.</p>	<p>Increase agricultural productivity/yields and on/off farm employment to reduce poverty while ensuring sustainable management of natural resources.</p>	<p>Increase agricultural output growth to 5%/year from current level below 3%. Increase yields of paddy, wheat & maize by 15% by 2004 from their current levels of 2.3, 1.4 & 1.7 tons/hectare. Increase area under year-round irrigation from 350,000 hectares to 450,000 by 2004. Improve input quality control & agricultural technologies and practices. Extend community forestry activities to cover 45% of the rural population by 2004.</p>	<p>Increase area under year-round irrigation by 40,000 hectares in NISP districts, and increase yields by 15-20% & incomes by 20% by 2004; develop location-specific agricultural techniques to increase yields; increase beneficiary participation. Increase number of extension worker field days & farmer classes by 20% by 2004. Implement a sustainable financing mechanism for biodiversity conservation.</p>	<p>Irrigation & Research/Extension Projects; Rural Water Supply Projects; possible PAF LIL; Terai Options Study; PER ADB, UK, FAO, USAID, Japan, IFAD, OPEC Fund, Kuwait Fund, Sweden, Germany, Switzerland, Australia, Denmark, Finland, Saudi Fund, INGOs</p>	<p>IAP to handover primary schools to communities. To date, 85% of the target progress has been achieved. The remaining 15% is expected in the next two years and new activities and instruments are envisioned. IDA discontinued financing for biodiversity conservation and forestry programs, as the policy environment was not conducive and shortage of funds is not an issue.</p>	
<p>Infrastructure Low road density (0.1 km per sq km); problems created by difficult geography compounded by inadequate road maintenance; poor management of urban water supply in Kathmandu; inadequate sewer connections and water supply in the Kathmandu valley.</p>	<p>Improve road maintenance and rehabilitation; also invest in new infrastructure, including low-cost labor-based roads, where required; improve quality and increase quantity of water to consumers.</p>	<p>Balance between recurrent and capital expenditures in accord with roads Priority Investment Plan; 56% of strategic highways network in good or medium condition; adoption of labor-base technology in district road construction; increased reporting of outputs achieved against budget categories; 10% increase in sewer connections; unaccounted water reduced from 35% to 25%.</p>	<p>300 km feeder roads constructed; DDCs able to plan/manage 700 km of district road maintenance and upgrading and other rural infrastructure; eight districts with sustainable district-managed maintenance by 2005. Private sector-managed Kathmandu water supply; increase yearly water supply in the Kathmandu valley to 6Mm³ and 4Mm³ outside the valley by 2004.</p>	<p>Rural Infrastructure LIL; Road Maintenance and Development Project; Multi-Modal Transit Project ADB, UK, Sweden, Japan, India, China, Germany</p>	<p>88% of the strategic network is in good or fair condition. Of the 197 km of new feeder road construction planned under the IDA credit, only 65 km completed with remaining works affected by poor security. District road management capacity has been enhanced with 500 km of roads regularly maintained in eight districts. 226 km of rural roads have been rehabilitated against a target of 340 km. Three Inland Container Depots constructed and two leased to private terminal operators.</p>	
<p>Rural Water Supply Supply-driven rural water supply and sanitation projects failed to deliver sustainable services. Main issues are: (i) lack of clarity of institutional roles/</p>	<p>Redefinition of the role of sector agencies. Implement rural water supply and sanitation schemes through a demand-driven approach and participatory decision-making process; O&M to be full responsibility of the</p>	<p>Limited direct service delivery role of Central Government; implement rural water schemes through a demand-driven approach and participatory decision-making process; improve donor coordination; establish</p>	<p>Completion of 900 schemes serving 394,000 people; communities able to manage, operate and maintain their systems sustainably.</p>	<p>Rural Water Supply Projects</p>	<p>The Fund Board's demand-drive and participatory decision-making process is demonstrating better results on the ground—communities are empowered; consistent policy on community contribution is being introduced; information sharing and coordination among the various actors has become more</p>	

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		<u>Performance Benchmarks</u>					
Diagnosis	Strategy	Overall	IDA-Assisted Initiatives	Instruments & Other Donors	Progress/Current Status		
responsibilities; (ii) many donors following different approaches; (iii) lack of monitoring and performance-based budget; and (iv) lack of consistent sector policy.	community.	sector monitoring and evaluation units and introduce performance-based budget.		ADB, HELVETAS, Dfid, WaterAid, WHO, UNICEF, Red Cross	transparent and open; the Government has decided to give the Fund Board a more permanent status through its own Act.		
Financial Sector Weak central bank regulatory capacity; burdensome Government mandates; banking system dominated by inefficient state-owned banks.	Improve efficiency and stability of financial sector; Improve accounting and auditing standards and practices to international standards.	Comprehensive financial sector reform introduced, including for rural banking.	Divestiture of RBB; reduce NPA to 10%; reduce the number of loss-making rural branches; improve internal management of major banks.	Financial Sector Study; Financial Sector TA Project	Considerable progress has been made; the proposed FSTA will help to: (i) strengthen NRB (particularly in bank supervision and accounting); (ii) reform the two largest banks (RBB and NBL) with professional management teams taking over day to day operations; and (iii) improve the financial environment (legal, capacity building and credit information).		
Telecommunications Low level of rural telephone connections; lack of private sector participation and competition.	Increase rural telephone connections; adequate interconnection provision; license second operator to compete with NTC and introduce private sector competition in telecommunications.	Increase rural connections to almost all 3,900 VDCs; adequate interconnection provision; license second operator to compete with NTC; decrease the number of staff per 1,000 working lines from 25 to 15 by 2002.	Telecommunications regulatory capacity strengthened; NTC readied for privatization; cellular & other special service providers licensed; ensure timely submission of financial statements.	Telecommunications Sector Reform Project	National telecommunications policy focused on sector liberalization adopted in 1999. 65 new private operators provide value added services and the government selected a second private mobile operator in March 2001. In May 2001 a license was given to a second private national operator for basic services. NTC has issued an operating license to the private operator in January 2001 to deliver services.		
Power Low level of access to electricity (only 15% of population, compared to 34% regional average); huge hydropower export potential.	Increase domestic power supply and facilitate private-sector exports where feasible.	Increase power generation to 550 MW by 2004; increase rural connections to 50,000; enhance energy conservation measures; establish clear framework for private sector investment.	Act as catalyst for 200MW of new private-sector power generation; 420 circuit km of power transmission and 2,800 km of distribution lines constructed.	Denmark, Finland, Japan Power Development Project	Power generation increased to 558 MW in 2002. The Hydro Development Policy was revised in 2001 further strengthening the framework for private sector participation in the sector. About 190,000 new connections were made over 75 districts, including to some non-rural loads. This has resulted in a modest improvement in service coverage to 18% of population. Planned IDA assistance will catalyze about 50 MW of new private sector generation; 30,000 rural connections; and 120 circuit km of power transmission.		
				ADB, USAID, UNDP, Japan, Finland, Germany, Canada, Norway			