

## Issue of Import Substitution

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### Abstract

*Nepal has to find ways of overcoming the existing difficulties, carrying out trade, strengthening the economy, and maintaining balance of payments. So, the nation needs to focus on economic growth and trade balance. In this context, this paper discusses import substitution measures, taking the agricultural and petroleum sectors as examples. The first is achieved through increased production, and the second with a feasible replacement, such as the generation and use of electricity. In this scenario, the paper describes few examples of import substitution policy adopted by different countries and explains how Nepal can use it through the agricultural and petroleum sector. The study suggests that Nepal can learn from the experiences of many countries which had adopted import substitution at times of economic hardships mainly after World War II.*

**Keywords:** *Trade protectionism; Import substitution; Agriculture; Petroleum product; Nepal*

### 1. Introduction

International trade has become an important aspect of the global supply chain; and it is more so in the case of smaller countries with less diverse natural resources and economic activities. Despite rich natural and cultural diversity, Nepal lacks a seashore and does not have large stores of coal, petroleum, natural gas, and precious metals. The mountainous landscape makes irrigation and land routes of transportation costly. High transportation cost means less competitive trade links. Yet, Nepal has to find ways of overcoming these difficulties, carrying out trade, strengthening the economy, and maintaining the balance of payments.

Historically, countries or regions have used different strategies in solving trade deficits. Such strategies include discouraging imports through tariff and non-tariff barriers, encouraging exports through monetary incentives, guiding consumers to use domestic products and services, reducing consumerism, and using forex for priority infrastructure developments and essential imports. Depending on national and international scenarios, each country has to find its own policy measures. While import substitution is an old practice, it became a major measure as a response to hardships following World War II, when most of the developing countries across Asia, Africa, and Latin America faced trade deficits.

As rightly put by Prebisch (1954), the principal goal of import substitution should not be to reduce overall spending on imports but to change the composition of imports

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from wasteful consumer goods to growth-enhancing capital goods. Both economic growth and overall consumer satisfaction cannot avoid import of capital goods and services. Both industrialized and developing countries have adopted such measures to the maximum benefit of their domestic economic growths.

South Korea applied import substitution policies in the 1950s and 1960s (Haggard et al., 1991). The preferences for the local products were tried even within the same country. In the nineteenth and twentieth centuries, Chicago and California gave some leverage to local products over those produced in other states (Persky et al., 1993).

In Latin American countries, the principal policy instruments used to promote import substitution industrialization were (Baer, 2015): protective tariffs, exchange controls, special preferences for domestic and foreign firms importing capital goods for new industries, preferential import exchange rates for industrial raw materials, fuels and intermediate goods, cheap loans by government development banks for favored industries, the construction by governments of infrastructure especially designed to complement industries, and the direct participation of government in certain industries, especially the heavier industries, such as steel, where neither domestic nor foreign private capital was willing or able to invest.

Russia linked its economic sovereignty through a high-profile import-substitution (importozameshchenie) campaign (Connolly and Hanson, 2016), following Vladislav Surkov's proposal. In 2006, he proposed the term 'sovereign democracy', "We wish to be an open nation among other open nations and to cooperate with them according to just rules and not to be managed from outside."

Ukraine tried to apply import substitution measures. Summarizing its experience from 2005 to 2016, Vasylytsiv et al. (2017) said that there is a situation when the flows of imported goods penetrate the domestic market without any barriers and countermeasures, which is facilitated by both the poor quality of the organization and the inefficient use of production capacities, as well as the expansion of the domestic market capacity, the development of market infrastructure and the growth of citizens' income. In the form of progress in 2005 the domestic share amounted to 70.5%, decreased by more than 14.0% within the next ten years, and its value in 2016 was 55.8%.

China introduced its trade reform policy at the end of the 1970s when China ranked 32<sup>nd</sup> among nations in global trade, due to China's import substitution strategy. Thirty years later, China became the world's largest exporter (Long, 2010). The major characteristics of the Chinese reforms included opening to the outside world, attracting FDIs, establishing joint venture companies, exempting taxes on income made for predefined years in the priority areas, and establishing special economic zones (SEZs). In the beginning years, China was able to attract investment from business tycoons of Chinese origin living in Hong Kong, Malaysia, Taiwan, Singapore, Europe, and the USA. When other businessmen saw people earn money in China, they also began to invest in China. In later years, China shifted preferential investment policies to its relatively backward vast West and inner lands.

The import substitution policy also has its downsides. It was realized as early as in 1973 known as 'import-substitution syndrome' (Diaz-Alejandro, 1975). However, it is still helping domestic economy of developing countries.

## 2. Current Nepalese scenario

In the fiscal year 2021/22, Nepal imported goods worth Rs 1.92 trillion whereas it was able to export goods worth as little as Rs 200.03 billion. Table 1 lists some major import goods and services. In case the Russia-Ukraine war continues or expands, Nepalese will face less employment in foreign lands, which means decrease in the remittance income, and a subsequent forex crisis.

To reflect the normal pictures avoiding the impact of coronavirus pandemic, let us see the import of goods and services of the fiscal year 2018/19. Import-export have been strongly influenced by COVID-19 and Russia-Ukraine war, which hopefully will not last very long.

Table 1. Import of goods/services

Goods/Services	NPR (FY 2075/76 or CE 2018/19)
Petroleum	
Iron and steel	216.4 billion
Machinery and parts	165.1 billion
Transport vehicles and parts	120.5 billion
Garments/ Apparels	91.2
Cement and clinkers	31.8 billion
Pharmaceutical finished products (excluding other components of healthcare)	13 billion 28.7 billion
Higher education	46.3 billion
Agricultural products (unprocessed plus processed)	323.7 billion in 2020/21

Source: Department of Customs and Nepal Rastra Bank

In any case, Nepal needs to focus on economic growth and trade balance. This paper discusses import substitution measures, taking agricultural and petroleum sectors as examples.

## 3. Agriculture

Until 1960s Nepal was a food surplus country. At that time Nepalese agriculture was more productive than other South Asian countries. 1980s was a turning point when Nepal faced food deficit (ADB, 2002). In the 1980s, food production continued to increase but slowly and it was unable to keep up with the population growth.

Indo-Nepal Treaties of Trade, Transit and Agreement for Co-Operation to control

unauthorised Trade signed in 1996 intensified Nepal’s economic ties with the market networks of India (Pandey et al., 2014), and lead to Nepal’s dependence on India for agricultural products. The treaty allowed Indian companies such as Dabur, Colgate-Palmolive Indian brands to directly access Nepali raw materials as well as the market.

With the turn of the century, a new trend emerged – farmers began to lose hope in agriculture, they began let their fields go barren, and go abroad in search of labour market (Fig 1).

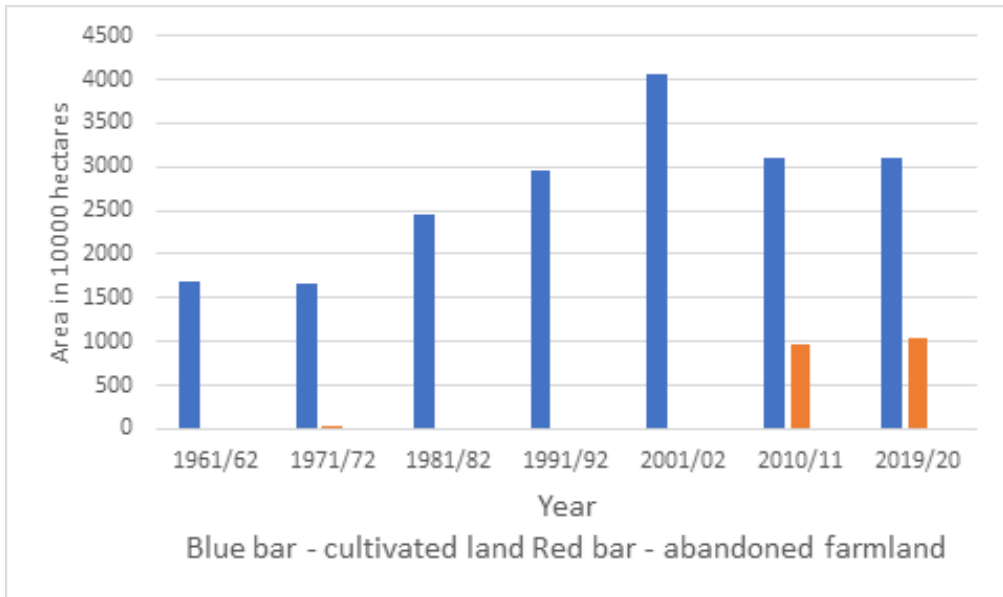


Figure 1. Trend in farmland abandonment (Chaudhary et al., 2020)

In past six decades, the population has almost tripled from 10.11 million in 1960 to 30.03 million in 2021, but paddy productivity has just doubled to 3.8 tons per hectare in 2022 (Republica, 2022) from 1.8 tons per hectare in 1960 (Tripathi et al, 2019).

Latest data show that Nepal imported worth Rs 324 billion (some claim it as Rs 378 billion) food in the year 2021/22. Considering our agricultural exports as well, Nepal had a net deficit of Rs 55 billion rupees. In relative terms, this meant a 17 percent trade deficit in agricultural sector. But in terms of livelihood, it is an issue of food security – a national crisis!

#### 4. Agricultural solutions exists

We need to address a basic question – welfare of the farmers vis a vis service sectors, wage earners, traders and secondary industries. In 2021 the agriculture with 23.9 % of the GDP had to support the livelihood of 60.4 % of the Nepaese population. Who dares to remain in a poor sector?

This should be done through free education and healthcare, price controls of the industrial products and services. This is possible only through tax cuts. Similarly, monetary subsidies should be scrapped. Government should invest in irrigation (Currently , only 56% of all arable land is irrigated, that also poorly), soil quality protection (encourage

home-produced organic manures, discourage chemical fertilizers, discourage import of the chemical fertilizers and produce fertilizer inside country), safe local storages (currently, at 5 % grains damage at the producer-level storage, and up to 50 % of the vegetables have to be wasted), high-yield locally improved seeds and low-cost transportation of agricultural products. The maximum ratio of the maximum retail price to the minimum purchase price should be fixed, based on national consensus, which should be continued for decades without revision.

We can learn and have tried to learn from Indian experience. As a response to widespread famines, growing food needs, and the threat of food insecurity, India launched Green Revolution mainly led by M.S. Swaminathan from 1967-68 to 1977-78. This resulted in a great increase in the production of food grains (especially wheat and rice) due to the introduction of new, high-yielding variety seeds, beginning in the mid-20th century. Since the mid-1970s, there was a growing push for adopting new mechanization technologies modeled after the Green Revolution's success in India and promoting monoculture of agricultural commodities suitable for the market (ADB, 2022).

The above approaches are recommended so as to make agriculture an attractive, viable sector, and help 10.30 lakh hectares of barren fields get cultivated (now only 30.9 out of 41.2 lakh hectares is cultivated up to 2019/20 as per Krishi Diary, 2079), increase per acre productivity (increased number of crops per year, increased yield of crops per season), decrease in post-harvest loss, and reduce the costs of storage and supply.

Our food habits also need to change. People are to be encouraged to utilize maize, wheat, millet, barley, buckwheat, potato, sweet potato, yams, and other products as alternatives and help reduce rice demand. Better health is possible through the intake of diverse and balanced foods.

## 5. Petroleum Products

Frankly, Nepal is not a rich country in terms of petroleum, natural gas, and coal. Here, our emphasis should not be on the production of these goods. Rather, we should emphasize utilizing alternate sources of energy – hydropower, wind, solar, firewood, human and animal excreta, green hydrogen, and nuclear reactors.

Look how from miserable load-shedding, Nepal has not only become self-sufficient but also an exporter of electricity. Electricity can be used in all sectors where it is technologically possible, replacing petroleum and coal. Globally, vehicles run on petroleum are soon getting phased out. This means we will be forced to switch to electric vehicles. Similarly, the introduction of electricity-run coal and cement industries will limit the use of coal.

Green energy will surely contribute to environmental protection. In the case of Nepal, it will help save billions of rupees in import of the fossil fuels. However, we need to understand the risks of the reservoir type of hydropower projects which can destroy our agricultural land, and invite seismic threats and floods as a result of dam failures. Also, we have to make preparations for the production of necessary batteries and their safe disposal.

## 6. Conclusion

In the fiscal year 2021/22, Nepal imported goods worth Rs 1.92 trillion whereas it was able to export goods worth as little as Rs 200.03 billion. So, Nepal needs to find its way to achieve trade balance and economic reform. Nepal can learn from the experiences of many countries which had adopted import substitution at times of economic hardships, as seen following World War II. Recent developments have shown how Nepal has become a net exporter of electricity from an importer, within the last two decades. The country is on the way to replacement of petroleum imports with electricity in the future.

Nepalese efforts to food security have not seen success. So, Nepal should emphasize both agriculture measures such as the provision of reliable irrigation, soil quality protection, proper food storage, high-yield locally improved seeds, and low-cost transportation of agricultural products, and broader measures such as free education and healthcare, price controls of the industrial products and services, tax cuts, and less monetary subsidies and grants to selected sectors and individuals.

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